

ACCOUNTING FOR CAPITAL STOCK AND EQUITY

**** PROBLEMS IN THIS MODULE INCLUDE TOPICS INCLUDED
IN THE DIVIDENDS MODULE ****

Key Terms and Concepts to Know

Forms of business organization and ownership:

- Sole proprietorship
- Partnership
- Corporation

Corporations and the advantages of being one

- Limited liability for owners
- Unlimited life
- Separate existence from the owners
- Files and pays its own taxes
- Operates as a legal person: may enter into contracts, sue and be sued, etc.
- Disadvantage is that dividends paid to owners are taxed twice (once at the corporate level before being paid and again as income to the owner recipient)

Corporate Ownership and Capital Stock

- Capital stock is a generic term referring to all forms of stock.
- Corporate ownership is evidenced by capital stock that can be purchased directly from the issuing corporation or on a stock market such as the New York Stock Exchange.
- Transactions by a corporation in its own stock are investment transactions. As such, they do not create revenue, expense, gain or loss. They add to or reduce paid-in capital within owners' equity. Occasionally, these transactions may affect retained earnings as well.
- Authorized Shares – number of shares a corporation is legally entitled to issue
- Issued Shares – number of shares sold to stockholders
- Outstanding Shares – shares issued minus any shares reacquired by the corporation; i.e., the number of shares still owned by shareholders
- Common Stock – basic class of stock ownership with right to vote

- Preferred Stock – stock with a preferential right to dividends (preferred shareholders receive their stated dividend before common shareholders may receive a dividend)
- Cumulative Preferred Stock – stockholders have the right to receive dividends in arrears (their regular dividends passed or not paid in previous years) before common shareholders may receive a dividend.
- Par value is an arbitrary, meaningless value assigned to stock by the issuing corporation.
- Stock may also be issued as no par stock, with or without a stated value. Stated value is accounted for in the same manner as par value.

Treasury Stock

- Treasury stock is stock issued and subsequently repurchased by a corporation.
- Held by the corporation (perhaps in its vault or treasury) for subsequent use.
- May be resold at a price greater or less than purchase cost.

Stock Splits

- Stock splits are adjustments to the number of shares and the par or stated value to adjust the market price of the stock and manage the number of shares outstanding.
- Stock splits do not change the balance in any equity account and do not require a journal entry
- For example, a 2 for 1 split doubles the number of shares authorized, issued and outstanding and halves the par or stated value and presumably market price.

Key Topics to Know

Transactions to Issue Stock

The value of the common or preferred stock issued is based on the market value given or received, whichever is more reliable. If stock is issued for cash, then the cash received dictates market value. If the stock is issued in exchange for non-cash assets, then either the market value of the assets or the market value of the stock may be used to value the transaction, whichever has the more reliable evidence of market value.

The stock account is always credited for shares issued x par value. Any difference between the total par value of the shares issued and market value is credited to a separate account, Paid-in Capital in Excess of Par. Cash or the non-cash asset account is debited. These entries apply to common or preferred stock. The only difference is that Preferred is substituted for Common in the account names.

The general form of the journal entry to issue capital stock is:

Cash	<i>shares issued x market price</i>	xxx	
	Common stock <i>shares issues x par</i>		xxx
	Paid-in capital in excess of par <i>difference</i>		xxx

Example #1

During February, X Company had the following common stock transactions:

- a) Issued 5,000 shares of \$100 par common stock at par
- b) Issued 5,000 shares of \$100 par common stock at a market price of \$110 per share.
- c) Issued 5,000 shares of no par common stock with \$100 stated value at a market price of \$115 per share
- d) Issued 5,000 shares of no par common stock at a market price of \$120 per share

Required: Journalize the four transactions.

Solution #1

a) Issuance of Stock at Par			
Cash	500,000		
Common stock			500,000
b) Issuance of Stock at \$110 per share			
Cash	550,000		
Common stock			500,000
Paid-in capital in excess of par			50,000
c) Issuance of Stock at \$115 per share			
Cash	575,000		
Common stock			500,000
Paid-in capital in excess of stated value			75,000
d) Issuance of Stock at \$120 per share			
Cash	600,000		
Common stock			600,000

Treasury Stock Transactions

Treasury stock transactions are investment transactions and, as such, affect only the balance sheet and have no effect on the income statement. Treasury stock is a contra-equity account and is deducted at the end of the owners' equity section.

Example #2

During July, X Company purchased 200 shares of its own \$100 par common stock for \$105. The stock was subsequently sold in three transactions: 100 shares at \$112, 50 shares at \$96 and 50 shares at \$92.

Required: Journalize the four transactions.

Solution #2

1. Purchase of treasury stock		
Treasury stock	21,000	
Cash		21,000
2. Sale of 100 shares at \$112 per share		
Cash	11,200	
Treasury stock		10,500
Paid-in capital-treasury stock		700
3. Sale of 50 shares at \$96 per share		
Cash	4,800	
Paid-in capital-treasury stock	450	
Treasury stock		5,250
4. Sale of 50 shares at \$92 per share		
Cash	4,600	
Paid-in capital-treasury stock	250	
Retained earnings	400	
Treasury stock		5,250

Retained Earnings is debited for the remainder because the paid-in capital-treasury stock account has been reduced to zero.

Practice Problems

Practice Problem #1

The following selected accounts appear in the ledger of C Company on January 1:

Preferred 4% Stock, \$100 par (10,000 shares authorized, 8,000 shares issued)	\$800,000
Paid-in capital in excess of par-preferred	80,000
Common Stock, \$20 par (60,000 shares authorized, 30,000 shares issued)	600,000
Paid-in capital in excess of par-common	900,000
Retained Earnings	1,277,000

During the year, C Company had the following transactions:

- a) Issued 20,000 shares of common stock at \$32 receiving cash.
- b) Sold 1,000 shares of preferred 4% stock at \$120.
- c) Purchased 5,000 shares of treasury common for \$220,000
- d) Sold 2,000 shares of treasury common for \$84,000
- e) Sold 1,500 shares of treasury common for \$68,500
- f) Issued 10,000 shares of common stock in exchange for Land costing \$385,000

Required: Journalize the entries to record the transactions.

Practice Problem #2

B Company is authorized to issue 50,000 shares of \$50 par value, 8%, cumulative, fully participating preferred stock, and 750,000 shares of \$5 par value common stock.

May 5	Exchanged 2,200 shares of preferred stock for a building with a market value of \$135,000.
July 20	Sold 1,550 shares of preferred stock for \$50 cash per share.
Dec. 20	Sold 1,000 shares of preferred stock at \$52 cash per share.

Required: Prepare journal entries to record the selected transactions.

Practice Problem #3

U Company's only treasury stock transactions for the current year follow: (1) 2,000 shares of its common stock were purchased on June 1 for \$80,000; (2) On July 1 it reissued 500 of these shares at \$45 per share; (3) On August 1 it reissued an additional 500 treasury shares at \$38 per share.

- Required:
- a) Journalize the entries for these transactions.
 - b) Calculate the balance in Paid-in Capital, Treasury Stock, on September 1 assuming its beginning-year balance is zero.

Problem #4

T Company, which had 300,000 shares of no par stated value \$10 common stock outstanding, declared a 5 for 3 stock split.

- Required:
- a) What will be the number of shares outstanding after the split?
 - b) What will be the stated value after the split?
 - c) If the common stock had a market value of \$90 per share before the split what would be an approximate market price per share after the split?

True / False Questions

1. Paid-in Capital is the amount stockholders have invested in the company.
True False
2. The Securities and Exchange Commission regulates all publicly held corporations.
True False
3. Limited liability means that even in the event of bankruptcy, stockholders in a corporation can lose no more than the amount they invested in the company.
True False
4. Authorized stock is the number of shares that have been sold to investors.
True False
5. Par value has a direct relationship to the market value of the common stock.
True False
6. The number of shares outstanding is equal to the number of shares issued minus the number of shares bought back.
True False
7. Treasury stock is the repurchase of a company's own issued stock.
True False
8. Stock repurchases reduce the number of shares outstanding, thereby increasing earnings per share.
True False
9. We record treasury stock at the cost of the shares reacquired.
True False
10. A company credits Additional Paid-in Capital for the portion of the cash proceeds above par value received for the issuance of stock.
True False
11. Treasury stock is a contra-equity account since treasury stock increases total stockholders' equity.
True False

12. When treasury stock is reissued, the difference between its cost and the cash received is reported as an increase/decrease in additional paid-in capital.
True False
13. Retained earnings represent the earnings retained in the corporation - earnings not paid out as dividends to stockholders.
True False
14. A 3-for-2 stock split will triple the reported dollar amount of stockholders' equity.
True False
15. When common stock is issued, the par value, or stated value, of the shares issued is recorded in the Common Stock account.
True False

Multiple Choice Questions

1. Retained earnings:
 - a) is the same as contributed capital
 - b) changes are summarized in the Retained Earnings Statement
 - c) cannot have a debit balance
 - d) over time will have a direct relationship with the amount of cash on hand if the corporation is profitable.

2. The charter of a corporation provides for the issuance of 100,000 shares of common stock. Assume that 20,000 shares were originally issued and 2,500 were subsequently reacquired. What is the number of shares outstanding?
 - a) 22,500
 - b) 17,500
 - c) 20,000
 - d) 82,500

3. A Company acquired land in exchange for 5,000 shares of its \$10 par common stock. The fair market value of the land is \$63,000 although it is appraised at \$60,000. The stock is widely traded and was selling for \$12.50 per share when exchanged for the land. At what amount should A Company record the land?
 - a) \$50,000
 - b) \$62,500
 - c) \$63,000
 - d) \$60,000

4. The excess of sales price of treasury stock over its cost should be credited to:
 - a) Treasury Stock Receivable
 - b) Premium on Capital Stock
 - c) Income from Sale of Treasury Stock
 - d) Paid-In Capital from Sale of Treasury Stock

5. A corporation purchases 10,000 shares of its own \$10 par common stock for \$17.50 per share. What will be the effect on total stockholders' equity?
 - a) Decrease, \$175,000
 - b) Decrease, \$100,000
 - c) Increase, \$175,000
 - d) Increase, \$100,000

6. A corporation has 25,000 shares of \$100 par value stock outstanding. If the corporation issues a 2-for-1 split or a 100% stock dividend, the number of shares outstanding after the split or dividend will be:
 - a) 25,000 shares
 - b) 50,000 shares
 - c) 75,000 shares
 - d) 100,000 shares

7. Easy transfer of ownership is a characteristic of which form of business organization?
 - a) Sole proprietorship
 - b) Partnership
 - c) Corporation
 - d) All of the above

8. In which forms of business organization are the owners personally liable for all the debts of the business?
 - a) Sole proprietorship and corporation
 - b) Sole proprietorship and partnerships
 - c) Partnership and corporation
 - d) All of them

9. Issuing stock to investors for cash at a price above par would result in
 - a) a debit to Common Stock and a credit to Cash
 - b) a debit to Cash and a credit to Common Stock
 - c) debits to Cash and PICE-common and a credit to Common Stock
 - d) a debit to Cash and credits to Common Stock and PICE-common

10. The par value of the shares issued represents:
 - a) A corporation's legal capital.
 - b) A corporation's stated capital.
 - c) A corporation's invested capital.
 - d) A corporation's owners' capital.

11. When treasury stock is purchased, the number of outstanding shares:
 - a) Increases
 - b) Decreases
 - c) Remains the same
 - d) Splits

12. Which of the following is not a characteristic of a corporation?
 - a) Separate legal existence
 - b) Unlimited liability for stockholders
 - c) Easy transferability of ownership interests
 - d) Ability to acquire capital easily

13. Which of the following is not a disadvantage of the corporate business form?
 - a) Organization Costs
 - b) Government regulation
 - c) Continuous life
 - d) Additional taxes

14. Which of the following is not a stockholder right?
 - a) The preemptive right
 - b) The right to share in dividends
 - c) The right to vote on the board of directors
 - d) The right to participate in management decisions

15. Which of the following represents the maximum number of shares that a corporation can issue?
 - a) Outstanding shares
 - b) Issued shares
 - c) Authorized shares
 - d) Treasury shares

Solutions to Practice Problems

Practice Problem #1

a)	Cash	640,000	
	Common Stock		400,000
	Paid-in capital-excess of par-common		240,000
b)	Cash	120,000	
	Preferred stock		100,000
	Paid-in capital-excess of par-preferred		20,000
c)	Treasury Stock	220,000	
	Cash		220,000
d)	Cash	84,000	
	Paid-in capital-Sale of Treasury Stock	4,000	
	Treasury Stock		88,000
	<i>(2,000 * 44 cost per share)</i>		
e)	Cash	68,500	
	Treasury Stock		66,000
	Paid-in capital-Treasury Stock		2,500
	<i>(1,500 * 44 cost per share)</i>		
f)	Land	385,000	
	Common Stock		200,000
	Paid-in capital-excess of par-common		185,000

Practice Problem #2

May 5	Building	135,000	
	Preferred Stock (2,200 * \$50)		110,000
	Paid-in Capital in Excess of Par Value, Preferred Stock		25,000
July 20	Cash (1,550 * \$50)	77,500	
	Preferred Stock		77,500
Dec. 20	Cash (1,000 * \$52)	52,000	
	Preferred Stock (1,000 * \$50)		50,000
	Paid-in Capital in Excess of Par Value, Preferred Stock		2,000

Practice Problem #3

a)

Jun. 1	Treasury Stock, Common	80,000	
	Cash		80,000
July 1	Cash (500 * \$45)	22,500	
	Treasury Stock, Common (500 * \$40)		20,000
	Paid-in Capital, Treasury Stock		2,500
August 1	Cash (500 * \$38)	19,000	
	Paid-in Capital, Treasury Stock		1,000
	Treasury Stock, Common (500 * \$40)		20,000

- b)
- There is a credit balance in Paid-in Capital, Treasury Stock of \$1,500:
 $\$2,500 - \$1,000 = \$1,500$

Problem #4

- a) 500,000 shares = 300,000 shares x 5 / 3
 b) \$6 = \$10 x 3 / 5
 c) \$54 per share = \$90 x 3 / 5

Solutions to True / False Problems

1. True
2. True
3. True
4. False - Authorized stock is the total number of shares available to sell, stated in the company's articles of incorporation. Issued stock is the number of shares that have been sold to investors.
5. False - Par value is the legal capital per share of stock that's assigned when the corporation is first established. Par value has no relationship to the market value of the common stock.
6. True
7. True
8. True
9. True
10. True
11. False - Treasury stock is a contra-equity account since treasury stock *decreases* total stockholders' equity.
12. True
13. True
14. False – Stock splits do not affect total stockholders' equity.
15. True

Solutions to Multiple Choice Questions

- | | |
|-----|---|
| 1. | B |
| 2. | B |
| 3. | B |
| 4. | D |
| 5. | A |
| 6. | B |
| 7. | C |
| 8. | B |
| 9. | D |
| 10. | A |
| 11. | C |
| 12. | B |
| 13. | C |
| 14. | D |
| 15. | C |