

# Financial Accounting

## Module 13: Accounting for Corporations



# Module Learning Outcomes

Describe the accounting and reporting concepts unique to corporations

13.1: Describe the corporate form of doing business

13.2: Account for issuance of Stock

13.3: Account for distributions to shareholders

13.4: Illustrate financial statement presentation of stockholder's equity

# Corporations

# Learning Outcomes: Corporations

13.1: Describe the corporate form of doing business

13.1.1: Describe the basic steps in forming a corporation

13.1.2: Identify the defining characteristics of a corporation

13.1.3: Identify different types of corporations

13.1.4: Recognize the benefits and drawback of the corporate form of doing business

# Describe the Basic Steps in Forming a Corporation

Corporations are chartered by the state. Each state has a corporation act that permits the formation of corporations by qualified persons. Incorporators are persons seeking to bring a corporation into existence. Most state corporation laws require a minimum of three incorporators, each of whom must be of legal age, and a majority of whom must be citizens of the United States.

After supplying the information requested in the incorporation application form, incorporators file the articles with the proper office in the state of incorporation. Each state requires different information in the articles of incorporation, but most states ask for the following:

- Name of corporation.
- Location of principal offices.
- Purposes of business.

# Describe the Basic Steps in Forming a Corporation (cont'd)

Each state requires different information in the articles of incorporation, but most states ask for the following: *(cont'd list)*

- Number of shares of stock authorized, class or classes of shares, and voting and dividend rights of each class of shares.
- Value of assets paid in by the incorporators (the stockholders who organize the corporation).
- Limitations on authority of the management and owners of the corporation.
- On approving the articles, the state office (frequently the secretary of state's office) grants the charter and creates the corporation.

As soon as the corporation obtains the charter, it is authorized to operate its business. The incorporators call the first meeting of the stockholders. Two of the purposes of this meeting are to elect a board of directors and to adopt the bylaws of the corporation.

# Identify the Defining Characteristics of a Corporation

Corporations have a number of distinguishing characteristics. The most significant of these are:

- Separate Legal Existence
- Continuous Life
- Ability to Acquire Capital
- Transferability
- Limited Liability
- Government Regulations
- Taxation
- Governance and Management



# Identify Different Types of Corporations

## **For Profit v. Not-For-Profit**

A corporation may be organized for the purpose of making a profit, or it may be not-for-profit. For-profit corporations include such well-known companies as McDonald's, Nike, PepsiCo, and Facebook.

Not-for-profit corporations are organized for charitable, medical, or educational purposes. Examples are the Salvation Army and the American Cancer Society

## **Publicly-held v. Privately-held**

Classification by ownership differentiates publicly held and privately held corporations. A publicly held corporation may have thousands of stockholders, such as IBM, Caterpillar, and Apple. When the stock is first issued, the corporation receives the proceeds, but subsequent trading is between individuals and institutions on a national securities exchange such as the New York Stock Exchange or NASDAQ.

In contrast, a privately held corporation usually has only a few stockholders, and does not offer its stock for sale to the general public. Privately held companies are generally much smaller than publicly held companies, although some notable exceptions exist.

# Recognize the Benefits and Drawbacks of the Corporate Form of Doing Business



# Recognize the Benefits and Drawbacks of the Corporate Form of Doing Business

Form of business	Advantages	Disadvantages
Sole Proprietorship	Easy and inexpensive to create	Unlimited liability, meaning business debts are personal debts
	Flexibility and control to your liking	Limited internal expertise
	Few Government regulations	Limited access to financial capital
	Tax advantages if struggling	Not separate from owners lifespan
	Profits taxed once	
Partnerships (General/ Limited Partnerships)	Easy to organize	Possible conflict development between partners
	Access to combined knowledge, skills and resources	Profits must be split between partners
	Few Government regulations	
	Profits taxed once at the partner level	
	Unlimited liability for general partners	

# Recognize the Benefits and Drawbacks of the Corporate Form of Doing Business (cont.)

Form of Business	Advantages	Disadvantages
Corporation	Limited liability	Double taxation
	Virtually unlimited access to equity and debt financing = ability to generate vast profits	Subject to extensive government regulations, especially publicly traded corps
	Easy to transfer ownership (publicly traded)	Complex to organize and maintain
	Legal entity separate from owners with continuous life	
Limited Liability Company	Simple to organize and operate	Possible conflict development between members
	Flexible in nature	Profits must be split between members
	Can elect to be taxed as a partnership (or sole proprietor if single-member LLC)	
	Legal entity separate from owners with continuous life	
S Corporation	Limited liability for owners	Restrictions on number and type of shareholders
	Greater credibility for financing	
	Taxed like a partnership	
	Not as regulated as publicly traded corporation	
	Legal entity separate from owners with continuous life	

# Capital Stock Transactions

# Learning Outcomes: Capital Stock Transactions

## 13.2: Account for issuance of Stock

13.2.1: Account for the issuance of stock

13.2.2: Distinguish between characteristics of common and preferred stock

13.2.3: Account for buying and selling shares of treasury stock

# Account for the Issuance of Stock

**Shares authorized** is the number of shares a corporation is allowed to issue (sell). For a large corporation this is based on a decision by its Board of Directors, a group elected to represent and serve the interest of the stockholders. Authorization is just permission to sell shares of stock; no action has actually taken place yet. Therefore, there is no journal entry for a stock authorization.

**Shares issued** is the number of shares a corporation has sold to stockholders for the first time. The number of shares issued cannot exceed the number of shares authorized.

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
20-				
Oct. 1	Checking		150,000.00	
	Common Stock			150,000.00
	To record issuance of 15,000 shares of \$10 par stock at \$10 per share			

# Distinguish Between Characteristics of Common and Preferred Stock

There are three main differences between common stock and preferred stock.

1. Preferred shareholders have priority over a company's income, meaning they are paid dividends before common shareholders.
2. In the event a company dissolves, preferred shareholders are paid after creditors but before common stockholders.
3. Preferred stock functions similarly to bonds since with preferred shares, investors are promised a fixed return on investment.

In addition:

- Dividends
- Liquidation
- Return on Investment
- Convertibility

# Account for Buying and Selling Shares of Treasury Stock

When a business buys back its own shares, these shares become “treasury stock” and are decommissioned. In and of itself, treasury stock doesn’t have much value. These stocks do not have voting rights and do not pay any distributions. However, in certain situations, the organization may benefit from limiting outside ownership. Reacquiring stock also helps raise the share price, providing investors with an immediate reward.

Journal				Page XX
Date	Description	Post. Ref.	Debit	Credit
20–				
Oct. 1	Treasury Stock		45,000.00	
	Checking			45,000.00
	To record repurchase of 1,000 shares of stock at \$45 per share.			

# Practice Question 1

The YZX company was forced into bankruptcy as sales plummeted in 2020 and had to liquidate its assets to pay off its debts and stockholders. If you owned stock in YZX, which type of stock would it be best to own at this point?

- A. Treasury stock
- B. Common stock
- C. Preferred stock
- D. Common stock after a stock split

# Distribution of Earnings

# Learning Outcomes: Distribution of Earnings

## 13.3: Account for distributions to shareholders

13.3.1: Define dividends and how they are declared and distributed

13.3.2: Account for the declaration and payment of dividends

13.3.3: Account for cumulative preferred dividends

13.3.4: Account for the declaration and distribution of stock dividends

13.3.5: Recognize the effects of a stock split on the financial statements

# Define Dividends and How They Are Declared and Distributed

**Cash dividends** are corporate earnings paid out to stockholders. They are payouts of retained earnings, which is accumulated profit. Therefore, cash dividends reduce both the Retained Earnings and Cash account balances.

There are three prerequisites to paying a cash dividend: a decision by the Board of Directors, sufficient cash, and sufficient retained earnings.

Four dates are associated with a cash dividend:

- Declaration Date
- Ex-Dividend Date
- Record Date
- Payment Date

# Account for the Declaration and Payment of Dividends

When a dividend is declared by the board of directors, the company will credit dividends payable and debit an owner's equity account called Dividends or perhaps Cash Dividends.

Cash Dividends is a contra stockholders' equity account that temporarily substitutes for a debit to the Retained Earnings account. Just like owner withdrawals are closed to owner's equity in a sole proprietorship at the end of the accounting period, Cash Dividends is closed to Retained Earnings.

Journal				Page XX
Date	Description	Post. Ref.	Debit	Credit
20X1				
Dec 10	Cash Dividends		12,000.000	
	Cash Dividends Payable			12,000.00
	To record declaration of cash dividend of \$0.50 on common stock			

# Account for Cumulative Preferred Dividends

## **Cumulative Preferred Dividends**

*Preferred stockholders* are paid a designated dollar amount per share before common stockholders receive any cash dividends.

If the dividend declared is not enough to pay the entire guaranteed amount per preferred share before common stockholders, the amount declared is divided by the number of preferred shares. Common stockholders would then receive no dividend payment.





# Account for the Declaration and Distribution of Stock Dividends

## Stock Dividends

Corporate earnings distributed to stockholders from retained earnings, which is accumulated profit. Stockholders receive additional shares of stock instead of cash. They transfer value from Retained Earnings to the Common Stock and Paid-in Capital in Excess of Par – Common Stock accounts, which increases total paid-in capital.

The total value of equity remains the same from both the investor's perspective and the company's perspective. All stock dividends require a journal entry for the company issuing the dividend. This entry transfers the value of the issued stock from the retained earnings account to the paid-in capital account.

The amount transferred between the two accounts depends on whether the dividend is a small stock dividend or a large stock dividend.

- A stock dividend is considered small if the shares issued are less than 25% of the total value of shares outstanding before the dividend. A journal entry for a small stock dividend transfers the market value of the issued shares from retained earnings to paid-in capital.
- Large stock dividends are those in which the new shares issued are more than 25% of the value of the total shares outstanding prior to the dividend. In this case, the journal entry transfers the par value of the issued shares from retained earnings to paid-in capital.

# Recognize the Effects of a Stock Split on the Financial Statements

## Stock Split

When a corporation reduces the par value of each share of stock outstanding and issues a proportionate number of additional shares.

- It may affect the par value and market price per share, reducing them proportionately.
- The total dollar value of the shares outstanding does not change.
- No journal entry is required for a stock split.



# Financial Statement Presentation

# Learning Outcomes: Financial Statement Presentation

- 13.4: Illustrate financial statement presentation of stockholders' equity
  - 13.4.1: Illustrate the balance sheet presentation of stockholders' equity
  - 13.4.2: Recognize the components of stockholders' equity

# Illustrate the Balance Sheet Presentation of Stockholders' Equity

Sole Proprietorship	Corporation
Capital contributions	Common stock, at par
	Paid-in capital
Net income less owner withdrawals	Retained earnings
	Accumulated other comprehensive gain/loss
	Treasury stock

# Illustrate the Balance Sheet Presentation of Stockholders' Equity

<b>Liabilities and Owner's Equity</b>	
<b>Current Liabilities</b>	
Accounts payable	9,060
Short-term loans	
Income taxes payable	3,349
Accrued salaries and wages	
Unearned revenue	
Current portion of long-term debt	
<i>Total current liabilities</i>	<u>12,409</u>
<b>Long-Term Liabilities</b>	
Long-term debt	3,450
Deferred income tax	
Other	
<i>Total long-term liabilities</i>	<u>3,450</u>
<b>Owner's Equity</b>	
Owner's investment	6,000
Retained earnings	5,567
Other	
<i>Total owner's equity</i>	<u>11,567</u>
<b>Total Liabilities and Owner's Equity</b>	<b><u>27,426</u></b>

# Recognize the Components of Stockholders' Equity

Any change in the Common Stock, Retained Earnings, or Dividends accounts affects total stockholders' equity and those changes are shown on the statement of stockholders' equity.

Stockholders' Equity can *increase* in two ways:

1. Stock is issued and Common Stock increases, and/or
2. Business makes a profit and Retained Earnings increases.

Stockholders' Equity can *decrease* in two ways:

1. Dividends are distributed and Retained Earnings decreases, and/or
2. Business takes a loss and Retained Earnings decreases.

## Practice Question 2

Grace is a new accountant for the FGH, Inc. and is compiling its Balance Sheet for the end of the year. Which of these accounts should Grace represent as Stockholders' Equity on the Balance Sheet?

- A. Stock Dividends
- B. Owner's Equity
- C. Cash Dividends
- D. Retained Earnings

# Quick Review

- What are the basic steps in forming a corporation?
- What are the defining characteristics of a corporation?
- How many different types of corporations are there and what are they?
- What are the benefits and drawback of the corporate form of doing business?
  
- What is the process for the issuance of stock?
- How are common and preferred stock similar and different?
- How are shares of treasury stock bought and sold?

# More Quick Review

- What are dividends and how are they declared and distributed?
- What is the process for the declaration and payment of dividends?
- How are cumulative preferred dividends factored?
- What process is followed for the declaration and distribution of stock dividends?
- What are the effects of a stock split on the financial statements?
- How is stockholders' equity presented on the balance sheet?
- What are the components of stockholders' equity?