Balance Sheet: Reporting Stockholder’s Equity

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Course Description

This course discusses generally accepted accounting principles (GAAP) for reporting stockholder's equity on the balance sheet. Stockholders' equity represents the cumulative net contributions by stockholders plus accumulated earnings less dividends. Stockholders' equity is synonymous with net worth, or net assets (assets less liabilities). This course discusses the accounting, financial statement presentation, and disclosures associated with preferred and common stock, stock retirement, treasury stock, dividends, appropriation of retained earnings, stock splits, stock warrants (including fractional share warrants), and quasi-reorganization.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	Basic Accounting
Advanced Preparation	None

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Balance Sheet:

Stockholder’s Equity

Learning Objectives:

After completing this chapter, you should be able to:

- Identify proper accounting procedures for common and preferred stock.
- Recognize accounting methods for acquisition of treasury stock.
- Recognize how dividends, stock splits and stock warrants affect stockholders’ equity.
- Explain how stockholders’ equity is presented.

Stockholders' equity represents the cumulative net contributions by stockholders plus accumulated earnings less dividends. Stockholders' equity is synonymous with net worth, or net assets (assets less liabilities). This course discusses the accounting, financial statement presentation, and disclosures associated with preferred and common stock, stock retirement, treasury stock, dividends, appropriation of retained earnings, stock splits, stock warrants (including fractional share warrants), and quasi-reorganization.

Stockholders' equity in a corporation is composed of five components:

1. Capital stock.
2. Additional paid-in capital.
3. Retained earnings.
4. Accumulated other comprehensive income (loss).
5. Noncontrolling (minor) interest.

In general, treasury stock is accounted for as a reduction of stockholders' equity.

Although many items affect owners' equity, the major decisions associated with owner investment are illustrated in the time line in Exhibit 1. Note that many of the issues associated with transactions involving owners may or may not occur during any given period. Dividends may or may not be paid, and options may or may not be granted. This course discusses many of the possible actions that may be taken by management that will affect owners' equity.

EXHIBIT 1

TIME LINE OF ISSUES ASSOCIATED WITH STOCKHOLDERS' EQUITY

ISSUE	*PAY*	*INCREASE*	*GRANT*	*REPURCHASE*	*CONVERT*	*REPORT*
preferred or common stock	cash dividends	shares outstanding through stock dividends or stock splits	options to officers and employees	shares of stock	other securities into shares of common stock	performance to current and potential investors

Capital stock represents monies paid or to be paid into the corporation by investors who purchase shares of stock. Each share of stock represents a unit of ownership in the corporation. Capital stock also includes shares to be issued at a later date, such as stock options and warrants, and stock dividends distributable. *Legal capital* is typically defined by state law and represents how much capital the company must have in order to protect the creditors. It usually includes the par value, stated value, and true no par value of all common and preferred stock issued. *Additional paid-in-capital* represents additional monies paid into the corporation by investors above the par value of shares issued, sale of donated treasury stock, and a variety of other sources that will be discussed in this course. (If stock is issued below par value, paid-in-capital is reduced.) *Retained earnings* represents income that the corporation has accumulated as a result of its day-to-day operating activities. *Accumulated other comprehensive income (loss)* represents the total of other comprehensive income (or loss) that has accumulated to date by an entity. Other comprehensive income (loss) is part of comprehensive income and is closed at the end of the period to accumulated other comprehensive income. (See the "Comprehensive Income" section in Course 1 for a full discussion on this topic.)

Preferred Stock

The capital stock component of stockholders' equity consists of two types of stock: preferred and common. *Common stock* has one major characteristic that preferred stock does not: voting rights; preferred stockholders usually do not have voting rights, but they enjoy other characteristics. *Preferred stock* may have a "participation" feature. *Participating* preferred stock is entitled to partake in dividend payments in excess of its predetermined dividend rate, on a proportionate basis using the total par values of the preferred and common shares outstanding. *Nonparticipating* preferred stock does *not* partake in excess dividends.

Preferred stock may be *cumulative.* If dividends are not declared by the board of directors in a particular year, the dividends accumulate. These "backlogged" dividends are termed dividends in arrears. Dividends in arrears and the preferred dividends for the current period must be paid before common shareholders may receive dividends. If preferred stock is *noncumulative*, the bypassed dividends do *not* accumulate.

Preferred stock has *preference* over common stock in the event of corporate liquidation. Preferred stockholders will receive the "liquidation value," sometimes stated as par value, before any monies are disbursed to common stockholders.

Convertible preferred stock may be exchanged for common stock through use of a stipulated conversion ratio. (As the market price of the common stock changes, so does the related convertible preferred stock.) When preferred stock is converted to common stock, any excess of preferred contributed capital over the par value is credited to paid-in-capital; any deficit is debited to retained earnings.

EXAMPLE

Trout Company issued 10,000 shares of $100 par value convertible preferred stock for $120 per share. The conversion is based on one share of preferred stock for four shares of common stock. The par value of the common stock is $18 per share. All preferred shares were converted into common shares. The journal entry for the conversion is:

Convertible preferred stock (10,000 ×$100)	1,000,000	
Additional paid-in-capital: excess of par preferred stock (10,000 × $20)	200,000	
Common stock (40,000 × $18)		720,000
Additional paid-in-capital: excess of par common stock (balance)		480,000

Preferred stock usually has no maturity date. However, there may be a call feature. *Callable preferred stock* may be redeemed at the stipulated call price at a predetermined date by the issuing company. The call (redemption) price is typically slightly more than the initial issue price. ASC 810-10-40-1, *Consolidation: Overall*, deals with the early extinguishment of a subsidiary's mandatorily redeemable preferred stock.

Preferred stock issued for services or property should be recorded at the market price of the stock issued. If market price of the stock is not known, the services or property should then be reported at their fair market value.

EXAMPLE

Erlach Company issued 2,000 shares of $10 par value preferred stock as compensation for 1,500 hours of legal services performed billable at $100 per hour. The market price of the stock is $60 per share. The journal entry is:

Compensation expense (2,000 shares × $60)	120,000	
Common stock (2,000 shares × $10)		20,000
Paid-in-capital (2,000 shares × $50)		100,000

The *costs to issue* stock include accounting and legal fees, printing charges, underwriting commissions, Securities and Exchange Commission (SEC) filing fees, and promoting costs for the issue. The prevalent accounting treatment is to charge such costs **against paid-in-capital** as incurred. However, costs incurred to defend against a takeover attempt of the company are expensed. Payments made to stockholders to induce them *not* to buy additional shares are also expensed.

When increasing rate preferred stock is issued, it should be recorded at its fair value, including the periodic increases in value in the early years due to dividends not being paid or paid at below market rates.

As per GAAP, full disclosure must be made of:

- Par, stated, or assigned value of preferred stock.
- Number of shares authorized, issued and outstanding.
- The amount of dividends in arrears, per share and in the aggregate.
- Liquidation values in the aggregate for preferred stock.
- The amounts of dividends in arrears, per share and in the aggregate.
- Call and conversion features—ASC 505-10-50, Equity: Overall, mandates footnote disclosure of call features and a five-year redemption schedule associated with preferred stock.
- Restrictions placed on issuance of stock.
- Participation rights.

ASC 860-20-55-21, *Transfers and Servicing: Sales of Financial Assets*, covers the sale of preferred stock with a put option in which the buyer may later transfer the securities back to the issuer at a fixed price. If the exercise of the put option is *probable*, the transaction is accounted for as a borrowing. In such a case, the difference between the selling price and the price of the put is amortized from the issue date to the first permissible put date. If the exercise of the put option is *not* probable, the transaction is accounted for as a straight sale.

ASC 860-10-10, *Transfers and Servicing: Overall*, applies to the sale of put options on the issuer's stock that require or permit cash settlement. This transaction is accounted for as a liability marked to fair value, with any resulting gain or loss included in the income statement.

Common Stock

Common stockholders have a residual interest in the corporation. They receive the benefits of success but also bear the ultimate risk of loss. Owning common stock guarantees neither dividends nor assets upon dissolution. In general, common stockholders control the management of the corporation and profit the most if the company is successful. If a corporation has authorized only one class of capital stock, that issue must be common stock. That is, a corporation cannot exist without a basic ownership interest.

Accounting for the issuance of common stock is simplistic. The following generic entry illustrates accounting for the issuance of common stock:

Cash (full amount of the proceeds)	xxx	
Common stock (par value shares issued)		xxx
Additional paid-in capital: excess of par (excess, if any)		xxx

If common and preferred shares are issued as a *unit* (e.g., three shares of common and one share of preferred), the proceeds received are allocated based on the relative market values of the securities.

Disclosure for common stock should include unusual voting rights, dividend rates, restrictions on dividends, rights and privileges of stockholders, shares authorized and issued, outstanding shares, and commitments to issue additional shares.

Note: When stock is issued in exchange for property or services, the transaction is recorded at the more clearly determinable of the fair values of the stock issued or of the property or services received.

ASC 505-10-45-2, *Equity: Overall*, applies to the classification of a contribution to an entity's equity in the form of a note receivable. Such a note should usually be presented as a reduction of equity. However, if the note is to be collected in cash before the financial statements are issued or available to be issued, it may be reported as an asset.

ASC 815-40-25 covers the sale of put options on the issuer's common stock. The proceeds received from issuing the puts should be reported as equity. Disclosure should also be made of the fair value of the put.

ASC 815-40-25 deals with the accounting for derivative financial instruments indexed to, and potentially settled in, a company's own stock.

ASC 505-60-25 and 845-10-25 covers spin-offs or other distributions of loans receivable to shareholders.

Accounting for Stock Subscriptions

It is not uncommon for a company to use stock subscription contracts to sell its stock to investors. In order to purchase the stock, the investor must sign a subscriptions contract and agree to buy a number of shares at a given price. The subscriptions contract specifies the required payment schedule for the shares as well as the manner in which defaults are handled. Generally, subscribed shares are not issued until the corporation receives full payment for them. However, many states consider subscribed common or preferred stock to be equivalent to outstanding common or preferred stock. That is, investors who have signed valid, bona fide subscription contracts have the same rights and privileges as stockholders who hold outstanding shares of stock. Another use of the stock subscription plan is for a company to sell its own stock directly to its employees through a stock purchase plan.

EXAMPLE

Hunter Corporation receives subscriptions for 12,000 shares of $14, $10 par value common stock on September 10, 2X13. The subscriptions contract requires a 40% down payment. On October 10th, two months later, the company receives the balance due on one half the subscription shares and issues 6,000 shares to those investors who have fully paid for their stock. The entries are shown below:

	Debit	Credit
	September 10, 2X13	
Subscriptions receivable	(12,000 × $14) 168,000	
Common stock subscribed		(12,000 × $10) 120,000
Paid-in capital in excess of par		(12,000 × $4) 48,000
Cash	($168,000 × 40%) 67,200	
Subscription receivable		67,200
	October 10, 2X13	
Cash	(12,000 × 50% × ($14 - [40% × $14]) 50,400	
Subscriptions receivable		50,400
Common stock subscribed	(12,000 × 50% × $10) 60,000	
Common stock		60,000

The Common Stock Subscribed account is reported on the balance sheet in the stockholders' equity section in the entity's capital stock section below common stock. The Common Stock Subscribed account indicates the intent of the entity to issue the applicable common stock after the subscription is fully paid. When this happens, the subscribed stock is converted into common stock. Although the Subscriptions Receivable account is, in fact, a special receivable, it is reported as a contra-stockholders' equity account on the balance

sheet. The reason is it is questionable whether this receivable will ever be collected by the issuing corporation since it may be difficult to obtain deficiency judgments against defaulting subscribers. Therefore, general practice follows the policy of presenting the subscriptions receivable account as a reduction to stockholders' equity at the bottom of the stockholders' equity section. ASC 505-10-45-2 notes the following in this regard:

An enterprise may receive a note, rather than cash, as a contribution to its equity from the sale of capital stock or a contribution to paid-in capital. The issue is whether an enterprise should report the note receivable as a reduction of shareholders' equity or as an asset.

The Task Force reached a consensus that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time. Some Task Force members would require collateralization or payment of the note prior to issuance of the financial statements to permit asset recognition.

The SEC requires that public companies report notes received in payment for the enterprise's stock as a deduction from shareholders' equity. Task Force members confirmed that the predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements.

The SEC Observer stated that, for registrants, exceptions to the general rule would be very rare.

Although the aforementioned citation focuses on the receipt of a note rather than the receipt of a signed subscriptions contract, the guidance is also appropriate for a subscriptions contract receivable account. It is interesting to note that the SEC also requires that public companies report notes received in payment for the enterprise's stock as a deduction from shareholders' equity.

Accounting for Defaults of Stock Subscriptions

Subscribers of stock may, on occasion, default on payment. There are several alternatives available to the entity in this situation and these generally follow the parameters permitted by the state in which the entity is incorporated. The following illustrates several alternatives of accounting for subscription defaults by corporations. However, it is not a comprehensive list of alternatives.

In each of the following examples, a single subscriber of 200 shares defaults after making a 40% down payment on the shares. It is assumed that the defaulting subscriber is one of the subscribers from the prior illustration who paid 40% of his or her subscriptions contract but has not yet remitted the remaining 60% of the total.

EXAMPLE 1

The company returns the full down payment to the defaulting subscriber. The entry simply consists of a reversal of the original entry made when the shares were subscribed.

Account	Debit	Credit
Common stock subscribed	(200 × $10) 2,000	
Paid-in capital in excess of par	(200 × $4) 800	
Subscriptions receivable		(200 × $14 × 60%) 1,680
Cash		(200 × $14 × 40%) 1,120

EXAMPLE 2

The company issues shares equal to the amount of the down payment made by the defaulting subscriber.

Amount paid-in by the defaulting subscriber: 200 × $14 × 40% = $1,120

Contract price of a share: $14

Number of shares issued to the defaulting subscriber: $1,120/$14 = 80 shares.

Account	Debit	Credit
Common stock subscribed	(200 × $10) 2,000	
Paid-in capital in excess of par	(200 × $4) 800	
Subscription receivable		(200 × $14 × 60%) 1,680
Common stock		(80 × $10) 800
Paid-in capital in excess of par		($1,120 - $800) 320

EXAMPLE 3

The company requires that the full amount paid-in by the defaulting subscriber be forfeited in accordance with state law.

Account	Debit	Credit
Common stock subscribed	(200 × $10) 2,000	
Paid-in capital in excess of par	(200 × $4) 800	
Subscription receivable		(200 × $14 × 60%) 1,680
Paid-in capital from forfeiture		(200 × $14 × 40%) 1,120

In this case, no cash is returned to the defaulting subscriber; it is forfeited and kept by the corporation.

Treasury Stock

Treasury stock is a term used to refer to shares of stock that have been issued and then reacquired by the issuing corporation. These shares are in shareholders' hands, and the corporation buys them in the market. The corporation holds the shares temporarily and then reissues them. Treasury stock may be kept on a first-in, first-out (FIFO) or average cost basis. While the corporation is holding on to these shares, the shares are said to be "in the treasury" and lose all their rights and characteristics while there. For example, treasury stock does not have the right to vote or to partake in dividends.

The reasons for acquiring treasury stock are diverse. The acquisition may be an effort to thwart a takeover attempt. It may be to support the market value of the shares. When the firm reacquires its own shares, the supply in the market is naturally reduced. With a sufficient demand, market price will then increase. Earnings per share will also become more attractive, because although treasury shares are considered issued shares, they are not considered to be outstanding while they are in the treasury. Another common reason for purchasing treasury shares is to reallocate ownership without issuing additional shares.

In some cases, the corporation laws require an appropriation of retained earnings equal to the cost of treasury stock on hand.

Treasury stock is presented on the balance sheet as a deduction from stockholders' equity and should not be presented as an asset. According to GAAP, it is not acceptable to show the stock of a corporation held in its own treasury as an asset.

The two most popularly used methods of accounting for treasury stock are the **cost and par value methods**. The former method is frequently used, whereas the latter method is used only in very limited circumstances. Both methods of accounting and presentation are comprehensively illustrated and explained below.

Under the **cost method,** the acquisition of treasury stock is recorded at the cost of the acquired shares. The journal entry is:

Treasury stock	xxxx	(shares × price per share)	
Cash		xxxx	(shares × price per share)

Correspondingly, the entry to record the reissuance of treasury shares requires a credit to treasury stock equal to the cost of the shares. If the reissuance is for an amount greater than the original cost of the treasury shares, a credit for the excess should be made to an account, titled Additional Paid-in-Capital: Treasury Stock. If the reissuance is for less than the original cost of the treasury shares, then this Additional Paid-in-Capital account would be debited for the difference.

However, Additional Paid-in-Capital may only be debited to the extent of its balance. This balance may be viewed as the result of "coming out ahead" rather than "falling behind" in the purchase and reissuance activities by an entity of its own treasury stock. After it is used up, any remaining deficiency as a result of selling the treasury stock should be debited to retained earnings.

A comprehensive illustration demonstrating the cost method of accounting for treasury stock follows:

EXAMPLE

If 15,000 shares of $25 par value common stock are issued for $30 at the beginning of the year and 3,000 of these shares are purchased for the treasury at $35 per share later that year, the entry for the acquisition of the treasury stock using the cost method is:

Treasury stock	105,000	(3,000 × $35)
Cash		105,000

If 500 of the treasury shares are reissued for $36 per share, the entry is:

Cash	18,000	
Treasury stock		17,000 (500 × $35)
Additional paid-in-capital: treasury stock		500

In the same year, if another 500 shares of the treasury stock are reissued for $20, the entry is:

Cash	10,000 (500 × $20)	
Additional paid-in-capital: treasury stock	500 (full balance)	
Retained earnings	7,000	
Treasury stock		17,500

Although the reissue price of $20 (above) is below par value (and cost), a discount on the issuance is not recorded. A discount occurs only when original issuance capital is sold below par. (Very few states allow stock to be issued below par.) This transaction is a reissuance of treasury stock.

If the remaining 2,000 shares of treasury stock are retired, all the original issuance capital relating to the treasury stock must be removed. In addition, the retired shares take on the status of authorized but unissued shares.

Common stock	50,000	(2,000 × $25)

Additional paid-in-capital: excess of par	10,000	(2,000 × $5)
Retained earnings	10,000	(deficiency)
Treasury stock		70,000 (2,000 × $35)

If there was a balance in the Additional Paid-in-Capital: Treasury Stock account, that amount should be utilized fully before debiting retained earnings. That is, if the balance in the Additional Paid-in-Capital: Treasury Stock is insufficient to balance the transaction, then retained earnings would be debited for the deficiency. In the above example, there is no balance in the Additional Paid-in-Capital: Treasury Stock account, so retained earnings is debited for the full deficiency instead.

If company stock is donated back to a corporation, the guidance of ASC 985-605-30-2, *Software: Revenue Recognition* prevails. ASC 985-605-30-2 requires that if a donation from a nongovernmental entity such as a stockholder occurs, the transaction should be recorded as revenue at the fair value of the donation and be disclosed in the "Other revenues or gains" section of the donee's income statement.

EXAMPLE

If 1,000 shares of an entity's stock are donated back to the entity by a wealthy stockholder when the shares are selling for $15 per share, the receiving corporation makes the following entry:

Treasury stock	15,000	(1,000 shares × $15)	
Revenue from donated treasury stock			15,000

1,000 shares are reissued later that year for $16 per share, the entry is:

Cash	16,000	(1,000 × $16)	
Treasury stock			15,000
Additional paid-in-capital: treasury stock			1,000

ASC 505-30-30, *Equity: Treasury Stock*, deals with the accounting for a purchase of treasury shares at a price significantly in excess of the current market price of the shares and the income statement classification of costs incurred in defending against a takeover attempt.

Footnote disclosures associated with treasury stock include the circumstances when it is presented as an asset, and amounts of treasury stock associated with rights and privileges.

The second method for recording treasury stock transactions is the **par value method**. The par value method accounts for treasury stock as if the shares are retired substantively (in substance) but not formally (actual retirement in accordance with law). Under this method, the treasury stock account is charged with the par (or stated) value of the shares involved. Other paid-in-capital accounts are proportionately reduced based on amounts recorded when the shares were issued. The balance in the common or preferred stock account remains the same.

The entries for accounting for treasury stock transactions under the par value method are illustrated below.

The same data is used that was given in the illustration of the cost method of accounting for treasury stock except that the initial acquisition of treasury stock occurs in two separate purchases instead of one. The first is for 1,500 shares of treasury stock at $35 per share and the second is for 1,500 shares at $28 per share.

Using the par value method, the entry for the first treasury stock acquisition is:

Account	Debit	Credit
Treasury stock	37,500 (1,500 × $25)	
Addition paid-in-capital: excess of par	7,500 (1,500 × $5)	
Retained earnings	7,500	
Cash		52,500 (1,500 × $35)

Recording the acquisition of 1,500 shares of treasury under the par value method requires debits to the treasury stock and additional paid-in-capital accounts for the amounts per share they were credited when the stock was originally issued (e.g., par: $25, additional paid-in-capital: excess of par: $5). It should be noted that 15,000 shares of $25 par value common stock were issued for $30 at the beginning of the year. (See the illustration for the cost method of accounting for treasury stock.)

The acquisition of another 1,500 shares of treasury stock at $28 requires the following entry:

Account	Debit	Credit
Treasury stock	37,500 (1,500 × $25)	
Additional paid-in-capital: excess of par	7,500 (1,500 × $5)	
Cash		42,000 (1,500 × $28)
Additional paid-in-capital: treasury stock		3,000

If 500 shares of the treasury stock are sold for $36, the entry is:

Account	Debit	Credit
Cash	18,000 (500 × $36)	
Treasury stock		12,500 (500 × $25)
Additional paid-in-capital: excess of par		5,500

The reissuance of treasury stock under the par value method thus is viewed as a virtual new issuance of stock, hence, the credit to additional paid-in-capital: excess of par. The par value method of accounting for treasury stock differs from the cost method because it reverses the original entry to issue the common stock, with any difference between carrying amount and purchase price adjusted through paid-in capital or retained earnings. It treats a subsequent reissuance as a new issuance of common stock.

If another 500 shares are sold at $20 per share, which is below the cost and par value of the issue, the entry recorded is:

Cash	10,000 (500 × $20)	
Retained earnings	2,500	
Treasury stock		12,500 (500 × $25)

As in the cost method, no discount on the issuance of stock occurs.

If the remaining 2,000 shares of treasury stock are retired, the entry is:

Common stock	50,000	
Treasury stock		50,000 (500 × $25)

This entry is simplistic because in the par value method all original issuance capital was removed from the accounts when the treasury stock is acquired. When actual retirement occurs, as shown above, all that is needed is a negation of the common stock and treasury stock accounts.

Under the par value method, treasury stock is presented as a contra account to the common stock it applies to under the capital stock section of stockholders' equity.

Some state laws prohibit the purchase of treasury stock unless earnings available for dividends exist; consequently, the retained earnings account must be restricted in an amount equal to the cost of treasury stock being held. This restriction must be disclosed by a note to the financial statements. The underlying theory here is that when a corporation purchases treasury stock, it is paying money to its own shareholders. This is viewed as being tantamount to a dividend. Consequently, the amount otherwise available for the distribution of dividends is restricted.

Note:

1. COST METHOD vs. PAR VALUE METHOD

COST METHOD:

a. Treasury stock is recorded at purchase *cost.*
b. Treasury stock is a contra-stockholders' account.

c. Debit treasury stock for purchase cost, and credit treasury stock at cost if shares reissued.
d. The initial issue price of stock does not affect subsequent treasury stock transactions.
e. No gain or loss can be recognized when treasury shares are re-issued.

PAR VALUE METHOD:

a. Treasury stock is recorded at *par* value
b. It is presented as a deduction from capital stock
c. Treasury stock is recorded at par when bought or reissued.
d. Any shortfalls between the par value and the reissue price of treasury stock is borne: first by Paid-In and then by Retained Earnings

2. Total stockholders' equity is the same regardless of which method is used.

Exhibit 2 lists the 10 largest companies in the United States (in terms of their April 2010 market value) and their stock repurchases, according to reported information. It is interesting to note that three of these 10 companies—Microsoft, Wal-Mart, and Bank of America—use the par value method of accounting for their treasury stock purchases. Note also that Berkshire Hathaway, Apple, and Google do not repurchase shares of their own stock. Because of poor operating performance associated with the 2008 worldwide financial meltdown, Bank of America did not buy back shares in 2008 or 2009, but did engage in stock buybacks in the years before 2008.

EXHIBIT 2
TREASURY STOCK PURCHASES FOR THE 10 LARGEST U.S. COMPANIES

Rank		Market Value (in $billions)	Repurchases During the Year	Balance Sheet Amount	Accounting Method
1.	*ExxonMobil*	$308.77	$19,703	$166,410	Cost
2.	*Microsoft*	254.52	2,611	0	Par Value
3.	*Wal-Mart*	205.37	7,397	0	Par Value
4.	*Berkshire*	190.86	0	0	-
5.	*Apple*	189.51	0	0	-
6.	*Procter &*	184.47	6,370	55,961	Cost
7.	*Johnson &*	174.90	2,130	19,780	Cost
8.	*General Electric*	169.65	214	32,238	Cost
9.	*Google*	169.38	0	0	-
10.	*Bank of America*	167.63	0	0	Par Value

Chapter Review Questions

1. At December 31, Year 3 and Year 4, Carr Corp. had outstanding 4,000 shares of $100 par value, 6% cumulative preferred stock and 20,000 shares of $10 par value common stock. At December 31, Year 3, dividends in arrears on the preferred stock were $12,000. Cash dividends declared in Year 4 totaled $44,000. What amounts were payable on each class of stock?

A. Preferred Stock = $44,000, Common Stock = $0
B. Preferred Stock = $36,000, Common Stock = $8,000
C. Preferred Stock = $32,000, Common Stock = $12,000
D. Preferred Stock = $24,000, Common Stock = $20,000

2. Sperry Corp.'s records included the following equity accounts: 20,000 shares of Preferred stock authorized with a par value of $15 (authorized) recorded at $255,000. Additional paid-in capital of preferred stock recorded at $15,000. 100,000 shares authorized of Common stock with no par value and a stated value of $5 recorded at $300,000. In Sperry's statement of equity, the number of issued and outstanding shares for each class of stock is

A. Common Stock = 60,000 shares, Preferred Stock = 17,000
B. Common Stock = 60,000 shares, Preferred Stock = 18,000
C. Common Stock = 63,000 shares, Preferred Stock = 17,000
D. Common Stock = 63,000 shares, Preferred Stock = 18,000

3. East Co. issued 1,000 shares of its $5 par common stock to Howe as compensation for 1,000 hours of legal services performed. Howe usually bills $160 per hour for legal services. On the date of issuance, the stock was trading on a public exchange at $140 per share. By what amount should the additional paid-in capital account increase as a result of this transaction?

A. $135,000
B. $140,000
C. $155,000
D. $160,000

4. Nest Co. issued 100,000 shares of common stock. Of these, 5,000 were held as treasury stock at December 31, Year 3. During Year 4, transactions involving Nest's common stock were as follows: On May 3 1,000 shares of treasury stock were sold; on August 6, 10,000 shares of previously unissued stock were sold; November 18, a 2-for-1 stock split took effect. Laws in Nest's state of incorporation protect treasury stock

from dilution. At December 31, Year 4, how many shares of Nest's common stock were issued and outstanding?

A. 220,000 shares issued and 212,000 shares outstanding
B. 220,000 shares issued and 216,000 shares outstanding
C. 222,000 shares issued and 212,000 shares outstanding
D. 222,000 shares issued and 212,000 shares outstanding

5. Asp Co. was organized on January 2, Year 4, with 30,000 authorized shares of $10 par common stock. During Year 4, the corporation had the following capital transactions: On January 5, it issued 20,000 shares at $15 per share. On July 14, it purchased 5,000 shares at $17 per share. On December 27, it reissued the 5,000 shares held in treasury at $20 per share. Asp Co. used the *par value method* to record the purchase and reissuance of the treasury shares. It had no prior treasury stock transactions. In its December 31, Year 4, balance sheet, what amount should Asp report as additional paid-in capital?

A. $100,000
B. $125,000
C. $140,000
D. $150,000

Dividends

There are a variety of dividends that a corporation can distribute. This section discusses cash dividends, stock dividends, property dividends, scrip dividends, and liquidating dividends.

A cash dividend is based on the number of outstanding shares (issued shares less treasury shares). As an example, a corporation has 7,000 shares of $50 par value, 8% preferred stock outstanding. Eight hundred shares are in the treasury. Dividends will be declared and paid only on the 6,200 shares that are actually in shareholders' hands. The dividend per share is $4, computed as 8% of the $50 par value. The total amount of dividends is $24,800 (6,200 shares × $4 per share). The following entry would be recorded on the date of declaration:

	Debit	Credit
Retained earnings	24,800	
Cash dividends payable		24,800

No entry is made at the date of record. On the date of distribution, the following entry would be made:

	Debit	Credit
Cash dividends payable	24,800	
Cash		24,800

An alternative treatment is to debit a dividends account in lieu of retained earnings. The dividends account would be closed out at the end of the accounting period against the retained earnings account. With this treatment, everything nets out the same as the treatment in the illustration, but by utilizing a dividends account, there is a specific record of dividends declared that can be utilized during the accounting period.

Note: When cash dividends are declared, a liability to the shareholders is created because the dividends must be paid once they are declared. At the declaration date, retained earnings must be debited, resulting in a decrease in retained earnings. When the cash dividends are subsequently paid, the cash dividends payable account is debited and a cash account credited. Thus, at the payment date, the amount of retained earnings is not affected.

Cumulative preferred stockholders have priority in receiving first any dividends in arrears, and then any current year dividend. If preferred stock is fully participating, the first dividend payment (after arrearages) goes to preferred stockholders in the amount stipulated, stated either as a dollar amount per share or as a percentage of par value. Next, common stockholders receive a total amount to the extent available based on the same per share percentage that the participating preferred stockholders got. Thereafter, the

amounts to be paid are on a pro rata basis to each class of stock based on the par value of the shares outstanding. Partially participating preferred stockholders share in the manner specified.

EXAMPLE

At December 31, 2X12, and 2X13, Archer Corp. had outstanding 2,000 shares of $100 par value 7% cumulative preferred stock and 10,000 shares of $10 par value common stock. At December 31, 2X12, preferred dividends in arrears were $6,000. The cash dividends declared in 2X13 were $22,000. The amount of dividends for 2X13 associated with the preferred and common stock is calculated as follows:

Total cash dividends declared		$22,000
Preferred stockholders receive:		
2X12 dividends in arrears	6,000	
2X13 dividends (2,000 × $7)	14,000	20,000
Balance to common stockholders		$2,000

A *stock dividend* arises when the corporation distributes additional shares of its own stock to its current stockholders. The number of shares to be distributed is phrased in terms of a percentage of the number of shares outstanding at the declaration date. For example, if a corporation has 120,000 shares outstanding when it declares a 10% stock dividend, the dividend will consist of 12,000 shares, and there will be 132,000 shares outstanding once the dividend shares are distributed. If the stock dividend is less than 20% to 25% of the outstanding shares at the date of declaration, retained earnings will be reduced in an amount equal to the market price of the shares at the date of declaration. This is referred to as a **small stock dividend**. If the stock dividend is greater than 20% to 25% of the outstanding shares at the date of declaration, retained earnings will be reduced in an amount equal to the par or stated value of the shares at the date of declaration. This is referred to as a **large stock dividend.** The area between 20% and 25% is considered a gray area. Accounting for stock dividends entails the use of an account called common stock dividend distributable. This is not a liability account. It is shown in the paid-in-capital section of stockholders' equity. It is a stockholders' equity account, which consists of the product of the number of shares declared and par value. It is disclosed in the capital stock section of stockholders' equity after common stock, because it represents the number of shares that will become common stock after the date of distribution.

EXAMPLE

A 5% stock dividend is declared on 6,000 shares of $6 par value common stock. The market price is $8 per share on the date of declaration. On the date of declaration, the following entry is made:

Retained earnings (300 shares × $8)	2,400	
Common stock dividend distributable (300 shares × $6)		1,800
Additional paid-in-capital: excess of par		600

The following entry would be made on the date of distribution:

Common stock dividend distributable	1,800	
Common stock		1,800

Assuming that the dividend was 30%, on the date of declaration, the following entry would be made:

Retained earnings (1,800 shares × $6)	10,800	
Common stock dividend distributable		10,800

The following entry would be made to record the distribution of the shares:

Common stock dividend distributable	10,800	
Common stock		10,800

Note: No entries are made to record the receipt of stock dividends. However, a memorandum entry should be made in the investment account to record additional shares owned. This treatment applies whether the investment is accounted for by the fair-value method, the equity method, or the cost method.

A *property dividend*, also called a "dividend in kind," is payable in assets of the corporation other than cash (e.g., inventory, securities). Property dividends are formally defined as a nonreciprocal transfer of nonmonetary assets between an enterprise and its owners; they should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset ASC 845-10-30. Disclosure should be made of the nature of the distribution and the accounting basis for the transferred assets.

The accounting for a property dividend entails a journal entry that will adjust the asset to be distributed to its market value at the date of declaration. For example, if the fair value of the asset is higher than the book value, the following would be the format for this entry:

Asset	xxx	
Gain on appreciation of asset		xxx

The following entry would record the declaration of the property dividend:

Retained earnings	xxx	
Property dividends payable		xxx

When the asset is distributed, the following entry is made:

Property dividends payable	xxx	
Asset		xxx

Exception: Property distributions in a reorganization or liquidation should be based on recorded amounts less any required reduction for impairment in value.

A *scrip (liability) dividend* is payable in the form of a liability such as a note payable. This type of dividend may occur when a business has financial difficulties and wants to defer payment of the dividend. Interest expense is accrued. However, the interest is *not* part of the dividend.

EXAMPLE

On January 1, 2X13, a liability dividend of $100,000 is declared in the form of a one-year, 10% note. The journal entry at the declaration date is:

Retained earnings	100,000	
Scrip dividends payable		100,000

When the scrip dividend is paid, the entry is:

Scrip dividends payable	100,000	
Interest expense	10,000	
Cash		110,000

A *liquidating dividend* is any dividend that is not based on earnings but instead is a reduction of paid-in-capital. A liquidating dividend is a return of paid-in-capital and requires full disclosure. Paid-in-capital is debited and dividends payable is credited. The existence of a liquidating dividend does not necessarily mean that the company is going out of business. However, a company that decides to halt operations may declare a final, liquidating dividend. The accounting for a liquidating dividend is based on the state laws where the business is incorporated. A liquidating dividend is *not* taxable to the recipient but rather reduces the basis in the investor's shares.

Exhibit 3 summarizes accounting treatment for various types of dividends.

Exhibit 3
Accounting Treatment for Various Types of Dividends

Type of Dividend	Date of Declaration	Date of Record	Date of Payment
Cash Dividends	Retained Earnings Dividends Payable	No Entry	Dividends Payable Cash
Property Dividends	Appropriate Assets (at fair market value) Gain on Appreciation of Assets Retained Earnings Property Dividends Payable	No Entry	Property Dividends Payable Appropriate Assets (at newly recorded fair market value)
Liquidating Dividends	Additional Paid-In Capital Dividends Payable	No Entry	Dividends Payable Cash
Small Stock Dividends (<20% - 25%)	Retained Earnings (at market value) Common Stock Dividends Distributable Paid-In Capital in Excess of Par	No Entry	Common Stock Dividends Distributable Common Stock
Large Stock Dividends (< 20% - 25%)	Retained Earnings (at stock's par or stated value) Common Stock Dividends Distributable	No Entry	Common Stock Dividends Distributable Common Stock

According to **Accounting Standards Update (ASU)** No. 2010-01 (ASC 505, *Equity*), *Accounting for Distributions to Shareholders with Components of Stock and Cash*, the stock part of a stockholder distribution that permits investors to receive stock or cash with a possible restriction of the cash to be received is deemed an issuance of shares; it is not considered a stock dividend. EPS computation will include these distributions. The effective date for this accounting is December 15, 2009 (ASC 505-20-15-2; 15-3; and 15-3A).

Restrictions of Retained Earnings

It is not uncommon for a corporation's board of directors to decide that a portion of the entity's retained earnings should be restricted and made unavailable for dividend declarations. The restriction is a communication mechanism that alerts financial statement users that the company's retained earnings balance, because of current circumstances, is partially (or totally) blocked and cannot be used for dividend declaration. The restrictions may be prompted by legal constraints, contractual terms, future plans that the board of directors has for the company, or unexpected material uses of cash that makes the declaring of cash dividends currently impossible.

Examples include restrictions due to bond indentures, plant expansion designs, and treasury stock acquisition restrictions based on state law. The disclosure of such restrictions of retained earnings may take the form of a note (the most common), a parenthetical notation, or a recorded journal entry in the

company's accounts, which results in a portion of its retained earnings balance being transferred to an **appropriated retained earnings account.** The latter disclosure (i.e., appropriation entry) is infrequently used because of the potential for confusion caused by simultaneous presentation of two retained balances on the balance sheet of the entity: one unrestricted—available for dividend declaration—and the other restricted—not available for dividend declaration.

Exhibit 4 presents Alberto-Culver Company's disclosure of restrictions on retained earnings and dividends.

EXHIBIT 4
DISCLOSURE OF RESTRICTIONS ON RETAINED EARNINGS AND DIVIDENDS

Alberto-Culver Company

Note 3 (in part): The $200 million revolving credit facility, the term note, and the receivables agreei ment impose restrictions on such items as total debt, working capital, dividend payments, treasury stock Lpurchases, and interest expense. At year-end, the company was in compliance with these arrangements, and $220 million of consolidated retained earnings was not restricted as to the payment of dividends.

Stock Splits

A corporation may have a superlative history of performance. The financial statements show a positive trend, and retained earnings are sizable. This will cause a high demand for this corporation's stock in the market. A share of stock with a $50 par value could attain a market value of $150 or more. On the surface, a corporation whose stock is performing so well in the market seems attractive. In reality, a market value that is too high will prove debilitating to the issuing company. The phenomenon that results is that there will actually be a chill on trading in that company's shares because the investment is not affordable. The corporation would like the market price to be lower, so that trading in its shares becomes more affordable and new investors are attracted. Further, the brokerage commission and/or dealer spread per share for a round lot (100 shares) is typically lower than for an odd lot (less than 100 shares).

In this situation, the corporation may engage in an accounting mechanism called a *stock split.* The size of a stock split is stated in the form of a ratio. The following illustration will demonstrate the effect of a 2 : 1 stock split. The corporation will call in all of the outstanding shares of $50 par value stock and reissue to each shareholder double the number of shares initially held, but with half of the original par value—in this example, $25. This will cause the presplit market price of $150 to drop to approximately $75. Now the corporation's shares will become a lot more affordable than before the split. The corporation will have achieved its aim of increasing trading in its shares and attracting new investors.

A stock split does not affect the balance in any account. The total par value of the shares outstanding is the same after the stock split as it was before. The stock split requires a memorandum entry in the general journal and in the relevant stock account. For example:

April 30	Memorandum: Issued additional 5,000 shares of Capital Stock in a 2 : 1 stock split. There are now 10,000 shares of Capital Stock outstanding with a par value of $25 per share.

A stock split has no impact on the financial statements except for a description of the stock shown on the balance sheet and disclosure of the cause.

EXAMPLE

A company had 200,000 shares outstanding at the beginning of the year. On March 1, it issued a 15% stock dividend. On May 1, the company purchased 40,000 of its shares. On November 1, a 2-for-1 stock split was issued. On December 31, there will be 380,000 shares outstanding, computed as follows:

	Shares
Balance—1/1	200,000
3/1—Stock dividend (200,000 × 15%)	30,000
5/1—Purchased treasury stock	(40,000)
Subtotal	190,000
11/1—Stock split	190,000
Balance—12/31	380,000

A reverse stock split achieves the opposite effects of a stock split by increasing the par value and market price per share.

Exhibit 5 summarizes and compares the effects in the balance sheet and related items of various types of dividends and stock splits.

EXHIBIT 5

EFFECTS OF DIVIDENDS AND STOCK SPLITS ON FINANCIAL STATEMENT ELEMENTS

			Declaration and Distribution of	
Effect on:	**Declaration of Cash Dividend**	**Payment of Cash Dividend**	**Small Stock Dividend**	**Large Stock Dividend**
Retained earnings	Decrease	-0-	Decrease[a]	Decrease[b]
Capital stock	-0-	-0-	Increase[b]	Increase[b]
Additional paid-in capital	-0--	-0-	Increase[c]	-o-
Total stockholders' equity	Decrease	-0-	-0-	-0-
Working capital	Decrease	-0-	-0-	-0-
Total assets	-0-	Decrease	-0-	-0-
Number of shares outstanding	-0-	-0-	Increase	Increase

¶

'Market price of shares. [b]Par or stated value of shares. 'Excess of market price over par.

Exhibit 6 provides a comprehensive example of the effects of a 100% stock dividend and a 2-for-1 stock split.

EXHIBIT 6

COMPARATIVE EXAMPLE—STOCK DIVIDEND VERSUS STOCK SPLIT

Stockholders' Equity*	
Common stock, $5 par, 50,000 shares outstanding	$250,000
Paid-in capital in excess of par	400,000
Retained earnings.............................	300,000
Total stockholders' equity	$950,000

*Prior to stock dividend or stock split.

Stockholders' Equity After 100% Stock Dividend		**Stockholders' Equity After 2-for-1 Stock Split**	
Common stock, $5 par, 100,000 shares outstanding	$500,000	Common stock, $2.50 par, 100,000 shares outstanding	$250,000
Paid-in capital in excess of par*	400,000	Paid-in capital in excess of par..........	400,000
Retained earnings	50,000	Retained earnings............................	300,000
Total stockholders' equity	$950,000	Total stockholders' equity	$950,000

*Some or all of the $250,000 transfer to common stock at par could have been made from paid-in capital in excess of par.

Stock Warrants

Stock warrants are certificates entitling the holder to acquire shares of stock at a predetermined price for a predetermined period of time. A corporation may decide to sell stock warrants as part of a bond sale to make the securities more attractive to the potential investor and to justify a lower interest rate. A *nondetachable* warrant is one that must be traded with the related security as a package. In other words, the issue is accounted for as convertible debt. The value of the nondetachable warrant is built into the price of the related security. A *detachable* warrant is one that can be traded separately from the bond. Consequently, the warrant has its own market value separate from that of the attached security. An allocation must be engaged in to account for the valuation of these warrants apart from the related bonds, and they are accounted for as additional paid-in-capital according to ASC 470-20-25-2, *Debt: Debt with Conversion and Other Options*. The method of first resort for this allocation is the *proportional* method if the market price of both the bond and warrant is determinable. If the market value of the bonds or their detachable warrants cannot be determined, the *incremental* method is used for this allocation.

When shares of preferred stock with detachable common stock warrants are issued at a price that exceeds both the par value and the fair value of the preferred stock, the consideration received must be allocated between the preferred stock and the detachable warrants. The amount allocated to the stock warrants outstanding should be recorded in the equity section as contributed capital. At the time the warrants are exercised, contributed capital will reflect both the cash received upon the exercise of the warrants and the carrying amount of the warrants. Total equity, however, will be increased only by the amount of cash received because the carrying amount of the warrants is already included in total equity.

EXAMPLE

A $10,000 par value bond with nondetachable stock warrants is issued at $12,000. The entry is as follows:

Cash	12,000	
Bonds payable		10,000
Premium on bonds payable		2,000

The warrants are detachable. The fair market value (FMV) of the bonds without the warrants is determined to be $9,500, and the FMV of the warrants is $3,000. The proportional method would produce the following allocation:

1.	FMV of bonds	$ 9,500
	FMV of warrants	13,000
	Total FMV	$12,500

2. $\frac{\$9{,}500}{\$\ 12{,}500} \times \$\ 12{,}000 = \$9{,}120$ allocated to bonds

3. $\frac{\$3{,}000}{\$\ 12{,}500} \times \$\ 12{,}000 = \$2{,}880$ allocated to warrants

The following journal entries would be necessary:

Cash	9,120	
Discount on bonds payable	880	
Bonds payable		10,000
Cash	2,880	
Additional paid-in-capital: stock warrants		2,880

If the FMV of the stock warrants was $1,500, but the FMV of the bonds could not be determined, the incremental method would be used for the allocation. If the proceeds for the entire sale were $12,000, and $1,500 is the FMV of the warrants, the difference of $10,500 will be accounted for as the FMV of the bonds. The following journal entries would be necessary:

Cash	10,500	
Bonds payable		10,000
Premium on bonds payable		500
Cash	1,500	
Additional paid-in-capital: stock warrants		1,500

If stock warrants expire or lapse, the entry requires a debit to paid-in-capital: stock warrants and a credit to additional paid-in-capital: expired stock warrants.

EXAMPLE

On December 31, 2X12, a company issued 2,000 of its 12%, 8-year, $1,000 face value bonds with detachable stock warrants, at par. Each bond has a detachable warrant for one common share at an option price of $40 per share. After issuance, the bonds had a market value of $2,100,000, and their warrants had a market value of $200,000. At year end 2X13, the bonds payable will be reported at $1,826,087, computed as follows:

Proceeds of issuance ($1,000 × 2,000)				$2,000,000
Allocated to warrants:				
Market value of bonds			$2,100,000	
Market value of warrants			200,000	
Total market value			$2,300,000	
To warrants:	$ 200,000 / $2,300,000	×	2,000,000	173,913
Bonds payable—12/31/2X13				$1,826,087

Note: A holder may become a stockholder by exercising the warrant and continue as a bondholder.

Disclosures associated with stock warrants include conversion terms and exercise prices.

EITF Consensus Summary No. 86-35 relates to debentures with detachable stock purchase warrants.

Restricted (Nonvested) Stock

Many companies have issued restricted (nonvested) stock as part of their share-based compensation to employees. In other situations, they have completely replaced the issuance of stock options with restricted stock plans, although the former still remains the more popular of the two. *Restricted stock* is referred as stock that is fully vested and outstanding shares whose sale is restricted for a specified time by a company. Restricted stock is more commonly used and refers here to nonvested shares granted to employees that are restricted from being sold by an employee until the restriction period (vesting period) has ended.)

Restricted stock plans are compensatory stock award plans where employees are given shares of stock in a company. However, the shares are restricted from being sold or transferred until vesting takes place. In addition, other vesting constraints or restrictions may exist, such as vesting of shares, based on successful

performance during the service period measured, for example, by the company reaching some predetermined level of gross profit, earnings, or earnings per share. If the constraints on the restricted stock plans are violated, the employee forfeits his or her rights to the shares. Restricted shares also would be forfeited if an employee is terminated before completion of the service or vesting period.

Companies issue restricted stock awards to employees and use them as a replacement for stock option plans because:

- Employees receiving restricted stock are owners of the company. As both employees and owners of the entity, they manifest a greater degree of commitment, motivation, and loyalty to the company than those who are not.
- Employees who receive restricted stock are more likely to perceive congruency with management's goals and objectives and strive to accomplish them.
- Stock options do not encourage commitment and loyalty on the part of the recipient to the issuing corporation. Instead, they encourage the employee to take the necessary steps to raise the company's stock price in the relative short term in order to make a large profit, sell the stock, and personally benefit from any resulting gains. These employees frequently make risky decisions that may not be in the best interest of the company for the sole purpose of increasing the short-term price of stock. On the other hand, employees holding restricted stock are more interested in the company's long-term objectives and strive to benefit the company.
- Unlike stock options, restricted stock does not become worthless. If the stock price underlying a stock option plan does not exceed the exercise price, the stock options may not have value. However, restricted stock retains some value. For example, assume a company grants a stock option plan to certain executive employees of the company. The shares covered by the plan are currently selling at $6 and the exercise price of the stock option under the plan is $5. If the fair value of the stock drops to $4, then the employees' stock options are virtually worthless. Although the restricted stock's value may have decreased by one third, it does not become worthless.

Under GAAP, the total compensation expense that must be recorded when restricted stock is issued is the fair value of an unrestricted share of the same class of stock at the date of grant multiplied by the number of shares that will be issued under the plan. Any changes in the fair value of the stock subsequent to the date of grant should not influence total compensation expense. Compensation expense should be accrued over the service period required by the plan. Similar to a stock option plan, the measurement date of a restricted stock program is the date of grant.

The accounting for restricted stock is illustrated below:

> Assume the Hunter and Trout Company establishes a restricted stock award plan to be granted to certain managerial executives of their entity. On July1, 2012, the Board of Directors grants

750,000 shares of the company's $3 par value common stock to employees, which requires a three-year vesting period. That is, the shares are subject to forfeiture if the employees quit or are terminated within three years from the date of grant. The fair value of the shares at the date of grant is $10. Assume the Hunter and Trout Company has a December 31 year-end.

Solution

The service (and vesting period) is three years in this problem. If the employees who are part of this award program quit or are terminated within three years from the date of grant, they forfeit their rights to the granted stock.

The measurement date of the plan is the date of grant (July 1, 2012). The fair value is $10 per share and 750,000 shares will be issued under the plan. At the date of grant, the product of these numbers should be used to compute the total compensation expense of the restricted stock program.

Total compensation = 750,000 shares of common stock × $10 = $7,500,000

Since the service period is 3 years, we must divide $7,500,000 by the 3 years to determine the compensation expense per year.

Compensation expense per year: $7,500,000/3 years = $2,500,000

The required entries are:

December 31, 2X12	Compensation expense 1,250,000 ($ 2,500,000/2)
	Additional paid-in capital—Restricted Shares 1,250,000
December 31, 2X13—	
December 31, 2X14	Compensation expense 2,500,000
	Additional paid-in capital—Restricted Shares 2,500,000
June 30, 2X15	Compensation expense 1,250,000 ($2,500,000/2)
	Additional paid-in capital—Restricted Shares 1,250,000

After the required three-year service period (vesting period) is ended (July 1, 2012—June 30, 2015), the shares are issued to those employees who are part of the awards program. The entry for the distribution of the shares is shown below:

July 1, 2X15	Additional paid-in capital—Restricted Shares	7,500,000	
	Common stock (750,000 × $3)		2,250,000
	Additional paid-in capital—In excess of par		5,250,000

Related entries for forfeiture of shares or required disclosures, for example, are comparable to those of other share-based compensation plans. For example, if a managerial employee is terminated in the illustration above, the employee's shares are forfeited. This event is accounted for as a change in accounting

estimate that must be recorded in the year of the forfeiture. The remaining total compensation expense, without the forfeited portion, should then be re-allocated over the remaining service period.

Fractional Share Warrants

A fractional share warrant is a warrant that is redeemable for a fractional share of stock. Consequently, more than one fractional warrant is required in order for the holder to acquire one full share.

EXAMPLE

A corporation has 2,000 shares of $10 par value stock outstanding. Each share has a market value of $18. A 15% stock dividend is declared. The number of dividend shares is 300 (2,000×15%). Included in the 300 shares are 200 fractional share warrants, each equaling one fourth of a share of stock. Thus, the dividend consists of 50 fractional shares and 250 regular shares. The journal entry at the date of declaration would be:

Retained earnings (300 shares × $18)	5,400	
Stock dividends distributable (250 shares × $10)		2,500
Fractional share warrants (50 shares × $10)		500
Additional paid-in-capital: excess of par		2,400

The journal entries at the date of issuance are:

Stock dividends distributable	2,500	
Common stock		2,500
Fractional share warrants	500	
Common stock		500

If only 60% of the fractional share warrants were turned in, the journal entry would be:

Fractional share warrants	300	
Common stock		300

Stock Rights

Stock rights allow current stockholders to buy additional shares of the company's stock to maintain their proportionate interest in the company. This is usually referred to as the *preemptive right*. In some cases, existing stockholders can purchase the newly issued shares at a discount and at either no or reduced fees.

No entry is made upon the issuance of stock rights. There is only a memorandum notation. When stock rights are exercised, common stock increases by the par value of the shares issued, and additional paid-in-capital increases for the excess of the issue price over the par value of the shares issued. If stock rights are redeemed by the issuing company, the effect is the same as if a cash dividend had been paid. For example, if 10,000 rights were redeemed at $.20 per right, stockholders' equity would be reduced by $2,000. Common stock and additional paid-in capital are affected only if the rights are exercised.

Reverse Spinoffs

According to ASC 505-60-05-4, *Equity: Spinoffs and Reverse Spinoffs*, a transaction should be treated as a reverse spinoff if the substance of the transaction is most realistically represented for shareholders by treating a legal spinee as the accounting spinnor.

Indexed to Stock

ASC 815-40-15, 5-8, *Derivatives and Hedging Relating to Contracts in Entity’s' Own Equity*, provides that if an instrument (or embedded feature) that has the characteristics of a derivative instrument is indexed to an entity's own stock, the company still needs to appraise if it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument).

A company shall appraise if an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:

- Step 1: Appraise the instrument's contingent exercise provisions, if any.
- Step 2: Evaluate the instrument's settlement provisions.

Redeemable Equity Instruments

In **Accounting Standards Update (ASU)** 2009-04 (August 2009) (ASC 480, *Distinguishing Liabilities from Equity*), *Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99*, preferred securities redeemable for cash or other assets are to be classified outside of permanent capital if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the holder's option, or (3) upon the occurrence of an event that is not solely within the control of the issuer. There is a major difference between a security with mandatory redemption or whose redemption is outside the control of the issuer and conventional equity capital. The SEC believes accountants should highlight the future cash obligations attached to this type of security to distinguish it from permanent capital.

Equity instruments with redemption features that are not solely within the control of the issuer must be classified as “temporary equity.”

According to the SEC, the initial carrying amount of a redeemable equity instrument should be its issuance date fair value.

For share-based payment arrangements with employees, the amount presented in temporary equity at each balance sheet date should be based on the redemption provisions of the instrument and should take into consideration the proportion of consideration received in the form of employee services.

Disclosures are required for redeemable equity instruments as follows:

- For a redeemable equity instrument that is not adjusted to its redemption amount, the reasons why it is not probable that the instrument will be redeemable.
- Description of the accounting method used to adjust the redemption amount of a redeemable equity instrument.
- If the registrant decides to accrete changes in the redemption amount of a redeemable equity instrument, the redemption amount of the equity instrument as if it were currently redeemable.
- Amount credited to equity of the parent upon the subsidiary's deconsolidation.

(ASC 480-10-S99)

Quasi-Reorganization

A quasi-reorganization gives a “new start” to a company with a deficit in retained earnings. It is undertaken to avoid a bankruptcy. The assets and liabilities are revalued, and the deficit in retained earnings is eliminated via a reduction of paid-in-capital. The date of the quasi-reorganization should be disclosed.

As per ASC 852-20-25, *Reorganizations: Quasi-Reorganizations*, in a quasi-reorganization:

1. The approval of the stockholders and creditors is required.

2. Net assets are almost always written down (a write-up is possible) to fair market value. If a write-down is unavailable, a conservative estimate must be made. Significant subsequent adjustments to such estimates should be charged or credited to paid-in-capital.

3. Paid-in-capital is debited to reduce the deficit in retained earnings. If paid-in-capital is not sufficient, the capital stock account will be debited.

4. Retained earnings will acquire a zero balance and will bear the date of the quasi-reorganization for 10 years subsequent to the reorganization (ASC 852-20-35-2). This puts readers on notice that the company's retained earnings have undergone a readjustment and are not representative of historic earnings and dividends.

The basic entry for a quasi-reorganization is:

Paid-in-capital	xxx	
Capital stock (if required)	xxx	
Assets		xxx
Retained Earnings		xxx

Caution: If potential losses exist at the readjustment date but the amounts of losses cannot be determined, there should be a provision for the maximum probable loss. If estimates used are subsequently shown to be incorrect, the difference goes to the paid-in-capital account.

Note: New or additional common stock or preferred stock may be issued in exchange for existing indebtedness. Thus the current liability account would be debited for the indebtedness and the capital account credited.

A parent with subsidiaries must not wind up with a credit balance in retained earnings when losses and deficits have been charged to paid-in-capital.

Any deferred tax liabilities as well as any tax loss carryforwards should be reported as an adjustment to paid-in-capital when they are recognized in a year after the quasi-reorganization.

EXAMPLE

A business shows the following balances before a quasi-reorganization:

Current assets	$200,000	Capital stock	$1,600,000
Fixed assets	600,000	Paid-in-capital	300,000
		Retained earnings	(1,100,000)
	$800,000		$800,000

Current assets are overvalued by $40,000, and fixed assets are overvalued by $150,000. The entries for a quasi-reorganization are:

Quasi-reorganization	190,000	
Current assets		40,000
Fixed assets		150,000
Quasi-reorganization	1,100,000	
Retained earnings		1,100,000
Paid-in-capital	300,000	
Quasi-reorganization		300,000
Common stock	990,000	
Quasi-reorganization		990,000

Noncontrolling interest (also referred to as **minority interest**) represents the portion of stockholders' equity owned by the less than 50% shareholders. This will arise in consolidated statements when there are one or more subsidiaries with outside ownership. Under ASC 810-10-45-6, noncontrolling interest is reported in stockholders' equity, separate from the stockholders' equity of the controlling interest.

Disclosure

Disclosure should be made of the following regarding stockholders' equity: dividend and liquidation preferences, unusual voting rights, conversion features (e.g., dates, rates), participation rights, sinking fund provisions, agreements to issue additional shares, dividends in arrears, call features associated with redeemable stock, and any other relevant rights or privileges of stockholders.

Under ASC 810-10-50-1A, in consolidated financial statements, a parent with one or more less than wholly owned subsidiaries must disclose the following either in the consolidated statement of changes in stockholders' equity or in the notes to the consolidated financial statement: a reconciliation of equity at the

beginning and end of the period split between equity (net assets) attributable to the controlling interest and equity attributable to the noncontrolling interest. That reconciliation must separately disclose net income, transactions with owners, and each component of comprehensive income.

ASC 505-10-50-3 and 50-6, *Equity: Overall*, states that companies should disclose important conversion features of contingently convertible securities and the potential impact of conversion. Useful quantitative and qualitative disclosures include:

- A description of events that would result in conversion.
- Conversion rights and timing.
- The conversion price and number of shares to be converted.
- Circumstances resulting in an adjustment in a contingency.
- The transaction manner to settle a conversion (e.g., cash, shares, combination of both).
- Whether and how contingently convertible securities have been included in computing diluted earnings per share.
- A description of derivative transactions entered into as a result of the issuance of contingently convertible securities (e.g., the terms of derivative transactions, number of shares underlying the derivatives, and potential effect of the issuance of contingently convertible securities).

In **Accounting Standards Update (ASU)** No. 2010-21 (August 2010), *Accounting for Technical Amendments to Various SEC Rules and Schedules* (ASC 505-10-S99-1), in a note or statement, there should be an appraisal of changes in other stockholders' equity and noncontrolling interests. The beginning balance should be reconciled to the ending balance for each period; and disclosure should be provided of the change in ownership interest in a subsidiary.

Under ASC 470-10-S99-1, the parent company should provide its investment in its subsidiaries based on its proportionate share of a subsidiary's net assets. In the situation of redeemable preferred stock, there should be a description of its redemption terms (e.g., sinking fund) and the rights. A company should consolidate majority owned entities; and disclosure should be provided of noncontrolling interests in consolidated subsidiaries.

Summary

An illustrative stockholders' equity section of the balance sheet appears as follows:

Capital stock:		
Preferred stock	$1,000,000	
Common stock	3,000,000	
Common stock subscribed	300,000	
Common stock dividend distributable	30,000	
Stock options	100,000	
Stock dividends	50,000	
Total capital stock		$4,480,000
Additional paid-in-capital		
In excess of par value: common stock	$120,000	
From treasury stock transactions	80,000	
Total additional paid-in-capital		200,000
Retained earnings		
Appropriated	$100,000	
Unappropriated	600,000	
Total retained earnings		700,000
Subtotal		$5,380,000
Less: treasury stock at cost		(300,000)
Noncontrolling interest		200,000
Accumulated other comprehensive income		1,000,000
Total Stockholders' equity		$6,280,000

An illustrative statement of retained earnings follows:

Balance—1/1/2X12	$400,000
Less: correction of error (prior period adjustment)	(100,000)
Balance—restated—1/1/2X12	$300,000
Add: net income	550,000
Less: dividends	(150,000)
Balance—12/31/2X12	$700,000

Exhibit 7 shows a comprehensive stockholders' equity section from the balance sheet of a sample company that includes most of the equity items.

EXHIBIT 7

COMPREHENSIVE STOCKHOLDERS' EQUITY PRESENTATION

SAMPLE COMPANY STOCKHOLDERS' EQUITY DECEMBER 31, 2X13		
Capital stock		
Preferred stock, $100 par value, 7% cumulative, 100,000 shares authorized, 30,000 shares issued and outstanding		$ 3,000,000
Common stock, no par, stated value $10 per share, 500,000 shares authorized, 400,000 shares issued		4,000,000
Common stock dividend distributable, 20,000 shares		200,000
Total capital stock		7,200,000
Additional paid-in capital*		
Excess over par—preferred	$150,000	
Excess over stated value—common	840,000	990,000
Total paid-in capital		8,190,000
Retained earnings		4,360,000
Total paid-in capital and retained earnings		12,550,000
Less: Cost of treasury stock (2,000 shares, common)		
Accumulated other comprehensive loss[19]		(360,000)
Total stockholders' equity		$12,000,000

**Accounting Trends and Techniques-2007* reports that of its 600 surveyed companies, 549 had additional paid-in capital; 339 used the caption "Additional paid-in capital"; 101 used "Capital in excess of par or stated value" as the caption; 80 used "Paid-in capital" or "Additional capital"; and 29 used other captions.

IFRS Connection

The primary IFRS reporting standards related to stockholders' equity are IAS 1 (*Presentation of Financial Statements*), IAS 32 (*Financial Instruments: Presentation*), and IAS 39 (*Financial Instruments: Recognition and Measurement)*. The accounting for transactions related to stockholders' equity, such as issuance of shares, purchase of treasury stock, and declaration and payment of dividends, are similar under both IFRS and U.S. GAAP. Major differences relate to terminology used, introduction of items such as revaluation surplus, and presentation of stockholders' equity information.

Many countries have different investor groups than the United States. For example, in Germany, financial institutions like banks are not only the major creditors but often are the largest stockholders as well. In the United States and the United Kingdom, many companies rely on substantial investment from private investors.

The accounting for treasury stock retirements differs between IFRS and U.S. GAAP. Under U.S. GAAP a company has three options: (1) charge the excess of the cost of treasury stock over par value to retained earnings, (2) allocate the difference between paid-in capital and retained earnings, or (3) charge the entire amount to paid-in capital. Under IFRS, the excess may have to be charged to paid-in capital, depending on the original transaction related to the issuance of the stock.

A major difference between IFRS and U.S. GAAP relates to the account Revaluation Surplus. Revaluation surplus arises under IFRS because companies are permitted to revalue their property, plant, and equipment to fair value under certain circumstances. This account is part of general reserves under IFRS and is not considered contributed capital.

Both IFRS and U.S. GAAP consider the statement of stockholders' equity a primary financial statement. However, under IFRS a company has the option of preparing a statement of stockholders' equity similar to U.S. GAAP or preparing a statement of recognized income and expense (SoRIE). The SoRIE reports the items that were charged directly to equity such as revaluation surplus and then adds the net income for the period to arrive at total recognized income and expense. In this situation, additional note disclosure is required to provide reconciliations of other equity items.

Chapter Review Questions

6. Selected information from the accounts of Row Co. at December 31, Year 4, follows: Total income since incorporation = $420,000; Total cash dividends paid = $130,000; Total value of property dividends distributed = $30,000; Excess of proceeds over cost of treasury stock sold, accounted for using the cost method = $110,000. In its December 31, Year 4, financial statements, what amount should Row Co. report as retained earnings?

A. $260,000

B. $290,000

C. $370,000

D. $400,000

7. When a company declares a cash dividend, retained earnings is decreased by the amount of the dividend on the date of

A. Declaration.

B. Record.

C. Payment.

D. Declaration or record, whichever is earlier.

8. A corporation issuing stock should charge retained earnings for the market value of the shares issued in a(n)

A. Employee stock bonus.

B. Pooling of interests.

C. 10% stock dividend.

D. 2-for-1 stock split.

9. A company declared a cash dividend on its common stock in December 2001, payable in January 2X13. Retained earnings will

A. Increase on the date of declaration.

B. Not be affected on the date of declaration.

C. Not be affected on the date of payment.

D. Decrease on the date of payment.

10. Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

A. As dividend revenue at Guard's carrying amount of the stock.

B. As dividend revenue at the market value of the stock.

C. As a reduction in the total cost of Guard stock owned.

D. As a memorandum entry reducing the unit cost of all Guard stock owned.

Glossary

Additional paid-in capital. The excess over par value paid in by stockholders in return for the shares issued to them.

Callable preferred stock. Preferred stock that grants the issuer the right to purchase the stock from stockholders at specified future dates and prices.

Cash dividend. When a corporation distributes a dividend in cash to the stockholders.

Common stock. The residual corporate interest that bears the ultimate risks of loss and receives the benefits of success.

Contributed capital. Capital stock and additional paid-in capital (also called paid-in capital).

Contributed capital (paid-in capital). The total amount paid in on capital stock.

Convertible preferred stock. Preferred stock that provides for the exchange of preferred stock into common stock at a specified ratio.

Cost method. The Treasury Stock account is debited for the cost of the shares acquired and is credited upon reassurance for this same cost.

Cumulative feature. A feature of preferred stock entitling the stockholder to receive current and unpaid prior-year dividends before common stockholders receive dividends.

Date of declaration. The date the board of directors meets and approves the declaration of a dividend.

Date of payment. The date the board of directions has approved to pay a dividend.

Date of record. The date on which owners of the stock are entitled to a declared dividend.

Discount on stock. The amount under par value paid I by stockholders in return for the shares issued to them.

Dividend. When a corporation distributes a assets (or issues additional stock) to the stockholders.

Earned capital. Capital that develops if the business operates profitable; it consists of all undistributed income that remains invested in the enterprise.

Equity capital. The contributed capital and earned capital of a corporation.

Large stock dividend. A stock dividend f more than 20-25% of the number of shares previously outstanding.

Liquidating dividend. A dividend not based on retained earnings; implying that stockholders are receiving a return of their investment, rather than profits.

No-par stock. Shares issued with no per-share amount printed on the stock certificate.

Paid-in capital. Capital stock and additional paid-in capital (also called contributed capital).

Par value stock. Capital stock that has been assigned a value per share in the corporate charter; it establishes the maximum responsibility of a stockholder I the event of insolvency or other involuntary dissolution.

Participating dividends. A feature of preferred stock enabling the stockholder to share ratably with common stockholders in any dividends beyond the rate specified on the preferred stock.

Preemptive right. A stockholder's right to share proportionately in any issues of stock of the same class.

Preferred stock. Capital stock that has contractual preferences over common stock in certain areas.

Property dividend. When a corporation distributes a dividend of an asset other than cash to the stockholders.

Retained earnings. Earnings retained for use in the business.

Small (ordinary) stock dividend. Stock dividends of less than 20-25%.

Stated value. The amount per share assigned by the board of directors to no par stock that becomes legal capital per share.

Statement of stockholders' Equity. The disclosure of changes in the separate accounts comprising stockholders' equity.

Stock dividend. The corporation issues additional stock to its stockholders rather than distributing any assets.

Stock split. The corporation will issue additional stock to its stockholders; for example, the terms may indicate a split of 20-for-1 which would indicate that for every one share of stock a shareholders owns, they will receive and additional share of stock.

Stockholders' (owners') equity. The cumulative net contributions by stockholders (owners) plus recorded earnings that have been retained.

Treasury stock. A corporation's own stock that has been issued, fully paid for, and reacquired by the corporation but not retired.

Appendix:

Annual Report References

Note: Skim through this section for more annual report references

Qualcomm

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Note 7. Capital Stock

Preferred Stock. The Company has 8,000,000 shares of preferred stock authorized for issuance in one or more series, at a par value of $0.0001 per share. In conjunction with the distribution of preferred share purchase rights, 4,000,000 shares of preferred stock are designated as Series A Junior Participating Preferred Stock, and such shares are reserved for issuance upon exercise of the preferred share purchase rights. At September 26, 2010 and September 27, 2009, no shares of preferred stock were outstanding.

Preferred Share Purchase Rights Agreement. The Company has a Preferred Share Purchase Rights Agreement (Rights Agreement) to protect stockholders' interests in the event of a proposed takeover of the Company. Under the original Rights Agreement, adopted on September 26, 1995, the Company declared a dividend of one preferred share purchase right (a Right) for each share of the Company's common stock outstanding. Pursuant to the Rights Agreement, as amended and restated on December 7, 2006, each Right entitles the registered holder to purchase from the Company a one one-thousandth share of Series A Junior Participating Preferred Stock, $0.0001 par value per share, subject to adjustment for subsequent stock splits, at a purchase price of $180. The Rights are exercisable only if a person or group (an Acquiring Person) acquires beneficial ownership of 20% or more of the Company's outstanding shares of common stock without approval of the Board of Directors. Upon exercise, holders, other than an Acquiring Person, will have the right, subject to termination, to receive the Company's common stock or other securities, cash or other assets having a market value, as defined, equal to twice such purchase price. The Rights, which expire on September 25, 2015, are redeemable in whole, but not in part, at the Company's option prior to the time such Rights are triggered for a price of $0.001 per Right.

Stock Repurchase Program. On March 1, 2010, the Company announced that it had been authorized to repurchase up to $3.0 billion of the Company's common stock. The stock repurchase program has no expiration date. When stock is repurchased and retired, the amount paid in excess of par value is recorded to paid-in capital. During fiscal 2010, 2009 and 2008, the Company repurchased and retired 79,789,000,

8,920,000 and 42,616,000 shares of common stock, respectively, for $3.0 billion, $284 million and $1.7 billion, respectively, before commissions and excluding $14 million of premiums received related to put options that were exercised in fiscal 2008. At September 26, 2010, approximately $1.7 billion remained authorized for repurchase under the Company's stock repurchase program.

At September 26, 2010, September 27, 2009 and September 28, 2008, no put options remained outstanding. During fiscal 2008, the Company recognized gains of $6 million in investment income due to decreases in the fair values of put options, including premiums received of $14 million.

Dividends. The Company announced increases in its quarterly dividend per share of common stock from $0.14 to $0.16 on March 11, 2008, from $0.16 to $0.17 on March 3, 2009, and from $0.17 to $0.19 on March 1, 2010. Cash dividends announced in fiscal 2010, 2009 and 2008 were as follows (in millions, except per share data):

	2010		*2009*		*2008*	
	Per Share	*Total*	*Per Share*	*Total*	*Per Share*	*Total*
First quarter	$ 0.17	$ 284	$ 0.16	$ 264	$ 0.14	$ 228
Second quarter	0.17	279	0.16	264	0.14	227
Third quarter	0.19	309	0.17	282	0.16	261
Fourth quarter	0.19	305	0.17	283	0.16	266
	$ 0.72	$ 1,177	$ 0.66	$ 1,093	$ 0.60	$ 982

On October 13, 2010, the Company announced a cash dividend of $0.19 per share on the Company's common stock, payable on December 22, 2010 to stockholders of record as of November 24, 2010, which will be reflected in the consolidated financial statements in the first quarter of fiscal 2011.

Sherwin-Williams

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Note 11—Capital Stock

At December 31, 2009, there were 300,000,000 shares of common stock and 30,000,000 shares of serial preferred stock authorized for issuance. Of the authorized serial preferred stock, 3,000,000 shares are designated as cumulative redeemable serial preferred and 1,000,000 shares are designated as convertible serial preferred stock (see Note 12). An aggregate of 13,381,449, 14,884,028 and 16,477,802 shares of common stock at December 31, 2009, 2008 and 2007, respectively, were reserved for future grants of

restricted stock and the exercise and future grants of option rights (see Note 13). Common shares outstanding shown in the following table included 475,628 shares of common stock held in a revocable trust at December 31, 2009, 2008 and 2007, respectively. The revocable trust is used to accumulate assets for the purpose of funding the ultimate obligation of certain non-qualified benefit plans. Transactions between the Company and the trust are accounted for in accordance with the Deferred Compensation —Rabbi Trusts Subtopic of the Compensation Topic of the ASC, which requires the assets held by the trust be consolidated with the Company's accounts.

	Common Shares in Treasury	*Common Shares Outstanding*
Balance at January 1, 2007	89,419,575	133,565,287
Shares tendered as payment for option rights exercised	18,593	(18,593)
Shares issued for exercise of option rights		2,345,069
Shares tendered in connection with grants of restricted stock	125,022	(125,022)
Net shares issued for grants of restricted stock		247,500
Treasury stock purchased	13,200,000	(13,200,000)
Balance at December 31, 2007	102,763,190	122,814,241
Shares tendered as payment for option rights exercised	4,706	(4,706)
Shares issued for exercise of option rights		1,275,151
Shares tendered in connection with grants of restricted stock	93,569	(93,569)
Net shares issued for grants of restricted stock		294,000
Treasury stock purchased	7,250,000	(7,250,000)
Balance at December 31, 2008	**110,111,465**	**117,035,117**
Shares tendered as payment for option rights exercised	**9,743**	**(9,743)**
Shares issued for exercise of option rights		**1,075,395**
Shares tendered in connection with grants of restricted stock	**88,461**	**(88,461)**
Net shares issued for grants of restricted stock		**424,561**
Treasury stock purchased	**9,000,000**	**(9,000,000)**
Balance at December 31, 2009	**119,209,669**	**109,436,869**

Note 12—Stock Purchase Plan and Preferred Stock

As of December 31, 2009, 23,520 employees contributed to the Company's ESOP, a voluntary defined contribution plan available to all eligible salaried employees. Participants are allowed to contribute up to the lesser of twenty percent of their annual compensation or the maximum dollar amount allowed under the

Internal Revenue Code. Prior to July 1, 2009, the Company matched one hundred percent of all contributions up to six percent of eligible employee contributions. Effective July 1, 2009, the ESOP was amended to change the Company match to one-hundred percent on the first three percent of eligible employee contributions and fifty percent on the next two percent of eligible contributions. Such participant contributions may be invested in a variety of mutual funds or a Company common stock fund and may be exchanged between investments as directed by the participant. Effective January 1, 2007, the ESOP was amended to permit participants to diversify both future and prior Company matching contributions previously allocated to the Company common stock fund into a variety of mutual funds.

The Company made contributions to the ESOP on behalf of participating employees, representing amounts authorized by employees to be withheld from their earnings on a pre-tax basis, of $70,025, $72,812 and $71,691 in 2009, 2008 and 2007, respectively. The Company's matching contributions to the ESOP charged to operations were $44,587, $54,001 and $52,683 for 2009, 2008 and 2007, respectively.

At December 31, 2009, there were 17,579,750 shares of the Company's common stock being held by the ESOP, representing 16.0 percent of the total number of voting shares outstanding. Shares of Company common stock credited to each member's account under the ESOP are voted by the trustee under instructions from each individual plan member. Shares for which no instructions are received are voted by the trustee in the same proportion as those for which instructions are received.

On August 1, 2006, the Company issued 500,000 shares of convertible serial preferred stock, no par value (Series 2 Preferred stock) with cumulative quarterly dividends of $11.25 per share, for $500,000 to the ESOP. The ESOP financed the acquisition of the Series 2 Preferred stock by borrowing $500,000 from the Company at the rate of 5.5 percent per annum. This borrowing is payable over ten years in equal quarterly installments. Each share of Series 2 Preferred stock is entitled to one vote upon all matters presented to the Company's shareholders and generally votes with the common stock together as one class. The Series 2 Preferred stock is held by the ESOP in an unallocated account. As the value of compensation expense related to contributions to the ESOP is earned, the Company has the option of funding the ESOP by redeeming a portion of the preferred stock or with cash. Contributions are credited to the members' accounts at the time of funding. The Series 2 Preferred stock is redeemable for cash or convertible into common stock or any combination thereof at the option of the ESOP based on the relative fair value of the Series 2 Preferred and common stock at the time of conversion.

At December 31, 2009, 2008 and 2007, there were no allocated or committed-to-be released shares of Series 2 Preferred stock outstanding. In 2009, the Company elected to fund the ESOP with cash. The Company redeemed 107,980 and 108,482 shares of the Series 2 Preferred stock for cash in 2008 and 2007, respectively.

12. Shareholders' Equity

As of the filing date of this report, the Board of Directors had not yet declared a dividend related to fiscal 2009. The Company paid a $648 million dividend ($0.35 per share) during the second quarter of fiscal 2009 related to fiscal 2008. The Company paid a $664 million dividend ($0.35 per share) during the second quarter of fiscal 2008 related to fiscal 2007. The Company paid a $637 million dividend ($0.31 per share) during the second quarter of fiscal 2007 related to fiscal 2006.

During fiscal 2009, the Company repurchased 5 million shares of Disney common stock for $138 million. During fiscal 2008, the Company repurchased 139 million shares of Disney common stock for $4.5 billion. During fiscal 2007, the Company repurchased 202 million shares of Disney common stock for $6.9 billion. On May 1, 2007, the Board of Directors of the Company increased the share repurchase authorization in place to repurchase 179 million additional shares. The repurchase program does not have an expiration date.

In April 2008, the Company redeemed $1.3 billion of convertible senior notes. Pursuant to the redemption, substantially all of the notes were converted into 45 million shares of the Company's common stock.

The par value of the Company's outstanding common stock totaled approximately $26 million.

The Company also has 1.0 billion shares of Internet Group stock at $.01 par value authorized. No shares are issued and outstanding.

Accumulated other comprehensive income (loss), net of tax,(1) is as follows:

	October 3, 2009	*September 27, 2008*
Market value adjustments for hedges and investments	**$ 18**	$ 78
Foreign currency translation and other	**105**	137
Unrecognized pension and postretirement medical expense	**(1,767)**	(296)
Accumulated other comprehensive loss[1]	**$(1,644)**	$(81)

[1] Accumulated other comprehensive income(loss) and components of other comprehensive income(loss) are recorded net of tax using a 37% estimated statutory tax rate.

Review Question Answers

1. At December 31, Year 3 and Year 4, Carr Corp. had outstanding 4,000 shares of $100 par value, 6% cumulative preferred stock and 20,000 shares of $10 par value common stock. At December 31, Year 3, dividends in arrears on the preferred stock were $12,000. Cash dividends declared in Year 4 totaled $44,000. What amounts were payable on each class of stock?

A. Incorrect. Common stock will receive a portion of the cash dividends.
B. **Correct.** Given that the preferred stock is cumulative, dividends in arrears and the preferred dividends for the current period must be paid before common shareholders may receive dividends. The preferred dividends for the current year ending December 31, Year 4 are $24,000 (4,000 shares x $100 par value x 6%). Consequently, the preferred shareholders should receive $36,000 [$12,000 (Year 3 dividends in arrears) + $24,000]. The common shareholders will receive the remaining $8,000 ($44,000 - $36,000).
C. Incorrect. The amount of $36,000 of preferred dividends must be paid prior to paying any dividends on common stock.
D. Incorrect. The figure of $24,000 for preferred stock dividends omits the $12,000 dividends in arrears that must be paid prior to paying dividends on common stock.

2. Sperry Corp.'s records included the following equity accounts: 20,000 shares of Preferred stock authorized with a par value of $15 (authorized) recorded at $255,000. Additional paid-in capital of preferred stock recorded at $15,000. 100,000 shares authorized of Common stock with no par value and a stated value of $5 recorded at $300,000. In Sperry's statement of equity, the number of issued and outstanding shares for each class of stock is

A. **Correct.** If an entity does not hold any stock as treasury stock, the number of shares of each type of stock may be determined by dividing the amount allocated to each stock account by the related par value or stated value. The number of shares of preferred stock issued and outstanding is therefore 17,000 ($255.000 ÷ $15 par value) and the number of shares of common stock issued and outstanding is 60,000 ($300,000 ÷ $5 stated value).
B. Incorrect. 18,000 shares of preferred would have a par value of $270,000.
C. Incorrect. 63,000 shares of common would have a stated value of $315,000.
D. Incorrect. 18,000 shares of preferred would have a par value of $270,000 and 63,000 shares of common stock would have a stated value of $315,000.

3. East Co. issued 1,000 shares of its $5 par common stock to Howe as compensation for 1,000 hours of legal services performed. Howe usually bills $160 per hour for legal services. On the date of issuance, the stock was trading on a public exchange at $140 per share. By what amount should the additional paid-in capital account increase as a result of this transaction?

A. **Correct.** When stock is issued in exchange for property or services, the transaction is recorded at the more clearly determinable of the fair values of the stock issued or of the property or services received. In this case, the value of the stock is used because it is more definite. The entry to record the transaction is: Legal expense (1,000 shares x $140 market price) = $140,000; Common stock (1,000 shares x $5 par value) = $5,000; Additional paid-in capital (difference) = $135,000.
B. Incorrect. The amount of $5,000 should be allocated to common stock.
C. Incorrect. The value of the stock should be used to record the transaction.
D. Incorrect. The amount of $5,000 should be allocated to common stock, and the value of the stock should be used to record the transaction.

4. Nest Co. issued 100,000 shares of common stock. Of these, 5,000 were held as treasury stock at December 31, Year 3. During Year 4, transactions involving Nest's common stock were as follows: On May 3 1,000 shares of treasury stock were sold; on August 6, 10,000 shares of previously unissued stock were sold; November 18, a 2-for-1 stock split took effect. Laws in Nest's state of incorporation protect treasury stock from dilution. At December 31, Year 4, how many shares of Nest's common stock were issued and outstanding?

A. **Correct.** In Nest's state, stock splits and dividends apply to treasury stock. Accordingly, the number of shares issued is 220,000 [(100,000 + 10,000) x 2]. The number of shares outstanding is 212,000 [(95,000 + 1,000 + 10,000) x 2].
B. Incorrect. The figure 216,000 does not properly account for the stock split on the treasury stock.
C. Incorrect. The figure 222,000 includes 1,000 shares of treasury stock sold on May 3 twice [(100,000 + 1,000 + 10,000) x 2]. A
D. Incorrect. The figure 222,000 includes 1,000 shares of treasury stock sold on May 3 twice [(100,000 + 1,000 + 10,000) x 2]. Moreover, 218,000 shares outstanding includes 4,000 treasury stock shares that are not outstanding [(95,000 + 4,000 + 10,000) x 2].

5. Asp Co. was organized on January 2, Year 4, with 30,000 authorized shares of $10 par common stock. During Year 4, the corporation had the following capital transactions: On January 5, it issued 20,000 shares at $15 per share. On July 14, it purchased 5,000 shares at $17 per share. On December 27, it reissued the 5,000 shares held in treasury at $20 per share. Asp Co. used the *par value method* to record the purchase

and reissuance of the treasury shares. It had no prior treasury stock transactions. In its December 31, Year 4, balance sheet, what amount should Asp report as additional paid-in capital?

A. Incorrect. The amount of $100,000 does not reflect the acquisition and reissuance of treasury stock.
B. **Correct.** Under the *par value method*, additional paid-in capital is debited for $25,000 (5,000 shares x $5 excess of the issue price over par) when the treasury stock is acquired. Treasury stock is debited for the $50,000 par value (5,000 shares x $10), and retained earnings is debited for $10,000 [5,000 shares x ($17 - $15)]. When the stock is reissued, additional paid-in capital is credited for $50,000 (5,000 shares x $10 excess over par). Thus, ending additional paid-in capital is $125,000 ($100,000 - $25,000 + $50,000).
C. Incorrect. The amount of $140,000 does not include the $25,000 debit to additional paid-in capital but does include the $10,000 amount that should be debited to retained earnings
D. Incorrect. The amount of $150,000 does not reflect the $25,000 debit resulting from the purchase of treasury stock.

6. Selected information from the accounts of Row Co. at December 31, Year 4, follows: Total income since incorporation = $420,000; Total cash dividends paid = $130,000; Total value of property dividends distributed = $30,000; Excess of proceeds over cost of treasury stock sold, accounted for using the cost method = $110,000. In its December 31, Year 4, financial statements, what amount should Row Co. report as retained earnings?

A. **Correct.** Retained earnings is increased by net income and decreased by net losses, dividends, and certain treasury stock transactions. Thus, retained earnings is $260,000 ($420,000 - $130,000 - $30,000). Because Row uses the *cost method* to account for treasury stock, the $110,000 excess of proceeds over the cost of treasury stock sold does not affect retained earnings. Under the cost method, the excess should be credited to additional paid-in capital.
B. Incorrect. The amount of $290,000 fails to subtract the $30,000 in property dividends.
C. Incorrect. The amount of $370,000 includes the $110,000 excess of proceeds over cost of treasury stock.
D. Incorrect. The amount of $400,000 includes the $110,000 excess of proceeds over cost of treasury stock and does not subtract the $30,000 value of property dividends distributed.

7. When a company declares a cash dividend, retained earnings is decreased by the amount of the dividend on the date of

A. **Correct.** Retained earnings is debited and dividends payable is credited on the date of declaration.
B. Incorrect. No entry is made on the record date.

C. Incorrect. Dividends payable is debited and cash is credited at the payment date.
D. Incorrect. No entry is made on the record date.

8. A corporation issuing stock should charge retained earnings for the market value of the shares issued in a(n)

A. Incorrect. The debit for an employee stock bonus is to compensation expense.
B. Incorrect. In a pooling of interests, owners' equity amounts of the participating entities are combined at current book values.
C. **Correct.** GAAP states that a small stock dividend (one in which the number of shares issued is fewer than 20 to 25% of those outstanding) should be accounted for by debiting retained earnings for the fair value of the stock and crediting a capital stock account for the par or stated value. A difference between the fair value and the par or stated value is credited to an additional paid-in capital account. Hence, retained earnings decreases, but total equity does not change.
D. Incorrect. A stock split has no effect on the capital accounts.

9. A company declared a cash dividend on its common stock in December 2001, payable in January 2X13. Retained earnings will

A. Incorrect. Retained earnings decrease on the declaration date.
B. Incorrect. Retained earnings is affected on the declaration date.
C. **Correct.** When cash dividends are declared, a liability to the shareholders is created because the dividends must be paid once they are declared. At the declaration date, retained earnings must be debited, resulting in a decrease in retained earnings. When the cash dividends are subsequently paid, the cash dividends payable account is debited and a cash account credited. Thus, at the payment date, the amount of retained earnings is not affected.
D. Incorrect. The amount of retained earnings is not affected on the payment date.

10. Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

A. Incorrect. The receipt of a stock dividend is not a revenue. The shareholder has the same proportionate interest in the investee.
B. Incorrect. The stock dividend does not result in revenue.
C. Incorrect. The cost per share, not the total cost, is reduced.

D. **Correct.** No entries are made to record the receipt of stock dividends. However, a memorandum entry should be made in the investment account to record additional shares owned. This treatment applies whether the investment is accounted for by the fair-value method, the equity method, or the cost method.