**CHAPTER 11**

**Answers to EOC Questions, Mini-Exercises, Multiple Choice Questions,**

**and Assigned Exercises and Problems.**

ANSWERS TO QUESTIONS

1. A corporation is a separate legal entity (authorized by law to operate as an individual). It is owned by a number of persons and/or entities whose ownership is evidenced by shares of capital stock. Its primary advantages are: (a) transferability of ownership, (b) limited liability to the owners, and (c) the ability to accumulate large amounts of resources.

2. The charter of a corporation is a legal document from the state that authorizes its creation as a separate legal entity. The charter specifies the name of the entity, its purpose, and the kinds and number of shares of capital stock it can issue.

3. (a) Authorized capital stock—the maximum number of shares of stock that can be sold and issued as specified in the charter of the corporation.

(b) Issued capital stock—the total number of shares of capital stock that have been issued by the corporation at a particular date.

(c) Outstanding capital stock—the number of shares currently owned by the stockholders.

4. Common stock—the usual or normal stock of the corporation. It is the voting stock and generally ranks after the preferred stock for dividends and assets distributed upon dissolution. Often it is called the residual equity. Common stock may be either par value or no-par value.

Preferred stock—when one or more additional classes of stock are issued, the additional classes are called preferred stock. Preferred stock has modifications that make it different from common stock. Generally, preferred stock has both favorable and unfavorable features in comparison with common stock. Preferred stock usually is par value stock and usually specifies a dividend rate such as “6% preferred stock.”

5. Par value is a nominal per share amount established for the common stock and/or preferred stock in the charter of the corporation, and is printed on the face of each stock certificate. The stock that is sold by a corporation to investors above par value is said to have sold at a premium, while stock that is sold below par is said to have sold at a discount. The laws of practically all states forbid the initial sale of stock by a corporation to investors below par value. No-par value stock does not have an amount per share specified in the charter. As a consequence, it may be issued at any price without involving a discount or a premium. It avoids giving the impression of a value that is not present.

6. The usual characteristics of preferred stock are: (1) dividend preferences, (2) conversion privileges, (3) asset preferences, and (4) nonvoting specifications.

7. The two basic sources of stockholders’ equity are:

Contributed capital—the amount invested by stockholders by purchase from the corporation of shares of stock. It is comprised of two separate elements: (1) the par or stated amount derived from the sale of capital stock (common or preferred) and (2) the amount received in excess of par or stated value.

Retained earnings—the accumulated amount of all net income since the organization of the corporation, less losses and less the accumulated amount of dividends paid by the corporation since organization.

8. Stockholders’ equity is accounted for in terms of source. This means that several accounts are maintained for the various sources of stockholders’ equity, such as common stock, preferred stock, contributed capital in excess of par, and retained earnings.

9. Treasury stock is a corporation’s own capital stock that was sold (issued) and subsequently reacquired by the corporation. Corporations frequently purchase shares of their own capital stock for sound business reasons, such as to obtain shares needed for employees’ bonus plans, to influence the market price of the stock, to increase earnings per share amounts, and to have shares on hand for use in the acquisition of other companies. Treasury stock, while held by the issuing corporation, confers no voting, dividend, or other stockholder rights.

10. Treasury stock is reported on the balance sheet under stockholders’ equity as a deduction; that is, as contra stockholders’ equity. Any “gain or loss” on treasury stock that has been sold is reported on the financial statements as an addition to contributed capital if a gain; if a loss, it is deducted from any previous contributed capital, or otherwise from retained earnings.

11. The two basic requirements to support a cash dividend are: (1) cash on hand or the ability to obtain cash sufficient to pay the dividend and (2) a sufficient balance in retained earnings, because the dividend represents a return of earnings to the stockholders. A cash dividend reduces both the assets of a corporation and stockholders’ equity by the amount of the dividend.

12. Cumulative preferred stock has a dividend preference such that, should the dividends on the preferred stock for any year, or series of years, not be paid, dividends cannot be paid to the common stockholders until all such dividends in arrears are paid to the preferred stockholders. Noncumulative preferred stock does not have this preference; therefore, dividends not paid in past periods will never be paid to the preferred stockholders.

13. A stock dividend involves the issuance to the stockholders of a dividend in the corporation’s own stock (rather than cash). A stock dividend is significantly different from a cash dividend in that the corporation does not disburse any assets, while in the case of a cash dividend, cash is decreased by the amount of the dividend. A cash dividend also reduces total stockholders’ equity by the amount of the dividend. In contrast, a stock dividend does not change total stockholders’ equity.

14. The primary purposes for issuing a stock dividend are: (1) to maintain dividend consistency; that is, to pay dividends each year either in cash or in capital stock, and (2) to capitalize retained earnings; that is, a stock dividend requires a transfer from the Retained Earnings account to the permanent contributed capital accounts for the amount of the dividend. Although this transfer does not change stockholders’ equity in total, it does cause a shift from retained earnings to contributed capital.

15. When a dividend is declared and paid, the three important dates are:

Declaration date—the date on which the board of directors votes the dividend. In the case of a cash dividend, a dividend liability comes into existence on this date and must be recorded as a debit to Retained Earnings and as a credit to Dividends Payable.

Date of record—this date usually is about one month after the date of declaration. It is the date on which the corporation extracts from its stockholders’ records the list of individuals owning shares. The dividend is paid only to those names listed on the record date. No entry in the accounts is made on this date.

Date of payment—the date on which the cash is disbursed to pay the dividend. It follows the date of record as specified in the dividend announcement. The entry to record the cash disbursement for the dividend is a debit to Dividends Payable and a credit to Cash.

16. Retained earnings is the accumulated amount of all net income of the corporation less all losses and less the accumulated amount of all dividends declared to date. The primary components of retained earnings are: beginning balance, plus net income, less net losses, minus dividends declared, equals the ending balance.

ANSWERS TO MULTIPLE CHOICE

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1. c) | 1. d) | 1. b) | 1. a) | 1. c) |
| 1. b) | 1. c) | 1. c) | 1. d) | 1. a) |

**MINI- EXERCISES**

**M11–1.**

Stockholders may:

1. Vote in the stockholders’ meeting (or by proxy) on major issues concerning management of the corporation.
2. Participate proportionately with other stockholders in the distribution of the corporation’s profits.
3. Share proportionately with other stockholders in the distribution of corporate assets upon liquidation.

Being able to vote is the most important of the rights because this ensures that the owners have an input at the stockholders’ meeting and some control of the management of the corporation, thus enabling them to protect their rights as stockholders.

**M11–2.**

Unissued shares = 90,000 (268,000 – 178,000)

**M11–3.**

|  |  |  |
| --- | --- | --- |
| Cash (170,000 × $21) (+A) | 3,570,000 |  |
| Common Stock (170,000 × $1) (+SE) |  | 170,000 |
| Capital in Excess of Par (+SE) |  | 3,400,000 |

The journal entry would be different if the par value were $2:

|  |  |  |
| --- | --- | --- |
| Cash (170,000 × $21) (+A) | 3,570,000 |  |
| Common Stock (170,000 × $2) (+SE) |  | 340,000 |
| Capital in Excess of Par (+SE) |  | 3,230,000 |

**M11–4.**

Common stock is the basic voting stock issued by a corporation. It ranks after preferred stock for dividends and assets distributed upon liquidation of the corporation. The dividend rate for common stock is determined by the board of directors, and is based on the company’s profitability. The dividend rate for preferred stock is fixed by a contract. Common stock has more potential for growth than preferred stock if the company is profitable. On the other hand, the investor may lose more money with common stock than with preferred stock if the company is not profitable.

Usually, It is advisable to invest in the common stock if you believe the company will be profitable. Common stock will receive a higher return on the $100,000 than preferred stock would.

**M11–5.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Assets | Liabilities | Stockholders’ Equity | Net Income |
| Purchased 20,000 shares of treasury stock | Decrease by $900,000 | No change | Decrease by $900,000 | No change |
| Sold 5,000 shares | Increase by $250,000 | No change | Increase by $250,000 | No change |
| Sold 10,000 shares | Increase by $370,000 | No change | Increase by $370,000 | No change |

**M11–6.**

|  |  |  |
| --- | --- | --- |
| 200,000 X $0.65 | = | $130,000 |

**M11–7.**

April 15:

|  |  |  |
| --- | --- | --- |
| Retained Earnings (-SE) | 65,000 |  |
| Dividends Payable (+L) |  | 65,000 |

June 14:

|  |  |  |
| --- | --- | --- |
| Dividends Payable (-L) | 65,000 |  |
| Cash (-A) |  | 65,000 |

**M11–8.**

|  |  |  |  |
| --- | --- | --- | --- |
| Past Year | 200,000 shares × $2 | = | $400,000 |
| Current Year | 200,000 shares × $2 | = | $400,000 |
| Total to Preferred Stockholders |  |  | $800,000 |

**M11–9.**

|  |  |
| --- | --- |
| Stock Dividend | Stock Split |
| No change in assets | No change in assets |
| No change in liabilities | No change in liabilities |
| Increase in common stock | No change in common stock |
| No change in stockholders’ equity: decrease retained earnings and increase contributed capital by the same amount. | No change in stockholders’ equity |
| Decreases market value | Decrease in market value |

**M11–10.**

|  |  |  |
| --- | --- | --- |
| Retained Earnings (-SE) | 800,000 |  |
| Common Stock (+SE) |  | 800,000 |

**EXERCISES**

**E11–3.**

Req. 1

|  |  |
| --- | --- |
| Stockholders’ Equity | |
| Contributed capital: |  | |
| Preferred stock, authorized 4,000 shares,  issued and outstanding, 3,000 shares | $ 24,000 | |
| Common stock, authorized 103,000 shares, issued and outstanding, 20,000 shares | 200,000 | |
| Capital in excess of par, preferred | 36,000 | |
| Capital in excess of stated value, no-par common | 120,000 | |
| Total contributed capital | 380,000 | |
| Retained earnings | 60,000 | |
| Total Stockholders’ Equity | $440,000 | |

Req. 2

The answer would depend on the profitability of the company and the stability of its earnings. The preferred stock has a 9% dividend rate. If the company earns more than 9%, the additional earnings would accrue to the current stockholders. If the company earns less than 9%, it would pay a higher rate to the preferred stockholders.

**E11–9.**

|  |  |
| --- | --- |
| Stockholders’ Equity | |
| Contributed capital: |  | |
| Preferred stock, 8%, par $50, authorized 59,000 shares,    issued and outstanding, 20,000 shares | $1,000,000 | | |
| Common stock, par $10, authorized 98,000 shares,     issued, 78,000 shares | 780,000 | | |
| Capital in excess of par, preferred stock | 600,000 | | |
| Capital in excess of par, common stock | 780,000 | | |
| Treasury stock | (80,000) | | |
| Retained earnings\* | 160,000 | | |
| Total stockholders’ equity | $3,240,000 | | |

\*($210,000 – $50,000 = $160,000.)

**E11–16.**

Req. 1

|  |  |  |  |
| --- | --- | --- | --- |
| Feb. 1: |  |  |  |
| Treasury stock, common (160 shares x $20) (+XSE, -SE) | 3,200 |  |  |
| Cash (-A) |  |  | 3,200 |
|  |  |  |  |
| July 15: |  |  |  |
| Cash (80 shares x $21) (+A) | 1,680 |  |  |
| Treasury stock, common (-XSE, +SE) |  |  | 1,600 |
| Capital in excess of par (+SE) |  |  | 80 |
|  |  |  |  |
| Sept. 1: |  |  |  |
| Cash (50 shares x $19) (+A) | 950 |  |  |
| Capital in excess of par (-SE) | 50 |  |  |
| Treasury stock, common (50 shares x $20) (-XSE, +SE) |  |  | 1,000 |
| . |  |  |  |

Req. 2

Dividends are not paid on treasury stock. Therefore, the amount of total cash dividends paid is reduced when treasury stock is purchased.

Req. 3

The sale of treasury stock for more or less than its original purchase price does not have an impact on net income. The transaction affects only balance sheet accounts. The cash received from the sale of treasury stock is a cash inflow which would affect the Statement of Cash Flows in the financing activities section.

**E11–19.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Item |  | Effect of Cash Dividend (Preferred) |  | Effect of Stock Dividend (Common) |
| Assets |  | –No effect on declaration date.  –Decreased by the amount of the dividend ($7,200) on payment date. |  | No effect because no assets are disbursed. |
| Liabilities |  | –Increased on declaration date ($7,200).  –Decreased on payment date ($7,200). |  | No effect—no entry on declaration date because no contractual liability is created (no assets are disbursed). |
| Stockholders’ equity |  | Decreased by the amount of the dividend (retained earnings decreased by $7,200). |  | –Total stockholders’ equity not changed.  –Retained earnings reduced and contributed capital increased by same amount ($120,000). |

**E11–21.**

Req. 1

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | Stockholders’ Equity | | | | | |
|  |  | Before Stock Dividend | |  |  | After Stock Dividend | |
| Contributed capital: |  |  |  |  |  |  |  |
| Common stock, authorized 65,000 shares |  |  |  |  |  |  |  |
| Outstanding: 30,000 shares, par $12 |  | $360,000 |  |  |  |  |  |
| Outstanding: 48,000 shares, par $12 |  |  |  |  |  | $576,000 |  |
| Capital in excess of par value |  | 120,000 |  |  |  | 120,000 |  |
| Retained earnings |  | 580,000 |  |  |  | 364,000 |  |
| Total stockholders’ equity |  | $1,060,000 |  |  |  | $1,060,000 |  |

Req. 2

|  |  |  |
| --- | --- | --- |
| **Item** |  | **Effects of Stock Dividend** |
| Assets |  | No change because no assets were disbursed. |
| Liabilities |  | No change because no liability was created (no assets were to be disbursed). |
| Stockholders’ equity |  | –Total stockholders’ equity not changed.  –Retained earnings was reduced by the amount of the dividend.  –The common stock account was increased by the same amount. |