Chapter 18 Shareholders’ Equity

THE NATURE OF SHAREHOLDERS’ EQUITY

Financial Reporting Overview
The ownership interests of the shareholders of a corporation are represented by two accounts.

- **Paid-in capital**
  - Amounts invested in the corporation by the shareholders
- **Retained earnings**
  - Amounts earned and retained by the corporation

Adjustments to ownership are reflected in other comprehensive income. These are changes in owners’ equity that are not the result of transactions between the corporation and the shareholders and are not reported in the traditional income statement. There are two terms used to describe these types of transactions.

- **Other comprehensive income**
  - Changes in owners’ equity that take place during the accounting period
- **Accumulated other comprehensive income**
  - The balance of accumulated changes as of the balance sheet date

For a number of reasons management may choose to repurchase shares of stock that were previously sold to the public. If these shares are held on a temporary basis for resale or reissue they are classified as **Treasury Stock**. Treasury stock is not an asset but is rather classified as a contra-equity account.

The Corporate Organization
A business entity may operate under a variety of legal structures. For a number of reasons the corporate form of business organization is used most frequently. In this course we are interested in companies that issue stock in exchange for capital contributions. There are two kinds of stock companies; closely-held or private companies in which the stock is held by a limited number of parties and not available to the general public; and public corporations for which stock is either listed on a stock exchange or available over-the-counter.

Articles of incorporation are filed with the secretary of state to form a corporation. If the business operates in more than one state it must file as a foreign corporation in each state in which it does business.

Limited Liability
The primary advantage of the corporate form of business is limited liability. This means that stockholders losses are limited to the amount they invest in the corporation. If the stock is issued at par or at a premium, there is no obligation on the part of the stockholder if the corporation ends up insolvent. On the other hand if the stock is issued at a discount then the stockholder might have a contingent liability for corporate debts for the difference between the par value and the purchase price. This is a very rare situation. Most stock is sold at a premium.
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**Formality of Profit Distribution**
Distributions to stockholders are made in the form of dividends. Dividends must be approved by the board of directors and must be in compliance with state laws. If there is preferred and common stock the dividends must meet the contractual obligations with regard to preferences and participation.