

ANSWERS TO QUESTIONS

1.
 - (a) Separate legal existence. A corporation is separate and distinct from its owners and it acts in its own name rather than in the name of its stockholders. In contrast to a partnership, the acts of the owners (stockholders) do not bind the corporation unless the owners are duly appointed agents of the corporation.
 - (b) Limited liability of stockholders. Because of its separate legal existence, creditors of a corporation ordinarily have recourse only to corporate assets to satisfy their claims. Thus, the liability of stockholders is normally limited to their investment in the corporation.
 - (c) Transferable ownership rights. Ownership of a corporation is shown in shares of capital stock. The shares are transferable units. Stockholders may dispose of part or all of their interest by simply selling their stock. The transfer of ownership to another party is entirely at the discretion of the stockholder.

2.
 - (a) Corporation management is an advantage to a corporation because it can hire professional managers to run the company. Corporation management is a disadvantage to a corporation because it prevents owners from having an active role in directly managing the company.
 - (b) Two other disadvantages of a corporation are government regulations and additional taxes. A corporation is subject to numerous state and federal regulations. For example, state laws prescribe the requirements for issuing stock, and federal securities laws govern the sale of stock to the general public. Corporations must pay both federal and state income taxes. These taxes are substantial. In addition, stockholders must pay income taxes on cash dividends received.

3.
 - (a)
 - (1) A charter is a document that creates a corporation. A charter is also referred to as the articles of incorporation.
 - (2) The by-laws are the internal rules and procedures for conducting the affairs of a corporation. They also indicate the powers of the stockholders, directors, and officers of the corporation.
 - (3) Organization costs are costs incurred in the formation of a corporation. Organization costs are expensed as incurred.
 - (b) Incorrect. A corporation must be incorporated in only one state. It is to the company's advantage to incorporate in a state whose laws are favorable to the corporate form of business organization. A corporation may incorporate in a state in which it does not have a headquarters office or major operating facilities.

4. In the absence of restrictive provisions, the basic ownership rights of common stockholders are the rights to:
 - (1) vote in the election of board of directors and in corporate actions that require stockholders' approval.
 - (2) share in corporate earnings through the receipt of dividends.
 - (3) keep the same percentage ownership when new shares of common stock are issued (the preemptive right).
 - (4) share in assets upon liquidation.

5.
 - (a) The two principal components of stockholders' equity for a corporation are paid-in capital (the investment of cash and other assets in the corporation by stockholders in exchange for capital stock) and retained earnings. The principal source of retained earnings is net income.
 - (b) Paid-in capital is the term used to describe the total amount paid-in on capital stock. Paid-in capital may result through the sale of common stock, preferred stock, or treasury stock.

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6. Each of the three basic financial statements for a corporation differs from those for a proprietorship. The income statement for a corporation will have income tax expense. For a corporation, a retained earnings statement is prepared to show the changes in retained earnings during the period. In the balance sheet, the owner's equity section is called the stockholders' equity section.
7. The maximum number of shares that a corporation is legally allowed to issue is the number authorized. Hawes Corporation is authorized to sell 100,000 shares. Of these shares, 70,000 shares have been issued. Outstanding shares are those issued shares which have not been reacquired by the corporation; in other words, issued shares less treasury shares. Hawes has 63,000 shares outstanding (70,000 issued less 7,000 treasury).
8. The par value of common stock has no effect on its market value. Par value is a legal amount per share which usually indicates the minimum amount at which a share of stock can be issued. The market value of stock depends on a number of factors, including the company's anticipated future earnings, its expected dividend rate per share, its current financial position, the current state of the economy, and the current state of the securities markets. Therefore, either investment mentioned in the question could be the better investment, based on the above factors and future potential. The relative par values should have no effect on the investment decision.
9. Among the factors which influence the market value of stock are the company's anticipated future earnings, its expected dividend rate per share, its current financial position, the current state of the economy, and the current state of the securities markets.
10. The issuance of stock does not have any effect on the issuer's net income. If stock is issued at a price above par, the excess is credited to a stockholders' equity account, Paid-in Capital in Excess of Par. This excess is part of the company's paid-in capital.
11. The sale of common stock below par value is not permitted in most states.
12. When stock is issued for services or noncash assets, the cost should be measured at either the fair market value of the consideration given up (in this case, the stock) or the fair market value of the consideration received (in this case, the land), whichever is more clearly evident. In this case, the fair market value of the stock is more objectively determinable than that of the land, since the stock is actively traded in the securities market. The appraised value of the land is merely an estimate of the land's value, while the market price of the stock is the amount the stock was actually worth on the date of exchange. Therefore, the land should be recorded at \$95,000, the common stock at \$20,000, and the excess (\$75,000) as paid-in capital in excess of par value.
13. A corporation may acquire treasury stock: (1) to reissue the shares to officers and employees under bonus and stock compensation plans, (2) to increase trading of the company's stock in the securities market in the hope of enhancing its market value, (3) to have additional shares available for use in the acquisition of other companies, (4) to reduce the number of shares outstanding and, thereby, increase earnings per share, and (5) to rid the company of disgruntled investors.
14. When treasury stock is purchased, treasury stock is debited and cash is credited at cost (\$12,000 in this example). Treasury stock is a contra stockholders' equity account and cash is an asset. Thus, this transaction: (a) has no effect on net income, (b) decreases total assets, (c) has no effect on total paid-in capital, and (d) decreases total stockholders' equity.

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15. When treasury stock is resold at a price above original cost, Cash is debited for the amount of the proceeds (\$18,000), Treasury Stock is credited at cost (\$12,000), and the excess (\$6,000) is credited to Paid-in Capital from Treasury Stock. Cash is an asset, and the other two accounts are part of stockholders' equity. Therefore, this transaction: (a) has no effect on net income, (b) increases total assets, (c) increases total paid-in capital, and (d) increases total stockholders' equity.
16. (a) Common stock and preferred stock both represent ownership of the corporation. Common stock signifies the basic residual ownership; preferred stock is ownership with certain privileges or preferences. Preferred stockholders typically have a preference as to dividends and as to assets in the event of liquidation. However, preferred stockholders generally do not have voting rights.
 (b) Some preferred stocks possess the additional feature of being cumulative. Most preferred stock is cumulative—preferred stockholders must be paid both current-year dividends and unpaid prior year dividends before common stockholders receive any dividends.
 (c) Dividends in arrears are disclosed in the notes to the financial statements.
17. The formula for computing book value per share when a corporation has only common stock outstanding is:

$$\frac{\text{Total Stockholders' Equity}}{\text{Number of Common Shares Outstanding}} = \text{Book Value per Share}$$

Book value per share represents the equity a common stockholder has in the net assets of the corporation from owning one share of stock.

18. Par value is a legal amount per share, often set at an arbitrarily selected amount, which usually indicates the minimum amount at which a share of stock can be issued. Book value per share represents the equity a common stockholder has in the net assets of the corporation from owning one share of stock. If the corporation has been reinvesting some of its earnings over the years, or if the stock was originally issued above par, or both, the book value per share will exceed the par value. Market value is generally unrelated to par value and at best only remotely related to book value. A stock's market value will reflect many factors, including the company's anticipated future earnings, its expected dividend rate per share, its current financial position, the current state of the economy, and the current state of the securities markets.
19. The answers are summarized in the table below:

Account	Classification
(a) Common Stock	Paid-in capital—capital stock
(b) Paid-in Capital in Excess of Par Value	Paid-in capital—additional paid-in capital
(c) Retained Earnings	Retained earnings
(d) Treasury Stock	Deducted from total paid-in capital and retained earnings
(e) Paid-in Capital from Treasury Stock	Paid-in capital—additional paid-in capital
(f) Paid-in Capital in Excess of Stated Value	Paid-in capital—additional paid-in capital
(g) Preferred Stock	Paid-in capital—capital stock