**CHAPTER-6-**

**Corporation Organization and Operation**

**Corporation** –is a legal entity distinct and separate from its owners. As an artificial legal being, a corporation may acquire, own, and dispose of property in its own name. It may also borrow money enter to contract sued be sued.

**Characteristics of corporation**

A number of characteristics distinguish a corporation from proprietorship and partnership.

1. **Separate legal entity**- A Corporation acts as an artificial person separate and distinct from their owners who are called stockholders or shareholders.
2. **Limited liability**-The liability of stockholders limited in their investment in the corporation, and creditors have on legal claim on personal assets of the owner.
3. **Continuous life and transferability of ownership**- The ownership of a corporation is divided in to shares of stock, which are transferable unit. This makes a corporation to have a continuous life regardless of change in the ownership of their stock.
4. **Corporate taxation**-corporations are separate taxable entities .They pay a variety of taxes not required for proprietorship and partnership
5. **Separation of ownership and management**-stockholders own the business, but a board of directors elected by stockholders –appoint corporate officers to manage the business.

**Advantages corporate form of organization.**

Several characteristics of corporation may make this form of organization more desirable than either a partnership or a proprietorship.

1. **Greater amount of capital can be raised**-large number of individual and institutions can more easily and efficiently acquire and dispose of ownership interest in a corporation than in a partnership.
2. **Owners liability is limited to the amount invested in the corporation**
3. **Ownership shares area easily transferable** –After the initial sale of stock, shares may be transferred in private sale transaction, traded (soled) on with out asking for approval from the Co. Management.
4. **Continuity of existence**-reefers to the unlimited life of a corporation the transfer of shares dose not affect the corporation’s ability to operate routinely over decades.
5. **Professional management** –the excellent record of growth and earnings in most large corporation indicate that the separation of ownership and control has benefited rather than injured stockholders.

**Disadvantages corporate form of organization.**

1. Double taxation exists –Income of a corporation is taxed twice.
2. Government regulation exists-corporation is subject more to government regulations than either proprietorship or partnership.
3. Not easy to form.
4. Large setting up cost.

**Formation of a corporation**

Creation of a corporation begins when its organizers, called the incorporators, obtain a charter form the state. The charter includes the authorization for the corporation to issue a certain number of shares of stock, which are shares of ownership in the corporation. To obtain a corporate charter, an application called the articles of incorporation is submitted to the state official.

The application (articles of incorporation) contains the following type of information.

* The name, purpose and duration of the proposed corporation
* Amounts kinds and number of shares of capital stock to be authorized
* The address of the corporation’s principal office
* The name and the address of incorporators

After the charter is obtained; the stockholders in the new corporation hold a meeting to elect board of directors and to establish by laws as a guide to the company’s affairs. The directors in turn meetings at which officers of the corporation are appointed.  
  
The formation and organization of a corporation requires significant costs. Such cost is called organization cost.

**Rights of stockholders**

The ownership of stock in corporation usually carries the following basic rights

* The right to receive a certificate as evidence of ownership interest, and to transfer such shares as they choose (through either sale or gift).
* The right to vote for board of directors and business matters
* The right to share in profits by receiving dividends
* To share in assets upon liquidation
* To share in assets upon liquidation

**CLASSES OF STOCKS**

In order to appeal to as many investors as possible, a corporation may issue more than one kind of capital stock. The two types of stock s are common and preferred. Stockholders normally acquire one of two basic types of stock as evidence of their ownership interest.

1. ***Common stock*** – is the most basic / primary/ capital stock issue by the corporation to stock holders.

* Common stock holder’s posses all the rights listed earlier
* Common stock holders are the primary owners of the corporation.
* If only one class of stock is issued its common stock.

1. **Preferred stock –**issued by a corporationto appeal investors who are unwilling to take all the risks involved in the common stock ownership.

* The rights of common stockholders are modified to provide the preferred Stockholders with certain advantages not available to common stock holders.

Most Preferred Stocks have the Following Distinctive Features.

* **Preferred as to dividends**

The preferred stockholders are entitled to received a dividend of specific amount before any dividend is paid on the common stock.  
The dividend is usually stated as a dollar amount per share or as a percentage of par values.

* **Cumulative Dividend Right**

The dividend preference carried by most preferred stock a cumulative one. If all or part of the regular dividend on preferred stock is omitted in a given year, the amount omitted is said to be in arrears and must be subsequent year before any dividend can be on the common stock.

* **Preferred as to assets in event of liquidation of the co**.

Most preferred stock carry a preference as to assets in the event of liquidation the corporation.  
If the business is terminated, the preferred stock entitled to payment in full of its par value or a higher stated liquidation value before any payment is made on common stock.

* **Participating dividend right**  
  The owners of participating preferred stock may receive –that participating in dividend beyond the stated amount or percentage
* **Callable at the option of the corporation**

most preferred stock include a call provision. The provision grates the issuing corporation the right to purchase the stock from the stockholders at stipulated call price.

* **Conversion privilege**  
  In order to add to the attractiveness of preferred stock as Investment Corporation sometimes offers conversion privilege which entitles the preferred stockholders to exchange their shares for common stock in stipulated price ratio
* **No voting right**

Preferred stockholders dividend give up some of the privileges according to common stockholders. E.g: the right to vote for member of the BOD.

Preferred stock very widely with the respect to the special rights and privileges granted.

**ISSUANCE OF CAPITAL STOCK**Stocks issued may have  
 par value   
 No par value but stated value   
 No stated value and no par value  
Stock may also be issued:  
 -At par when a stock is issued at the same amount of par   
 -At premium   
 -At discount  
**Issuing common stock at par**This is when a stock is issued at the same amount of par   
e.g. suppose WOW Corporation issue 500 share its Birr 10 par common stock for cash equal to its par value. The stock issuance entry is:  
 Jan. 10 cash (500×10) ----------------------------- 5000  
 common stock ----------------------------------5000  
 (To record the issuance of common stock at par)  
The amount invested in the corporation is called paid in capital or contributed capital. The credit to common stock records an increase in the paid –in capital of the corporation.  
**Issuing Common stock at Premium**

A corporation usually issues its common stock for a price above par value. The excess amount above par value is called a premium.

E.g. Assume XYZ Corporation issue 4000 shares its Birr 10 par common stock for a price of Birr 25  
January 15 Cash (400025) ------------------------------------------ 100,000  
 Common stock ------------------------------------ 40,000  
 Paid in capital ------------------------------------- 60,000  
(To record issuance of common stock)

The premium on the sale of common stock is not a gain; income or profit to the Co. because the entry is dealing with its own stockholders.

This illustrates one of the fundamentals of accounting: a Co. can’t earn profit nor it incurs a loss which it sells its stock or buys stock from its own stockholders.  
**Paid- in capital** C/ stock, Br.10 par 20,000 shares authorized, 4500shares issued------------- 45,000  
Paid-in capital in excess of par -----------------------------------------------------60,000  
 Total paid-in capital -----------------------------------------------------------------105,000  
Retained earnings -------------------------------------------------------------------85,000  
Total stockholders’ equity ---------------------------------------------------------190,000  
  
Since both par value and premium amounts increase the Co. capital they appear on the stock holder’s equity section of the balance sheet.

**Issuing Common Stock at Discount**stock issued at a price below par is said to be issued at discount

E.g. Assume a corporation issued 1,000 shares of Br 5 par common stock for Br.3 per share. The entry to record the issuance   
  
Cash (1,000 3) --------------------------------3000  
Discount on common stock (1000 2) ----- 2000  
 Common stock (1000 5) ---------------------5000  
  
The discount is reported in stockholders equity section of the balance sheet immediately after the stock a/c (as just shown for reporting a premium).However, the discount b/c it has a debit balance is subtracted from the credit balance par value of the stock issued to figure the capital amount.

The issuance of stock at discount is rare. In fact, it is illegal in most states. When a stock is sold at discount the stockholders has a contingent liability for the discount amount. The corporation later liquidates; its creditors can require the original stockholder to pay the discount amount.

**Issuing Non par Common Stock**

The contingent liability on common stock issued at a discount may why some state laws allow companies to issue no par stock. If the stock s no par value, there can be no discount and thus no contingent liability.

E.g: stock issuance entry is:. Assume Co. issues 300 shares of no par common stock for Br.20 per share. The   
 Cash (300 20) ---------------------------- 6000  
 Common stock -------------------------- 6000  
 (To issue no par common stock)

**Issuing no –par common stock with a stated value**accounting for non- par stock with a stated value is identical to accounting for par value stock. The premium account for non par common stock is entitled” paid in capital in excess of its stated value- common.’’  
 Cash……………………………..xxx  
 Common stock ………………………………….xxx  
 C/ stock in excess of stated value common ……..xxx

***Issuing common stock through subscriptions?***

Stock subscription is a contract in which the investor agreed to pay the subscription price at a future date in a series of installment. The subscriber receives no shares until he/she pay the contract price in full. The subscriber normally makes a payment when he/ she sign the subscription contract; the balance paid in installment.

Assume a corporation receives a subscription on jan.30 for 5,000 shares of Br10 par common stock. The subscription price is Br 18 per share. A 20% down payment is received at the time the subscription contract is signed. The remainder is due in two equal installments on May 1 and Apr 1 2003. The corporation will issue the stock when the subscriber pays in full. The entry to record the receipt of the subscription is:

Jan 30 Cash………………………………………….....18,000

Stock subscription receivable-common…………72,000

Common stock subscribed (5,000 X Br10)………..…50, 000

Paid in capital in excess of par-common….….……...40,000

(To record the sale of subscription to 5,000 shares of Br 10 per capital at Br 8 and the receipt of 20 % down payment).

Entries to record receipt of the two installments and issuance of the stock are:

May 1 Cash………………………………36,000

Stock subscriptions receivable-common…….36,000

(To record receipt of first installment on common stock subscription).

Apr 1 Cash…………………………………36,000

Stock subscriptions receivable-common……36,000

(To collect second installment on common stock subscription).

When the subscription price is paid in full, the stock is issued by the following entry: April 1 Common stock subscription……………50,000

Common stock……………………50,000

(To record the issuance of 5,000 shares of Br 10 par common stocks under subscriptions)

The last entry is needed to transfer the par value of the stock from the subscribed account to common stock

**ISSUING PREFERRED STOCKS**

Accounting for preferred stock follows the same pattern as illustrated for common stock.  
Assume the wow corporations’ charter authorizes issuance of shares of 5%, Br. 100 par preferred stock. On Feb .1 the corporation issues 400 shares at a price of Br 110. The issuance entry is:

Feb 1 Cash (400xBr110---------------------------44,000)

Preferred stock (400x Br 100) ---------------------------- 40,000

Paid in capital excess of par- preferred (400x10) -------- 4,000

(To issue preferred stock at a premium)  
Like that of a common stock preferred stock often sells at its par value or at a premium but seldom at a discount. Accounting for no-par preferred stock follow the same pattern illustrated for no par common stock.

**Classification of preferred stock**

1. **cumulative but non participative:**

Cumulative dividend feature offers preferred stockholders the right to receive both current year dividend and un paid prior years(s) dividend called **dividends in arrears** before common stockholders receive any dividends. If preferred stock is non-cumulative, the corporation is not obligated to pay dividends in arrears Dividend in arrears are not consider as a liability ,b/c no obligation exists until the board of director declares the dividends.

**S**uppose in previews example preferred stock is cumulative, non-participating feature and the corporation did not declared or pay dividend during 1999 and 2000,the allocation of dividend will be determined as follows:

**Preferred common total**

Total outstanding stock (par) Br.100, 000 Br. 500,000 Br.600, 000

Total dividend declared 150,000

First, preferred dividend in arrears   
(8%xBr50x2000sh.x2years) 16000 (16000)

Amount remaining 134,000  
 second, regular current preferred div.  
 (8%xBr.50x2000 share) 8000 (8000)  
Amount remaining 24,000 126,000

Third, remaining allocated to common Br.126, 000 (126,000)  
amount remaining -0-  
Total distribution 24,000 + 126,000 = 150,000

**b). CUMULATIVE & PARTICIPATING**

Participating dividend feature gives preferred stockholders the right to receive dividend beyond the specified rate (amount) by sharing proportionally with common stockholders for any remaining amount

If, however, the preferred dividend is limited to the specified rate (amount) the stock is referred to as non-participating*.*

*Ex*. supposes in the previous example the preferred stock is both cumulative and participating and the corporation did not declare dividend during 1999 and 2000. The amount of dividend for each class at the end of 2001 is determined as follows:

**Preferred common Total**

*Total outstanding stock (par) Br.100,000Br.500,000Br.600,000*

*Total dividend Declared 154,000  
First, preferred dividends in arrears*(8%xBr.50x2000sh.x2yrs) 16,000 (16,000)  
Amount remaining 138,000   
second ,regular current preferred dividends

(8%xBr.50x2,000sh.) 8000 (8000)

Amount remaining Br.130, 000  
 Third, common dividend   
(8%xBr.10x50, 000sh.)40,000 (40,000)

Amount remaining 90,000  
Fourth, remainder allocated each the same  
15% percentage (90,000/600,000=14.33%)!5%  
15%xBr.100,000 15,000 (15,000)  
15%xBr.500,000 75,000 (75,000)

Amount remaining ------ ------- Br 0  
Total distribution 39,000115,000154,000

Participating preferred stock is rare .In fact, preferred stock is non-participating un less it is specifically described as participating on the stock certificate and in the financial statement.  
**Treasury stock**

**Definition-**treasury stock is a corporation’s own stock that has been issued, fully paid for, and reacquired by the issuing co., but not re-issued.  
**Reasons for reacquisition**To make stock available to issue to officers and employed under bonus plan.

-To support the stocks current market price by decreasing the Supply stock  
available to the public.  
-To increase earning per share by reducing the number of shares outstanding.  
-To avoid a take overran outside party  
  
Treasury stock is still consider issued but not out standing and, there for, is not include in computing earning per share and does not received dividend.  
-The difference between an issued stock and treasury sock is the treasury stock has been issued and bought back.

-Treasury Shares are issued but are not outstanding because they are not longer in the hand of stockholders  
-The purchase of treasury stock decreases the corporation’s assets and its stockholders equity.  
-The purchase of treasury stock is usually recorded at accost in treasury stock account.

The stock holders section before purchase of treasury stock is as follows.

Paid in capital

Common stock,Br.1 par, 10,000 shares authorized,8000 shares  
 issued and outstanding Br.8,000  
 paid-in capital in excess of par-common 12,000  
 Total paid -in capital 20,000  
 Retained earnings 14,600  
 Total stockholder equity Br.34,000

On sep.10 the corporation purchases 1,000 shares of its Br.1par common as treasury stock, paying cash ofBr.7.50 per share

The corporation records the purchase as follows:  
Sept.10. Treasury stock-common (1000xBr.7.50) -------------7,500   
 Cash----------------------------------------------------7,500   
 ***(****To record purchase of 1,000 share of treasury –stock at Br.7.5 per share)*

Treasure stock is recorded at cost, without reference to the par value of the stock. The treasury stock account is reported beneath retained earnings on the balance sheet, and its balance is subtracted from the sum of total paid-in capital and retained earning, as follows;

Common stock,Br.1per,10,000 share authorized,  
 8000 shares issued, 7000 share outstanding Br. 8,000  
 Paid in capital in excess of par common 12,000  
 total paid in capital 20,000  
 Retained earnings 14,600  
 Total paid in capital and retained earnings 34,600  
 Less: treasury stock(1,000shares at cost) 7,500  
 Total stockholder’s equity Br.27,000

Observe that the purchase of treasury stock does not decrease the number of shares issued. The common stock, paid in capital in excess of par, and retained earnings account remain unchanged

However, total stockholder’s’ equity decreases by the cost of treasury stock. Also, share of outstanding decrease from 8,000 to 7,000.  
Only outstanding shares have the right to vote, receive cash dividends, and share in asset if the corporation liquidates.

While shares are hold in the treasury, they do not the right of outstanding shares-they can’t vote receive dividends.

b) **Sale of treasury stock above cost**-If the sale is greater than reacquisition cost, the d/c is credited to the account paid-in capital from treasury stock.

Suppose in the pervious e.g. The co. Resold 200 of its treasury shares for Br.9 per share, the entry is

Dec.10. Cash (200sh. X Br.9) 1800  
 Treasury stock, common (200shxbr.7.50) 1500  
 paid-in capital from treasury stock 300  
 (To sell 200 share of treasury stock at Br 9/share)

Br. 300 credit in the entry is not made to gain on sale of treasury stock for two reasons:  
 1) Gains on sales occur when assets are sold and treasury stock is not an asset  
 2) A corporation does not realize a gain or suffer a loss from stock transfer with its   
stockholders.  
C) **Sales of treasury stock below cost**-At the time the re-sale price is less than cost. The d/c between these two amounts is debited to paid- in capital from treasury stock account, then the co. debits retained earning to the remaining amounts.  
  
For e.g. assume the corporation sold 400 share of treasure stock at Br 7 per share. The entry is:

Dec.15. Cash (400sh x Br 7) 2,800  
 Paid in capital from treasury stock (400sh x Br 0.5) 200  
 Treasury stock (400sh x Br 7.5 cost) 3000  
The sale of treasury stock increase both total assets and total stockholder equity.

Assume, however, that the corporation sold the 400 shares of the treasury stock at Br 5 per share. The entry is:   
Dec.15. Cash (400 Sh x Br 5) 2000  
 Paid in capital from treasury stock 300  
Retained earning 700  
 Treasury stock, common (400 xBr7.5) 3,000

(To record sales of 400 Sh of treasury stock at Br 7)