Share Transactions

We're all familiar with the stock market in one way or another, where people buy and sell company stocks on a daily basis. These stocks are sold in units known as **shares** and they are actually fractions of a company! Why would companies split themselves up and sell ownership to others?

Anyone who owns shares of a company is called a shareholder. Although you don't get ownership of the physical assets of the company, shares grant you voting rights or other benefits. The more shares you own, the more influence you hold. Companies sell you shares in exchange for cash to raise money for the company. These funds are then used to help finance and grow the business.

As for you, these shares represent an investment in the company. You put your money into the company expecting that the company will make good decisions and grow in the future, which in turn will also grow the value of the shares that you own. This value growth shows up as an increase in share value.

Since the value of these shares are constantly changing, how do we keep track of what's going on? How do we account for the value of shares and share transactions? Let's take a look!

Shares are usually issued in exchange for cash. For example, when the apparel company LiliLime issues 10,000 shares at $12 per share on January 1, they are effectively selling a portion of the company for cash. We calculate the total proceeds from the issuance of shares by multiplying the price per share by the total number of shares issued. In this case, LiliLime raised a total of $120,000 in cash. We debit the cash account and credit the common shares account for this amount.

Remember the basic accounting equation which always hold truel.

In this case, LiliLime's total assets have increased since they debited cash, and their shareholder's equity increased since they credited Common Shares. Because we have increased both sides of the accounting equation by the same dollar amount, we can see that the equation balances out properly!

In the above LiliLime example, we received cash in exchange for Common Shares. However, there are cases where we debit something other than cash. Can you think of any situation when this might occur?

Let's consider the situation where companies issue Common Shares in exchange for other types of assets such as land, buildings, equipment, or even services such as compensation to lawyers. Maybe you are the CEO of a company and need legal counsel but you're short on cash. Instead of paying your lawyer $2,000 in cash, you might issue them $2000 worth of common shares for your company instead! Because such services are still assets, this transaction will still keep our accounting equation balance.

Isn't this great? Whenever we're short on cash, we can simply issue new shares to get some more money! However, that sounds too good to be true. Recall the

basic economic principles of supply and demand. When we issue more shares, we increase the supply of shares, which ends up driving down their value in the market. That means the price of our shares will go down. Thus, if we've issued too many shares, we can undervalue our company in the market, so companies have to be wary about the number of shares they issue.

Companies can buy back their own shares to reduce the supply of shares, in an effort to drive the share price back up. This is called **reacquisition**, and it's one tool companies can use to gain control if they feel that their shares are being undervalued in the market. When companies buy back shares, they will cancel the shares to take them out of circulation.

Let's continue with the LiliLime example. Recall that LiliLime issued 10,000 shares at $12 per share on January 1st. This $12 price set on issuance date is called the issuance price. Now, they decide to reacquire 1,000 shares on January 14th. Because some time has passed, there is a possibility that the current price of the shares has changed. The current price of the shares is called the **purchase price,** as it is the price LiliLime must pay to buy back the shares**.**

Although we know that LiliLime issued their shares at $12 per share, we might not always have this information. Thus, we base our calculations on an average issuance price instead, where we divide the balance of the common shares account by the number of shares outstanding.

Lililime's current common shares account has a balance of $120,000 and they have issued a total of 10,000 common shares on January 1st. Since we haven't seen LiliLime issue any more shares since then, we know that only 10,000 shares are outstanding. What is the average issuance price in this case? It is $12.

Knowing the average issuance price lets us adjust the common shares account correctly. Share transactions involve numbers of shares and possible differences in the prices of shares. 10,000 shares worth $12 each will be worth a different monetary amount than 10,000 shares worth $10 each, even though we are looking at 10,000 shares in both cases.

Now that we know the average issuance price, we can examine the accounting treatment for three possible scenarios. The easiest scenario to deal with is when the purchase price today is the same as the average issuance price. Otherwise, the purchase price can be either higher or lower than the average issuance price. Let's proceed with the assumption that LiliLime uses cash to buy back shares in each scenario.

On January 14th, LiliLime wants to reacquire 1,000 of their common shares, currently worth $12 each. In the first scenario, because the purchase price is equal to the average issuance price, the journal entry is simply a debit to Common Shares for $12000, as $12 per share for 1000 shares is $12000. We credit the Cash account by the same amount.

Now, what do we do if the purchase price is not equal to the average issuance price? Remember Lililime's average issuance price was $12. Say the market value

is $10 instead on January 14th. This means that the company is purchasing the shares at a lower price than the average issuance price, with a difference of $2 per share. This discrepancy goes to the Contributed Surplus account.

Although we are buying back 1,000 shares, these shares are now worth $10 each and not $12 each. We recorded them on our books at $12 each, so we must use this average issuance price of $12 to properly account for the number of shares we are buying back. We debit the common shares account for 1,000 shares at $12.

Because we are only buying back these shares at $10, we only pay $10 cash per share for 1,000 shares.

If you'll notice, the debit and credit side does not quite match up yet. Remember the contributed surplus account? The difference goes to contributed surplus to balance the journal entry, representing a "surplus" from the initial contribution of cash that we got from shareholders back when we first issued these shares.

We still have one last scenario to cover, but you can probably guess what happens when the reacquisition price is higher than the average issuance price. That's right! Instead of crediting contributed surplus, we will debit it.

Before we get into the final example, it's worth noting that Contributed Surplus is an account that has a **credit balance, and cannot be debited unless it has a nonzero credit balance**. Think of the contributed surplus account like a reloadable transit card. Although you can add any amount of money you want to the card, you can't use the card if your balance hits $0. You need to add money to it first to be able to use it again. Contributed Surplus works in the exact same way. If the credit balance is large enough, then you can debit it until the balance becomes $0. After that, you cannot keep on debiting it. Further debit amounts come out of retained earnings because there is no more "surplus" cash available to draw from.

Let's complete our last scenario. It's now January 21st, and LiliLime's average issuance price is still at $12, but the purchase price is now at $16! The value of the shares has gone up since January 14th, when they were last priced at $10 per share. No new shares have been issued. In this case, we debit $12,000 to the Common Shares account like previously.

We then credit cash for $16,000 since 1,000 shares worth $16 each will cost the company $16,000 cash to reacquire.

Because the credit side is larger than the debit side, we need to debit the contributed surplus with the difference which is $4,000.

Hold on a second. Remember that the contributed surplus account only has a balance of $2,000 from January 14th. If you'll recall, at the time, shares were selling for $10 per share while the average issuance price was $12. So you had accounted for the difference by crediting Contributed Surplus for $2000. That means of the $4000 difference, we can **only** debit a maximum of $2,000

to Contributed Surplus, because that's the credit balance already in the account. Therefore, we debit retained earnings for the remaining $2,000 because contributed surplus has been zeroed out.

Remember to always use up the balance in contributed surplus first before debiting Retained Earnings for any leftover amounts needed to balance.

To summarize, companies can issue shares in an effort to raise cash and reacquire shares they previously issued for many reasons, one of which is to control share prices. Because the market value of shares is always changing, we need to account for both the **average issuance price** and the **purchase price** of shares when recording these transactions. The contributed surplus account has a credit normal balance and is used to balance entries involving share transactions with differing values. If we run out of contributed surplus, we have to use retained earnings to balance the entry.