**unit 9. accounting for corporations**

####  Contents

* 1. Aims and Objectives
	2. Introduction
	3. Definition of Corporation
	4. Characteristics of Corporation
	5. Advantages of Corporate form of Organization
	6. Disadvantages of Corporate form of Organization
	7. Formation of a Corporation
		1. Organization Costs
		2. Rights of Stockholders

9.7 Authorization and Issuance of Stocks

* + 1. Types of Stocks / Shares
		2. Issuance of Par-value Stocks
			1. Authorization
			2. Par-value Stock issued for cash
			3. Par-value Stock issued on a subscription basis
			4. Non cash issuance of Capital Stock
			5. Issuance of No-par Stock

9.8 Accounting for Retained earnings and Dividends

* + 1. Nature of Retained Earnings
		2. Nature of Dividends
		3. Relevant Dividends dates
		4. Dividends and Characteristics of Preferred Stock
			1. Participating and Non participating preferred stock
			2. Cumulative and Non cumulative preferred stock

 9.9 Accounting for Treasury Stocks

* + 1. Reasons to acquired Treasury Stocks
		2. Recording and Reporting Treasury Stock Transactions

9.10 Equity Per Share

9.11 Summary

9.12 Answers to Check Your Progress

9.13 Model Exam Questions

9.14 Glossary

**9.1 Aims and Objectives**

This unit aims at discussing different issues related to a corporate form of organization such as the characteristics of a corporation, accounting and reporting practical for the issuance of stocks. Treasures stocks and equity per share. After studying this chapter, you will be able to:

* + - describe the characteristics, advantages and disadvantages of the corporate form of business organization
		- explain the rights of stockholders and the role of corporate directions.
		- differentiate among authorized, issued and outstanding shares.
		- Account for the issuance of capital stock
		- understand the nature of retained earnings and dividends
		- account for treasury stock transactions
		- know how to calculate earnings per share.

**9.1 Introduction**

Assume that you are planning to start a new business. Would you choose a sole proprietorship, a partnership or a corporation? In principles of accounting 1 and previous chapter of principles of accounting you have studied about the first two forms of business organizations. In this chapter the importance of corporate form of organization will be discussed.

**9.2 DEFINITION of Corporation**

A corporation is a legal entity having an existence separate and distinct from that of its owners. In the eyes of the law there are two persons and a corporation is an ‘artificial person’ having many of its own rights and responsibilities.

**9.3 CHARACTERISTICS of corporation**

Among the characteristics of a corporation are:

a) A corporation is a separate legal entity. According to the law a corporate entity may own property in its own name, may enter into contract and responsible for its own debts.

* 1. A corporation has a legal status in court. According to the law a corporation may sue and be sued as if it were a real person.
	2. A corporation has its own charter. A corporation is created by obtaining charter from the state in which the company is to be incorporated.
	3. A corporation pays income taxes on its earnings. The income of a corporation is subject to income taxes, which must be paid by the corporation.

**9.4 Advantages of the corporate form of organization**

A corporate entity has many advantages not available in other forms of organization. Among the advantages are the following:

1. ***Continuous existence:*** A corporation has perpetual existence in that its continuous existence is not dissolved by the death on retirements of any of its members.
2. ***No personal liability for owners:*** Since a corporation is a separate legal entity, the creditors of a corporation have a claim against the assets of the corporation, not the personal property of the owners.
3. ***Separation of managements from ownership:*** the owners of a corporation (called stock holders or shareholders) own the corporation but they do not manage it on a daily basis. To administer the affairs of the corporation, president and other officers are hired for it. Thus, individual stockholder has no rights to participate in the management's activity of the corporation unless the stockholder has been hired as a corporate officer.
4. ***Easily transferable ownership shares:*** ownership of a corporation is evidenced by transferable shares of stocks. These shares of stocks may be sold by one investor to another without dissolving or disrupting the business organization.

**9.5 Disadvantages of corporate form of organization**

Some of the disadvantages of the corporation are:

1. ***Double taxation:*** corporate earnings are taxed two times. The earnings are taxed first as a corporate income taxes and again as personal income taxes if the corporation. Distributes its earnings to stockholders.
2. ***Difficulties to control:*** since ownership is usually separated from managements, owners are unable to exercise active control over management actions.
3. ***Greater regulation:*** since a corporation comes into existence according to the law of the state, the law may provide for considerable regulation of the corporation’s activities. For example, the withdrawal of funds from a corporation is subjects to certain limits sets by law.

**9.6 formation of a corporation**

A corporation is created by obtaining a corporate charter. The charter is given from the states in which the corporation is to be incorporated. To obtain a corporate charter an application called articles of incorporation are prepared by t he organizers called incorporators and submitted to the state corporations commissioner or other designated officials. These articles of incorporation specify the purpose of the business, its location, the names of the organizers, the classes and numbers of shares of capital stock authorized, and the consideration to be paid in by the organizers for their respective shares. The article of incorporation is approved by the state and charter is issued. Once a charter is obtained a board of directors is elected. The directors in turn hold meetings at which officers of the corporation are appointed.

**9.6.1 Organization costs**

In the process of incorporation, the organizers must pay for necessary costs such as payment of an incorporation fee to the state, payment of fees to attorneys for their services in drawing up the articles of incorporation, payment to promoters and variety of other outlays necessary to bring the corporation into existence. These costs are charged to an asset account called organization costs. In the balance sheets, organization costs appear under the ‘other assets’ caption.

**9.6.2 Rights of Stockholders**

The stockholders who are the owners of a corporate entity have the following basic rights:

1. ***The rights to votes:*** the common stockholders have the right to elect the board of directors, and thereby to be represented in the management of the business.
2. ***The rights to participate in the earnings of a corporation:*** Stockholders in corporations may not make withdrawal of company assets. However, the earnings of a profitable corporation may be distributed to stockholders is the form of cash dividend. The payment of a dividend always requires formal authorization by the board of directors.
3. ***The rights to share in the distribution of assets upon liquid action:*** when a corporation ends its existence, the creditors of the corporation must first be paid is full; any remaining assets are dividend among stockholders in proportion to the number of shares owned.
4. ***Pre-emptive rights:*** the current stockholders has the right to purchase the shares of the corporation on a prorate basis when new stocks are offered for sale. This preemptive rights is designed to provide each stockholder the opportunity to maintain a proportional ownership in the corporation.

**Check Your Progress Exercise -1**

* 1. When a business is organized as a corporation:
	2. Stockholders are liable for the debts of the business
	3. Stockholders do not have to pay personal income taxes

 on dividend received.

* 1. Each stockholder has the rights to make managerial decision.
	2. Owners cannot withdraw assets from the business at will.
	3. Explain the meaning of the term double taxation at it applies to corporate profits.

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**9.7 authorization and issuance of stocks**

The state officials approve the articles of incorporation, which specify the number of shares a corporation is authorized to issue. The total number of shares that may be issued is known as ***the authorized shares***. When the corporation receives cash is exchange for stock certificates, which represents the number of shares issued, the shares become ***issued shares***. Shares that are issued and held by the stockholders are called ***outstanding shares***. Sometimes a corporation requires shares from its own shareholders. These shares are called ***treasury stocks***, which reduce the number of outstanding shares.

A corporation may choose not to issue immediately all the authorized shares even though it is customary to have a large number of authorized shares than presently needed. If more capital is needed, the previously authorized shares will be readily available for issue. A corporation can apply to the state for permission to increase the number of authorized shares.

**9.7.1 Types of Stocks/Shares**

Many corporations issue several classes of capital stock, each providing investors with different rights and opportunities. The basic types of stock issued by every corporation is called ***common stock***. Common stock possessed the traditional rights of ownership such as voting rights, participation residual dividends, and residual claim to assets in the event of liquidation. When any of these rights is modified, the term preferred stock is used. Preferred stock specifies different rights that distinguish it from common stock. Some of the distinctive features for preferred stocks are priority claims on dividends, cumulative dividend rights, priority as to assets is the event of liquid action of a corporation and no voting power.

Stocks according to their nature are classified into ***par value*** and ***no-par stocks***. Par value stocks with a designated dollar amount per share as stated in the corporate charter and printed on the stock certificates. On the other hand, some states allow corporations to issue stocks without designating a par value. Such stocks are called ***no-par stocks***. When no par stocks are issued by a corporation, the entire issuance price is viewed as a legal capital, which is subject to withdrawal. Sometimes some states authorize the issuance of no-par stock with a stated, or assigned, value per share that is established permanently by the corporate directors and is in the laws. Most corporations use a stated value for no par stock.

**9.7.2 Issuance of Par-value Stocks**

***9.7.2.1 Authorization***

Authorization of par value stocks, specified in the unit may be recorded as a memo entry in the general journal and in the ledger accounts. Most states require the total number of shares authorized be shown on each stock certificate, in addition to the number of shares represented by that particular stock certificates.

***9.7.2.2 Par value stock issued for cash***

When stocks are issued to various investors, a stock certificate specifying the number of shares represented is prepared for each investor/or stockholder. When par value stock is issued for cash, the capital stock account is credited with the par value of the shares issued regardless of whether the issuance price is more or less than par. If par value stock is issued for more than par value (at premium), paid in capital in excess of par account is credited for the excess of selling price over par. This paid in capital is excess of par does not represent a profit to the corporation rather it is part of the invested capital. If par value stock is sold by corporation for less than par (at discount), a negative stockholders’ equity accounts, Discount on common (or preferred) stock, is debited for the amount of the discount.

For example, assume that 50,000 shares of Br. 2 par value common stock have seen authorized and that 10,000 of these authorized shares are issued at a price of Br. 10 each. The entry would be:

 Cash………………………………………………………100.000

 Common Stock…………………………………..20,000

 Paid-in-capital is excess of par………………… 80,000

***9.7.2.3 Par value stock issued on a subscription basis***

During the start-up of a corporation, prospective investors may sign a contract to purchase a specified number of shares on credits with payments due at one or more specified future dates. One reason for this procedure is to attract small investors. Another reason is to appeal to investors who prefer not to invest cash until the corporation is ready to start business operations. A corporation may also sell its capital stock on credit after incorporation.

When stock is subscribed, the company debits stock subscription receivable for the subscription price, credits capital stock subscribed for the par value of the subscribed shares, and credits paid in capital in excess of the subscription price over par value. Later, as cash is collected, the entry is a debit to cash and a credit to stock subscription receivable. When the entire subscription price is collected, the stock certificates are issued for the subscribers. The issuance of stock is recorded by debiting capital stock subscribed and crediting capital stock. The following illustration demonstrates the accounting procedures for stock subscriptions.

Assume that 120,000 shares of RAM corporation common stock, par br. 10, are subscribed for at Br. 12 by Misrak Binda. The total is payable in three installments. The following entries are processed by RAM Corporation.

Common stock subscription Receivable 1,440,000

 Common stock subscribed 1,200,000

 Paid-in-capital in excess of par 240,000

 To record receipt of subscription for 120,000 shares

Cash 480,000

 Common stock subscription receivable 480,000

 *To record receipt of 1st payment*

Cash 480,000

 Common stock subscription Receivable 480,000

 *To record receipt of final payment*

Cash 480,000

 Common stock subscription Receivable 480,000

 *To record receipt of final payment*

 Common stock subscribed 1,200,000

 Common stock 1,200,000

*To record issuance of stock*

***9.7.2.4 Non Cash Issuance of Capital Stock***

Corporations sometimes issue capital stock for non-cash assets such as in exchange for real estate. The current markets value of the stock issued or the non-cash consideration received, whichever is must reliable, determinable, is used to record the transaction. If the market value of either capital stock issued or the no cash items are not reliable, the value are established by the corporation’s board of directors.

***9.7.2.5 Issuance of No-par Stock***

Some states allow corporations to issue stock without designating a par or stated value. When this no par stock is issued, the entire issuance price is credited to the capital stock account and is viewed as legal capital not subject to withdrawal.

**9.8 accounting for retained earnings and dividends**

**9.8.1 Nature of Retained Earnings**

Capital provided to a corporation by stockholders in exchange for shares of either preferred or common stock is called ***paid in capital*** or ***contributed capital***. The second major type of stockholders’ equity is a retained earnings. The amount of the retained earnings account at any balance sheet date represents the accumulated earnings (net income) of the company since the date of incorporation, less any losses and all dividends distributed to stockholders.

**9.8.2 Nature of Dividends**

A dividend is a distribution of earnings to stockholders is the form of assets or shares of the issuing company’s stock. Type of dividends includes the following.

1. Cash dividend

 Cash disbursed

1. Property Dividend

 Non cash assets disbursed

1. Stock Dividend

 Corporations own stock disbursed

1. Liquidating Dividend

 Return of contributed capital

1. Scrip Dividend

 Creation of a liability by declaring a dividend to be paid at a specific future date.

**9.8.3 Relevant dividend dates**

Prior to payment, dividends must be declared by the board of directors of the corporation. The important dividend dates are:

1. ***Date of Declaration:*** on this date, the corporation’s board of directors formally approves and announces the dividend to be distributed. The declaration is recorded on this date as a debit to dividends and a credit to dividends payable.
2. ***Date of payment:*** this date is determined by the board of directors and is usually stated is declaration. At the date of payment the liability recorded at the date of declaration is debited and the appropriate asset account is credited.

**9.8.4 Dividend and Characteristics of preferred stock**

A corporation with both preferred stock and common stock may declare dividends on the common only after it meets the requirements of the stated dividend on the preferred. The preferred dividend may be stated in monetary terms or as a percent of par.

***9.8.4.1 Participating and non-participating preferred stock***

A participating preferred stock receives a minimum dividend but also receives higher dividend when the company pays substantial dividends on common shares. The preferred stockholders’ right may be to receive dividend only a stated amounts. Such stock is said to be ***nonparticipating.***

To illustrated, assume the following information

* Common stock issued 4,000
* Preferred stock issued 2,000
* Dividend per share of preferred stock Br. 10

The corporation reported net income of Br. 150,000 for the third year and the BOD declared both of the net income as dividend. If the preferred stock issued by the corporation is participating, the preferred stockholders will receive. Br. 30,000 (Br. 20,000 + Br. 10,000), and the common stockholders will receive Br. 60,000 (Br. 40,000 + Br. 20,000).

***9.8.4.2 Cumulative and Non-cumulative preferred stock***

Cumulative preferred means that if the company fails to pay a preferred dividend, its obligation accumulates and all omitted dividends must be paid in the future before any common dividends are paid. The cumulative preferred stockholders would receive all accumulated unpaid dividends (called dividend in arrears) before the holders of common shares receive anything. Preferred stock not having this cumulative rights is called no cumulative.

For example, assume the following information

* Cumulative preferred, 10% of Br. 100 par (10,000 shares issued)
* Common stock of Br. 90 par (40,000 shares issued)
* The Board of Directors (BOD) did not declare dividend in year 2
* Year 3 dividend declared by the BOD amounts to Br. 320,000.
* Year 1 dividend declared and distributed amounts to Br. 200,000.

If the preferred stock is cumulative, the preferred stockholders will receive Br. 200,000 (Br. 100,000 + Br. 100,000), and the common stock holders will receive Br. 120,000 (Br. 320,000 – Br. 200,000).

**Check Your Progress Exercise –2**

* + 1. State the classification (assets, liability, stockholders’ equity, revenue or expense) of each of the following accounts
	1. subscription receivable
	2. organization costs
	3. paid in capital is excess of par value
	4. retained earnings
	5. preferred stock
		1. If a corporation has outstanding 1,000 shares of Br. 9 cumulative preferred stock of Br. 100 par and dividends have been passed for the preceding three years, what is their amount of preferred dividends that must be declared is the current year before a dividend can be declared on common stock?
			+ 1. Br. 9,000 c) Br. 36,000

 b) Br. 27,000 d) None

**9.9 Accounting for Treasury stocks**

Treasury stock is a corporation’s own stock (preferred or common) that has been issued and required by the issuing corporation. A corporation may also accept shares of its own stock in payment of a debits owed by a stockholder or as a donation from a stockholder.

Treasury stock does not reduce the number of shares issued, but does reduce the number of outstanding shares. The purchase of treasury stock decreases both assets and stockholders’ equity. Moreover, treasury stock does not carry voting, dividend, preemptive, or liquidating rights and is not assets.

**9.9.1 Reasons to acquire Treasury Stocks**

In general treasury steps are to acquire for the following reasons:

1. to support (increase) the markets price of the stock
2. to I increase earnings par share by reducing the number of shares outstanding.
3. To reduce dividend payment payments by reducing the number of shares outstanding.
4. To provide shares for reassurance to employees as a bonus
5. To use the share acquired for stock dividend
6. To reissue with a higher price

**9.9.2 Recording and reporting Treasury stock Transactions**

There are several methods of accounting for the purchase and the resale of treasure stock. A commonly used method is the cost basis. When the stock is purchased by the corporation, treasury stock account is debited for the price paid for it. The par and the price at which the stock was originally issued are ignored. When the stock is resold, treasury stock is credited at the price paid for it, and the difference between the price paid and the selling price is debited or credited to an account entitled paid in capital from sale of treasury stock.

To illustrate the cost method, assume that Harambe Corporation had 50,000 shares of Br. 10 par common stock outstanding at the beginning of the current year. The company purchased 500 shares for cash and received 500 shares in settlement of a debt from stockholders. The markets price of stocks was Br. 30/share. The following entry is required involving the transactions.

 Treasury stock 30,000

 Cash 15,000

 Notes Receivable 15,000

If the company sells 600 shares of the treasury stock for Br. 31 each, the entry would be:

 Cash 18,600

 Treasury stock 18,000

 Paid in capital from sale of 600

 Treasury stock

Paid in capital from sale of treasury stock is reported in the paid in capital section of the balance sheet. Treasury stock is deducted from the total of the paid in capital and Retained earnings.

**9.10 Equity per share**

The amount appearing on the balance sheet as total stockholders’ equity can be stated in terms of the equity per share. When there is only one class of stock, the equity per share is determined by dividing total stockholders’ equity by the number of shares outstanding. For a corporation with both preferred and common stock, it is necessary first to allocate the total equity between the two classes. To illustrate, consider the following statements of stockholders’ equity at December 31, 19x1.

- 9 to preferred stock, Br. 50 par value, authorized 20,000 shares, issued and

Outstanding 12,000 share Br. 600,000

- Common stock, no par, stated value Br. 2 per share,

authorized 500,000 shares, issued 400,000 shares of which 25,000

 shares are held is the treasury 800,000

- Paid in capital is excess of per

 -Preferred Br. 50,000

 -Common 1,000,000 1,050,000

- Retained earnings 2,000,000

 Subtotal Br. 4,450,000

- Less cost of 25,000shares of common stock

**Reacquired and held in treasury**  250,000

- Total stockholders’ equity Br. 4,200,000

If the preferred stock is entitled to receive Br. 105 per share upon liquidation and if there is no preferred dividend in arrears, the computation of earnings per share are as follows:

Preferred EPS = Equity allocated to preferred stock

 Number of o/s shares of preferred stock

 = 105 X 12,000

 12,000

 = Br. 105/share

Common EPS = Equity allocated to common stock

 Number of o/s shares of common stock

 = 2,940,000

 375,000

 = Br. 7.84 /share

**Check Your Progress Exercise -3**

* + 1. A corporation reacquired 1,000 shares of its own Br. 50 par common stock for Br. 75,000 recording it at costs. What effects does it has on stockholders’ equity?

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* + 1. If the Retained Earnings account has a debit balance, how is it presented in the balance sheet and what is it called?

**………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………**

* + 1. How is book value per share of common stock computed when a company has only one class of stock?

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**9.11 Summary**

* A Corporation has the following most important characteristics:
* Separate legal existence, limited liability, and transferable units of stocks.
* The primary advantages of a corporation are no personal liability of stockholders for the debts of the business, the transferability of ownership shares, continuity of existence and ability to hire professional managements.
* Stockholders in a corporation normally have the rights to elect the board of directors, to share in dividends declared by the directors, to share is the distribution of assets if the corporation is liquidated, and to subscribe to additional shares if the corporation decides to increases the number of shares outstanding.
* Common stock represents the true residual ownership of a corporation. These share have voting rights and cannot be called. Preferred stock has preference over common stock with respects to dividends and to distributions in the events of liquidation.
* When capital stock is issued, appropriate asset accounts are debited for the market price of stock. A capital stock account is credited for the par value of the issued shares. The difference between the market value received and the par value of the issued shares is credited or debited to additional paid in capital accounts.
* The stockholders; equity sections are classified into two: paid-in-capital and retained earnings.
* Any treasury stock held at the end of an accounting period is deducted from the total of the paid-in-capital and retained earnings of the corporation.
* To determine the equity per share, the equity allocated to each class is divided by the number of shares outstanding of the respective class.

**9.12 answer to check your progress**

***Check Your Progress Exercise - 1***

1. D
2. According to double taxation concept corporate income is taxed two times; when earned to the corporation and then again taxed to the stockholders when distributed as dividends.

***Check Your Progress Exercise - 2***

1. a) Assets

 b) Assets

 c) Stockholders’ equity

 d) Stockholders’ equity

 e) Stockholders’ equity

2. C

***Check Your Progress Exercise - 3***

1. The stockholders’eq2uity decrease for Br. 375,00
2. The debit balance is deducted from paid in capital and is called defects.
3. EPS = Total stockholders’ equity

 Number of shares outstanding

**9.13 model exam questions**

**Part 1. Short answer questions**

1. When a corporation issues stock at a premium, does the premium constitute income? Explain.
2. What type of expenditure is charged to the organization costs accounts?
3. When stock is issued by a corporation is exchange for assets other than cash, accounts face the problem of determining the dollar amounts at which to record the transaction. Discuss the factors to be considered and explain their significance?

#### Part 2. Workout questions

1. Early in the year Yetimwork Demissie and several friends organized a corporation called mobile communications, Incorporation. The corporation was authorized to issue 50,000 of Br. 100 per value, 10% cumulative preferred stock and 400,000 shares of Br, 2 par value common stock. The following transactions occurred during the year.

Jan. 6 Issued for cash 20,000 shares of common stock at Br. 14 per share. The shares were issued to Binda and 10 other investors.

Jan. 7 Issued an additional 500 shares of common stock to Binda is exchange for his services in organizing the corporation. The stockholders agreed that these services were worth Br. 11,000.

Jan12 Issued 2,500 shares of preferred stock for cash of Br. 250,000.

Jan. 4 acquired land as a building site in exchange for 15,000 shares of common stock. In view of the appraised value of the land, the directors agreed that the common stock was to valued for purpose of this transaction at Br. 15 per share.

Nov15 The first annual dividend of Br. 10 per share was declared on the preferred stock to be

Paid December 20.

Dec20 Paid the cash dividend declared on November 15,

Dec31 After the revenue and expenses were closed into the Income summary account, that

account indicated a net income of Br. 106,500.

***Instructions***

1. Prepare journal entries in general journal form to record the above transactions
2. Prepare stockholders’ equity section of the Mobile communications, Inc. balance sheets at December 31.

2. Belay publications was organized early in 19x1 with authorization to issue 20,000 shares of Br. 100 par value preferred stock and 1 million shares of Br. 1 par value common stock. All of the preferred stock was issued at par, and 300,000 shares of common stock were sold for Br. 20 per share. The preferred stock pays a 10% cumulative dividend and is callable at Br. 105. During the first five years of operations, the corporation earned a total of Br. 4,460,000 and paid dividends of Br. 1 per share each year on the common stock. In 19X6, however, the corporation reported a net loss of Br. 1,600,000 and paid no dividends.

###### *Instruction*

Prepare the stockholders’ equity section of the balance sheet at December 31, 19X6.

**9.14 glossary**

**Board of directors:** Persons elected by common stockholders to direct the affairs of a corporation.

**Capital stock:** Transferable units of ownership is a corporation. A broad term, which may

 refer to common stock, preferred stock, or both.

**Common stock:** A type of capital stock, which possesses the basic rights of ownership including the rights to vote.

**Corporation:** A business organized as a legal entity separate from its owners.

**Legal capital:** Equal to the par value or stated value of capital stock issued. This amount

 cannot be removed without special legal action.

**Paid in capital:** the amounts invested in a corporation by its stockholders.

**Par value (or stated Value):** the minimum amount per share to be invested is the corporation by its own owners and cannot be withdrawn except by special legal action.

**Preferred stock:** a class of capital stock usually having preferences as to dividends and in the distribution of assets inevents of liquid action.

**Stock certificate:** a document issued by a corporation as evidence of the ownership of the number of shares stated on the certificate.

**Subscriptions to Capital stock:** formal promises to buy shares of stock from a corporation with payment at a later date.