Chapter 14

CORPORATIONS:
DIVIDENDS & OTHER TOPICS

New Accounting Terms

- Stock dividend
- Cumulative dividend
- Non-cumulative dividend
- Retained earnings
- Stock split
- Corporation I/S
- Discontinued operations
- Extraordinary items
- Other revenues/gains
- Other expenses/losses
- Income tax expense
- EPS
- P-E ratio
- Payout ratio

Stock Dividends

- A stock dividend is a pro rata distribution of the corporation's own shares to its shareholders.
- A stock dividend results in a **decrease** in R/E and an **increase** in C/S.
- In most cases, the FMV of the shares is assigned to the dividend shares.
- Total shareholders' equity remains the same.
- BV per share changes, goes down usually.

Stock Dividends: Purpose & Benefits

- Satisfies shareholders' dividend expectations without spending cash
- Increases marketability of corporation's shares
  - Increasing number of shares will cause market price to decrease and make shares more affordable
- Reinvest R/E
- Emphasizes that a portion of shareholders' equity has been permanently retained in the business
  - Therefore unavailable for cash dividends

Stock Dividends

Declaration date

DR Stock Dividends* - *Common*

CR Stock Dividends Distributable

Record date

No entry

Payment date

DR Stock Dividends Distributable

CR Common Stock

* *Stock Dividends is a Retained Earnings account.*

STOCK DIVIDEND EFFECTS

	Before Stock Dividend	After Stock Dividend
Shareholders' equity		
Common shares	$500,000	$575,000
Retained earnings	300,000	225,000
Total shareholders' equity	$800,000	$800,000
Issued shares	50,000	55,000
Book value per share	$ 16.00	$ 14.55

Stock dividends change the composition of S/E because a portion of R/E is transferred to C/S. However, total S/E remains the same. The number of shares increases and so the BV per share decreases.

Benefits of stock dividends

❖ For shareholder:

- More shares with which to earn even more dividend income
- More shares for future gain, as share price may climb

Stock Splits

❖ A stock split involves the issue of additional shares to shareholders according to their percentage of ownership.

❖ The number of shares increases.

❖ The BV per share decreases.

❖ A stock split has no effect on total value of share capital, R/E, or S/E.

❖ No journal entry required.

❖ Most common stock split is 2:1.

❖ Opposite is stock consolidation.

STOCK SPLIT EFFECTS

A stock split does not affect total value of share capital, R/E, or S/E. However, the number of shares increases & book value per share decreases.

	Before Stock Split	After Stock Split
Shareholders' equity		
Common shares	$500,000	$500,000
Retained earnings	300,000	300,000
Total shareholders' equity	$800,000	$800,000
Issued shares	50,000	100,000
Book value per share	$ 16.00	$ 8.00

Comparison of Effects

Type	Cash a/c	C/S $	R/E	S/E
Cash Div	↓	N/C	↓	↓
Stock Div	N/C	↑	↓	N/C
Stock Split	N/C	N/C	N/C	N/C

Reacquisition of Shares

Stock Buyback / Repurchase

❖ Reacquired shares are a corporation's own shares that have been issued, fully paid for, and then reacquired by the corporation.

❖ Reacquired shares are generally retired and cancelled.

❖ Rarely, these shares are not retired, but are held as treasury shares for later reissue.

❖ Reasons

- Reduce quantity or raise share price
- Increase EPS
- If authorized share limit reached, may need additional shares for employee bonuses or purchase of other companies

Steps to Record Requisition

❖ Remove cost of shares from share capital account

- Based on average cost per share (must be calculated)

❖ Record cash paid for the shares

❖ Record the gain or loss on reacquisition

Requisition of Shares: Below Average Cost

- Average cost of shares:
  - = Balance in Common Shares Account / Number of Common Shares Issued
- If shares reacquired at a price < average cost:
  - Difference is a "gain" on reacquisition
  - This "gain" is credited to a new shareholders' equity account for the contributed capital from the reacquisition:

Sept. 23	Common Shares (5,000 × $2)	10,000	
	Contributed Surplus—Reacquisition of Shares		2,500
	Cash (5,000 × $1.50)		7,500
	To record reacquisition and retirement of 5,000 common shares.		

Requisition of Shares: Above Average Cost

- If shares reacquired at a price > average cost:
  - Difference is a "loss" on reacquisition
  - Additional cost of shares is first debited to contributed capital from previous reacquisitions (if any)
  - Remaining difference is debited to retained earnings:

Dec. 5	Common Shares (10,000 × $2)	20,000	
	Contributed Surplus—Reacquisition of Shares	2,500	
	Retained Earnings ($7,500 − $2,500)	5,000	
	Cash (10,000 × $2.75)		27,500
	To record reacquisition and retirement of 10,000 common shares.		

Retained Earnings

- Retained earnings is the cumulative net incomes less net losses that is retained in the business (i.e. not distributed to shareholders)

R/E, opening balance
+/- Net Income / Loss
- Dividends
= R/E, ending balance

R/E Restrictions

- In some cases there may be retained earnings restrictions that make a portion of the balance currently **unavailable** for dividends

- Restrictions result from following causes:
  - Legal
  - Contractual
  - Voluntary

Change in Accounting Policy

- Occurs when the policy used in current year is different that that used in prior year
- Only occurs when change:
  - Is required by GAAP
  - Provides more reliable and relevant information
- Must be applied retroactively (prior years restated) unless not practical to do so
- Using a new accounting method due to a change in circumstances is not a change in accounting policy
  - No retroactive application

Change in Accounting Estimates

- Estimates of future conditions and events are made often in accounting
  - For example, bad debt expense or warranty expense
- These estimates may need to be changed due to:
  - A change in circumstances
  - New information becoming available
- The new estimate is used from now on
  - Do not go back and change prior periods

Correction of Prior Period Errors

- When a material error is discovered after the financial statements have been issued
- Correction is made directly to Retained Earnings
  - Since effect of error is now located there (all revenues and expenses have been closed to retained earnings)
- Net of any income tax effect
- Example: overstatement of cost of goods sold
  - Understatement of inventory, profit (now retained earnings), and income tax payable

Feb. 12	Merchandise Inventory	10,000	
	Income Tax Payable		3,000
	Retained Earnings		7,000
	To adjust for overstatement of cost of goods sold in a prior period.		

Presentation of Prior Period Adjustments

- Adjustment is added to (or deducted from) opening balance of retained earnings, net of income tax effect
- Financial statements of prior years are restated to reflect the change
- Details of the change and its impact disclosed in a note to the financial statements

Statement of Changes in Shareholders' Equity

- Required for companies following IFRS
- Shows changes in shareholders equity during year
  - Including contributed capital, retained earnings, other comprehensive income
- Companies following ASPE:
  - Continue to use a Statement of Retained Earnings
  - Other changes are reported in notes to the statements

Summary of Shareholders' Equity Transactions

Transaction	Impact on Shareholders' Equity Accounts
1. Issuance of share capital	1. Common or Preferred Shares is increased.
2. Reacquisition of share capital	2. Common or Preferred Shares is decreased. Contributed Surplus may be increased or decreased. Retained Earnings may be decreased.
3. Correction of a prior period error that affected the prior year's ending retained earnings	3. Opening Retained Earnings is either increased or decreased as required to make the correction.
4. Cumulative effect of a change in accounting policy on the prior year's ending retained earnings	4. Opening Retained Earnings is either increased or decreased as required to make the adjustment.
5. Profit (loss)	5. Retained Earnings is increased (decreased).
6. Other comprehensive income (loss)	6. Accumulated Other Comprehensive Income is increased (decreased).
7. Cash dividends are declared	7. Retained Earnings is decreased.
8. Stock dividends are declared	8. Retained Earnings is decreased and Stock Dividends Distributable is increased.
9. Stock dividends are distributed	9. Stock Dividends Distributable is decreased and Common Shares is increased.
10. Stock split	10. Number of shares issued increases; there is no effect on account balances.

Corporation I/S

- The income statement for a corporation includes essentially the same sections as in a sole proprietorship.
- The major differences are:
  - Income from operations
  - Income from discontinued operations
  - Other comprehensive income
  - Income tax expense
  - EPS info

- Corporations are separate legal entities and so they pay their own income tax.

I/S with those Differences

LEADS INC.
Income Statement
For the Year Ended December 31, 2011

Sales	$800,000
Cost of goods sold	600,000
Gross profit	200,000
Operating expenses	50,000
Income from operations	150,000
Income from discontinued operations	6,000
Other comprehensive income	4,000
Income before income tax	160,000
Income tax expense	32,000
Net Income	$128,000

Additional Sections of an I/S

ADDITIONAL SECTIONS OF I/S:

1. Income from discontinued operations
2. Other comprehensive income
3. Income tax expense
4. EPS info

❖ These sections report material items not typical of regular operations.

Discontinued Operations

❖ Discontinued operations refers to the disposal of a significant segment of a business, such as the elimination of an entire activity.
- Eg. If GE sold their credit card division
- Eg. If HP sold their laptop division

❖ Each item should be carefully explained in the notes to the financial statements.

Other Comprehensive Income

❖ OCI is income from extraordinary items: from events & transactions that may be:
- Infrequent
- Non-typical
- Not subject to management decision

❖ OCI is reported in a separate section after income from discontinued operations.

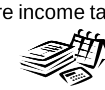
❖ Examples: disposal of long-term assets, foreign exchange gain/loss, wins/losses in lawsuits, damages from an earthquake

Income Tax Expense

❖ Private companies:
- Usually about 20% of Income before income tax

❖ Public companies:
- Usually about 38% of Income before income tax

❖ One of the biggest expenses



❖ Reported on I/S after all incomes & expenses have been reported

Earnings Per Share

❖ Earnings per share (EPS) indicates the N/I earned by each common share

❖ Companies report EPS on the I/S

❖ The formula to calculate EPS is as follows:

Net Income – Preferred Dividends ÷ **Number of Common Shares** = **Earnings per Share**

Earnings per Share: Complex Capital Structure

❖ When a company has securities that can be converted into common shares
- Example: convertible preferred shares
- If converted, the additional common shares will result in a reduced (diluted) EPS figure

❖ Two EPS amounts are calculated:
- Basic EPS: calculation on preceding page
- Fully diluted EPS: calculated as if all securities were converted into common shares

❖ Calculation of weighted average number of shares becomes more complicated

EPS Reporting Example

HWA ENERGY INC.

EPS Info:

Income from operations	$5.50
Income from discontinued operation	2.00
Other comprehensive income	(1.50)
Income tax expense	(2.00)
Net income	4.00

Price–Earnings Ratio

The price-earnings (P/E) ratio helps investors determine whether the shares are a good investment in relation to incomes. It is a per share calculation, calculated as follows:

Market price per share ÷ Earnings per share = Price-Earnings Ratio

A high P/E ratio can be one indicator that investors believe the company has future growth potential.

Payout Ratio

- Indicates what percentage of profit a company is distributing to its shareholders
- Can be calculated for common, preferred and all dividends:

Cash Dividends ÷ Profit = Payout Ratio

- Payout ratios vary with the industry
- High payout ratios can indicate that a company is not reinvesting enough in its operations