

Stock Dividends

Declaration date

DR Retained Earnings
CR Stock Dividends Payable

Record date

No entry

Payment date

DR Stock Dividends Payable
CR Common Stock



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 company:

- § To satisfy shareholders' dividend expectations without spending cash
- § To increase marketability of its shares by increasing number of shares & decreasing market price per share
- § To reinvest retained earnings



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

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

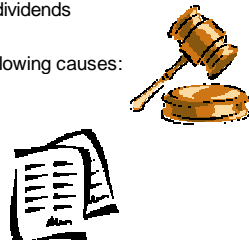


R/E Restrictions

✓ 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



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:

$$\frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Number of Common Shares}} = \text{Earnings per Share}$$

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	<u>4.00</u>

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:

$$\frac{\text{Market price per share}}{\text{Earnings per share}} = \text{Price-Earnings Ratio}$$

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