CH 8 - Equity

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Shareholder's Rights

1. Sell Shares
2. Vote
3. Dividends
4. Residual Value

Shareholder's Equity

1. Share Capital
   - Authorized $\implies$ Maximum number of shares allowed to distribute
   - Issued $\implies$ Number of shares sold to shareholders
   - Outstanding $\implies$ Number of shares in shareholders hands (because company can purchase themselves' share, so shares in shareholders hands decreased)
2. Contributed Surplus
3. Accumulated other Comprehensive Income
4. Retained Earnings

Classes of Shares

1. Common
   - Basic form of Capital
   - Has the Four Rights
   - Shareholders benefit if the company succeeds
2. Preferred
   - Has advantageover common
     ‣ Receive Dividends first
     ‣ Receive Assets in first liquidation
   - Earn Fixed Dividends
   - Very Few corporation Issues

Issuing Shares

1. For Cash

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Cash	5,000,000	
	Common Shares		5,000,000
	Issued 100,000 common shares at $50 per share		

2. For Non-Cash Assets

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Date	Accounts and explanation	Debit	Credit
	Equipment	4,000	
	Building	120,000	
	Common Shares		124,000
	Issued shares in exchange for equipment and building		

Some Companies want to purchase their own shares because:

1. The company needs the repurchased shares to fulfill future share issuance commitments.
2. The purchase may help support the share's current market price.
3. Management wants to avoid a takeover by an outside party.

Retained Earnings:

$$\textbf{Beg. R.E.} + \textbf{Net Income} - \textbf{Dividends} = \textbf{End R.E.}$$

- Debit balance $\longrightarrow$ Lifetime Earnings > Lifetime losses & Dividends
- Credit balance $\longrightarrow$ Lifetime Earnings < Lifetime losses & Dividends

Cash Dividends

Before a company can pay a cash dividend it must have:

1. Retained Earnings in excess of the desired dividend enough cash to pay the dividend
2. Board of directors has authority to declare a dividend Company not obligated to pay dividend until declared

The Process of Cash Dividends:

1.

1. Declaration date

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Retained Earnings		
	Dividends Payable		

2. No Journal Records

3.

3. Payment date

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Dividends Payable		
	Cash		

Stock Dividends

1. Proportional distribution of stock to shareholders
2. Increase Share Capital and decrease Retained Earnings
   - Total equity is unchanged
3. Reasons stock dividends are distributed
   - Continue dividends, but conserve cash
   - Reduce market price of shares

The Process of Stock/Share Dividends

1. Declaration date

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Retained Earnings		
	Stock Dividends Distributable		

2. Date of record   No journal entry

3. Payment date

JOURNAL			
Date	Accounts and explanation	Debit	Credit
	Stock Dividends Distributable		
	Common Shares		

Preferred Share Dividends

1. Paid dividends before common shareholders
2. Expressed as an annual dollar figure or as a percentage of the share's stated value
   - May be cumulative
3. Passed dividends are owed to preferred shareholders
   - In arrears

The Process of Stock/Share Dividends

Example:

The preferred shares of Pinecraft are cumulative. Suppose the company passed the 20X1 preferred dividend of $150,000. In 20X2, the company declares a $500,000 dividend.

Retained Earnings	500,000	
Dividends Payable, Preferred ($150,000 × 2 years)		300,000
Dividends Payable, Common ($500,000 − $300,000)		200,000
To declare a cash dividend		

Stock Split

1. Results in an increase or decrease in the number of issued and outstanding shares, but does not affect any financial statement balances
2. Increases or decreases market value per share

Summary

Effect on Total					
Transaction	**Assets**	**=**	**Liabilities**	**+**	**Shareholders' Equity**
Issuance of shares	Increase		No effect		Increase
Repurchase of shares	Decrease		No effect		Decrease
Declaration of cash dividend	No effect		Increase		Decrease
Payment of cash dividend	Decrease		Decrease		No effect
Stock dividend	No effect		No effect		No effect
Stock split	No effect		No effect		No effect

Ratio

1. Return on Asset $= \frac{\text{Net Income}}{\text{Average Total Asset}} = \frac{\text{Net Income}}{\frac{\text{Jan1 Asset + Dec31 Asset}}{2}}$

   General Benchmark: The higher the better, $\sim 10\%$ indicates a good return.

2. Return on Equity $= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Common Shareholder's Equity}} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\frac{\text{Jan1 Common Equity + Dec31 Common Equity}}{2}}$

   General Benchmark: The higher the better $\sim 15\%$ indicates a good return