

The Corporate Form of Organization

- **corporation** is a legal entity that is separate and distinct from its owners
 - owners known as shareholders
- 2 common classifications
 - purpose
 - **profit**
 - **non profit**
 - ownership
 - **public**
 - **private**
- public corporations
 - can have thousands of shareholders
 - shares are regularly traded on a securities market
- private corporations
 - usually has few shareholders
 - does not offer its shares for sale to the general public
 - much smaller than public companies

Characteristics of a Corporation

- **Separate Legal Existence**
 - corporation acts under its own name rather than in the name of its shareholders
 - pays income tax as a separate entity
- **Limited Liability of Shareholders**
 - liability of shareholders is limited to their investment in the shares of the corporation
 - creditors only have access to corporate assets to satisfy their claims
 - shareholders cannot be made to pay for the company's liabilities out of personal assets
 - may lose more than their investment
- **Transferable Ownership Rights**
 - ownership of a corporation is held in shares of capital
 - are transferable units
 - shareholders -> can't dispose part or all of their interest in a corporation just by selling their shares

- transfer of shares is up to shareholders
 - doesn't require approval from the corporation or other shareholders
- doesn't affect the corporation's financial position
 - corporation does not participate in the transfer
- **Ability to Acquire Capital**
 - corporations obtain capital by issuing shares
 - buying shares in a corporation -> attractive to an investor
 - shareholders have limited liability, and shares are readily transferable
 - only small amounts needed to invest
- **Continuous Life**
 - corporations have an unlimited life
 - is a separate legal entity therefore its life is not affected by withdrawal etc.
 - corporations can have an indefinite and continuous life
- **Corporation Management**
 - shareholders are able to invest without having to manage it personally
 - shareholders manage it indirectly through a board of directors
- **Government Regulations**
 - Canadian companies can be incorporated federally or provincially
 - regulations under each level of government
- **Income Tax**
 - corporations pay federal and provincial income taxes
 - as separate legal entities
 - personal income taxes can be delayed

Share Issue Considerations

- shares are divided into different classes
- rights and privileges for each class of shares are stated in articles of incorporation
- classes are usually identified by generic terms: common shares, preferred shares etc.
- corporations with one class of shares
 - class has the rights and privileges of common shares

Vote Shareholders have the right to vote on certain matters, such as the election of the board of directors. Each shareholder normally has one vote for each common share owned.



Dividends Shareholders share in the distribution of the corporate profit through dividends, in proportion to the number of shares owned.



Liquidation Shareholders share in any assets that remain after liquidation, in proportion to the number of shares owned. This is known as a residual claim because shareholders are paid only if any cash remains after all the assets have been sold and all liabilities paid.



Authorized Share Capital

- amount of share capital a corporation authorizes to sell
 - indicated in its articles of incorporation
- specified as unlimited or specific amounts
- canadian companies have an unlimited amount of authorized shares
- specified number: amount of authorized shares anticipates a company's initial and later capital needs

Issue of Shares

- **initial public offering** the first time a corporation's shares are offered for sale to the public
 - company's receive cash (less financing or issue fees) from the sale of the shares
 - their assets increase
 - shareholders' equity increases
- **issued shares** are authorized shares that have been sold
- when shares have been issued and sold -> they are traded on the secondary market
 - when investors buy and sell shares from each other and not from the company using a stock exchange
- company receives no additional assets and issues no additional shares when shares are sold among investors
 - no impact on a company's financial position

Fair Value of Shares

- share prices change according to the interaction between buyers and sellers
- price follows the trend of a company's profits and dividends

- factors beyond a company's control influences share prices
- commonly reported measure of the fair value of a company's total equity is its market capitalization
 - **market capitalization** is calculated by # of issued shares x the share price at any given date

Legal Capital

- **share capital** when shares are issued they form share capital of the corporation
- retained earnings can be distributed to shareholders as dividends OR retained in the company for operating needs
- share capital is also **legal capital**
 - cannot be distributed to shareholders
 - must remain invested in the company for the protection of corporate creditors
- **no par value shares** are shares that have not been assigned a predetermined value, are issued
 - all proceeds received are considered to be legal capital

Common Shares

- **contributed capital**
 - the amount shareholders paid or contributed to the corporation in exchange for shares of ownership
 - includes **share capital**
- capital consists of both common shares and preferred shares

Issue of Shares

- common shares can be issued or sold to investors
 - investors who become shareholders of the corporation
- when no par value common shares are issued, entire proceeds from the sale become legal capital
- proceeds of the share issued are credited to the Common Shares account

Jan. 12	Cash	2,000	
	Common Shares		2,000
	(To record issue of 1,000 common shares)		

- common shares are normally exchanged for cash
- can be issued for consideration other than cash
 - services
- non cash consideration

- should be recorded at the **fair value of the consideration received**
 - goods or services
- the fair value of the consideration given up can be used
- 5000 common shares issued in exchange for a parcel of land, share trading at \$3.50 per share
- land valued at \$20,000
- transaction recorded using the value of the land, consideration received (rather than the value of the common shares ($5,000 \times \$3.50$) the consideration given up)

Jan. 27	Land	20,000	
	Common Shares		20,000
	(To record issue of 5,000 common shares in exchange for land)		

Retained Earnings

- are the cumulative profits that have been retained in the company

Dividends

- **dividend** is an equal distribution of a portion of a corporation's retained earnings to its shareholders
- many high growth companies do not pay dividends
- policy: to retain all of their profit to make it easier for the company to grow
- investors purchase shares in companies with the hope that share prices will increase in value
 - and that profit will be realized when they sell their shares
- other investors:
 - purchase shares of established companies with the hope of earning dividends
 - with the hope of profiting from some share price appreciation when they sell their shares
- cash dividends
 - most common in practice
- stock dividends are also declared

Cash Dividends

- **cash dividends** a distribution of cash to shareholders
- can be paid to preferred or common shareholders
 - **if dividends are paid to both preferred and common**

shareholders -> preferred shareholders have to be paid first

- two part solvency test under the Canada Business Corporations Act (for a corporation to pay a cash dividend):
 - must have sufficient cash or resources to be able to pay its liabilities
 - they become due after the dividend is declared and paid
 - net realizable value of its assets must exceed the total of its liabilities and share capital
- companies must also have enough retained earnings **before** it can pay a dividend
 - is not a requirement for federally incorporated companies
- companies can't pay dividends unless
 - its board of directors decides to do so
 - the board declares the dividend to be payable
- BOD has authority to determine amount of retained earnings to be distributed in the form of dividends
 - as well as the amount to be retained in the company
- **dividends do not accrue much like interest on a loan**
 - **are not a liability until declared**
- **entries for cash dividends**
 - 3 dates important
 - declaration date
 - record date
 - payment date
 - **declaration date** the BOD formally authorizes the cash dividend and announces it to shareholders
 - commits the corporation to a binding legal obligation
 - entry: increase in Cash Dividends
 - decrease in retained earnings
 - increase in the liability Dividends Payable

<u>Declaration Date</u>			
Dec. 1	Cash Dividends	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividend)		

- Cash Dividends account is closed into
 - retained earnings will be reduced
 - all at the end of the year

- **dividends payable:** current liability
 - normally paid within a month or so
- **record date** is when the ownership of shares is determined
 - individual share owners may change as shares are bought and sold on the secondary market
 - transactions between shareholders does not affect company financial position
 - HOWEVER, company's do have to maintain shareholder records
 - which identify individual owners
 - identifies who to pay the dividend to
- **payment date** dividends are paid to the shareholders

<u>Payment Date</u>			
Jan. 20	Dividends Payable	50,000	
	Cash		50,000
	(To record payment of cash dividend)		

	Assets	Liabilities	Shareholders' Equity	
			Share Capital	Retained Earnings
Declaration of cash dividend	NE	+	NE	-
Record date	NE	NE	NE	NE
Payment of cash dividend	-	-	NE	NE
Cumulative effect of declaration and payment of cash dividend	-	NE	NE	-

Stock Dividends

- **stock dividends** are a distribution of the corporation's own shares to shareholders
- cash dividends are paid in cash
- stock dividends are distributed or paid in shares
- cash dividends **decreases assets** (cash account) **and shareholders' equity** (retained earnings account)
- stock dividends **do not change either assets, liabilities or total shareholders' equity**
 - no cash is paid
 - no liabilities are assumed

- changes in shareholders' equity offset each other
- stock dividends affect:
 - decrease in retained earnings
 - increase in share capital
 - **does not change total shareholders' equity**
- **what are the purposes and benefits of a stock dividend?**
 - a corporation issues a stock dividend for these reasons
 - to satisfy shareholders' dividend expectations while conserving cash
 - to increase the marketability of the shares.
 - number of shares increases, share price decreases on the stock market
 - decreasing the market price of the shares makes it easier for investors to purchase them
 - to emphasize that a portion of shareholders' equity has been permanently reinvested in the legal capital of the business and is unavailable as cash dividends
- there are declaration dates, record dates and distribution or payment dates
- size of a stock dividend and value to be assigned to each dividend are determined by the BOD
 - only when the dividend is declared
 - Canada Business Corporations Act requires stock dividends be recorded at **fair value**(market price per share) at the declaration date
 - is what the corporation would have received if the shares had been issued for cash **rather than as a stock dividend**
- **Entries for Stock Dividends**
 - 50,000 common shares with a balance of \$500,000 in Common Shares
 - \$300,000 in Retained Earnings
 - june 30, there is a declaration of a 10% stock dividend to shareholders to be distributed on August 5th,
 - share price on June 30 is \$15 per share
- number of shares to be issued = 5,000 (50,000 x 10%)
- total amount to be debited to Stock Dividends account = \$75,000 (5,000 x \$15)

- fair value at the declaration date which is relevant for the transaction
 - not fair value on record date or payment date

June 30	Stock Dividends	75,000	
	Common Stock Dividends Distributable		75,000
	(To record declaration of 10% stock dividend)		

- Stock Dividends Distributable is a shareholders' equity account
 - not a liability - assets are not used to pay the dividend
 - will be paid with common shares
- if statement of financial position is prepared before the dividend shares are issued, distributable account is reported as share capital in the shareholders' equity section of the balance sheet
- cash dividends, stock dividends account will be closed into and reduce the Retained Earnings account at the end of the year
- **no entry at the record date**
- dividend shares are issued on August 5th, Stock Dividends Distributable is decreased - debited
 - Common Shares is increased - credited

Aug. 5	Stock Dividends Distributable	75,000	
	Common Shares		75,000
	(To record issue of 5,000 common shares in a 10% stock dividend)		

	Before Stock Dividend	Change	After Stock Dividend
Shareholders' equity			
Common shares	\$500,000	+ \$ 75,000	\$575,000
Retained earnings	300,000	-75,000	225,000
Total shareholders' equity	\$800,000	\$ 0	\$800,000
Number of shares	50,000	+5,000	55,000

Stock Splits

- stock splits are not dividends
- **stock splits** are like a stock dividend, involves the issue of additional shares to shareholders according to their percentage ownership
- stock splits are usually larger than stock dividends
- example
 - stock dividends might result in an additional 10% of common shares issued

- stock splits could result in 100% more common shares issued
- purpose of a stock split
 - increase the marketability of the shares by lowering the share price
 - most investors buy shares in multiples of 100, reducing the price per share through stock splits
 - making a company's shares more affordable for the average investor
- a lower stock a market price increases investors' interest in a company and makes it easier for a corporation to issue additional shares
- effect of a stock split on the share price
 - inversely proportional to the size of the split
 - the larger the split, the lower the price per share
- number of shares is increased by a **specified proportion**
- example
 - in a 2 for 1 stock split, a company has 100,000 shares issued before the split will issue an additional 100,000 shares and have a total of 200,000 shares (100,000 x 2) issued after the split
 - Stock splits do not effect total share capital, retained earnings or total shareholders' equity
 - effects only **the number of shares increased**

	Before Stock Split	Change	After Stock Split
Shareholders' equity			
Common shares	\$500,000	\$0	\$500,000
Retained earnings	300,000	0	300,000
Total shareholders' equity	\$800,000	\$0	\$800,000
Number of shares	50,000	+50,000	100,000

- a stock split does not affect the balances in shareholders' equity accounts
- **not necessary to journalize a stock split**
- **memos are only needed**

Comparison of Effects

- cash dividends, stock dividends and stock splits have varying affects on a company's financial position

	Shareholders' Equity					
	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Share Capital</u> + <u>Retained Earnings</u>	<u>Number of Shares</u>
Cash dividend	-		NE		NE -	NE
Stock dividend	NE		NE		+ -	+
Stock split	NE		NE		NE NE	+

Retained Earnings Restrictions

- balance in retained earnings is generally available for dividend declaration
- **retained earnings restrictions** which make a portion of the balance unavailable for dividends
- **Legal Restrictions**
 - treasury shares are a company's own shares that have been repurchased and held for later reissue
 - portion of retained earnings equal to the cost of any treasury shares purchased
 - must be restricted from being paying dividends
- **Contractual restrictions**
 - long term debt contracts could restrict retained earnings as a condition for the loan
 - restrictions known as **debt covenants** - among other things, limit the use of corporate assets for the payment of dividends
 - makes it more likely a corporation will be able to meet its required loan payments
- **Voluntary Restrictions**
 - BOD could voluntarily create retained earnings restrictions for specific purposes
 - could authorize a restriction because of a future plant expansion
 - through reducing the amount of retained earnings available for dividends, company makes more cash available for the planned expansion
- retained earnings does not represent a claim on any specific asset
- restrictions inform users that a portion of retained earnings is not available for dividend payments
- no journal entry necessary to record a retained earnings restriction
- disclosed in the notes to the financial statements

Presentation of Shareholders' Equity

Statement of Financial Position

- shareholder's equity section have the following recorded
 - contributed capital
 - retained earnings
 - accumulated other comprehensive income


Contributed Capital

- two classifications
- **Share Capital**
 - consists of preferred and common shares
 - gives additional rights
 - preferred shares are shown before common shares
 - legal capital, number of shares authorized, number of shares issued and particular share preferences
 - reported for each class of shares directly in the shareholders' equity section on the balance sheet OR in a note to the financial statement
 - any stock dividends distributable existing at year end are also reported under share capital
 - private companies reporting under ASPE do not require to disclose the number of shares authorized
 - only number issued along with related rights and privileges
- **Additional Contributed Capital**
 - includes amounts contributes from reacquiring and retiring shares
 - shares issued with a par or stated value, amounts paid for the shares in excess of the par or stated value are recorded as additional contributed capital
 - company with a variety of sources of additional contributed capital but distinguish each one by source
 - share capital is most often used instead of contributed capital

- Retained Earnings
- are cumulative profits or losses since incorporation that have been retained in the company
- Beginning Retained Earnings +/- Profit - dividends = Ending Retained Earnings
- has a credit balance for a normal balance


Accumulated Other Comprehensive Income IFRS

- revenues, expenses, gains or losses are included in profit
- certain gains and losses bypass profit and are recorded as direct

LULULEMON ATHLETICA INC.		lululemon  athletica	
Balance Sheet (partial)			
January 31, 2010			
(in U.S. thousands)			
		2010	2009
Shareholders' equity			
Contributed capital			
Common shares, \$0.01 par value, 200,000 shares authorized and 51,126 shares issued in 2010 (50,422 in 2009)	\$ 511	\$ 504	
Additional paid-in capital	<u>158,921</u>	<u>155,961</u>	
Total contributed capital	159,432	156,465	
Retained earnings	67,809	9,528	
Accumulated other comprehensive income (loss)	<u>5,867</u>	<u>(11,151)</u>	
	<u>\$233,108</u>	<u>\$154,842</u>	

Statement of Changes in Equity IFRS

- discloses changes in total shareholders' equity for the period
- changes in shareholders' equity account
 - includes contributed capital, retained earnings, accumulated other comprehensive income
- is a required statement for companies reporting under IFRS

LULULEMON ATHLETICA INC.							lululemon  athletica	
Statement of Shareholders' Equity (partial)								
Year Ended January 31, 2010								
(in U.S. thousands)								
	Common Shares							
	Number of Shares	Legal Capital	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total		
Bal., February 1, 2009	50,422	\$504	\$155,961	\$ 9,528	\$(11,151)	\$154,842		
Comprehensive income								
Net income				58,281		58,281		
Foreign currency translation adjustment					17,018	17,018		
Stock-based compensation			1,758			1,758		
Common shares	134	1	(1)					
Restricted share issuance	15							
Stock option exercises	<u>555</u>	<u>6</u>	<u>1,203</u>			<u>1,209</u>		
Bal., January 31, 2010	<u>51,126</u>	<u>\$511</u>	<u>\$158,921</u>	<u>\$67,809</u>	<u>\$ 5,867</u>	<u>\$233,108</u>		

Measuring Corporate Performance

Dividend Record

- companies reward investors for their investment through paying them dividends
- **payout ratio** measures the percentage of profit distributed as cash dividends
- CASH DIVIDENDS / PROFIT

	2010	2009
Profit	\$2,104	\$1,854
Cash dividends	503	474
Dividends per common share	1.30	1.01
Common share price	66.35	57.34

PAYOUT RATIO = $\frac{\text{CASH DIVIDENDS}}{\text{PROFIT}}$		
(in millions)	2010	2009
Payout ratio	$\frac{\$503}{\$2,104} = 23.9\%$	$\frac{\$474}{\$1,854} = 25.6\%$
Industry average	28.9%	n/a

- **dividend yield** a measure which interests shareholders
 - DIVIDEND PER SHARE / MARKET PRICE PER SHARE

DIVIDEND YIELD = $\frac{\text{DIVIDEND PER SHARE}}{\text{MARKET PRICE PER SHARE}}$		
	2010	2009
Dividend yield	$\frac{\$1.30}{\$66.35} = 2.0\%$	$\frac{\$1.01}{\$57.34} = 1.8\%$
Industry average	1.4%	2.8%

- is a measure of profit generated for the shareholder by each share
- based on the market price of each share
- is a measure of a shareholder's return on their investment
- dividend income is only one part of an investor's return on investment in shares

	<u>Payout Ratio (%)</u>	<u>Dividend Yield (%)</u>
BCE	23.3	5.5
Eastern Platinum	0.0	0.0
Empire	8.6	1.4
Google	0.0	0.0
Kimberly-Clark	39.3	4.3
Royal Bank	34.0	5.0

Earnings Performance

- earnings performance or profitability of a company is measured in different ways

Earnings Per Share

Profit Available to Common Shareholders (Profit – Preferred Dividends)	÷	Weighted Average Number of Common Shares	=	Earnings per Share
\$58,281 – \$0	÷	70,251	=	\$0.83

figure 11-10

- **profit available to Common Shareholders**
 - calculated by Profit - Preferred Dividends
 - preferred shareholders have preferential rights to receive these dividends before the common shareholders can share in remaining amounts
- **weighted average number of common shares**
 - considers the impact of shares issued at different times throughout the year
 - issue of shares is constantly changing throughout the year
 - shares issued or purchased throughout the year are weighted by the fraction of the year or period
 - **no change in the number of shares issued during the year, weighted average number of shares will be the same as the ending balance**

Date	Actual Number		Weighted Average
Jan. 1	100,000	$\times \frac{12}{12} =$	100,000
July 1	(7,500)	$\times \frac{6}{12} =$	(3,750)
Oct. 1	10,000	$\times \frac{3}{12} =$	2,500
	102,500		98,750

- **complex capital structure**
 - corporations have a complex capital structure when they have securities that may be converted into common shares
 - example of convertible security is convertible preferred shares
 - preferred shares converted into common shares, additional common shares result in a reduced, diluted, earnings per share figure/ number
 - two earnings per share figures are calculated when a corporation has a CCS
 - **basic earnings per share**
 - figure 11-10

- **diluted earnings per share**

- calculates hypothetical earnings per share as if all securities can be converted into or exchanged for common shares

Return on Equity

- **return on common shareholders' equity** is a widely used ratio measuring profitability from the common shareholders' viewpoint
- shows how many dollars were earned for each dollar invested by common shareholders
- PROFIT AVAILABLE TO COMMON SHAREHOLDERS' / AVERAGE COMMON SHAREHOLDERS' EQUITY
- average common shareholders' equity = total shareholders' equity - legal capital of any preferred shares

(in U.S. thousands)	2010	2009	2008
Profit	\$ 58,281	\$ 39,363	\$ 30,843
Shareholders' equity	233,108	154,842	112,034

RETURN ON COMMON SHAREHOLDERS' EQUITY = $\frac{\text{PROFIT} - \text{PREFERRED DIVIDENDS}}{\text{AVERAGE COMMON SHAREHOLDERS' EQUITY}}$		
(in U.S. thousands)	2010	2009
Return on common shareholders' equity	$\frac{\$58,281 - \$0}{(\$233,108 + \$154,842) \div 2} = 30.0\%$	$\frac{\$39,363 - \$0}{(\$154,842 + \$112,034) \div 2} = 29.5\%$
Industry average	22.2%	20.4%