

## **Busi 293 Notes**

### **Chapter Twelve**

### **Reporting and Interpreting Shareholders' Equity**

We have now completed our review of the asset and liability sections of the Statement of Financial Position. We will turn our attention to the Shareholders' Equity or the net assets section. A company may have been incorporated under either Provincial or Federal Company Acts. Remember that a corporation is a separate legal entity from its shareholders. It may enter into contracts and is responsible for filing its own tax returns.

While the Shareholders' Equity section may contain a number of components, we will focus on the two largest components:

- **Contributed Capital** – permanent investments from shareholders
- **Retained Earnings** – the net earnings of the company since inception less the cumulative amount of dividends paid by the company.

Refer to textbook reference A for an example of Shareholders' Equity section of a company who follows IFRS.

Unlike a lender who loans money to the company (i.e. a bondholder from Chapter 11) and expects to be repaid, an investor who purchases shares in a corporation is making a permanent investment. The company is under no obligation to repay any investment made by the shareholder. The shareholder is free to sell his/her shares to another party. The benefits of being a shareholder are summarized in textbook reference B.

While some companies issue more than one class of shares, most have only one class of shares known as common shares. In this case each shareholder must receive equal treatment. Generally each share entitles the shareholder to one vote at shareholder meetings.

When a company sells shares to the public for the first time the company is making **an initial public offering or an IPO**. Additional shares offerings sold to the public are **called secondary share offerings**. Remember a company records share transactions when it issues shares and receives consideration in return. When two shareholders sell/buy shares between themselves, there is no effect on the company and therefore no entry is recorded.

Shares may be issued for cash, assets or services. Shares should be recorded at the fair market value of the shares issued or at the value of the consideration received by the company, whichever is more reliable. When common shares are issued, the journal entry is:

Dr Cash  
Cr Common shares

The maximum number of shares which a company may issue is known as the **authorized number of shares**. This number is specified in a company's incorporation documents. The number of shares which have been issued by the company is known as the **issued number** of shares. The number of shares which are issued and held by external shareholders is known as the **outstanding number of shares**. Generally the number of shares issued and outstanding are equal.

Textbook reference C provides an excellent summary of authorized, issued and outstanding shares. Notice the reference to Treasury shares which are shares a company has reacquired from shareholders. We will discuss such shares in the next section of these notes.

Although the textbook makes reference to par and no par value shares (textbook reference D), most shares issued today are no par value shares. The full amount of any consideration received is recorded in the Common shares account.

## Redemption of shares/Treasury Shares

Occasionally a company may wish to repurchase its own common shares. Normally this occurs when the market price has fallen well below the amount management believes the shares are worth. In the United States, the common shares which are repurchased are called Treasury Shares and are shown as a deduction from common shares. Such shares may be reissued when markets improve. In Canada, Treasury Shares are uncommon as repurchased shares are generally cancelled.

In accounting for the acquisition and cancellation of a company's own shares, there are three scenarios which may arise in Canada:

- The shares are repurchased for an amount that is equal to **the average issue price** of the shares repurchased.
- The shares are repurchased for an amount that is **less than the average issue price** of the shares repurchased.
- The shares are repurchased for an amount that **is more than the average issue price** of the shares repurchased.

Any differences arising on the above noted share transactions are capital transactions and **should not be recorded on the Statement of Profit and Loss**. Recall that a gain or loss arising on bonds payable is, however, recorded in the Statement of Profit and Loss. (Chapter 11)

## **Redemption of shares/Treasury Shares** continued

The journal entries for each of the above noted scenarios are:

Shares repurchased **at the average issue price:**

Dr Common Shares  
Cr           Cash

Shares repurchased **at a price below the average issue price:**

Dr Common Shares  
Cr           Cash  
Cr           Contributed Surplus (part of Shareholders' Equity)

Notice that the difference is credited to an account known as Contributed Surplus (part of Shareholders' Equity).

Shares repurchased **at a price above the average issue price:**

Dr Common Shares  
Dr Contributed Surplus  
Dr Retained Earnings  
Cr           Cash

Notice that the debit to Common Shares in all three scenarios is always based on the average issue price (total \$ amount paid for Common shares /number of common shares issued and outstanding) of the shares repurchased. Any difference would first eliminate any Contributed Surplus in respect of that class of shares (i.e. amounts which arose from previous purchase transactions in that class of shares) with any remainder being charged to Retained Earnings. If there is no balance in Contributed Surplus, the total difference is charged to Retained Earnings.

## Cash Dividends

An investor may purchase shares of a company to achieve many objectives including gaining control of the company, profiting from an increase in the price of the shares and/or receiving periodic dividend income from their investment. The directors of the company will determine whether any dividend payments will be made. Such a decision must consider the company's present cash position and its need for cash in the future. The directors are under no legal obligation to declare dividends. However most investors expect and appreciate dividend payments.

There are three important dates with respect to dividends:

- **Declaration Date** – the date the dividend is declared by the Board of Directors and becomes a liability of the company.
- **Date of Record** – the date that the recipient of the dividend is determined – the registered shareholder who is entitled to receive the dividend.
- **Payment Date** – the date the payment is actually made to shareholders of record.

Notice that the date of record is not usually the same day as the declaration date. This is because large companies whose shares are traded actively require time to ensure their share capital records are properly updated. **A dividend can only be paid if the company has retained earnings from which to pay the dividend and the cash necessary to make the payment.** A dividend cannot force Retained Earnings into a debit (deficit) position.

## **Cash Dividends** continued

The journal entry on the declaration date is:

Dr Dividends declared or Retained Earnings  
Cr            Dividends payable

**Dividends declared account is not an expense** but rather a distribution of Retained Earnings. Therefore it appears on the Statement of Retained Earnings. Some textbooks debit Retained Earnings as opposed to Dividends declared. I prefer to use Dividends declared so that opening Retained Earnings always equals ending Retained Earnings from the previous year.

**On the date of record no entry is necessary** however the company can now establish the name of each shareholder entitled to a dividend payment. Remember each share within a class must receive the same amount of dividend payment.

The journal entry on the payment date is:

Dr Dividends payable  
Cr            Cash

Companies may also distribute assets (other than cash) or additional shares as dividends. Dividends in the form of assets are relatively rare and will not be discussed. However the distribution of additional shares known as Stock Dividends is much more common and will now be discussed.

## Stock Dividends

A company may have Retained Earnings (i.e. past earnings which have been retained by the company) but have little cash or desire to distribute any of its cash. In such cases, the Board of Directors may wish to make a distribution of Retained Earnings in the form of additional common shares. Essentially a portion of Retained Earnings will be reclassified to Common Shares – often referred to as capitalization of Retained Earnings. Each shareholder will receive a proportionate share of the additional shares issued. Because a Stock Dividend is issuable to each shareholder, each shareholder maintains their present % interest in the company (i.e. a shareholder who holds a 10% interest in the company before the stock dividend will hold a 10% interest after the stock dividend). . As there are more shares now outstanding, the market price of each share will likely drop. However, as each shareholder owns more shares, the value of their total investment should remain relatively unchanged.

Consider a company which declares a 20% stock dividend. The journal entry on the declaration date is:

Dr Stock dividends declared or Retained Earnings  
Cr            Common shares issuable

The amount of the entry is determined as follows:

Calculation

= Number of common shares currently outstanding \* 0.20 \* Fair Market value of a common share on the declaration date.

## Stock Dividends continued

Common shares issuable is not a liability account as no resources of the company will be used to satisfy the obligation. Rather additional common shares will be issued. The account is part of Shareholders' Equity. As with cash dividends, no journal entry is necessary on the date of record.

When the additional shares are distributed (i.e. **date of issuance**) the following entry is necessary:

Dr Common shares issuable  
Cr            Common shares

## Stock Splits

In good economic times you may have noticed that some companies split their stock. A stock split is not a dividend. In most cases a stock split is completed in order to make the company's shares more affordable for investors. A stock split will result in a decrease in the market price of a company's stock. Many more investors can purchase shares trading at \$10 as opposed to \$100. As with dividends, the Board of Directors must approve and announce a stock split. Assume a company announces a 3 for 1 stock split. Each shareholder will be entitled to receive a further 2 shares from the company for each share he/she currently own. Notice that the numbers of issued and outstanding shares will increase - at the conclusion of the stock split, the company will have three times as many shares issued and outstanding. There is no journal entry to record the entry but rather the number of issued and outstanding shares will be revised.

Please refer textbook reference F for a good discussion on stock dividends and stock splits.

## Preferred Shares

A company may choose to have more than one class of shares outstanding. Each class will entitle the shareholder to different rights. Preferred shareholders usually have a preference for receiving dividends before common shareholders. Most preferred shares contain a fixed dividend rate or amount but are not granted voting rights. Investors in preferred shares are looking for dividend income and are usually more risk averse than common shareholders. Textbook reference F does a good job of discussing other features which may be attached to preferred shares. When both common and preferred shares are outstanding, the company must be careful in determining which shareholders have priority to dividends declared. In order to make a proper determination, one must determine whether the preferred shares carry a cumulative or non-cumulative feature.

Most preferred shares contain a cumulative preference for dividends. A cumulative feature means that the right to receive a dividend for a year is retained by the preferred shareholder even if no dividend is declared for that year. The amount in respect of dividends on cumulative preferred shares which have not been declared in prior years is known as **dividends in arrears**. These amounts are not shown as liabilities as there is no legal obligation to pay them (i.e. they have not been declared by the directors). However dividends in arrears should be disclosed in the notes to the financial statements as investors should be aware that these dividends **would have to be paid prior to the distribution of any dividends on common shares**. Preferred shares which are noncumulative are only entitled to the dividend declared in the current year. As a result, there is no such thing as dividends in arrears on noncumulative preferred shares. Textbook reference G provides some good examples to review.

## Accumulated Other Comprehensive Income

As noted in Chapter 6, public companies reporting under IFRS must report accumulated other comprehensive income as a separate section of Shareholders' Equity. It represents items other than investments by or distributions to shareholders. Examples of items included in this section are unrealized gains or losses from the revaluation of certain assets to fair market value, and certain gains or losses on the translation of financial statements of companies controlled by the company that report their results in foreign currencies. This topic will be discussed in further detail in your intermediate accounting courses.

## Ratios affecting Shareholders' Equity

### Earnings per share (EPS)

Calculation:

=  $\frac{\text{Net income} - \text{preferred dividends}}{\text{Average number of common Shares outstanding}}$

This is a very important ratio often used by investors to gauge the profitability of the company. Analysts watch EPS results very closely.

### Dividend Yield

Calculation:

=  $\frac{\text{Dividends per common share}}{\text{Market price of common share}}$

Indicates the return common shareholders are earning on their investment - the higher the return, the more attractive the company.