

Chapter 11- Reporting and Analyzing Shareholders Equity

Corporate Form of an Organization

Corporation

- Legal entity that is separate and distinct from its owners (shareholders)
- Commonly classified by purpose and by ownership

Purpose

- Profit (McDonalds, Sears Canada, Research in Motion etc)
- Not for Profit (United Way, Canadian Cancer Society, University of Ottawa etc)

Ownership

- Publicly Held Corporation
 - Shares traded on organized stock exchange and may have thousands of shareholders
- Privately Held Corporation
 - Shares not traded on organized stock exchange and may have only a few shareholders

Characteristics of Corporations

Separate Legal Existence

- An entity separate and distinct from owners
- Acts under its own name rather than in the name of shareholders
- May buy, own, and sell property; borrow money; may sue or be sued; and pays its own income tax

Limited Liability

- Creditors have recourse only to corporate assets to satisfy claims
- Liability of shareholders limited to investment in corporation

Transferable Ownership Rights

- Ownership is evidenced by shares, which are transferable units
- Transfer of ownership rights among shareholders has no effect on operating activities of the corporation or on a corporation's assets, liabilities or shareholders' equity

Government Regulations

- Federal and provincial laws usually prescribe the requirements for issuing shares and the distributions of profits permitted to shareholders.
- Provincial securities regulations govern the sale of share capital to the general public, and corporations listed in foreign security markets must also respect their requirements.
- Complying with securities regulations increases the cost and complexity of the corporate form of organization.

Income Tax

- Corporations, as separate legal entities, must pay federal and provincial income tax.
- Shareholders must pay taxes on cash dividends.

Share Issue Considerations

The shares of camping are divided into different classes such as Class A and Class B.

- The rights and privileges for each class of shares are stated in the articles of incorporation
- The classes are usually identified by the generic terms common shares and preferred shares

Rights of common shareholders:

1. Vote
2. Dividends
3. Residual

Bankruptcy?

Creditors First

Common Shareholders Last

Preferred Shares:

1. Dividend preference: priority claim over common shares on any distribution of dividends.
 1. Cumulative dividends: when dividends are declared to be payable, preferred shareholders must be paid both current-year dividends and any unpaid prior year dividends (dividends in arrears) before common shareholders receive dividends.
 2. Noncumulative dividends: dividend that is not paid in any year is lost forever.
2. Liquidation preference: priority claim over common shares on corporate assets if the corporation fails.
3. Other preferences: example convertible preferred shares, redeemable preferred shares, retractable preferred shares.

Authorized Share Capital

- The number of authorized shares a corporation is authorized to sell is indicated in its article of incorporation
- It may be specified as an unlimited amount or a certain number
 - Most Canadian public companies have an unlimited number of authorized shares
- The authorization of share capital does not result in a formal accounting entry
- The number of shares authorized must be disclosed in the shareholders equity section of the statement of financial position

Issues of Shares

- Issued shares are authorized shares that have been sold
- The first time a corporations shares are offered to the public, the offer is called an initial public offering (IPO). The company receives the cash (less any financing or issue fees) from the sale of IPO shares
- Once these shares have been initially issued, they continue trading on the secondary market
 - Investors buy and sell shares from each other, rather than from the company
 - The market price per share is established by the integration between buyers and sellers. Generally, the price follows the trend of a company's profit and its dividends
 - A commonly reported measure of fair value of a company's total equity is its market capitalization calculated by multiplying the number of shares issued by the share price at any given date.

- Market Capital: Share price x # of shares outstanding

Common Shares

- Commonly issued for cash, but may also be issued for other considerations (e.g., services).
- When the issue of common shares for cash is recorded, all of the proceeds received upon issue are considered to be legal capital and this amount is credited to Common Shares.

Example:

Hydro-Slide, Inc., issues 1,000 shares common shares for cash at \$6 per share.

Cash		6,000
	Common Shares	6,000
(To record issue of 1,000 common shares)		

- When shares are issued for a noncash consideration, they should be recorded at their **cash equivalent price**.
 - Under **IFRS**: The cash equivalent price is the fair value of the consideration received. If the fair value of the consideration received cannot be reliably determined, the fair value of the consideration given up is used.
 - Under **ASPE**: record the most reliable of the two values- the fair value of the consideration received or the fair value of the consideration given up.

Example

On March 8, a publicly traded company issued 5,000 common shares for cash of \$30 per share. On April 20, when the shares were trading at \$35, the company issued an additional 3,000 common shares in exchange for land with a fair value of \$110,000

- Prepare the journal entires for each transaction
- Would your answer change if you wear unable to determine the land's fair value on April 20?

Journal Entires

Cash		150,000
	Common Shares	150,000
(March 8)		

Land		110,000
	Common Shares (3,000 shares)	110,000
(April 20)		

Answer change?

Yes it would be 105,000 instead of 110,000

Dividends and Stock Splits

Dividends

- A dividend is a distributed of retained earning by a corporation to its shareholders a pro rata basis
 - Pro rata means that if you own 10% of the common shares, you will receive 10% of the dividend
 - Retained earning are the cumulative profits since incorporation that have not been distributed to the shareholders in the form of dividends
- Dividends are generally reported as an annual dollar amount per share, even though it is usual to pay dividends quarterly
- Cash dividends are the most common in practice, but stock dividends are also declared fairly often

Cash Dividends

- Cash dividends are the distribution of cash to shareholders
- For a corporation to pay a cash dividend, it must meet a two-part solvency test and be declared by the board of directors
- Solvency Test:
 - 1. It must have sufficient cash or other resources to be able to pay its liabilities as they come due after the divided is declared and paid
 - 2. The net realizable value of its assets must exceed the total of its liabilities and share capital
- Declaration of Dividends
 - The board of directors has full authority to determine the amount of retained earnings to be distributed in the form of dividends and the amount to be retained in the business
 - Dividends are not a liability until declared

Entries for Cash Dividends

- Three dates are important in connection with dividends
 1. The declaration date
 2. The record date
 3. The payment date

1. The declaration date

- The date the board of directors formally authorizes the dividend and announces it to the shareholders

DR. Cash Dividends
CR. Dividends Payable
(To record declaration of cash dividend)

2. The record date

- The purpose of the record date is to identify the person or entires that will receive the dividend
- NO ENTRY IS REQUIRED ON THE RECORD DATE

3. The payment date

- Dividend cheques are mailed to the shareholders and the payment of the dividend is recorded

- The entry on the payment date is:

DR. Dividends Payable
CR. Cash
(To record payment of cash dividend)

Example

On December 1, 2012, the director of a company declares a \$0.50 per share cash dividend on 100,000 common shares. On January 20, the company pays the dividends. Prepare the journal entries

Dec 1 2012

DR. Cash Dividends (0.50 x 100,000) 50,000
CR. Dividends Payable 50,000

Jan 20 2013

DR. Dividends Payable 50,000
CR. Cash 50,000

Stock Dividend

- Distribution of the corporation's own shares to shareholders
- Results in a decrease in RE and an increase in share capital
- Does not decrease total shareholders equity or total assets
- Valued using the fair value per share at the declaration date
- On the declaration date:
 - DR. Stock Dividends
 - CR. Common Stock Dividends Distributable (This is not a liability account)
- When the dividend shares are issued:
 - DR. Common Stock Dividends Distributable
 - CR. Common Shares

Example

On June 30, a company declares a 10% stock dividend on its 50,000 common shares, to be distributed on August 5. On June 30, the market value of its shares is \$15 per share.

1. Prepare the journal entry to record the declaration of the stock dividend
2. Divided shares of the company are issued on August 5
3. What is the effect of composition of share dividends on shareholders equity?

Before the stock dividend payment, the company had \$500,000 of common shares and \$300,000 of retained earnings.

1. June 30

DR. Stock Dividends 75,000 (50,000 x 10% x \$15)
CR. Common Stock Dividends Distributable 75,000

2. August 5

DR. Common Stock Dividends Distributable 75,000
CR. Common Shares 75,000

3. The effect is none on the totals, but retained earnings does increase and the retained earnings does decrease

	Cash dividend	Stock dividend
Declaration date	Dr. Cash dividends Cr. Dividends payable	Dr. Stock dividends Cr. Common stock dividends distributable
Payment date	Dr. Dividends payable Cr. Cash	Dr. Common stock dividends distributable Cr. Common shares

Stock Splits

- Like a stock dividend, it involves the issue of additional shares to shareholders according to their percentage ownership.
- A stock split results in a reduction in the legal capital **per share** and is usually much larger than a stock dividend.
- The purpose of a stock split is to increase the marketability of the shares by lowering the share price, making it easier for the corporation to issue additional shares and also to increase investor interest.
- In a stock split, the number of shares is increased in the same proportion that the legal capital per share is decreased.
- A stock split does not have any effect on total share capital, retained earnings, and total shareholders' equity. However, the number of shares increases.
- Because a stock split does not affect the balances in shareholders' equity accounts, it is not necessary to journalize a stock split.

Example

Assume that instead of issuing a 10% share dividend, IBR splits its 50,000 common shares on a 2-for-1 basis. What is the effect of IBR's stock split on shareholders' equity?

	Before Share Split	After Share Split
Shareholders' equity		
Common shares	\$500,000	\$500,000
Retained earnings	<u>300,000</u>	<u>300,000</u>
Total shareholders' equity	<u>\$800,000</u>	<u>\$800,000</u>
Number of shares	<u>50,000</u>	<u>100,000</u>

Comparison Between Dividends and Stock Splits

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

Financial Statement Presentation

Statement of Financial Position Presentation

In the shareholders equity section of the statement of the financial position, we report:

- Contributed Capital
- Retained Earnings
- Accumulated and Comprehensive Income

Statement of Changes in Equity

This statement discloses changes in total shareholders equity for the period, as well as changes in each shareholders equity account, including:

- Contributed Capital
- Retained Earnings
- Accumulated and Comprehensive Income

1. Contributed Capital

- **Share Capital**—consists of preferred and common shares
 - Preferred shares are shown before common shares because of their additional rights
 - Information about the legal capital, number of shares authorized, number of shares issued, and any particular share preferences is reported for each class of shares
- **Additional Contributed Capital** includes amounts contributed from reacquiring and retiring shares, or from other shareholder transactions

2. Retained Earnings

- Are the cumulative profits (or losses) that have been retained in the company (not distributed to shareholders) since its incorporation. The normal balance is a credit, but if a deficit (debit balance) exists it is reported as a deduction from shareholders' equity.

3. Accumulated Other Comprehensive Income (AOCI)

- Includes the gains and losses that bypass profits but affect shareholders' equity.
- Comprehensive income includes all changes in shareholders' equity during a period except changes that result from the sale or repurchase of shares or the payment of dividends.
- Examples of comprehensive income include certain translation gains and losses on foreign currency, unrealized gains and losses from cash flow hedges, and unrealized pension cost from a minimum pension liability adjustment.
- Not all companies will have examples of other comprehensive income. However, if they do, they must report:
 - Comprehensive income separately in a statement of comprehensive income,
 - Accumulated other comprehensive income as a separate component of shareholders' equity.

Example: SFP

OZABAL INC.
Statement of Financial Position (Partial)
December 31, 2012

Shareholders' equity	
Contributed capital	
Share capital	
\$1.25 Preferred shares, no par value, noncumulative, 100,000 shares authorized, 10,000 issued.....	\$250,000
Common shares, no par value, unlimited number of common shares authorized, 250,000 issued.....	500,000
Common stock dividends distributable.....	50,000
Contributed capital – reacquisition of common shares .	<u>25,000</u>
Total contributed capital.....	\$ 825,000
Retained earnings (Note R)	900,000
Accumulated other comprehensive loss	<u>(50,000)</u>
Total shareholders' equity	<u>\$1,675,000</u>

Example: Statement of Changes in Equity

STENGEL CORPORATION
Statement of Changes in Equity
Year Ended December 31, 2012

	Common Shares		Retained Earnings	Accumulated Other Comprehensive Loss	Total
	Number of Shares	Legal Capital			
Balance, Jan. 1	75,000	\$1,700,000	\$ 900,000	\$(125,000)	\$2,475,000
Cash dividends			(75,000)		(75,000)
Stock split, April 1	150,000				
Stock dividends	11,250	157,500	(157,500)		
Profit			400,000		400,000
Balance, Dec. 31	<u>236,250</u>	<u>\$1,857,500</u>	<u>\$1,067,500</u>	<u>\$(125,000)</u>	<u>\$2,800,000</u>

Example

Prepare statement of changes in equity and shareholders equity sections.

A company responded to the following changes to the shareholders equity accounts for the year ended December 2015

Accumulated other comprehensive income:		Retained Earnings:	
Balance: Jan 1	90,000	Bal Jan 1	1,500,000
Other comprehensive incomes	(25,000)	Profit:	400,000
Balance: Dec 31.	<u>65,000</u>	Calc Dividends	(70,000)
Additional Calculated Capital		Balance Dec 31	<u>1,830,000</u>
Balance Jan 1	<u>540,000</u>	Common Shares	
Balance Dec 31	<u>540,000</u>	Bal Jan 1	800,000
		Shares Declared	<u>180,000</u>
		Bal Dec 31	<u>980,000</u>

Statement of Changes in Equity

(a)

THE BLUE CANOE LIMITED
Statement of Changes in Equity
Year Ended December 31, 2015

	Common Shares	Additional Contributed Capital	Retained Earnings	Accumulated Other Compre- hensive Income	Total
Balance Jan 1	<u>\$800,000</u>	<u>\$540,000</u>	<u>\$1,500,000</u>	<u>\$90,000</u>	<u>\$2,930,000</u>
Issued common shares	180,000				180,000
Profit			400,000		400,000
Cash dividends			(70,000)		(70,000)
Other comprehensive income				(25,000)	(25,000)
Balance Dec 31	<u>\$980,000</u>	<u>\$540,000</u>	<u>\$1,830,000</u>	<u>\$65,000</u>	<u>\$3,415,000</u>

Equity Statement

(b)

THE BLUE CANOE LIMITED
Statement of Financial Position (Partial)
December 31, 2015

Shareholders' equity	
Contributed capital	
Common shares	\$980,000
Additional contributed capital	<u>540,000</u>
Total contributed capital	\$1,520,000
Retained earnings	1,830,000
Accumulated other comprehensive income	<u>65,000</u>
Total shareholders' equity	<u>\$3,415,000</u>

Evaluate Dividends and Earnings Performance

Dividend Record

- The payout ration
 - Measures the percentage of profits distributed in the form of cash dividends to common shareholders
 - Higher is better is investor looking for income

$$\text{Payout ratio} = \frac{\text{Cash dividends}}{\text{Profit}}$$

- The dividend yield
 - Measures the profit generated by each share, based on the market price of the shares
 - Higher is better if investor looking for income

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}}$$

Earning Performance

1. Earnings per share EPS

$$\text{Earnings per share} = \frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$$

- The weighed average number of common shares is calculated by multiplying the number of shares issued by the faction of the year that they have been issued
 - When a corporation has securities that may be converted into common shares, it must report basic earnings per share and diluted earnings per share
 - The diluted earnings per share is a hypothetical figure that assumes all securities that can be converted into or exchanged for, common shares have actually been converted or exchanged

- CANT USE EPS TO COMPARE COMPANIES

2. Return on common shareholder's

- Widley used ratio that measures profitably for the common shareholders viewpoint
- Profits available to the common shareholders is profits less ant preferred dividends
- Higher is better

$$\text{Return on common shareholders' equity} = \frac{\text{Profit available to common shareholders}}{\text{Average common shareholders' equity}}$$

Example

Calculate and evaluate the dividend record

The following information is available for two companies: Nike and Adidas

(in millions of \$ our share information)

	Nike (in USD)	Adidas (EURO)
Market price per share	53.68	67.33
Total cash dividends	619	282
Dividends per share	1,565	135
Profit	2,223	791

- Calculate the payout ratio and the dividend yield for each company
- What company would investors favour for dividend incomes purposes?

PAYOUT RATIO NIKE

$$\begin{aligned} & 619/2,223 \\ & = 0.28 \\ & 28\% \end{aligned}$$

ADIDAS

$$\begin{aligned} & 282/791 \\ & = 0.357 \\ & 36\% \end{aligned}$$

DIVIDEND YIELD NIKE

$$\begin{aligned} & 1,565/53.68 \\ & = 0.29 \\ & 2.9\% \end{aligned}$$

ADIDAS

$$\begin{aligned} & 135/67.33 \\ & = 0.2 \\ & 2\% \end{aligned}$$

The dividend yield is higher so the investor should pick Nike