Introduction to Accounting 2

Modul 7

Chapter 15

CORPORATIONS: Dividends, Retained Earnings, and Income Reporting

After studying this chapter, you should be able to:

1. Prepare the entries for cash dividends and stock dividends.
2. Identify the items that are reported in a retained earnings statement.
3. Prepare and analyze a comprehensive stockholders' equity section.
4. Describe the form and content of corporation income statements.
5. Compute earnings per share.

DIVIDENDS (STUDY OBJECTIVE 1)

- Distribution by a corporation to its stockholders on a pro rata (proportional) basis
- May be in the form of cash, property, scrip (promissory note to pay cash), or stock
- May be expressed in one of two ways:
    1. As a percentage of the par or stated value of the stock
    2. As a dollar amount per share

Cash Dividends

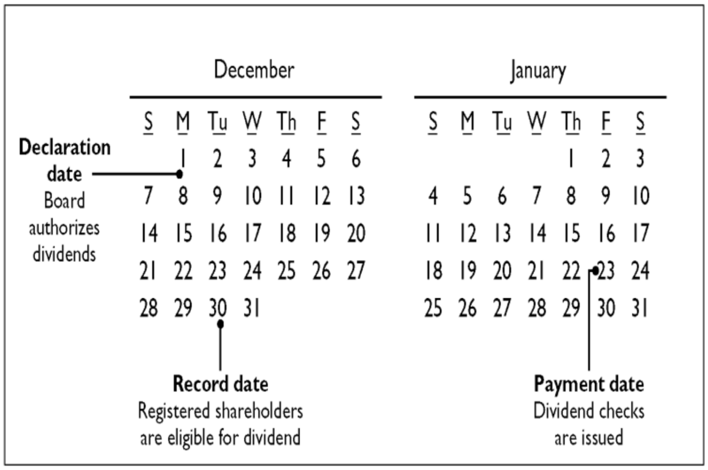
- For a corporation to pay a cash dividend it must have:
    a. Retained earnings
    b. Adequate cash
    c. A declaration of dividends

Entries for Cash Dividends

Three important dates in connection with dividends:

- Declaration date
  Board of Directors formally declares a cash dividend and a liability is recorded.
- Record date
  Marks the time when ownership of outstanding shares is determined from the records maintained by the corporation.
- Payment date
  Date dividend checks are mailed to the stockholders and the payment of the dividend is recorded.

Key Dividend Dates



Declaration Date

Assume that on December 1, 2005, the directors of Media General declare a 50 cents per share cash dividend on 100,000 shares of $10 par value common stock. The dividend is $50,000 (100,000 x 50 cents) and the entry to record the declaration is:

Dec. 1	Retained Earnings	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividend)		

A	=	L	+	SE
		+50,000		−50,000 Div

Cash Flows
no effect

Record Date

The purpose of the record date is to identify the persons or entities that will receive the dividend, not to determine the dividend liability. For Media General, the record date is December 22. No entry is required on this date because the corporation’s liability recognized on the declaration date is unchanged.

Dec. 22	No entry necessary		

Payment Date

Assuming the payment date is January 20 for Media General, the entry on that date is**:**

Jan. 20	Dividends Payable	50,000	
	Cash		50,000
	(To record payment of cash dividend)		

A	=	L	+	SE
−50,000		−50,000		

Cash Flows
−50,000

Payment of the dividend *REDUCES* both current assets and current liabilities but has no effect on stockholders' equity.

Allocating Cash Dividends Between Preferred and Common Stock

- Cash dividends
  Must be paid first to preferred stockholders *before* any common stockholders are paid.
- *Cumulative* preferred stock
  Any dividends in arrears and the current year dividend must be paid to preferred stockholders before allocating any dividends to common stockholders.
- Preferred stock is *not cumulative*
  Only the current year's dividend must be paid to preferred stockholders before paying any dividends to common stockholders.

Allocating Cash Dividends Between Preferred and Common Stock

Assume that IBR Inc. has 1,000 shares of 8%, $100 par value cumulative preferred stock and 50,000 shares of $10 par value common stock outstanding at December 31, 2005. If the Board of Directors declares a $6,000 cash dividend on December 31, the entire $6,000 will go to preferred stockholders because their annual dividend is $8,000,(1,000 shares x $8) .

Dec. 31	Retained Earnings	6,000	
	Dividends Payable		6,000
	(To record $6 per share cash dividend to preferred stockholders)		

A	=	L	+	SE
		+6,000		−6,000 Div

Cash Flows
no effect

$2,000 has gone into arrears for preferred stockholders

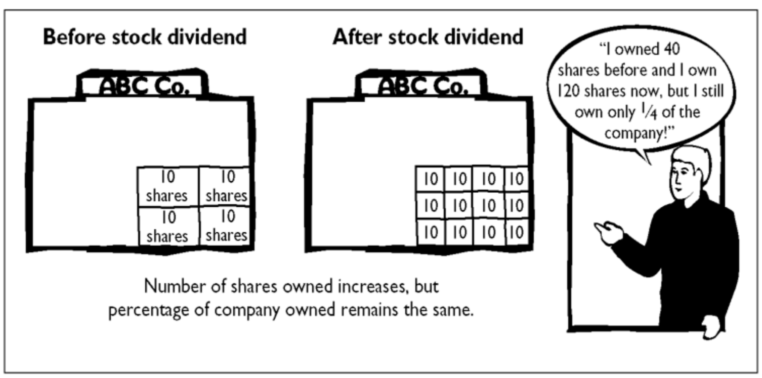
Allocating Cash Dividends Between Preferred and Common Stock

Total dividend		$50,000
Allocated to preferred stock		
Dividend in arrears, 2005 (1,000 x $2)	$2,000	
2006 dividend (1,000 x $8)	8,000	
		10,000
Remainder allocated to common stock		$40,000

At December 31, 2005, IBR declares a $50,000 cash dividend. The allocation of the dividend to the two classes of stock is shown above.If the preferred stock was NON-cumulative, preferred stockholders would have received only $8,000 in dividends in 2006 and common stockholders would have received $42,000.

Stock Dividends

- Pro rata distribution to stockholders of the corporation's own stock
  - ✓ Results in a *decrease* in retained earnings and an *increase* in paid-in capital
  - ✓ At a minimum, the par or stated value must be assigned to the dividend shares; in most cases, however, fair market value is used
- A stock dividend does NOT decrease Total Assets or Total Stockholders' Equity.



Number of shares owned increases, but percentage of company owned remains the same.

Disclosure

Rally would present the information in the following format.

Rally Inc. Income Statement (partial)

Net income	$211,000
Earnings per share	$2.00

Earnings per Share

The formula to compute earnings per share when there is no preferred stock is as follows:

$$\frac{Net\ Income}{Weighted\ Average\ Common\ Share\ Outstanding} = \text{Earning Per Share}$$

Purposes and Benefits of a Stock Dividend

Corporations issue stock dividends generally for one or more of the following reasons:

1. To satisfy stockholders' dividend expectations without spending cash
2. To increase the marketability of stock by increasing the number of shares
3. To emphasize that a portion of stockholders' equity has been permanently reinvested in the business and unavailable for cash dividends

Stock Dividends Distinguished

- SMALL stock dividend
  - Less than 20-25% of the corporation's issued stock
  - Assign fair market value to small stock dividends
    Assumption that a small stock dividend will have little effect on the market price of the shares previously outstanding.
- LARGE stock dividend
  - Greater than 20-25% of the corporation's issued stock
  - Par or stated value per share is normally assigned

Entries for Stock Dividends

Assume that Medland Corporation has a balance of $300,000 in retained earnings and declares a 10% stock dividend on its 50,000 shares of $10 par value common stock. The current fair value of its stock is $15 per share and the number of shares to be issued is 5,000 (10% of 50,000). The amount to be debited to Retained Earnings is $75,000 (5,000 x $15).

Retained Earnings	75,000	
Common Stock Dividends Distributable		50,000
Paid-in Capital in Excess of Par Value		25,000
(To record declaration of 10% stock dividend)		

A	=	L	+	SE
				−75,000 Div
				+50,000 CS
				+25,000 CS

Cash Flows
no effect

NOTE!!!

Retained Earnings is debited for the fair market value of the stock issued because this is a SMALL stock dividend. Common Stock Dividends Distributable is credited for the par value of the dividend shares (5,000 x $10), and the excess is credited to Paid-in Capital.

Statement Presentation of Common Stock Dividends Distributable

Common Stock Dividends Distributable is a stockholders' equity account; it is not a liability because assets will NOT be used to pay the dividend. If a balance sheet is prepared before the dividend shares are issued, the distributable account is reported in paid-in capital as an addition to common stock.

Paid-in capital	$ 500,00	
Common Stock	50,000	
Common Stock dividends distributable		550,000

When the dividend shares are issued, Common Stock Dividends Distributable is *debited* and Common Stock is *credited*

Stock Dividend Effects

	Before Dividend	After Dividend
Stockholders' equity		
Paid-in capital		
Common stock, $10 par	$500,000	$550,000
Paid-in capital in excess of par value	—	25,000
Total paid-in capital	500,000	575,000
Retained earnings	300,000	225,000
Total stockholders' equity	**$800,000**	**$800,000**
Outstanding shares	**50,000**	**55,000**
Book value per share	**$16.00**	**$14.55**

Stock dividends change the composition of stockholders' equity because a portion of retained earnings is *transferred* to paid-in capital. However, *total* stockholders' equity and the par or stated value per share remain the same

Stock Splits

- The issuance of additional shares to stockholders according to their percentage ownership
  - *Number* of shares increased in the same proportion that par or stated value per share is decreased
- Has *no effect* on total paid-in capital, retained earnings, and total stockholders' equity.
- Not necessary to formally journalize a stock split

Stock Split Effects

Assume instead of a 10% dividend, Medland Corporation splits its 50,000 shares of common stock on a 2-for-1 basis. This means that one share of $10 par value stock is exchanged for two shares of $5 par value stock. A stock split DOES NOT have any effect on total paid-in capital, retained earnings, and total stockholders' equity. However, number of shares increases and book value per share decreases.

	Before Stock Split	After Stock Split
Stockholders' equity		
Paid-in capital		
Common stock	$500,000	$500,000
Paid-in capital in excess of par value	–0–	–0–
Total paid-in capital	500,000	500,000
Retained earnings	300,000	300,000
Total stockholders' equity	**$800,000**	**$800,000**
Outstanding shares	**50,000**	**100,000**
Book value per share	**$16.00**	**$8.00**

Differences Between the Effects of Stock Splits and Stock Dividends

Item	*Stock Split*	*Stock Dividend*
Total paid-in capital	**No change**	**Increase**
Total retained earnings	**No change**	**Decrease**
Total par value (common stock)	**No change**	**Increase**
Par value per share	**Decrease**	**No change**

RETAINED EARNINGS (STUDY OBJECTIVE 2)

- Net income retained in the business.
- Balance in retained earnings is part of the stockholders' claim on the total assets of the corporation.
  - A net loss is recorded in Retained Earnings by a closing entry in which *Retained Earnings* is debited *and Income Summary* is credited*.*

Stockholders' Equity with Deficit

Balance Sheet (partial)

Stockholders' equity	
Paid-in capital	
Common stock	$800,000
Retained earnings (deficit)	**(50,000)**
Total stockholders' equity	$750,000

A debit balance in retained earnings is identified as a DEFICIT. It is reported as a deduction in the stockholders' equity section, as shown above.

Retained Earnings Restrictions

- Portion of the balance currently *unavailable* for dividends.
  1. Legal
     States may require that corporations restrict re for the cost of treasury stock purchased.
  2. Contractual
     Long term debt contracts may restrict re as a condition for a loan.
  3. Voluntary
     The board of directors may voluntarily restrict re for specific purposes such as future plant expansion.

Disclosure of Unrestricted Retained Earnings

- The balance in retained earnings is generally available for dividend declarations. Some companies state this fact.
- In the notes to its financial statements, Martin Lockheed Corporation states:

LOCKHEED MARTIN CORPORATION
Notes to the Financial Statements

At December 31, retained earnings were unrestricted and available for dividend payments.

Disclosure of Restriction

Tektronix Inc. Notes to the Financial Statements

Certain of the Company's debt agreements require compliance with debt covenants. Management believes that the Company is in compliance with such requirements for the fiscal year ended May 26, 2001. The Company had unrestricted retained earnings of $223.8 million after meeting those requirements

Retained earnings restrictions are generally disclosed in the notes to the financial statements. For example, Tektronix had the above note in a recent financial statement.

Prior Period Adjustments

Correction of a *material* error in reporting net income in a previously issued financial statement.

1. Made directly to Retained Earnings.
2. Reported in the current year's retained earnings statement as an adjustment of the beginning balance of Retained Earnings.

Assume that General Microwave discovers in 2005 that it understated depreciation expense in 2004 by $300,000 as a result of computational errors. These errors overstated net income for 2004, and the current balance in retained earnings is also overstated. The entry for the prior period adjustment, assuming all tax effects are ignored, is as follows:

Retained Earnings	300,000	
Accumulated Depreciation		300,000
(To adjust for understatement of depreciation in a prior period)		

NOTE: A DEBIT TO AN INCOME STATEMENT ACCOUNT IN 2005 WOULD BE INCORRECT BECAUSE THE ERROR PERTAINS TO A PRIOR PERIOD

Statement Presentation of Prior Period Adjustments

Assuming that General Microwave has a beginning balance of $800,000 in retained earnings, the prior period adjustment is reported as follows:

GENERAL MICROWAVE Retained Earnings Statement (partial)	
Balance, January 1, as reported	$800,000
Correction for overstatement of net income in prior period (depreciation error)	**(300,000)**
Balance, January 1, as adjusted	$500,000

NOTE: REPORTING THE CORRECTION IN THE CURRENT YEAR'S INCOME STATEMENT WOULD BE INCORRECT BECAUSE IT APPLIES TO A PRIOR YEAR'S INCOME STATEMENT.

Debits and Credits to Retained Earnings

Retained Earnings	
1. Net Loss	1. Net income
2. Prior period adjustments for overstatement of net income	2 Prior period adjustment for understatement of net income
3. Cash dividends and stock dividends	
4. Some disposals of treasury stock	

Many corporations prepare a retained earnings statement to explain the changes in retained earnings during the year.

COMPREHENSIVE STOCKHOLDERS' EQUITY SECTION (STUDY OBJECTIVE 3)

- Common Stock Dividends Distributable
    - Shown Under Capital Stock In Paid-In-Capital
- Retained Earnings restrictions
    - Disclosed In The Notes To The Financial Statements

CORPORATION INCOME STATEMENTS (STUDY OBJECTIVE 4)

- Includes essentially the same sections as in a proprietorship or a partnership except for the reporting of income taxes
- For tax purposes, corporations are considered to be a separate legal entity.
- Income tax expense
    - Reported in a separate section of the corporation income statement before net income

Income Statement with Income Taxes

LEADS INC.
Income Statement
For the Year Ended December 31, 2005

Sales	$800,000
Cost of goods sold	600,000
Gross profit	200,000
Operating expenses	50,000
Income from operations	150,000
Other revenues and gains	10,000
Other expenses and losses	(4,000)
Income before income taxes	**156,000**
Income tax expense	**46,800**
Net income	$109,200

Income Tax Expense

Using the preceding Income Statement, the adjusting entry for income tax expense at December 31, 2005, would be as follows:

Income Tax Expense	46,800	
Income Taxes Payable		46,800
(To record income taxes for 2005)		

A	=	L	+	SE
		+46,800		−46,800 Exp

Cash Flows
no effect

EARNINGS PER SHARE (STUDY OBJECTIVE 5)

- Frequently reported in the financial press
- Used by stockholders and investors to evaluate profitability
- Indicates the net income earned by each share of outstanding common stock

EPS and Preferred Stock Dividends

When a corporation has both preferred and common stock, the current year's dividend declared on preferred stock is subtracted from net income to arrive at income available to common stockholders. Assume that Rally Inc. reports net income of $211,000 on its 102,500 weighted average common shares. During the year it also declares a $6,000 dividend on its preferred stock.

$$\frac{Net\ Income\ \ minus\ \ prefered\ \ devidens}{Weighted\ Average\ \ Common\ \ Share\ \ Outstanding} = \text{Earning Per Share}$$

$$\frac{(\$211{,}000 - \$6{,}000)}{102{,}500} = \$2 \text{ EPS}$$

Therefore, Rally has $205,000 ($211,000 - $6,000) available for common stock dividends. EPS is $2 ($205,000 / 102,500).

REVIEW

1. The date a cash dividend becomes a binding legal obligation to a corporation is the

a. Declaration date.
b. Earnings date.
c. Payment date.
d. Record date.

2. The income statement for Nadeen, Inc. shows income before income taxes $700,000, income tax expense $210,000, and net income $490,000. If Nadeen has 100,000 shares of common stock outstanding throughout the year, earnings per share is:

a. $7.00.
b. $4.90.
c. $2.10.
d. No correct answer is given.

3. PT Abadi Jaya is an electronic wholesaler located in Jember. During its current fiscal year, ended December 31, 2008. PT Abadi Jaya completed the following selected transactions:

Feb. 3	Purchased 2.500 shares of its own common stock at Rp26.000,00, recording the stock at cost. (Prior to the purchase, there were 40.000 shares of Rp20.000,00 per common stock outstanding)
May 1	Declared a semiannual dividend aof Rp1.000,00 on the 10.000 shares of preferred stock and a Rp300 dividend on the common stock to stockholders of record on May 1, payable on June 15.
June 15	Paid the cash dividend
Sept. 23	Sold 1.000 shares of treasury stock at Rp28.000,00, receiving cash
Nov. 1	Declared semiannual dividend of Rp1.000,00 on the preferred stock and Rp300,00 on the common stock. In addition, a 5% common stock dividend was declared on the common stock outstanding, to be capitalized at the fair market value of the common stock, which is estimated at Rp30.000,00
Dec. 1	Paid the cash dividend and issued the certificates for the common stock dividend

Instructions:

Journalized the entries to record the transaction for PT Abadi Jaya

Reference

Weigandt, Kieso, and Kimmel. (2005). Accounting Principles, 6th Ed. Canada: John Wiley and Sons.

Reeve, James M, Caarl S. Waren and Jonathan E. Duchac. Principles of Accounting. Singapore: Cengage Learning Asia Pte Ltd. (R)