Chapter 17

Earnings per Share and Retained Earnings

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Earnings per Share

While earnings per share (EPS) is one of the most-watched numbers in corporate America, the ability of a company to earn a profit does not always translate to the ability to pay a large dividend.

Earnings per Share

For example, Microsoft chose to reinvest its earnings to fuel future growth until 2003. Eventually, Microsoft grew to a point where it could no longer sustain the growth rate and then it began paying dividends.

Earnings and Earnings per Share

- A corporation summarizes the components of its net income on its income statement, which are:
  - Income (loss) from continuing operations
  - Results from discontinued operations
  - Extraordinary gains or losses
- A corporation also reports its earnings per share on its income statement.

Simple Capital Structure

- For computing earnings per share, there are two types of corporate capital structures—simple and complex.
- A simple capital structure is one that consists only of common stock outstanding.
- A corporation with a simple capital structure is required to report basic earnings per share.

Basic Earnings per Share

$$\frac{\text{Net Income – Preferred Dividends}}{\text{Weighted Average Number of Common Shares Outstanding}}$$

Lapan Corporation reports net income of $48,000, and declares and pays dividends of $8,000 on its preferred stock. It also declares and pays dividends of $12,000 on its 16,000 shares of common stock.

$$\frac{\$48{,}000 - \$8{,}000}{16{,}000} = \underline{\underline{\$2.50}}$$

Disregard common stock dividends in calculating EPS.

Weighted Average Shares

Since a corporation earns its net income over the entire year, the earnings relate to the common shares outstanding during the year.

Weighted Average Shares

McTeal Corporation had 12,000 shares of common stock outstanding at the beginning of the year. On March 2, it issued 2,700 shares; on July 3, it issued another 3,300 shares, and on December 1, it reacquired 480 sl

The nearest whole month is used.

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–February	12,000	2/12	=	2,000
March–June	14,700	4/12	=	4,900
July–November	18,000	5/12	=	7,500
December	17,520	1/12	=	1,460
	Total weighted average common shares			15,860

Weighted Average Shares

Wallers Corporation begins operations in January 2010 and issues 5,000 shares of common stock that are outstanding during all of 2010. On December 31, 2010, it issues a two-for-one stock split.

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–February	5,000	12/12	=	5,000
The two-for-one split is retroactive to January 1.				5,000
	Total weighted average common shares			10,000

Continued

Weighted Average Shares

On May 27, 2011, Wallers Corporation issues 5,000 shares of common stock; on August 3, 2011, it issues a 20% stock dividend; and on October 5, 2011, it issues 2,000 shares of stock.

2010 Data on 2011 Statement

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–February	5,000	12/12	=	5,000

5,000 200% 120% = 12,000 equivalent whole units

Continued

Weighted Average Shares

2011 Data on 2011 Statement

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–May	10,000			
June–July	15,000			
August–September	18,000			

Issued 5,000 shares

Issued 20% stock dividend

Weighted Average Shares

2011 Data on 2011 Statement

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–May	12,000	Increases 20%		
June–July	18,000	Increases 20%		
August–September	18,000			

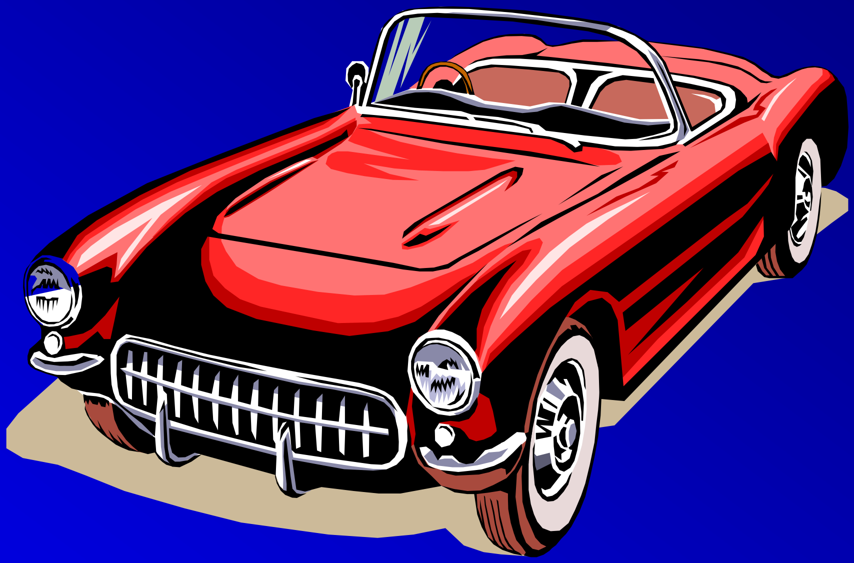
Weighted Average Shares

2011 Data on 2011 Statement

Months Shares Are Outstanding	Shares Outstanding	Fraction of Year Outstanding	=	Equivalent Whole Units
January–May	12,000	5/12	=	5,000
June–July	18,000	2/12	=	3,000
August–September	18,000	2/12	=	3,000
October–December	20,000	3/12	=	5,000
				16,000

Complex Capital Structure

Many corporations have a more complex capital structure that includes outstanding convertible securities or contingent shares that could have a dilutive effect on earnings per share. These securities are referred to as potential common shares.



Diluted Earnings per Share

A corporation with a complex capital structure is required to report two earnings per share amounts on the face of its income statement.

The two amounts are basic earnings per share and diluted earnings per share.

Diluted Earnings per Share

The amount for diluted earnings per share shows the earnings per share after including *all* potential common shares that would reduce earnings per share.

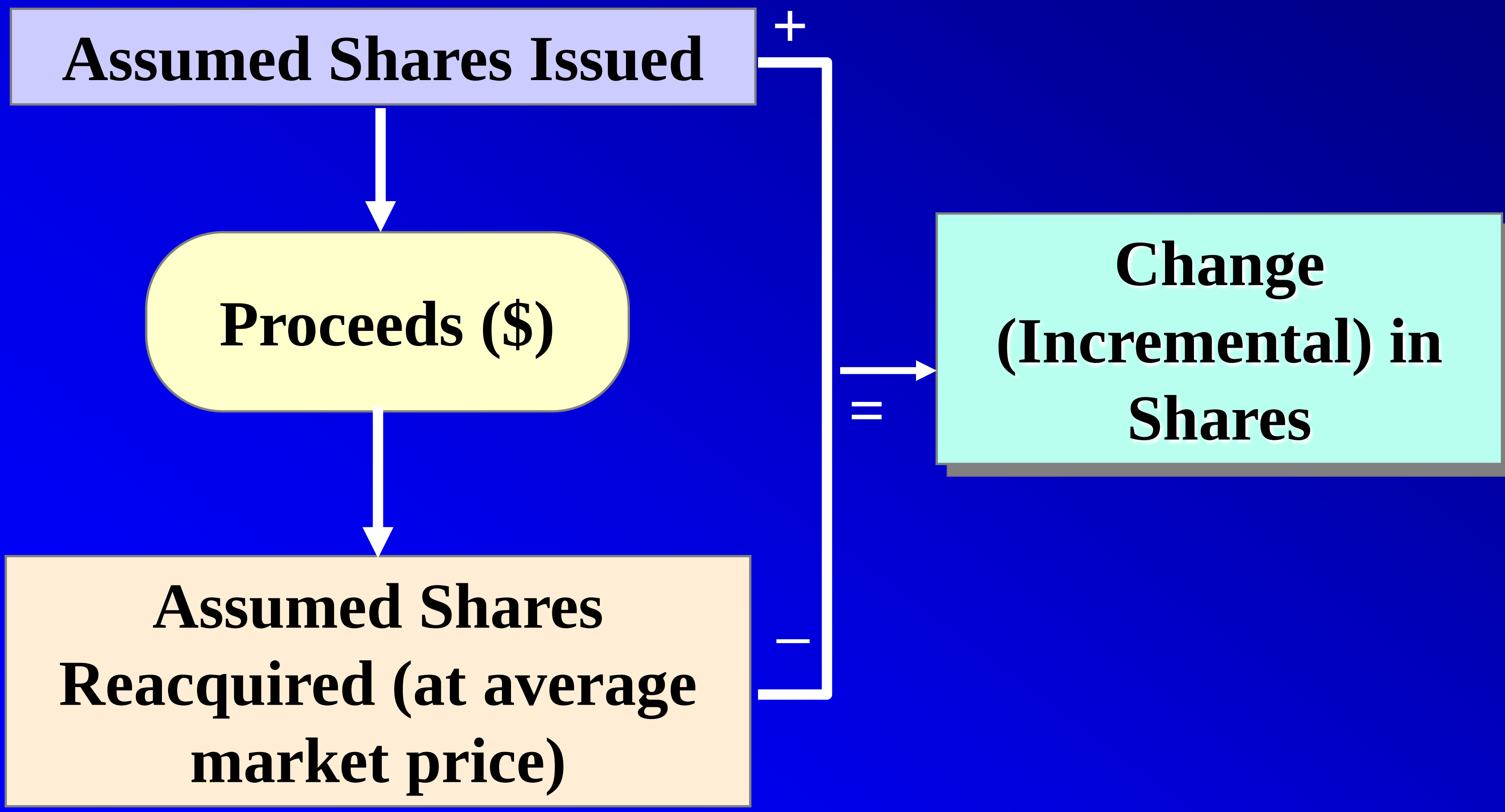
Diluted Earnings per Share

To be included in the diluted earnings per share calculation, any potential common share must have a *dilutive* effect on earnings per share.

Diluted Earnings per Share

Step 1:	Compute the basic earnings per share.
Step 2:	Include dilutive stock options and warrants and compute a tentative diluted earnings per share (DEPS).
Step 3:	Develop a ranking of the impact of each convertible preferred stock and convertible bond on DEPS.
Step 4:	Include each dilutive convertible security in DEPS in a sequential order based on the ranking and compute a new tentative DEPS.
Step 5:	Select the lowest computed DEPS as the diluted earnings per share.

Stock Options and Warrants

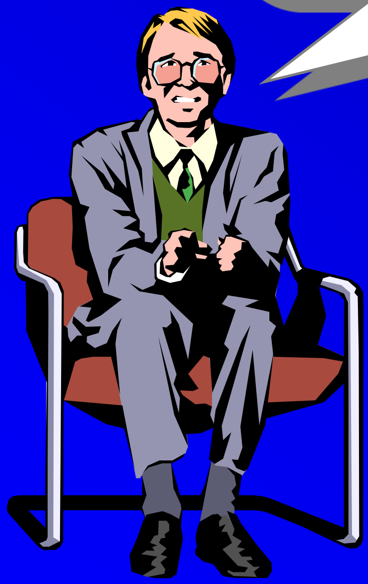


Treasury Stock Method

1. Determine the average market price of common shares during the period.
2. Compute the shares issued from the assumed exercise of all options and warrants.
3. Compute the proceeds received from the assumed exercise by multiplying the shares issued by the option price [plus any unrecognized compensation cost (net of tax) per share].
4. Compute the assumed shares reacquired by dividing the proceeds by the average market price.
5. Compute the incremental common shares.

Convertible Securities

Convertible bonds and convertible preferred stock are considered for inclusion in DEPS *after* stock options and warrants.



Convertible Securities

If bonds were assumed to be converted into common stock, the numerator increases because net income would be larger since the interest expense (net of income taxes) for the converted bonds would not exist.

Testing to Determine Whether a Convertible Security is Dilutive

If the impact of the first ranked convertible security is less than the initial tentative DEPS, add the potential income to the numerator and the potential shares to the denominator and continue this procedure until the impact of the next convertible security is *more* than the previously computed tentative DEPS.

Computation and Reporting of Diluted Earnings per Share

Format

Explanation	Earnings (Adjustments)	Shares (Adjustments)	=	Earnings Per Share
Basic earnings per share	$xxxx	xxx	=	$xxx Basic
Increment in shares (options)		xx		
$DEPS_1$ earnings and shares	$xxxx	xxx	=	$xxx $DEPS_1$
Savings in interest expense (bonds)	xxx			
Increment in shares (bonds)		xxx		
$DEPS_2$ earnings and shares	$xxxx	xxx	=	$xxx $DEPS_2$
Savings in preferred dividends	xxx			
Increment in shares from preferred stock	xxx			
Diluted earnings and shares	$xxxx	xxx	=	$xxx Diluted

Additional Disclosures

When a corporation reports its basic and diluted earnings per share on its income statement, it also is required to make additional disclosures in the notes to its financial statements.

Additional Disclosures

These include a schedule or note which includes information that:

1. **Identifies the amount of preferred dividends deducted to determine the income available to common stockholders.**
2. **Describes the potential common shares that were *not* included in the diluted earnings per share computation because they were antidilutive.**
3. **Describe any material impact on the common shares outstanding of transactions after the close of the accounting period but before the issuance of the financial report.**

IFRS vs. U.S. GAAP

Due to convergence efforts, IFRS and U.S. GAAP are similar in regard to computing and reporting basic and diluted earnings per share. However, the following differences do exist:

- **When using the treasury stock method, IFRS do not require a company to include any unrecognized compensation cost in the assumed proceeds from issuing the stock.**
- **GAAP requires that any unvested contingently issuable shares be excluded from basic EPS calculations. IFRS has no such requirement.**

IFRS vs. U.S. GAAP

Due to convergence efforts, IFRS and U.S. GAAP are similar in regard to computing and reporting basic and diluted earnings per share. However, the following differences do exist:

- **For contracts that may be settled in shares or cash, if a cash settlement is presumed, U.S. GAAP requires an adjustment to earnings but IFRS do not.**
- **Finally, because IFRS do not have the concept of extraordinary items, there is no EPS disclosure related to extraordinary items.**

Types of Dividends

- Cash
- Property
- Scrip
- Stock
- Liquidating

Dividend Considerations

- Declared
- Not larger than unrestricted retained earnings
- Not paid on treasury stock
- Other restrictions
- Scrip

Cash Dividends

There are four significant dates for a cash dividend.

- **The date of declaration**
- **The ex-dividend date**
- **The date of record**
- **The date of payment**

Cash Dividend

Date	Accounting Procedures
Date of Declaration	Reduce Retained Earnings Increase Liabilities
Date of Record	Memorandum Entry
Date of Payment	Reduce Assets Reduce Liabilities

Property Dividends

Occasionally, a corporation will declare a property dividend that is payable in assets other than cash.

Property Dividends

The corporation typically uses marketable securities of other companies that it owns for the property dividend.

Property Dividends

The corporation records a property dividend at the fair value of the asset transferred, and recognizes a gain or loss.

Stock Dividends

Stockholders often view stock dividends favorably even though:

1. They receive no corporate assets.
2. Their percentage ownership does not change.
3. Theoretically the total market value of their investment will remain the same.
4. Future cash dividends may be limited because retained earnings is decreased by the amount of the stock dividend.

Stock Dividends

What factors might enhance the perceived attractiveness of a stock dividend?

Stock Dividend

Stock Dividends

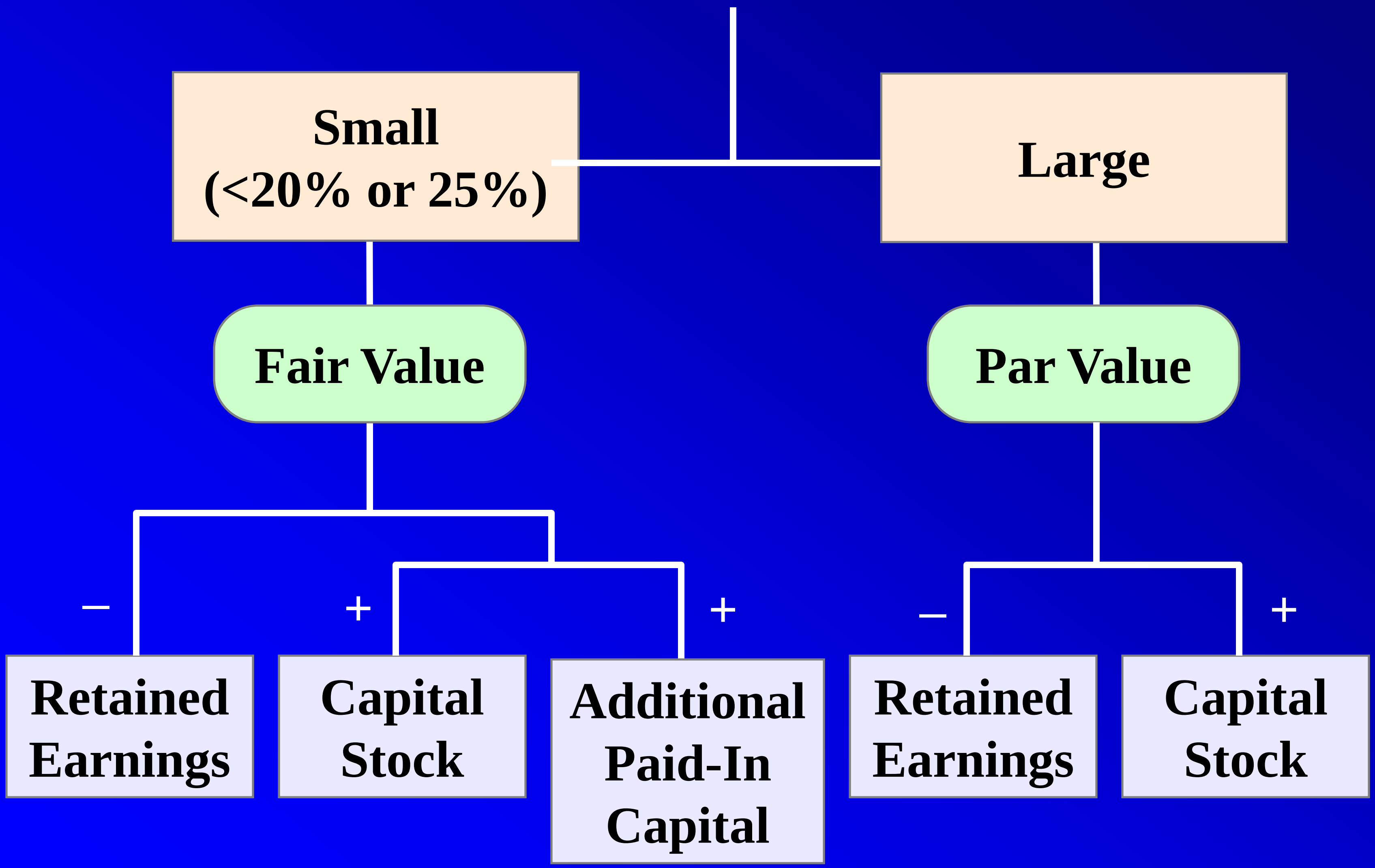
1. **The stockholders may see the stock dividend as evidence of corporate growth.**
2. **The stockholders may see the stock dividend as evidence of sound financial policy.**
3. **Other investors may see the stock dividend in a similar light, and increased trading in the stock may cause the market price *not* to decrease proportionally.**

Continued

Stock Dividends

4. The corporation may state that it will pay the same fixed cash dividend per share, in which case individual shareholders will receive higher total future cash dividends.
5. The stockholders may see the market price decreasing to a lower trading range, making the stock more attractive to additional investors so that the market price may eventually rise.

Stock Dividends



Stock Dividends

Stockholders' equity prior to the stock dividend:

Common stock, $10 par (20,000 shares issued and outstanding)	$200,000
Additional paid-in capital	180,000
Retained earnings	320,000
Total Stockholders' Equity	$700,000

Small Stock Dividend

Ringdahl Corporation declares and issues a 10% stock dividend. On the date of declaration, the stock sells for $23

20,000 shares × 0.10 × $23

Date of Declaration

Retained Earnings	46,000	
Common Stock To Be Distributed		20,000
Additional Paid-in Capital From Stock Dividend		26,000

Par

Continued

Small Stock Dividend

Ringdahl Corporation declares and issues a 10% stock dividend. On the date of declaration, the stock sells for $23 per share.

Date of Issuance

Common Stock To Be Distributed	**20,000**	
Common Stock, $10 par		**20,000**

Par

Small Stock Dividend

Stockholders' equity prior to the stock dividend:

Common stock, $10 par (22,000 shares issued and outstanding)	$220,000
Additional paid-in capital	206,000
Retained earnings	274,000
Total Stockholders' Equity	$700,000

Note: Total remained the same

Large Stock Dividend

Ringdahl Corporation declares and issues a 40% stock dividend. On the date of declaration, the stock sells for $2

20,000 shares × 0.40 × $10

Date of Declaration		
Retained Earnings	80,000	
Common Stock To Be Distributed		80,000
Date of Issuance		
Common Stock To Be Distributed	80,000	
Common Stock, $10 par		20,000

Continued

Small Stock Dividend

Stockholders' equity prior to the stock dividend:

Common stock, $10 par (28,000 shares issued and outstanding)	$280,000
Additional paid-in capital	180,000
Retained earnings	240,000
Total Stockholders' Equity	$700,000

Note: Total is the same as the small stock dividend

Prior Period Adjustments (Restatements)

Corporations are required to report a few events as either retrospective adjustments or prior period adjustments (restatements) of retained earnings. These include changes in accounting principles, a change in accounting entity, and corrections of errors of prior periods.

Prior Period Adjustments (Restatements)

Prior period adjustments and retrospective adjustments look the same. Changes in accounting principles are called retrospective adjustments and error corrections are called prior period adjustments.

Restrictions (Appropriations) of Retained Earnings

To indicate that a certain portion of retained earnings is not available for dividends, a corporation may restrict (appropriate) retained earnings. A restriction (appropriation) of retained earnings means that the board of directors establishes a formal policy that a portion of retained earnings is unavailable for dividends.

Statement of Retained Earnings

Although not a required separate financial statement, many corporations include a statement of retained earnings in their financial statements.

Statement of Retained Earnings

Retained earnings, as previously reported, January 1, 2010

Plus (minus): Prior period and retrospective adjustments (net of income tax effect)

Adjusted retained earnings, January 1, 2010

Plus (minus): Net income (loss)

Minus: Dividends (specifically identified, including per share amounts)

Reductions because of retirement or reacquisition of capital stock

Reductions because of conversion of bonds or preferred stock

Retained earnings, December 31, 2010

Accumulated Other Comprehensive Income

Other comprehensive income (loss) might include four items:

- **Unrealized increases (gains) or decreases (losses) in the fair value of investments in available-for-sale securities**
- **Translation adjustments from converting the financial statements of a company's foreign operation into U.S. dollars**
- **Certain gains and losses on "derivative" financial instruments**
- **Certain pension plan gains, losses, and prior service cost adjustments**

Accumulated Other Comprehensive Income

A corporation may report its comprehensive income (net of income taxes):

- **On the face of its income statement**
- **In a separate statement of comprehensive income**
- **In its statement of changes in stockholders' equity**

Stockholders' Equity Section of a Corporate Balance Sheet

- **Contributed Capital (Paid-in Capital)**
  - **Preferred stock**
  - **Common stock**
  - **Additional paid-in-capital**
- **Retained earnings**
- **Accumulated other comprehensive income**
  - **Unrealized gains and losses on securities available for sale**
  - **Change in additional liability related to pensions**
  - **Certain gains and losses on derivative financial instruments**
  - **Amount from foreign currency translation adjustments and gains and losses from certain forward exchange contracts**
- **Less: Treasury stock (at cost)**
- **Total stockholders' equity**

Statement of Changes in Stockholders' Equity

GAAP states: "…disclosure of changes in the separate accounts comprising stockholders' equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period…is required to make the financial statements sufficiently informative."

IFRS vs. U.S. GAAP

- Under IFRS, a corporation's shareholders' interests (the term used for stockholders' equity) consists of two sections: (a) share capital and (b) other equity.
- Many of the disclosures required under share capital are the same as those required under U.S. GAAP—for example, the number of shares authorized, issued, and outstanding, par value, reacquired shares and rights, preferences, and restrictions regarding dividends.
- IFRS require disclosure of the "movement" in share capital accounts and other equity for the period.

Chapter 17

The End