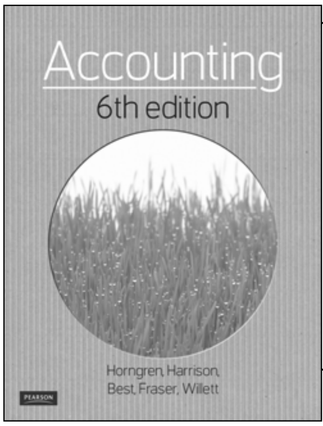

PowerPoint to accompany

Companies: Retained earnings, share splits and buy-backs, and the income statement

Chapter 15

Learning Objectives

1. Account for share dividends
2. Distinguish share splits from share dividends
3. Account for share buy-backs
4. Report transfers to reserves
5. Analyse a company income statement

Retained Earnings and Dividends

- Retained Earnings shows the amount of profits allowed to accumulate from the beginning of the company's life to the present.
- Retained Earnings represents a claim on assets, but it is *not* cash.

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Retained Earnings and Dividends

- The balance in the Income Summary account is closed to Retained Earnings at period end.
- Dividends are distributions to the shareholders.
- To declare dividends there must be adequate retained earnings.

Objective 1

Account for share dividends.

Share Dividends

- What are share dividends?
- They are a proportional distribution of a company's own shares to shareholders.
- They do not change total shareholders' equity.
- A share dividend is a transfer of retained earnings to share capital (contributed equity).

Reasons for a Share Dividend

- To continue dividends but conserve cash.
- To reduce the market price of shares:
  - How ?
  - Why ?

Recording Share Dividends

- Same sequence as cash dividends.
- Assume Perth Limited declared a dividend of $1 per share for 90,000 shares.

What are the entries when the dividend is declared and distributed?

Share Dividends Example

Retained Earnings	90,000	
Dividend payable		90,000
To declare an ordinary share dividend from retained earnings		

Dividend Payable	90,000	
Ordinary Share Capital		90,000
To issue 90,000 ordinary shares in a share dividend		

Share Splits

- This is an increase in the number of shares.
- The market value is usually reduced proportionately.

Share Splits

- A 5-for-1 share split means that the company would have five times as many issued shares after the split as it had before.
- Each share's market value would be divided by (almost or about) five.

Share Splits Example

- Prior to a 5-for-1 split, Adelaide Limited had 500,000 shares with a market price of $10.
- After the split, 2,500,000 shares are issued.
- What is the *approximate* market value per share?
- $10 ÷ 5 = $2.

Objective 2

Distinguish share splits from share dividends.

Similarities Between Share Splits and Share Dividends

Both increase the number of shares owned per shareholder.

Neither change the investor's cost of the shares they own.

Neither creates taxable income for the shareholder.

Differences Between Share Splits and Share Dividends

- A *share dividend* shifts an amount from retained earnings to share capital.
- A *share split* affects no account balance.
- Both increase the number of issued shares.
- Both *usually* decrease the market price of each share.
- Both *usually* decrease earnings per share.

Objective 3

Account for share buy-backs.

Share Buy-backs

- Purchasing your own shares decreases assets and shareholders' equity.

Share Buy-back Example

- Melbourne Limited purchased 1,000 of its own ordinary shares for $20 per share.

Share Capital	20,000	
Cash		20,000
To buy back 1,000 ordinary shares		

- Retained earnings could be debited but rarely is.

Share Buy-back Example

Share Capital
(Before buy-back of ordinary shares)

Share Capital 50,000 ordinary shares (issued for $4)	$200,000
Retained earnings	50,000
Total Shareholders' equity	$250,000

Share Buy-back Example

(After buy-back of ordinary shares)

Share Capital 49,000 ordinary shares	$180,000
Retained earnings	50,000
Total Shareholders' equity	$230,000

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Share Buy-back

- No gain or loss is recognised on the buy-back of shares.
- The share buy-back is debited against shareholders' equity.
- The accounting standard (AASB 101) simply requires the details disclosed in the statement of changes in equity.
- Tax implications of share buy-backs are important (capital gain or franked dividend?).

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Objective 4

Report transfers to reserves.

Retained Earnings

- Appropriations are transfers (by a formal journal entry) of retained earnings.
- A company may appropriate – segregate in a separate account a portion of retained earnings for a specific use or as a general reserve.
- An appropriation does not decrease total retained earnings.
- But a reserve is ***not*** cash or funds.

Objective 5

Analyse a company's income statement.

The Income Statement

Allied Electronics Ltd
Income Statement
for the year ended 31 December 20X1

Revenue		$500 000
Cost of sales		240 000
Gross profit		260 000
Distribution, marketing and administration expenses		(190 000)
Finance costs		(10 000)
Profit before income tax		60 000
Income tax expense		(18 000)
Profit from continuing operations		42 000
Profit from discontinued operations		12 000
Profit for the period		$54 000
Earnings per share:		
Profit from continuing operations		$1.40
Profit from discontinued operations		.40
Profit for the period		$1.80
Note: Material restructuring costs included in expenses of continuing operations	$10 000	

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Analysing the Quality of Earnings

- Net profit is probably the most important piece of information about a company.
- Two aspects are critical:
  - Trend of a company's earnings and
  - Makeup of a company's earnings.
- AASB 101 prescribes the separation of continuing operations from discontinuing operations.

Continuing Operations

- The top section reports continuous operations
- The accounting standards also require details to be disclosed in a note to the accounts when a revenue or expense is of such a size or nature, that it is relevant in explaining the financial performance.
- Material items (once called significant or abnormal items) need to be disclosed separately.

Continuing Operations

- They may include large inventory write-downs or retrenchment payouts etc.
- Income Tax expense is derived from continuing profit

Discontinuing Operations

- Large businesses may have multiple operations
- These may be based on business or location (geographical) –
  - these are called segments (AASB 8)
- A business may close down or sell a segment –
  - these are discontinued operations.

Analysing the Quality of Earnings

- AASB 101 no longer requires the income statement report an *all-inclusive* or *comprehensive* earnings *(*profit) figure.
- Prior period adjustments are made to the opening balances – mainly retained earnings (AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors)*.
- Significant adjustments will need separate disclosure – usually in the notes.

Earnings per share (EPS)

- Arguably the most commonly used business statistic
- Formula is

EPS = Profit after income tax – preference dividend / weighted average number of ordinary shares issued

Earnings Per Share Example

- On January 1, Sydney Limited had 100,000 ordinary shares outstanding.
- On May 31, the company re-purchased 40,000 shares.
- On September 1, they issued 30,000 new ordinary shares.
- Profit (earnings) for the year was $135,000.
- What are the earnings per share?

Earnings Per Share Example

No. of Shares Outstanding		Fraction of Year		Weighted Average
100,000	×	151/365	=	41,370
60,000	×	92/365	=	15,123
90,000	×	122/365	=	30,082
Total				86,575

EPS = profits after tax minus preference dividends ÷ 86,575 =$1.56

EPS and Preferred Shares & Options

- Companies with complex capital structures present two sets of EPS amounts:

1 EPS based on ordinary shares issued (basic EPS).

2 EPS based on ordinary shares issued plus the number of additional ordinary shares that would arise from conversion of the preference shares or exercise of options (diluted EPS).

Reporting Comprehensive Income

- Comprehensive income is the change in total shareholders' equity from all sources other than its owners
- Includes
  - Revaluation reserve
  - Gains and losses on conversion of foreign operations
  - Gains and loses on same type of superannuation plans
- See Exhibit 15.4 page 580

EXHIBIT 15-4 **Reporting comprehensive income**

Allied Electronics Ltd
Statement of Comprehensive Income
for the year ended 31 December 20X1

Profit for the period	$54 000
Other comprehensive income:	
Gain on property revaluation	10 000
Comprehensive income	$64 000

Statements of changes in equity

- The statement shows
  - The amounts of transactions with owners (shareholders) in their capacity as owners (which covers such things as dividends, and the issue or buy-back of shares).
  - For each component of equity, a detailed reconciliation of the carrying amount at the beginning and the end of the period.
- See exhibit 15.5 page 580

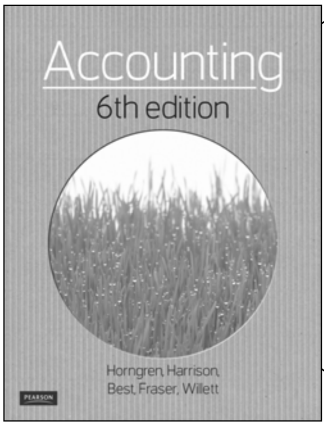
EXHIBIT 15.5 **Statement of changes in equity**

Allied Electronics Ltd
Statement of Changes in Equity
for the year ended 31 December 20X1

	SHARE CAPITAL Ordinary shares $	RESERVES Asset Revaluation Reserve $	General Reserve $	RETAINED EARNINGS $	TOTAL EQUITY $
Balance at start of period	80 000	30 000	13 000	130 000	253 000
Comprehensive income for the year—					64 000
Gain on property revaluation	–	10 000	–	–	
Profit for the period	–	–	–	54 000	
Issue of share capital	20 000	–	–	–	20 000
Share buy-back	(5 000)	–	–	–	(5 000)
Dividends	–	–	–	(32 000)	(32 000)
Balance at end of period	95 000	40 000	13 000	152 000	300 000

Prior period adjustments

- AASB108 requires that if any errors are detected they must be corrected in prior period adjustments and retained earnings (or other equity line) be amended correctly
- The same thing happens with a change in accounting policy



PowerPoint to accompany

End of
Chapter 15