


**Chapter 2, Module 4 – Financial Statements**

**Slide 1**

*Chapter 2 Module 4*

**AMIS 211**  
**Introduction to Financial Accounting**

Professor Marc Smith



The slide content is enclosed in a black rectangular border. At the top, there is a dark grey horizontal bar with the text "Chapter 2 Module 4" in a white, italicized serif font. Below this bar, the text "AMIS 211" and "Introduction to Financial Accounting" is centered in a bold, black, sans-serif font. Underneath, the name "Professor Marc Smith" is centered in a smaller, black, sans-serif font. At the bottom of the slide content area, there is a logo for Ohio State University Fisher College of Business, consisting of a small square with "OHIO STATE UNIVERSITY" and the word "FISHER" in a large, bold, serif font, with "COLLEGE OF BUSINESS" in a smaller, sans-serif font below it. At the very bottom of the slide content area, there is a dark grey horizontal bar.

Hi everyone. Welcome back.

In this module, let's talk a little bit about the next financial statement: the Statement of Owners' Equity.

And, let's go ahead and get right into it.

Please go to the next slide with me.

Slide 2

*Chapter 2 Module 4: Owners' Equity*

**STATEMENT OF OWNERS' EQUITY**

**The statement of owners' equity simply shows the changes in equity for a period of time (the same period of time as that covered by the income statement)**

We can define the Statement of Owners' Equity.

It is kind-of a basic financial statement.

It simply shows the changes in Equity for a period of time. Typically, the period of time is the same period of time as that covered by the Income Statement.

It is also worth noting here that: Hey, look! Just like the Income Statement—the Statement of Owners' Equity covers a time period; whereas the Balance Sheet is a specific Point-in-Time Financial Statement.

Let's go ahead to the next slide.

Slide 3

*Chapter 2 Module 4: Owners' Equity*

**2 Categories of Equity (Chapter 2 Module 2)**

- 1. Contributed Capital**
- 2. Retained Earnings**

**Retained Earnings:**

Retained earnings represents net income of the business kept within the company for expansion (rather than given to owners in the form of a dividend)

If you remember back from our previous discussion of the Balance Sheet, we said that: Equity really has two (2) different components.

We had 1) the Contributed Capital—the amount that was invested by Owners into the company; typically, when they buy stock.

And, we had 2) the Retained Earnings.

And, we said: “Hey, look! We are going to give a more thorough discussion of Retained Earnings. (We said this when we dealt with the Balance Sheet.) We are going to give a more thorough discussion of Retained Earnings a little later.” How often do you hear the Instructor say that and “the little bit later” never comes.

Here we are!

We are going to give a little bit more discussion to this idea of Retained Earnings.

Remember what we said it was:

Retained Earnings—we defined it as: Net Income that was earned by the company and then reinvested back into the company rather than giving the profits to the Owners—the rightful Owners, if you will—because they are the Stockholders that are entitled to those profits. But, Retained Earnings represents the income the company keeps rather than giving out to the Owners in the form of a dividend.

Now, go to the next slide with me.

**Slide 4**

<i>Chapter 2 Module 4: Owners' Equity</i>	
<b>Question:</b>	<b>As an owner (stockholder), the net income of the company belongs to you. So, why would you allow the company to keep (retain) the net income?</b>
<b>Answer:</b>	<b>To allow the company to grow and expand and hopefully make more money in the future and thus become more valuable.</b>

And, let's answer this question related to this Retained Earnings.

As an Owner or Stockholder, why would you allow this? Why aren't you up in arms? Why aren't you at the company's door demanding your share of the profit? How dare they take it and reinvest it in themselves rather than giving it back to you! Why aren't Owners up in arms over this?

The answer is: what we want them to do is re-invest so that they can grow—so that they can grow and become more profitable—earn better income in the future—maybe by taking it and buying new, more efficient equipment or

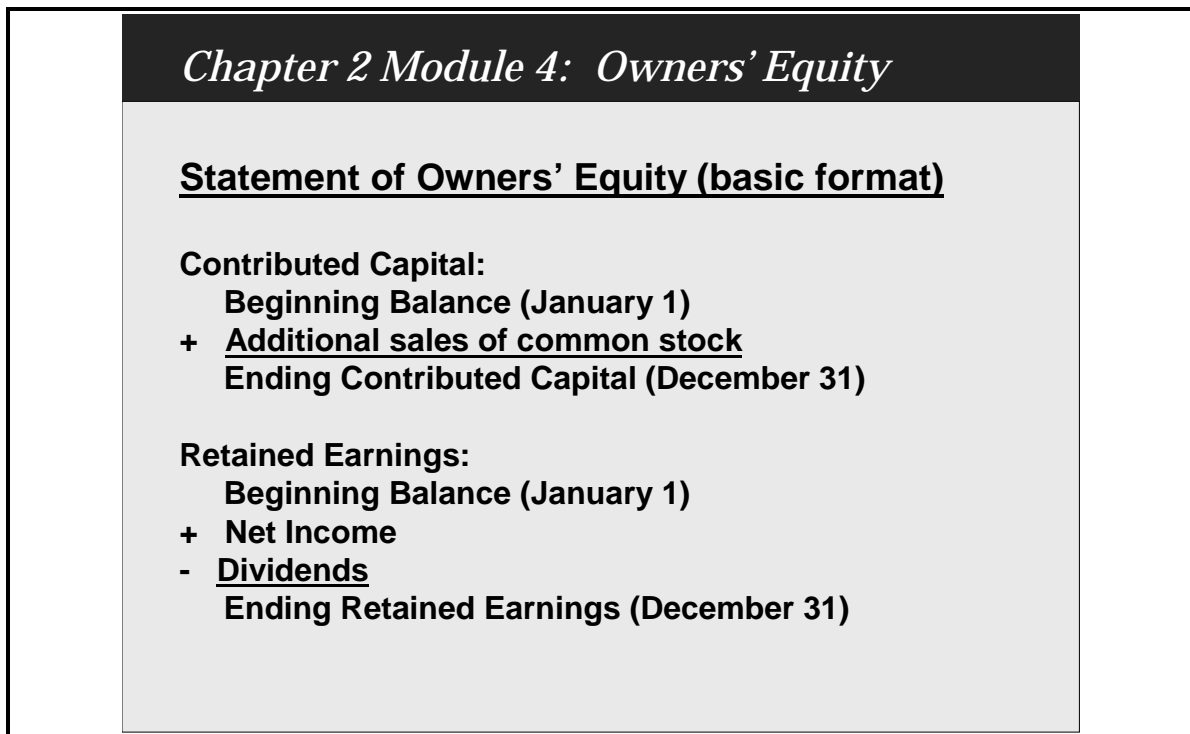
machinery. We are able to expand the business—grow it—and it becomes worth more—our stock does—down the road.

So, the idea is: (at least, in theory) the company takes the income, it—for the most part—re-invests it back into itself so that it can grow and become more valuable in the future.

And, that is the idea of investing and waiting for a good return. Let the company re-invest in itself and grow and expand so that at some point down the road, it is more valuable than it is today and just getting a simple old dividend.

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**Slide 5**



***Chapter 2 Module 4: Owners' Equity***

**Statement of Owners' Equity (basic format)**

**Contributed Capital:**  
Beginning Balance (January 1)  
+ Additional sales of common stock  
Ending Contributed Capital (December 31)

**Retained Earnings:**  
Beginning Balance (January 1)  
+ Net Income  
- Dividends  
Ending Retained Earnings (December 31)

The Statement of Owners' Equity looks something like this.

Remember there were the two (2) components: 1) the Contributed Capital and 2) the Retained Earnings.

For the Contributed Capital: take the Beginning Balance (say at January 1<sup>st</sup>), add (+) to it all additional sales of stock during the year. Because: that is how Contributed Capital goes up—when Owners buy more stock. And, that tells us: the Ending Contributed Capital—the amount of Contributed Capital at December 31<sup>st</sup>, if you will.

Because: remember this Owners' Equity Statement covers a period of time, typically, from January 1 through December 31.

The second piece of this is 2) the Retained Earnings piece.

You take your Beginning Retained Earnings—remember what it is: Net Income that the company earns and then re-invests back in itself.

We will take the Beginning Retained Earnings, plus (+) the Net Income.

But maybe all of that Net Income is not re-invested. Maybe some of it is given back to the Owners in the form of a dividend.

So, you take the Beginning Retained Earnings, plus (+) Net Income, minus (-) the Dividends that are paid. And, that equals (=) the Ending Retained Earnings (i.e. the Retained Earnings at December 31).

Just as a little FYI:

One of the little formulas that are very important, often used in a lot of calculations, and one that students have a tendency to forget is this little equation dealing with Retained Earnings.

In your notes there in your notebook or on your power point slides or whatever—star that or circle it—use different colors—or whatever.

That is an important equation—one that you really want to be comfortable with and be able to work with.

Let's go to the next slide.

## Slide 6

*Chapter 2 Module 4: Owners' Equity*

A basic version of the statement of owners' equity with numbers is shown below:

	Contributed Capital	Retained Earnings	Total
Jan. 1, 2005	\$ 6,450	\$ 500	\$ 6,950
Net income		1,085	1,085
Less: dividends		(200)	(200)
Sale of stock	3,100		3,100
Dec. 31, 2005	<u>\$ 9,550</u>	<u>\$ 1,385</u>	<u>\$10,935</u>
	=====	=====	=====

And, let's take a look at what a Statement of Owners' Equity would look like.

And, here (on Slide 6) you can see we have the two pieces:

1) The Contributed Capital, January 1<sup>st</sup> of the year of 2005: \$6,450. During the year, Owners purchased more stock from us in the amount of \$3,100; giving us: Ending Contributed Capital of \$9,550.

The other piece: 2) the Retained Earnings. You have the Beginning Balance plus (+) the Net Income that we earn, minus (-) the Dividends that we have paid; gives us: the Ending Retained Earnings.

Adding those two (2) pieces together—1) the Contributed Capital and 2) the Retained Earnings gives us the Total Stockholders' Equity that we will eventually see on the Balance Sheet. And, it looks like: \$10, 935.

Let's go to the next slide.

Slide 7

*Chapter 2 Module 4: Dividends*

**PLEASE NOTE:**

**Dividends paid by the company to its stockholders (owners) are NOT considered to be an expense!!!!**

**The reason for this is there is not a legal requirement for the company to pay a dividend. A dividend is paid at the discretion of the company!**

Here is something very important about these Dividends.

Remember the Retained Earnings formula: Beginning Retained Earnings plus (+) Net Income minus (-) Dividends.

Note that: Dividends that the company pays to its stockholders are not—even though it is counterintuitive—they are NOT considered to be an Expense. The Dividends that are paid are NOT an Expense of the organization.

The reason is: there is no legal requirement on the company to pay a Dividend. They do not have to pay Dividends. They can go 100 years and just keep re-investing their income in themselves rather than paying out a Dividend.

Because of that: Dividends are NOT an Expense. They are paid out of the Net Income that we earn. They are NOT considered an Expense.

This is another one to star, or circle, or put some colors next to, or whatever to remind you that is an important concept.

And, not only is it an important concept but, historically, in this class, that is an area that a lot of students will miss. They will think that a Dividend should be an Expense. And, it is NOT. It is NOT considered an Expense.

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**Slide 8**

<i>Chapter 2 Module 4: Dividends</i>	
<b>Question:</b>	<b>How do dividends paid effect the company's net income?</b>
<b>Answer:</b>	<b>Dividends have NO EFFECT on the company's net income. This is because they are not classified as an expense.</b>

So, answer my question:

How do Dividends that the company pays affect Net Income?

I am going to give you the answer in a second. But, answer it to yourself real quickly.

How do dividends impact the company's Net Income?

The answer is: **THEY DON'T!**

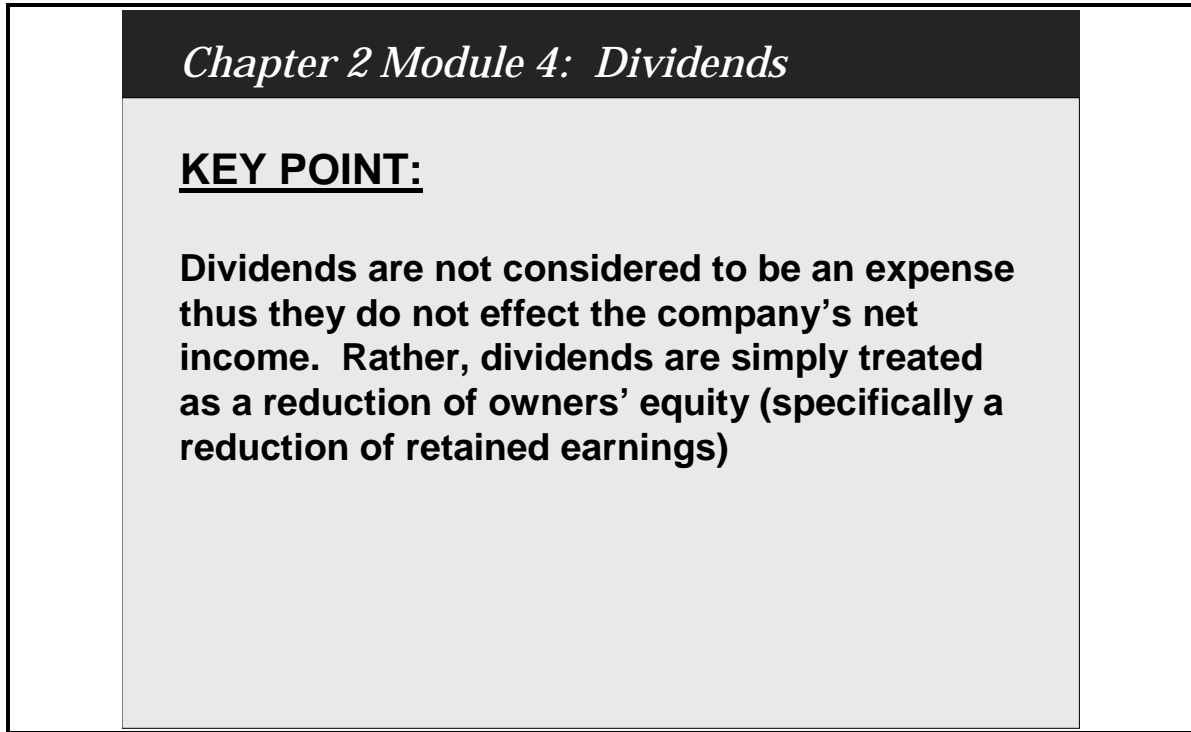
Dividends have no effect on Net Income. Remember: they are NOT an Expense. They are not part of the company's Net Income. Rather, the

Dividends are paid out of the Income that we earn. They are not a factor in calculating the Net Income because they are not an Expense.

This is a very important idea to keep in mind.

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**Slide 9**

A rectangular box with a black border containing slide content. The top part is a dark grey header with the text 'Chapter 2 Module 4: Dividends' in white italicized font. Below the header is a light grey background with the text 'KEY POINT:' in bold black font, followed by a paragraph of bold black text explaining that dividends are not an expense and are treated as a reduction of equity.

*Chapter 2 Module 4: Dividends*

**KEY POINT:**

**Dividends are not considered to be an expense thus they do not effect the company's net income. Rather, dividends are simply treated as a reduction of owners' equity (specifically a reduction of retained earnings)**

And, note this key point:

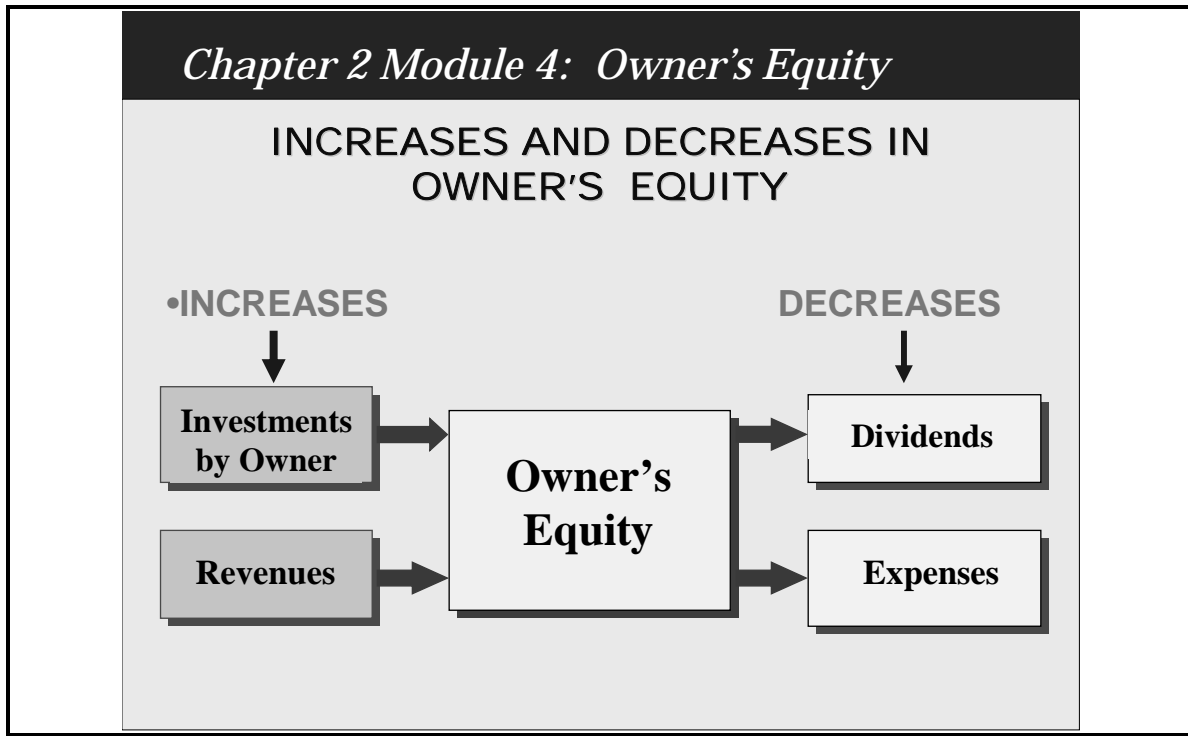
Dividends are not considered to be an Expense; hence, they do not affect the company's Net Income. They will not be found on the Income Statement. Rather, Dividends simply reduce Equity, specifically, Retained Earnings.

You will find them on the Statement of Owners' Equity that you saw a couple of slides ago as a reduction of Retained Earnings. But, they are not considered an Expense.

This is one to keep in mind because this is a very important idea and one that can be a little bit tricky and counterintuitive.

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**Slide 10**



And, here you can sort-of see a diagram of what impacts Owners' Equity.

Increases to Equity include: Investments by owners (i.e. sales of stock).

They also include Revenues. Because: remember Net Income increases Equity. It increases Retained Earnings. It is Beginning Retained Earnings plus (+) Net Income.

So, Revenues, which increase Net Income; hence, they increase Equity.

The decreases to Equity include: the Dividends that we pay. It is a decrease to Retained Earnings.

And, it includes our Expenses. Expenses reduce Net Income. And, by reducing Net Income we also reduce Retained Earnings.

We will wrap the module up with that but that is such an important comment. You are going to hear it a whole bunch over the next couple of chapters.

When the Net Income of the company is affected; that will cause the Equity—specifically Retained Earnings—to also be affected.