Student Confusion about Small and Large Stock Dividends

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When students learn about stock dividends, they may be confused about several factors: why companies issue stock dividends, why investors might like or dislike stock dividends, how to account for stock dividends, and why there is a distinction between and difference in the way we account for small versus large stock dividends. This paper gives some background on stock dividends and then focuses on the different ways of accounting for small and large stock dividends. Perhaps it is time for the Financial Accounting Standards Board to reconsider if these methods are appropriate. Some suggestions for possible changes are given (Smith, 2016).

INTRODUCTION

A company's dividend policy can signal to shareholders and to the market the success of that particular company. Cash dividends are the most common. In these cases, shareholders receive an amount of cash for each share of stock owned. Property dividends, much less common than cash dividends, require the distribution of noncash assets to the shareholders. Cash and property dividends reduce the retained earnings and assets of the corporation issuing the dividend. In other words, they are seen as a distribution of a portion of the company's earnings to the owners as a return on their investment. A company can also pay liquidating dividends in some cases, especially in the case of a corporate liquidation. These dividends reduce the contributed capital of the corporation and are seen as a return of capital to the shareholders.

Stock dividends are not a distribution of corporate assets, but are instead, a distribution of additional shares of stock to existing stockholders. While requiring a reduction of retained earnings or other paid-in capital, stock dividends do not require assets and can therefore be seen as an alternative way to satisfy shareholders when liquid assets are not available to pay a cash dividend. However, stock dividends have an interesting history which has impacted the way we account for them. Students are likely introduced to dividends in their introductory financial accounting class, but the intermediate financial accounting sequence covers more of the details of dividends. However, although stock dividends may be discussed in these classes, it is unlikely that students spend much time actually thinking critically about stock dividends, why they may be declared, how we account for them, and whether the accounting makes sense. Student may be introduced briefly to the accounting methods for small and large stock dividends, but they may not get much explanation as to why there is a difference and what the impact is on the financial statements.

In many basic examples, the amount capitalized for a small stock dividend exceeds the amount capitalized for a large stock dividend for the same company. Since small stock dividends are capitalized at fair value and large stock dividends are capitalized at par value, a 10 percent stock dividend recorded at the fair value of the stock of $45 per share would result in capitalizing a larger amount than a 30 percent stock dividend for the same stock with a $5 par value. Even though three times as many shares are issued from the large stock dividend, the small stock dividend will result in the capitalization of three times as much into contributed capital accounts. The students may be especially confused about why this apparent anomaly exists.

This paper will give some background on stock dividends in general and then focus on the different ways of accounting for small and large stock dividends. While these two methods of accounting for stock dividends exist under current general accepted accounting standards (GAAP), perhaps it is time for the Financial Accounting Standards Board (FASB) to reconsider if these methods are appropriate. In this discussion, some of the differences of how stock dividends are presented in contemporary intermediate accounting textbooks will also be presented.

STOCK DIVIDENDS

Stock dividends represent a pro rata distribution of additional shares of stock to existing stockholders. Since no assets are distributed by the company declaring the stock dividend, the stockholders do not experience an increase in their net assets. Their proportionate ownership of the company is maintained, but the ownership is represented by more shares. In essence, the ownership of the company is divided into more pieces with each piece representing a proportionately smaller share of the company. If a stock dividend does not involve the distribution of company assets nor does it increase the shareholders' net assets, why would a company declare a stock dividend?

Spiceland, et. al. (2016) indicate that in some cases, companies declare stock dividends to give stockholders the illusion that they are receiving a real dividend. On the other hand, they also recognize that a company may have the desire to capitalize retained earnings through a stock dividend to reduce the amount of retained earnings which might otherwise be available for a cash dividend, allowing that amount to be reinvested in the company without requiring a large retained earnings balance. Stice and Stice (2014) present another reason why companies might issue stock dividends. If the company wants to signal that it expects favorable future earnings, a stock dividend which decreases retained earnings might indicate to shareholders that future earnings will be sufficient to pay expected cash dividends. Although companies that issue regular cash dividends will want to continue to do so to avoid sending a negative signal to the market, other companies that give irregular dividends may decide to issue a stock dividend if the retained earnings balance warrants a dividend but the liquid assets are not adequate to do so.

Wahlen, et. al. (2013) list some of the reasons why shareholders may not necessarily appreciate a stock dividend. Reasons why stockholders may be unimpressed with a stock dividend include the following: they receive no assets from the corporation, their percentage ownership in the company does not change, the total value of their investment will not theoretically change since the value of the company will not have changed simply because of an equity transaction, and the reduction of retained earnings from the stock dividend may limit what the company can pay out in future cash dividends.

However, Wahlen, et. al. (2013) also list some reasons why a stock dividend may be perceived positively by the stockholders: (1) a stock dividend might be a signal of corporate growth or sound financial policy, (2) if other investors view the stock dividend in this way, the stock may experience increased trading such that the market price does not decrease in proportion to the additional shares issued, (3) if the corporation indicates that future cash dividends per share will not decrease, the larger number of shares owned will mean the shareholders will received larger future cash dividend totals, and (4) if the stock dividend reduces the market price of the stock to a more attractive trading range, additional investors may enter the market for the stock and increase the future market price. As mentioned earlier, Stice and Stice (2014) also indicate that a stock dividend may be a signal of expected future earnings which will be available to pay future cash dividends.

ACCOUNTING FOR STOCK DIVIDENDS

Tucker (1985, 73) indicated that "stock dividends have been a controversial issue for over 100 years though they date back to at least 1690. . .." He provides a historical background for the evolution of accounting principles related to stock dividends. Much of the concern focused on stock dividends that were smaller in percentage terms, especially recurring dividends year after year, with arguments that these dividends were deceptive ways of issuing stock without adequate payment to the issuing corporation. The controversy also relates to a discussion of whether stock dividends are taxable income to the recipient. Current GAAP defines small stock dividends as those that are less than 20-25 percent dividends and large stock dividends are those that are greater than 20-25 percent dividends. However, the SEC has refined the definition for publicly traded companies in Accounting Series Release No. 124. For SEC purposes, stock dividends of 25 percent or more are defined as large stock dividends, whereas stock dividends less than 25 percent are defined as small stock dividends (Stice and Stice, 2014).

The concern about small stock dividends over many years and through legal court proceedings led to the 1941 issuance of Accounting Research Bulletin #11 by the Committee on Accounting Procedure. A revised bulletin was issued in 1952, but the accounting requirements of the revised bulletin were similar to the original; both seemed to be an attempt to discourage small stock dividends or at least penalize corporations for issuing them (Tucker, 1985). One argument against small stock dividends is that the investors may think of them as real dividends such that the market price may not adjust appropriately and proportionately for the increase in the number of shares. To discourage small stock dividends, the accounting standards required the capitalization of the new stock issued at its market value. The requirement that small stock dividends be recorded at market value is still incorporated in current GAAP.

Whereas a small stock dividend is recorded at market value, a large stock dividend is viewed as similar to a stock split with the assumption that the stock market will recognize and adjust for the changing value of each share because the company is now represented by an increased number of shares. A stock split results in a change in both the number of shares outstanding and the par value per share but does not result in any net change in a capital stock account, as the total par value after the split is the same as the total par value before the split. However, a large stock dividend does not change the par value per share but only changes the number of shares. Therefore, even though a large stock dividend can be viewed as similar to a stock split, the argument follows that the par value per share for the new shares issued under a large stock dividend needs to be recorded as an increase to the capital stock account.

TEXTBOOK COVERAGE OF STOCK DIVIDENDS

Contemporary intermediate accounting textbooks present some differences in perspective as to how stock dividends should be recorded. Wahlen, et. al. (2013, 16-10) indicate that "a small stock dividend is viewed as a simultaneous sale of stock and payment of a dividend." They also indicate that the appropriate fair value at which to capitalize the dividend would be the market price after the declaration of the dividend (when the total value of the company has been divided into more pieces). However, since they admit that no method has been developed to determine the decrease in fair value, they illustrate a journal entry for a small stock dividend at the fair value of the stock before the dividend. Stice and Stice (2014), on the other hand, assume that the fair value of the stock would be decreased proportionately, so they illustrate the journal entry for a small stock dividend at the adjusted fair value after the dividend, assuming a proportionate decrease in the stock value. For example, they illustrate a 10 percent stock dividend for stock that had a market value of $22 per share. Since each share will become 1.1 shares after the dividend, they divide $22 by 1.1 and assume the adjusted fair value of the stock is $20 per share.

Although Spiceland, et. al. (2016) and Kieso, et. al. (2015) admit that the fair value of the stock will decline after a small stock dividend, they illustrate the journal entry for small stock dividends by capitalizing the fair value of the stock before the dividend. They do not discuss whether the market value after the dividend should be used instead. Interestingly, since the current accounting standards for small stock dividends were based, at least in part, on the argument that the market may not adjust the value of the stock for a small stock dividend, it may be counterintuitive to use an adjusted market value, as this would be contrary to the original thought process in setting the standard. However, Spiceland, et. al. (2016) cite research which supports the intuitive conclusion that the market will adjust for a small stock dividend (Foster and Vickrey, 1978; Spiceland and Winters, 1986).

Large stock dividends and stock splits are different and have different accounting treatment. Although they both result in additional shares of stock, a stock split requires no journal entry, whereas a large stock dividend requires an entry to capitalize at least the par value of the new shares issued into the capital stock account. Stice and Stice (2014) treat large stock dividends as completely different from stock splits and present separately the journal entry for large stock dividends compared to no entry for stock splits. They indicate that GAAP is less specific on how to handle large stock dividends because the concern about small stock dividends leading to the specific GAAP requirement to capitalize fair value did not apply to large stock dividends. GAAP only requires capitalization of retained earnings for a large stock dividend to the extent required by legal requirements. Because of the lack of specificity on how large stock dividends are to be recorded, stock dividends and stock splits are often mislabeled in the financial press. "*The Wall Street Journal*'s description of a distribution as a split or dividend agrees with the actual accounting for the distribution only about 25% of the time (Stice and Stice, 2014, 13-43, citing research by Rankine and Stice, 1997).

While Stice and Stice (2014) do not actually mention it, the other three intermediate textbooks consulted (Kieso, et. al., 2015; Spiceland, et. al., 2016, and Wahlen, et. al., 2013) all mention that a large stock dividend should not be called a dividend. Instead, it should be called "a stock split effected in the form of a dividend." This may be suggested because the effect of a large stock dividend and a stock split can be so similar in terms of the addition to the number of new shares issued.

Wahlen, et. al. (2013) present the journal entry for a large stock dividend as a reduction of retained earnings. Kieso, et. al. (2015) state that a paid-in capital account might often be reduced instead of retained earnings, although the journal entry they illustrate debits retained earnings. Stice and Stice (2014) indicate that the debit can be either to a paid-in capital account or to retained earnings, and they illustrate both, showing a debit to retained earnings as the first example. Spiceland, et. al. (2016) state that most companies will debit paid-in capital (illustrated first) but also admit that retained earnings could instead be debited (illustrated second). Perhaps the only reason for capitalizing retained earnings for a large stock dividend is to meet any legal requirements. Conceptually, a reallocation among contributed capital accounts seems to be more consistent with the idea of dividing the existing company into more shares. It also seems to be a little more consistent with the accounting for a stock split, where no journal entry is made. Perhaps the reduction of retained earnings should be reserved for cash or property dividends that will actually result in a distribution of assets rather than a distribution of additional shares of stock.

It appears that for both small and large stock dividends, there are some differences as to how different textbooks illustrate the journal entries and calculations. This may mean that different companies may also be accounting for these dividends in different but similar ways.

STOCK DIVIDEND ANOMALY

Because of the different ways of accounting for small versus large stock dividends, students may be confused why a larger amount is often capitalized for a small stock dividend than for a large stock dividend for the same company. For example, if a company has 100,000 shares of stock outstanding with a $5 par value and a $45 market value, a 10 percent stock dividend would be recorded at the fair value of the shares issued. In this case, the small stock dividend would be recorded at $450,000 (100,000 x 10% x $45). If the same company declared a 30 percent stock dividend, the amount recorded for the dividend would only be $150,000 (100,000 x 30% x $5). Even though the large stock dividend resulted in the issuance of 30,000 additional shares compared to 10,000 shares for the small stock dividend, the amount capitalized for the small stock dividend is three times the amount capitalized for the large stock dividend.

While the explanation provided above might give an objective, mathematical answer as to why the outcomes differ, it might not provide a completely intuitive and rational explanation. This is especially true when formal research has shown that capital markets do revalue stock prices when small stock dividends are issued (Foster and Vickrey, 1978; Spiceland and Winters, 1986). This research argues against the need to capitalize small stock dividends at market value based on the assumption that the market does not revalue the stock.

CONCLUSION

Perhaps GAAP for stock dividends should be reconsidered. Since the empirical evidence seems to indicate that the stock market reacts to both small and large stock dividends, perhaps the arguments for the capitalization of market value for small stock dividends are not valid and need no further consideration. Perhaps all stock dividends should be capitalized at par value, recognizing the need to increase the capital stock account for the par value of the additional shares issued. This would eliminate the need to distinguish small from large stock dividends and would also eliminate the anomaly discussed above. If FASB goes farther and requires the capitalization of the par value from other paid-in capital accounts rather than retained earnings, the possible confusion between stock and cash dividends would be alleviated. In fact, a new term such as “stock distributions” could be used in place of stock dividends. If we no longer called these distributions stock dividends, it might be less confusing to students, shareholders, and financial statement users. While stock distributions would still be different from stock splits (technically and from an accounting standpoint), neither would affect retained earnings and be confusing as to whether the shareholders were receiving anything other than additional shares representing the same total ownership claim on the corporation. Instead of potentially appearing as a distribution of corporate earnings to the owners as a return on their investment, it would more definitely appear as a reallocation of paid-in capital among an increasing number of shares of stock.

Is it time for the FASB to reconsider how we account for stock dividends? It is likely this issue has been considered, but it is probably an issue that is not very high on the priority list for an entity which may consider the stock dividend anomaly to be minor compared to other issues that the FASB faces. If current GAAP is artificially reducing the number of small stock dividends that might otherwise be declared, perhaps the FASB is not very worried about the issue. Even though empirical evidence seems to indicate that both small and large stock dividends are incorporated in stock values in capital markets, there has previously not been any catalyst forceful enough to cause a serious reconsideration of GAAP for stock dividends.

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