Chapter 14

Corporations: Dividends, Retained Earnings, and Income Reporting

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1. Prepare the entries for cash dividends and stock dividends.
2. Identify the items 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.

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- Scan **Study Objectives**
- Read **Feature Story**
- Read **Preview**
- Read text and answer **DO IT!** p. 612 p. 615 p. 619 p. 623
- Work **Comprehensive DO IT!** p. 625
- Review **Summary of Study Objectives**
- Answer **Self-Study Questions**
- Complete **Assignments**

Feature Story

OWNING A PIECE OF THE ACTION

Van Meter Industrial, Inc., an electrical-parts distributor in Cedar Rapids, Iowa, is 100% employee-owned. For many years the company has issued bonuses in the form of shares of company stock to all of its employees. These bonus distributions typically have a value equal to several weeks of pay. Top management always thought that this was a great program. Therefore, it came as quite a surprise a few years ago when an employee stood up at a company-wide meeting and said that he did not see any real value

in receiving the company's shares. Instead, he wanted "a few hundred extra bucks for beer and cigarettes."

As it turned out, many of the company's 340 employees felt this way. Rather than end the stock bonus program, however, the company decided to educate its employees on the value of share ownership. The employees now are taught how to determine the worth of their shares, the rights that come with share ownership, and what they can do to help increase the value of those shares.

As part of the education program, management developed a slogan, "Work ten, get five free." The idea is that after working 10 years, an employee's shares would be worth the equivalent of about five years' worth of salary. For example, a person earning a $30,000 salary would earn $300,000 in wages over a 10-year period. During that same 10-year period it was likely that the value of the employee's shares would accumulate to about $150,000 (five years' worth of salary). This demonstrates in more concrete terms why employees should be excited about share ownership.

A 12-member employee committee has the responsibility of educating new employees about the program. The committee also runs training programs so that employees understand how their cost-saving actions improve the company's results—and its stock price. It appears that the company's education program to encourage employees to act like owners is working. Profitability has increased rapidly, and employee turnover has fallen from 18% to 8%. Given Van Meter's success, many of the 10,000 other employee-owned companies in the United States might want to investigate whether their employees understand the benefits of share ownership.

Source: Adapted from Simona Covel, "How to Get Workers to Think and Act Like Owners," *Wall Street Journal Online*, February 15, 2008.

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Inside Chapter 14...

Preview of Chapter 14

As indicated in the Feature Story, a profitable corporation like Van Meter Industrial, Inc. can provide real benefits to employees through its stock bonus plan. And as employees learn more about the role of dividends, retained earnings, and earnings per share, they develop an understanding and appreciation for what the company is providing to them.

The content and organization of Chapter 14 are as follows.

Corporations: Dividends, Retained Earnings, and Income Reporting

Dividends	Retained Earnings	Statement Presentation and Analysis
• Cash dividends	• Retained earnings restrictions	• Stockholders' equity presentation
• Stock dividends	• Prior period adjustments	• Stockholders' equity analysis
• Stock splits	• Retained earnings statement	• Income statement presentation
		• Income statement analysis

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DIVIDENDS

STUDY OBJECTIVE 1

Prepare the entries for cash dividends and stock dividends.

A **dividend** **is a corporation's distribution of cash or stock to its stockholders on a pro rata (proportional) basis.** Investors are very interested in a company's dividend policies and practices. Dividends can take four forms: cash, property, scrip (a promissory note to pay cash), or stock. Cash dividends predominate in practice. Also, companies declare stock dividends with some frequency. These two forms of dividends will be the focus of discussion in this chapter.

Dividends may be expressed in two ways: (1) as a percentage of the par or stated value of the stock, or (2) as a dollar amount per share. The financial press generally reports **dividends as a dollar amount per share**. For example, Boeing Company's dividend rate is $1.60 a share, Hershey Foods Corp.'s is $1.19, and McDonald's is $1.50.

Cash Dividends

A **cash dividend** is a pro rata distribution of cash to stockholders. For a corporation to pay a cash dividend, it must have:

1. **Retained earnings.** The legality of a cash dividend depends on the laws of the state in which the company is incorporated. Payment of cash dividends from retained earnings is legal in all states. In general, cash dividend distributions from only the balance in common stock (legal capital) are illegal.

   A dividend declared out of paid-in capital is termed a **liquidating dividend**. Such a dividend reduces or "liquidates" the amount originally paid in by stockholders. Statutes vary considerably with respect to cash dividends based on paid-in capital in excess of par or stated value. Many states permit such dividends.
2. **Adequate cash.** The legality of a dividend and the ability to pay a dividend are two different things. For example, Nike, with retained earnings of over

$4.8 billion, could legally declare a dividend of at least $4.8 billion. But Nike's cash balance is only $1.8 billion.

Before declaring a cash dividend, a company's board of directors must carefully consider both current and future demands on the company's cash resources. In some cases, current liabilities may make a cash dividend inappropriate. In other cases, a major plant expansion program may warrant only a relatively small dividend.

3. **A declaration of dividends.** A company does not pay dividends unless its board of directors decides to do so, at which point the board "declares" the dividend. The board of directors has full authority to determine the amount of income to distribute in the form of a dividend and the amount to retain in the business. Dividends do not accrue like interest on a note payable, and they are not a liability until declared.

The amount and timing of a dividend are important issues. The payment of a large cash dividend could lead to liquidity problems for the company. On the other hand, a small dividend or a missed dividend may cause unhappiness among stockholders. Many stockholders expect to receive a reasonable cash payment from the company on a periodic basis. Many companies declare and pay cash dividends quarterly.

ENTRIES FOR CASH DIVIDENDS

Three dates are important in connection with dividends: (1) the declaration date, (2) the record date, and (3) the payment date. Normally, there are two to four weeks between each date. Companies make accounting entries on two of the dates—the declaration date and the payment date.

On the **declaration date**, the board of directors formally declares (authorizes) the cash dividend and announces it to stockholders. Declaration of a cash dividend **commits the corporation to a legal obligation**. The obligation is binding and cannot be rescinded. The company makes an entry to recognize the decrease in retained earnings and the increase in the liability Dividends Payable.

To illustrate, assume that on December 1, 2010, the directors of Media General declare a 50¢ per share cash dividend on 100,000 shares of $10 par value common stock. The dividend is $50,000 (100,000 × 50¢) The entry to record the declaration is:

Declaration Date

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

A	=	L	+	SE
				−50,000 Div
		+50,000		

Cash Flows
no effect

Dividends Payable is a current liability: it will normally be paid within the next several months.

Instead of debiting Retained Earnings, the company may debit the account Dividends. This account provides additional information in the ledger. Also, a company may have separate dividend accounts for each class of stock. When using a dividend account, the company transfers the balance of that account to Retained Earnings at the end of the year by a closing entry. Whichever account is used for the dividend declaration, the effect is the same: Retained earnings decreases, and a current liability increases. *For homework problems, you should use the Retained Earnings account for recording dividend declarations.*

At the **record date**, the company determines ownership of the outstanding shares for dividend purposes. The records maintained by the corporation supply this information. In the interval between the declaration date and the record date, the corporation updates its stock ownership records. For Media General, the

HELPFUL HINT
The purpose of the record date is to identify the persons or entities that will receive the dividend, not to determine the amount of the dividend liability.

record date is December 22. No entry is required on this date because the corporation's liability recognized on the declaration date is unchanged.

Record Date

Dec. 22	No entry necessary		

On the **payment date**, the company mails dividend checks to the stockholders and records the payment of the dividend. Assuming that the payment date is January 20 for Media General, the entry on that date is:

A	=	L	+	SE
		−50,000		
−50,000				

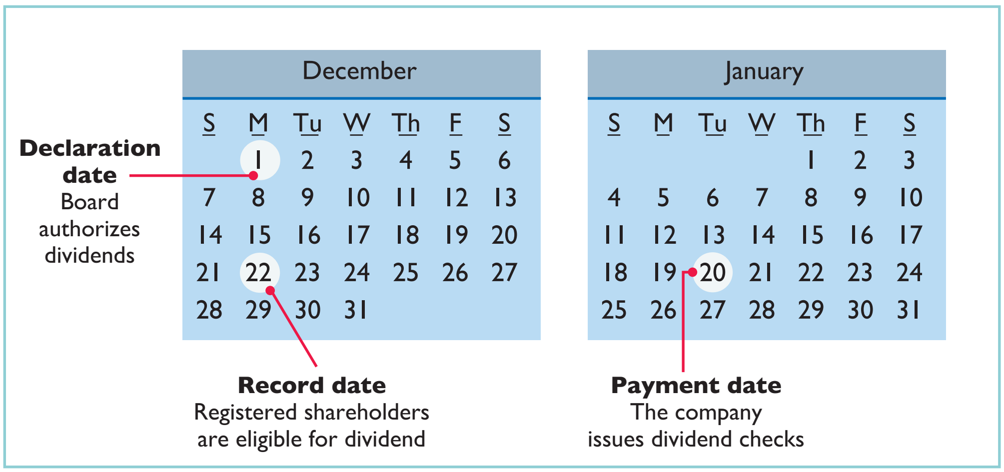
Cash Flows
−50,000

Payment Date

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

Note that payment of the dividend reduces both current assets and current liabilities. It has no effect on stockholders' equity. The **cumulative effect** of the **declaration and payment** of a cash dividend is to **decrease both stockholders' equity and total assets**. Illustration 14-1 summarizes the three important dates associated with dividends for Media General.

Illustration 14-1
Key dividend dates



ALLOCATING CASH DIVIDENDS BETWEEN PREFERRED AND COMMON STOCK

As explained in Chapter 13, preferred stock has priority over common stock in regard to dividends. Holders of cumulative preferred stock must be paid any unpaid prior-year dividends and its current year's dividend before common stockholders receive dividends.

To illustrate, assume that at December 31, 2010, IBR Inc. has 1,000 shares of 8%, \$100 par value cumulative preferred stock. It also has 50,000 shares of \$10 par value common stock outstanding. The dividend per share for preferred stock is \$8 (\$100 par value × 8%). The required annual dividend for preferred stock is therefore \$8,000 (1,000 × \$8). At December 31, 2010, the directors declare a \$6,000 cash dividend. In this case, the entire dividend amount goes to preferred stockholders because of their dividend preference. The entry to record the declaration of the dividend is:

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 Div
		+6,000		

Cash Flows
no effect

Because of the cumulative feature, dividends of $2 per share are in arrears on preferred stock for 2010. The company must pay these dividends to preferred stockholders before it can pay any future dividends to common stockholders. IBR should disclose dividends in arrears in the financial statements.

At December 31, 2011, IBR declares a $50,000 cash dividend. The allocation of the dividend to the two classes of stock is as follows.

Illustration 14-2
Allocating dividends to preferred and common stock

Total dividend		$50,000
Allocated to preferred stock		
Dividends in arrears, 2010 (1,000 × $2)	**$2,000**	
2011 dividend (1,000 × $8)	**8,000**	10,000
Remainder allocated to common stock		$40,000

The entry to record the declaration of the dividend is:

Dec. 31	Retained Earnings	50,000	
	Dividends Payable		50,000
	(To record declaration of cash dividends of $10,000 to preferred stock and $40,000 to common stock)		

A	=	L	+	SE
				−50,000 Div
		+50,000		

Cash Flows
no effect

What if IBR's preferred stock were not cumulative? In that case preferred stockholders would have received only $8,000 in dividends in 2011. Common stockholders would have received $42,000.

ACCOUNTING ACROSS THE ORGANIZATION

Why Companies Are Increasing Their Dividends

The decision whether to pay a dividend, and how much to pay, is a very important management decision. In recent years, many companies have substantially increased their dividends, and total dividends paid by U.S. companies hit record levels.

One explanation for the increase is that Congress lowered, from 39% to 15%, the tax rate paid by investors on dividends received, making dividends more attractive to investors. Another driving force for the dividend increases was that companies were sitting on record amounts of cash. Because they did not see a lot of profitable investment opportunities, companies decided to return the cash to shareholders.

Bigger dividends are still possible in the future. Large companies paid out 32% of their earnings as dividends in 2007—well below the historical average payout of 54% of earnings.

Source: Alan Levinsohn, "Divine Dividends," *Strategic Finance*, May 2005, pp. 59–60.

? What factors must management consider in deciding how large a dividend to pay?

DO IT!

DIVIDENDS ON PREFERRED AND COMMON STOCK

MasterMind Corporation has 2,000 shares of 6%, $100 par value preferred stock outstanding at December 31, 2010. At December 31, 2010, the company declared a $60,000 cash dividend. Determine the dividend paid to preferred stockholders and common stockholders under each of the following scenarios.

1. The preferred stock is noncumulative, and the company has not missed any dividends in previous years.
2. The preferred stock is noncumulative, and the company did not pay a dividend in each of the two previous years.
3. The preferred stock is cumulative, and the company did not pay a dividend in each of the two previous years.

action plan

✔ Determine dividends on preferred shares by multiplying the dividend rate times the par value of the stock times the number of preferred shares.

✔ Understand the cumulative feature: If preferred stock is cumulative, then any missed dividends (dividends in arrears) and the current year's dividend must be paid to preferred stockholders before dividends are paid to common stockholders.

Solution

1. The company has not missed past dividends and the preferred stock is noncumulative; thus, the preferred stockholders are paid only this year's dividend. The dividend paid to preferred stockholders would be $12,000 (2,000 × .06 × $100). The dividend paid to common stockholders would be $48,000 ($60,000 − $12,000).
2. The preferred stock is noncumulative; thus, past unpaid dividends do not have to be paid. The dividend paid to preferred stockholders would be $12,000 (2,000 × .06 × $100). The dividend paid to common stockholders would be $48,000 ($60,000 − $12,000).
3. The preferred stock is cumulative; thus, dividends that have been missed (dividends in arrears) must be paid. The dividend paid to preferred stockholders would be $36,000 (3 × 2,000 × .06 × $100). The dividend paid to common stockholders would be $24,000 ($60,000 − $36,000).

Related exercise material: **E14-2, E14-17,** and **DO IT! 14-1.**

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Stock Dividends

A **stock dividend** is a pro rata distribution to stockholders of the corporation's own stock. Whereas a company pays cash in a cash dividend, a company issues shares of stock in a stock dividend. **A stock dividend results in a decrease in retained earnings and an increase in paid-in capital.** Unlike a cash dividend, a stock dividend does not decrease total stockholders' equity or total assets.

To illustrate, assume that you have a 2% ownership interest in Cetus Inc.; you own 20 of its 1,000 shares of common stock. If Cetus declares a 10% stock dividend, it would issue 100 shares (1,000 × 10%) of stock. You would receive two shares (2% × 100). Would your ownership interest change? No, it would remain at 2% (22 ÷ 1,100). **You now own more shares of stock, but your ownership interest has not changed.** Illustration 14-3 (next page) shows the effect of a stock dividend for stockholders.

The company has disbursed no cash, and has assumed no liabilities. What are the 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 the corporation's stock. When the number of shares outstanding increases, the market price per share decreases. Decreasing

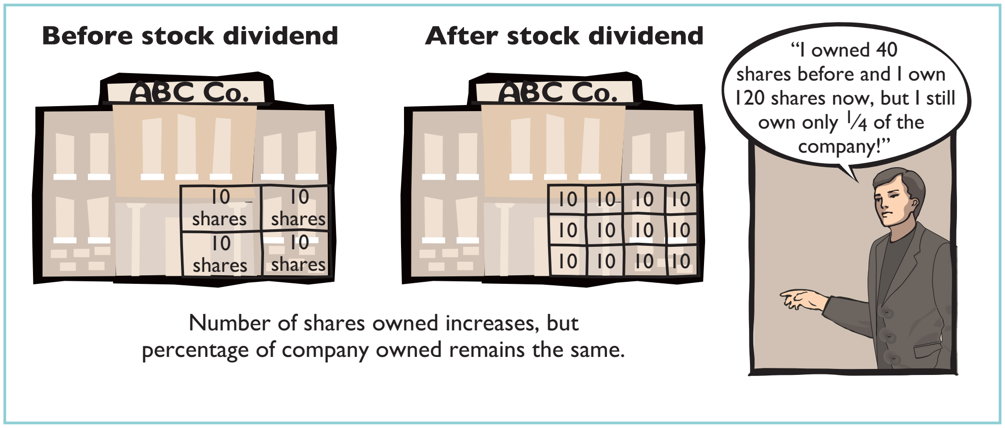


Illustration 14-3
Effect of stock dividend for stockholders

the market price of the stock makes it easier for smaller investors to purchase the shares.

3. To emphasize that a portion of stockholders' equity has been permanently reinvested in the business (and is unavailable for cash dividends).

When the dividend is declared, the board of directors determines the size of the stock dividend and the value assigned to each dividend. Generally, if the company issues a **small stock dividend** (less than 20–25% of the corporation's issued stock), the value assigned to the dividend is the fair market value per share. This treatment is based on the assumption that a small stock dividend will have little effect on the market price of the outstanding shares. Many stockholders consider small stock dividends to be distributions of earnings equal to the fair market value of the shares distributed. If a company issues a **large stock dividend** (greater than 20–25%), the value assigned to the dividend is the par or stated value. Small stock dividends predominate in practice. Thus, we will illustrate only entries for small stock dividends.

ENTRIES FOR STOCK DIVIDENDS

To illustrate the accounting for small stock dividends, assume that Medland Corporation has a balance of $300,000 in retained earnings. It declares a 10% stock dividend on its 50,000 shares of $10 par value common stock. The current fair market value of its stock is $15 per share. The number of shares to be issued is 5,000 (10% × 50,000). Therefore the total amount to be debited to Retained Earnings is $75,000 (5,000 × $15). The entry to record the declaration of the stock dividend is as follows.

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

Medland debits Retained Earnings for the fair market value of the stock issued ($15 × 5,000). It credits Common Stock Dividends Distributable for the par value of the dividend shares ($10 × 5,000), and credits Paid-in Capital in Excess of Par Value for the excess over par ($5 × 5,000).

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 the company prepares a balance sheet before it issues the dividend shares, it reports the distributable account under Paid-in capital as shown in Illustration 14-4 (next page).

Illustration 14-4
Statement presentation of common stock dividends distributable

Paid-in capital		
Common stock	$500,000	
Common stock dividends distributable	**50,000**	$550,000

A	=	L	+	SE
				−50,000 CS
				+50,000 CS

Cash Flows
no effect

When Medland issues the dividend shares, it debits Common Stock Dividends Distributable, and credits Common Stock, as follows.

Common Stock Dividends Distributable	50,000	
Common Stock		50,000
(To record issuance of 5,000 shares in a stock dividend)		

EFFECTS OF STOCK DIVIDENDS

How do stock dividends affect stockholders' equity? They **change the composition of stockholders' equity**, because they transfer to paid-in capital a portion of retained earnings. However, **total stockholders' equity remains the same**. Stock dividends also have no effect on the par or stated value per share. But the number of shares outstanding increases. Illustration 14-5 shows these effects for Medland Corporation.

Illustration 14-5
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**
Par value per share	**$10.00**	**$10.00**

In this example, total paid-in capital increases by $75,000, and retained earnings decreases by the same amount. Note also that total stockholders' equity remains unchanged at $800,000.

Stock Splits

A **stock split**, like a stock dividend, involves issuance of additional shares to stockholders according to their percentage ownership. **A stock split results in a reduction in the par or stated value per share.** The purpose of a stock split is to increase the marketability of the stock by lowering its market value per share.

The effect of a split on market value is generally *inversely proportional* to the size of the split. For example, after a recent 2-for-1 stock split, the market value of Nike's stock fell from $111 to approximately $55. The lower market value stimulated market activity, and within one year the stock was trading above $100 again.

In a stock split, the number of shares increases in the same proportion that par or stated value per share decreases. For example, in a 2-for-1 split, one share of $10 par value stock is exchanged for two shares of $5 par value stock. **A stock split does**

HELPFUL HINT
A stock split changes the par value per share but does not affect any balances in stockholders' equity.

not have any effect on total paid-in capital, retained earnings, or total stockholders' equity. But the number of shares outstanding increases, and par value per share decreases. Illustration 14-6 shows these effects for Medland Corporation, assuming that it splits its 50,000 shares of common stock on a 2-for-1 basis.

Illustration 14-6
Stock split effects

	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**
Par value per share	**$10.00**	**$5.00**

A stock split does not affect the balances in any stockholders' equity accounts. Therefore **it is not necessary to journalize a stock split**.

Illustration 14-7 summarizes the significant differences between stock splits and stock dividends.

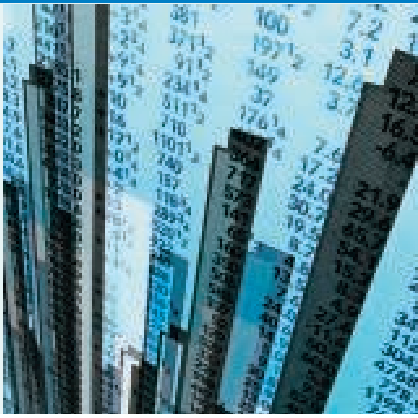
Illustration 14-7
Differences between the effects of stock splits and stock dividends

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

INVESTOR INSIGHT

Would You Pay $133,900 for One Share of Stock?

A handful of U.S. companies have no intention of keeping their stock trading in a range accessible to mere mortals. These companies never split their stock, no matter how high their stock price gets. The king is investment company Berkshire Hathaway's Class A stock, which sells for a pricey $133,900—per share! The company's Class B stock is a relative bargain at roughly $4,452 per share. And who is the CEO of Berkshire Hathaway? Warren Buffett, one of the richest individuals in the world.



? How does the effect on share price following a stock split compare to the effect on share price of treasury shares acquired?

DO IT!

STOCK DIVIDENDS AND STOCK SPLITS

Sing CD Company has had five years of record earnings. Due to this success, the market price of its 500,000 shares of $2 par value common stock has tripled from $15 per share to $45. During this period, paid-in capital remained the same at $2,000,000. Retained earnings increased from $1,500,000 to $10,000,000. CEO

Joan Elbert is considering either (1) a 10% stock dividend or (2) a 2-for-1 stock split. She asks you to show the before-and-after effects of each option on (a) retained earnings and (b) total stockholders' equity.

action plan

- ✔ Calculate the stock dividend's effect on retained earnings by multiplying the number of new shares times the market price of the stock (or par value for a large stock dividend).
- ✔ Recall that a stock dividend increases the number of shares without affecting total stockholders' equity.
- ✔ Recall that a stock split only increases the number of shares outstanding and decreases the par value per share.

Solution

(a) (1) The stock dividend amount is $2,250,000 [(500,000 × 10%) × $45]. The new balance in retained earnings is $7,750,000 ($10,000,000 − $2,250,000).

(2) The retained earnings balance after the stock split would be the same as it was before the split: $10,000,000.

(b) (1) Stock dividends change the composition of stockholders' equity because they transfer to paid-in capital a portion of retained earnings. However, total stockholders' equity remains the same.

(2) In a stock split, the number of shares increases in the same proportion that par or stated value per share decreases. A stock split therefore does not have any effect on total paid-in capital, retained earnings, or total stockholders' equity.

Related exercise material: **BE14-3, E14-4, E14-5, E14-6, E14-7,** and **DO IT! 14-2.**

✔ The Navigator

RETAINED EARNINGS

STUDY OBJECTIVE 2

Identify the items reported in a retained earnings statement.

As you learned in Chapter 13, **retained earnings** is net income that a company retains for use in the business. The balance in retained earnings is part of the stockholders' claim on the total assets of the corporation. It does not, though, represent a claim on any specific asset. Nor can the amount of retained earnings be associated with the balance of any asset account. For example, a $100,000 balance in retained earnings does not mean that there should be $100,000 in cash. The reason is that the company may have used the cash resulting from the excess of revenues over expenses to purchase buildings, equipment, and other assets.

To demonstrate that retained earnings and cash may be quite different, Illustration 14-8 shows recent amounts of retained earnings and cash in selected companies.

Illustration 14-8
Retained earnings and cash balances

	(in millions)	
Company	**Retained Earnings**	**Cash**
Disney Co.	$24,207	$3,670
Intel Corp.	28,984	6,598
Kellogg Co.	4,217	1,026
Amazon.com	(1,837)	1,022

HELPFUL HINT

Remember that Retained Earnings is a stockholders' equity account, whose normal balance is a credit.

Remember from Chapter 13 that when a company has net income, it closes net income to retained earnings. The closing entry is a debit to Income Summary and a credit to Retained Earnings.

When a company has a **net loss** (expenses exceed revenues), it also closes this amount to retained earnings. The closing entry in this case is a debit to Retained

Earnings and a credit to Income Summary. This is done even if it results in a debit balance in Retained Earnings. **Companies do not debit net losses to paid-in capital accounts.** To do so would destroy the distinction between paid-in and earned capital. A debit balance in Retained Earnings is identified as a **deficit**. It is reported as a deduction in the stockholders' equity section, as shown below.

Illustration 14-9
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

Retained Earnings Restrictions

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

LOCKHEED MARTIN CORPORATION
Notes to the Financial Statements

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

Illustration 14-10
Disclosure of unrestricted retained earnings

In some cases, there may be **retained earnings restrictions**. These make a portion of the retained earnings balance currently unavailable for dividends. Restrictions result from one or more of the following causes.

1. **Legal restrictions.** Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation's legal capital that is being temporarily held as treasury stock. When the company sells the treasury stock, the restriction is lifted.
2. **Contractual restrictions.** Long-term debt contracts may restrict retained earnings as a condition for the loan. The restriction limits the use of corporate assets for payment of dividends. Thus, it increases the likelihood that the corporation will be able to meet required loan payments.
3. **Voluntary restrictions.** The board of directors may voluntarily create retained earnings restrictions for specific purposes. For example, the board may authorize a restriction for future plant expansion. By reducing the amount of retained earnings available for dividends, the company makes more cash available for the planned expansion.

Companies generally disclose **retained earnings restrictions** in the notes to the financial statements. For example, Tektronix Inc., a manufacturer of electronic measurement devices, had total retained earnings of $774 million, but the unrestricted portion was only $223.8 million.

Illustration 14-11
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. The Company had unrestricted retained earnings of $223.8 million after meeting those requirements.

Prior Period Adjustments

Suppose that a corporation has closed its books and issued financial statements. The corporation then discovers that it made a material error in reporting net income of a prior year. How should the company record this situation in the accounts and report it in the financial statements?

The correction of an error in previously issued financial statements is known as a **prior period adjustment**. The company makes the correction directly to Retained Earnings, because the effect of the error is now in this account. The net income for the prior period has been recorded in retained earnings through the journalizing and posting of closing entries.

To illustrate, assume that General Microwave discovers in 2010 that it understated depreciation expense in 2009 by $300,000 due to computational errors. These errors overstated both net income for 2009 and the current balance in retained earnings. The entry for the prior period adjustment, ignoring all tax effects, is as follows.

A	=	L	+	SE
				−300,000 RE
−300,000				

Cash Flows
no effect

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

A debit to an income statement account in 2010 is incorrect because the error pertains to a prior year.

Companies report prior period adjustments in the retained earnings statement.[1] They add (or deduct, as the case may be) these adjustments from the beginning retained earnings balance. This results in an adjusted beginning balance. For example, assuming a beginning balance of $800,000 in retained earnings, General Microwave reports the prior period adjustment as follows.

Illustration 14-12
Statement presentation of prior period adjustments

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

Again, reporting the correction in the current year's income statement would be incorrect because it applies to a prior year's income statement.

[1] A complete retained earnings statement is shown in Illustration 14-14 on the next page.

Retained Earnings Statement

The **retained earnings statement** shows the changes in retained earnings during the year. The company prepares the statement from the Retained Earnings account. Illustration 14-13 shows (in account form) transactions that affect retained earnings.

Illustration 14-13
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 adjustments for understatement of net income
3. Cash dividends and stock dividends	
4. Some disposals of treasury stock	

As indicated, net income increases retained earnings, and a net loss decreases retained earnings. Prior period adjustments may either increase or decrease retained earnings. Both cash dividends and stock dividends decrease retained earnings. The circumstances under which treasury stock transactions decrease retained earnings are explained in Chapter 13, page 585.

A complete retained earnings statement for Graber Inc., based on assumed data, is as follows.

Illustration 14-14
Retained earnings statement

GRABER INC.
Retained Earnings Statement
For the Year Ended December 31, 2010

Balance, January 1, as reported		$1,050,000
Correction for understatement of net income in prior period (inventory error)		50,000
Balance, January 1, as adjusted		1,100,000
Add: Net income		360,000
		1,460,000
Less: Cash dividends	$100,000	
Stock dividends	200,000	300,000
Balance, December 31		$1,160,000

DO IT!

RETAINED EARNINGS STATEMENT

Vega Corporation has retained earnings of $5,130,000 on January 1, 2010. During the year, Vega earned $2,000,000 of net income. It declared and paid a $250,000 cash dividend. In 2010, Vega recorded an adjustment of $180,000 due to the understatement (from a mathematical error) of 2009 depreciation expense. Prepare a retained earnings statement for 2010.

action plan

- ✔ Recall that a retained earnings statement begins with retained earnings, as reported at the end of the previous year.
- ✔ Add or subtract any prior period adjustments to arrive at the adjusted beginning figure.
- ✔ Add net income and subtract dividends declared to arrive at the ending balance in retained earnings.

Solution

VEGA CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2010

Balance, January 1, as reported	$5,130,000
Correction for overstatement of net income in prior period (depreciation error)	(180,000)
Balance, January 1, as adjusted	4,950,000
Add: Net income	2,000,000
	6,950,000
Less: Cash dividends	250,000
Balance, December 31	$6,700,000

Related exercise material: **BE14-4, BE14-5, E14-8, E14-9,** and **DO IT! 14-3.**

✔ The Navigator

STATEMENT PRESENTATION AND ANALYSIS

Stockholders' Equity Presentation

STUDY OBJECTIVE 3

Prepare and analyze a comprehensive stockholders' equity section.

Illustration 14-15 presents the stockholders' equity section of Graber Inc.'s balance sheet. Note the following: (1) "Common stock dividends distributable" is shown under "Capital stock," in "Paid-in capital." (2) A note (Note R) discloses a retained earnings restriction.

Illustration 14-15
Comprehensive stockholders' equity section

GRABER INC.
Balance Sheet (partial)

Stockholders' equity		
Paid-in capital		
Capital stock		
9% Preferred stock, $100 par value, cumulative, callable at $120, 10,000 shares authorized, 6,000 shares issued and outstanding		$ 600,000
Common stock, no par, $5 stated value, 500,000 shares authorized, 400,000 shares issued and 390,000 outstanding	$2,000,000	
Common stock dividends distributable	**50,000**	2,050,000
Total capital stock		2,650,000
Additional paid-in capital		
In excess of par value—preferred stock	30,000	
In excess of stated value—common stock	1,050,000	
Total additional paid-in capital		1,080,000
Total paid-in capital		3,730,000
Retained earnings **(see Note R)**		1,160,000
Total paid-in capital and retained earnings		4,890,000
Less: Treasury stock—common (10,000 shares)		80,000
Total stockholders' equity		$4,810,000

Note R: Retained earnings is restricted for the cost of treasury stock, $80,000.

Instead of presenting a detailed stockholders' equity section in the balance sheet and a retained earnings statement, many companies prepare a **stockholders' equity statement**. This statement shows the changes (1) in each stockholders' equity account and (2) in total that occurred during the year. An example of a stockholders' equity statement appears in PepsiCo's financial statements in Appendix A (page A7).

Stockholders' Equity Analysis

Investors and analysts can measure profitability from the viewpoint of the common stockholder by the **return on common stockholders' equity**. This ratio shows how many dollars of net income the company earned for each dollar invested by the common stockholders. It is computed by dividing **net income available to common stockholders** (which is net income minus preferred stock dividends) by average common stockholders' equity.

To illustrate, Walt Disney Company's beginning-of-the-year and end-of-the-year common stockholders' equity were $31,820 and $30,753 million respectively. Its net income was $4,687 million, and no preferred stock was outstanding. The return on common stockholders' equity ratio is computed as follows.

Net Income Available to Common Stockholders	÷	Average Common Stockholders' Equity	=	Return on Common Stockholders' Equity
($4,687 − $0)	÷	($31,820 + $30,753) / 2	=	**15.0%**

Illustration 14-16
Return on common stockholders' equity ratio and computation

As shown above, if a company has preferred stock, we would deduct the amount of **preferred dividends** from the company's net income to compute income available to common stockholders. Also, the par value of preferred stock is deducted from total average stockholders' equity to arrive at the amount of common stockholders' equity.

Income Statement Presentation

STUDY OBJECTIVE 4
Describe the form and content of corporation income statements.

Income statements for **corporations are the same as the statements for proprietorships or partnerships except for one thing: the reporting of income taxes**. For income tax purposes, corporations are a separate legal entity. As a result, corporations report **income tax expense** in a separate section of the corporation income statement, before net income. The condensed income statement for Leads Inc. in Illustration 14-17 shows a typical presentation.

Illustration 14-17
Income statement with income taxes

LEADS INC.
Income Statement
For the Year Ended December 31, 2010

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

Note that the corporation reports income before income taxes as one line item and income tax expense as another.

Companies record income tax expense and the related liability for income taxes payable as part of the adjusting process. Using the data for Leads Inc., in Illustration 14-17, the adjusting entry for income tax expense at December 31, 2010, is:

A	=	L	+	SE
				−46,800 Exp
		+46,800		

Cash Flows
no effect

Income Tax Expense	46,800	
Income Taxes Payable		46,800
(To record income taxes for 2010)		

The income statement of PepsiCo, in Appendix A presents another illustration of income taxes.

Income Statement Analysis

STUDY OBJECTIVE 5
Compute earnings per share.

The financial press frequently reports earnings data. Stockholders and potential investors widely use these data in evaluating the profitability of a company. A convenient measure of earnings is **earnings per share (EPS)**, which indicates the net income earned by each share of outstanding **common stock**.

EPS AND PREFERRED DIVIDENDS

The existence of preferred dividends slightly complicates the calculation of EPS. When a corporation has both preferred and common stock, we must subtract the current year's preferred dividend from net income, to arrive at **income available to common stockholders**. Illustration 14-18 shows the formula for computing EPS.

Illustration 14-18
Formula for earnings per share

Net Income minus Preferred Dividends	÷	Weighted-Average of Common Shares Outstanding	=	Earnings per Share

ETHICS NOTE
In order to meet market expectations for EPS, some managers engage in elaborate treasury stock transactions. These transactions can be very costly for the remaining shareholders.

To illustrate, assume that Rally Inc. reports net income of $211,000 on its 102,500 weighted-average common shares.[2] During the year it also declares a $6,000 dividend on its preferred stock. Therefore, the amount Rally has available for common stock dividends is $205,000 ($211,000 − $6,000). Earnings per share is $2 ($205,000 ÷ 102,500). If the preferred stock is cumulative, Rally deducts the dividend for the current year, whether or not it is declared. Remember that companies report **earnings per share only for common stock**.

Investors often attempt to link earnings per share to the market price per share of a company's stock.[3] Because of the importance of earnings per share, most companies must report it on the face of the income statement. Generally companies

[2]The calculation of the weighted average of common shares outstanding is discussed in advanced accounting courses.

[3]The ratio of the market price per share to the earnings per share is called the *price/earnings (P/E) ratio*. The financial media report this ratio for common stocks listed on major stock exchanges.

simply report this amount below net income on the statement. For Rally Inc. the presentation is as follows.

Illustration 14-19
Basic earnings per share disclosure

RALLY INC.
Income Statement (partial)

Net income	$211,000
Earnings per share	**$2.00**

DO IT!

STOCKHOLDERS' EQUITY AND EPS

On January 1, 2010, Sienna Corporation purchased 2,000 shares of treasury stock. Other information regarding Siena Corporation is provided below.

	2009	2010
Net income	$110,000	$110,000
Dividends on preferred stock	$10,000	$10,000
Dividends on common stock	$2,000	$1,600
Weighted average number of shares outstanding	10,000	8,000*
Common stockholders' equity, beginning of year	$500,000	$400,000*
Common stockholders' equity, end of year	$500,000	$400,000

*Adjusted for purchase of treasury stock.

Compute (a) return on common stockholders' equity for each year and (b) earnings per share for each year, and (c) discuss the changes in each.

action plan

✔ Determine return on common stockholders' equity by dividing net income available to common stockholders by the average common stockholders' equity.

✔ Determine earnings per share by dividing net income available to common stockholders by the weighted-average number of common shares outstanding.

Solution

(a)

Return on common stockholders' equity:

2009: $$\frac{(\$110{,}000 - \$10{,}000)}{(\$500{,}000 + \$500{,}000)/2} = 20\%$$

2010: $$\frac{(\$110{,}000 - \$10{,}000)}{(\$400{,}000 + \$400{,}000)/2} = 25\%$$

(b)

Earnings per share:

2009: $$\frac{(\$110{,}000 - \$10{,}000)}{10{,}000} = \$10$$

2010: $$\frac{(\$110{,}000 - \$10{,}000)}{8{,}000} = \$12.50$$

(c) Between 2009 and 2010, return on common stockholders' equity improved from 20% to 25%. Earnings per share increased from $10 to $12.50. While this would appear to be good news for the company's common stockholders, these increases should be carefully evaluated. It is important to note that net income did not change during this period. The increase in both ratios was due to the purchase of treasury shares, which reduced the denominator of each ratio. As the company repurchases its own shares, it becomes more reliant on debt and thus increases its risk.

Related exercise material: **BE14-6, BE14-7, BE14-9, BE14-10, E14-12, E14-13, E14-14, E14-15, E14-16, E14-17,** and **DO IT! 14-4.**

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Be sure to read **ALL ABOUT YOU: *Corporations Have Governance Structures—Do You?*** on page 624 for information on how topics in this chapter apply to your personal life.

all about YOU

Corporations Have Governance Structures—Do You?

As discussed previously in this text, the scandals and bankruptcies at Enron, WorldCom, and other companies brought many changes to the way America does business. One of the primary lessons has been that companies need to take corporate governance and management oversight more seriously. As part of this effort, many companies have developed a code of ethics. The purpose of a code of ethics is to clearly specify standards of conduct to deter wrongdoing and promote honest and ethical conduct. It also is intended to be an expression by top management of its "tone at the top" —that is, to indicate that top management takes ethics seriously. Many other organizations, including university student groups, also have formulated ethics codes.

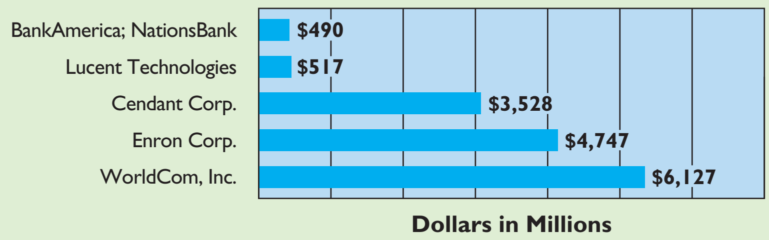
Some Facts

* Under Sarbanes-Oxley, a company must disclose in its annual report whether it has a code of ethics. It must also disclose any changes to or waivers of the code of ethics.
* Enron had a code of ethics. In a number of instances, Enron's board of directors knowingly waived requirements of the code so that the CFO could set up and run special purpose entities. Ultimately these waivers contributed to Enron's downfall.
* In some instances U.S. federal prosecutors have pressured companies to not pay the legal-defense bills of employees accused of wrong-doing, thus making it harder for the employees to defend themselves.
* In a recent survey of 1,436 workers, 34% said that they have seen unethical activities at their workplace, but only 47% said they are likely to report these activities. Many cited fear of retaliation by their bosses as the reason for not reporting.

About the Numbers

Stockholders often lose money as a result of unethical behavior by management. When they do, they often file lawsuits against the company in an effort to recoup these losses. The graph below shows just how expensive these class-action lawsuits can be for companies.

Top Class-Action Securities Settlements



Source: Elaine Buckberg, Todd Foster, and Ronald I. Miller, "Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?" NERA Economic Consulting, *www.nera.com* (accessed June 26, 2006).

What Do You Think

Many universities have become concerned about student cheating. In particular, the prevalence of digital documents on the Internet has made it very easy to plagiarize. Many schools now have student ethics codes. Do you think that these ethics codes serve a useful purpose?

YES: Anything that will reduce unethical behavior is a good thing. An ethics code establishes what is and is not acceptable behavior, which helps universities maintain ethical standards for academic work and weed out those students who try to get ahead by non-ethical means.

NO: The existence of an ethics code won't affect student behavior. If students have a propensity to cheat, a document that tells them what is and is not good behavior is not going to be a deterrent. Students already know what cheating is, and that it is wrong.

Sources: "Whistleblowing Workers: Becoming an Endangered Species?" *HR Focus,* June 2006, p. 9; Lauren Etter, "The Enron Trial Finally Begins," *Wall Street Journal,* February 4, 2006, p. A7.

The authors' comments on this situation appear on page 640.

Comprehensive DO IT!

On January 1, 2010, Hayslett Corporation had the following stockholders' equity accounts.

Common Stock ($10 par value, 260,000 shares issued and outstanding)	$2,600,000
Paid-in Capital in Excess of Par Value	1,500,000
Retained Earnings	3,200,000

During the year, the following transactions occurred.

April	1	Declared a $1.50 cash dividend per share to stockholders of record on April 15, payable May 1.
May	1	Paid the dividend declared in April.
June	1	Announced a 2-for-1 stock split. Prior to the split, the market price per share was $24.
Aug.	1	Declared a 10% stock dividend to stockholders of record on August 15, distributable August 31. On August 1, the market price of the stock was $10 per share.
	31	Issued the shares for the stock dividend.
Dec.	1	Declared a $1.50 per share dividend to stockholders of record on December 15, payable January 5, 2009.
	31	Determined that net income for the year was $600,000.

Instructions

(a) Journalize the transactions and the closing entry for net income.
(b) Prepare a stockholders' equity section at December 31.

action plan

- ✔ Award dividends to outstanding shares only.
- ✔ Adjust the par value and number of shares for stock splits, but make no journal entry.
- ✔ Use market value of stock to determine the value of a small stock dividend.
- ✔ Close Income Summary to Retained Earnings.

Solution to Comprehensive DO IT!

(a)

Apr. 1	Retained Earnings (260,000 × $1.50)	390,000	
	Dividends Payable		390,000
May 1	Dividends Payable	390,000	
	Cash		390,000
June 1	Memo—two-for-one stock split increases number of shares to 520,000 (260,000 × 2) and reduces par value to $5 per share.		
Aug. 1	Retained Earnings (52,000* × $10)	520,000	
	Common Stock Dividends Distributable (52,000 × $5)		260,000
	Paid-in Capital in Excess of Par Value (52,000 × $5)		260,000
	*520,000 × .10		
31	Common Stock Dividends Distributable	260,000	
	Common Stock		260,000
Dec. 1	Retained Earnings (572,000** × $1.50)	858,000	
	Dividends Payable		858,000
	**(260,000 × 2) + 52,000		
31	Income Summary	600,000	
	Retained Earnings		600,000

(b) HAYSLETT CORPORATION

Stockholders' equity	
Paid-in capital	
Capital stock	
Common stock, $5 par value, 572,000 shares issued and outstanding	$2,860,000
Additional paid-in capital in excess of par value	1,760,000
Total paid-in capital	4,620,000
Retained earnings	2,032,000
Total stockholders' equity	$6,652,000

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SUMMARY OF STUDY OBJECTIVES

1 **Prepare the entries for cash dividends and stock dividends.** Companies make entries for both cash and stock dividends at the declaration date and at the payment date. At the *declaration date* the entries are: cash dividend—debit Retained Earnings, and credit Dividends Payable; small stock dividend—debit Retained Earnings, credit Paid-in Capital in Excess of Par (or Stated) Value, and credit Common Stock Dividends Distributable. At the *payment date,* the entries for cash and stock dividends are: cash dividend—debit Dividends Payable and credit Cash; small stock dividend—debit Common Stock Dividends Distributable and credit Common Stock.

2 **Identify the items reported in a retained earnings statement.** Companies report each of the individual debits and credits to retained earnings in the retained earnings statement. Additions consist of net income and prior period adjustments to correct understatements of prior years' net income. Deductions consist of net loss, adjustments to correct overstatements of prior years' net income, cash and stock dividends, and some disposals of treasury stock.

3 **Prepare and analyze a comprehensive stockholders' equity section.** A comprehensive stockholders' equity section includes all stockholders' equity accounts. It consists of two sections: paid-in capital and retained earnings. It should also include notes to the financial statements that explain any restrictions on retained earnings and any dividends in arrears. One measure of profitability is the return on common stockholders' equity. It is calculated by dividing net income minus preferred stock dividends by average common stockholders' equity.

4 **Describe the form and content of corporation income statements.** The form and content of corporation income statements are similar to the statements of proprietorships and partnerships with one exception: Corporations must report income taxes or income tax expense in a separate section before net income in the income statement.

5 **Compute earnings per share.** Companies compute earnings per share by dividing net income by the weighted-average number of common shares outstanding during the period. When preferred stock dividends exist, they must be deducted from net income in order to calculate EPS.

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GLOSSARY

Cash dividend A pro rata distribution of cash to stockholders. (p. 608).

Declaration date The date the board of directors formally declares a dividend and announces it to stockholders. (p. 609).

Deficit A debit balance in retained earnings. (p. 617).

Dividend A corporation's distribution of cash or stock to its stockholders on a pro rata (proportional) basis. (p. 608).

Earnings per share The net income earned by each share of outstanding common stock. (p 622)

Liquidating dividend A dividend declared out of paid-in capital. (p. 608).

Payment date The date dividend checks are mailed to stockholders. (p. 610).

Prior period adjustment The correction of an error in previously issued financial statements. (p. 618).

Record date The date when ownership of outstanding shares is determined for dividend purposes. (p. 609).

Retained earnings Net income that is retained in the business. (p. 616).

Retained earnings restrictions Circumstances that make a portion of retained earnings currently unavailable for dividends. (p. 617).

Retained earnings statement A financial statement that shows the changes in retained earnings during the year. (p. 619).

Return on common stockholders' equity A measure of profitability that shows how many dollars of net income were earned for each dollar invested by the owners; computed as net income minus preferred dividends divided by average common stockholders' equity. (p. 621).

Stock dividend A pro rata distribution to stockholders of the corporation's own stock. (p. 612).

Stockholders' equity statement A statement that shows the changes in each stockholders' equity account and in total stockholders' equity during the year. (p. 621).

Stock split The issuance of additional shares of stock to stockholders according to their percentage ownership; is accompanied by a reduction in the par or stated value per share. (p. 614).

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 1) **1.** Entries for cash dividends are required on the:
- **a.** declaration date and the payment date.
- **b.** record date and the payment date.
- **c.** declaration date, record date, and payment date.
- **d.** declaration date and the record date.

(SO 1) **2.** Which of the following statements about small stock dividends is true?
- **a.** A debit to Retained Earnings for the par value of the shares issued should be made.
- **b.** A small stock dividend decreases total stockholders' equity.
- **c.** Market value per share should be assigned to the dividend shares.
- **d.** A small stock dividend ordinarily will have no effect on book value per share of stock.

(SO 1) **3.** Which of the following statements about a 3-for-1 stock split is true?
- **a.** It will triple the market value of the stock.
- **b.** It will triple the amount of total stockholders' equity.
- **c.** It will have no effect on total stockholders' equity.
- **d.** It requires the company to distribute cash.

(SO 1) **4.** Encore Inc. declared an $80,000 cash dividend. It currently has 3,000 shares of 7%, $100 par value cumulative preferred stock outstanding. It is one year in arrears on its preferred stock. How much cash will Encore distribute to the common stockholders?
- **a.** $38,000.
- **b.** $42,000.
- **c.** $59,000.
- **d.** None.

(SO 1) **5.** Raptor Inc. has retained earnings of $500,000 and total stockholders' equity of $2,000,000. It has 100,000 shares of $8 par value common stock outstanding, which is currently selling for $30 per share. If Raptor declares a 10% stock dividend on its common stock:
- **a.** net income will decrease by $80,000.
- **b.** retained earnings will decrease by $80,000 and total stockholders' equity will increase by $80,000.
- **c.** retained earnings will decrease by $300,000 and total stockholders' equity will increase by $300,000.
- **d.** retained earnings will decrease by $300,000 and total paid-in capital will increase by $300,000.

6. Which of the following can cause a restriction in retained earnings? (SO 2)
- **a.** State laws regarding treasury stock.
- **b.** Long-term debt contract terms.
- **c.** Authorizations by the board of directors in light of planned expansion of corporate facilities.
- **d.** All of the above.

7. All *but one* of the following is reported in a retained earnings statement. The exception is: (SO 2)
- **a.** cash and stock dividends.
- **b.** net income and net loss.
- **c.** sales revenue.
- **d.** prior period adjustments.

8. A prior period adjustment is: (SO 2)
- **a.** reported in the income statement as a nontypical item.
- **b.** a correction of an error that is made directly to retained earnings.
- **c.** reported directly in the stockholders' equity section.
- **d.** reported in the retained earnings statement as an adjustment of the ending balance of retained earnings.

9. In the stockholders' equity section, Common Stock Dividends Distributable is reported as a(n): (SO 3)
- **a.** deduction from total paid-in capital and retained earnings.
- **b.** addition to additional paid-in capital.
- **c.** deduction from retained earnings.
- **d.** addition to capital stock.

10. Katie Inc. reported net income of $186,000 during 2010 and paid dividends of $26,000 on common stock. It also has 10,000 shares of 6%, $100 par value, noncumulative preferred stock outstanding. Common stockholders' equity was $1,200,000 on January 1, 2010, and $1,600,000 on December 31, 2010. The company's return on common stockholders' equity for 2010 is: (SO 3)
- **a.** 10.0%.
- **b.** 9.0%.
- **c.** 7.1%.
- **d.** 13.3%.

(SO 4) **11.** Corporation income statements may be the same as the income statements for unincorporated companies *except* for:
a. gross profit.
b. income tax expense.
c. operating income.
d. net sales.

(SO 4) **12.** During 2010 Talon Inc. had sales revenue $376,000, gross profit $176,000, operating expenses $66,000, cash dividends $30,000, other expenses and losses $20,000. Its corporate tax rate is 30%. What was Talon's income tax expense for the year?
a. $18,000.
b. $52,800.
c. $112,800.
d. $27,000.

(SO 3) **13.** The return on common stockholders' equity is defined as:
a. Net income divided by total assets.
b. Cash dividends divided by average common stockholders' equity.
c. Income available to common stockholders divided by average common stockholders' equity.
d. None of these is correct.

14. If everything else is held constant, earnings per share is increased by: (SO 5)
a. the payment of a cash dividend to common shareholders.
b. the payment of a cash dividend to preferred shareholders.
c. the issuance of new shares of common stock.
d. the purchase of treasury stock.

15. 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: (SO 5)
a. $7.00.
b. $4.90.
c. $2.10.
d. No correct answer is given.

Go to the book's companion website,
www.wiley.com/college/weygandt,
for Additional Self-Study questions.

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QUESTIONS

1. (a) What is a dividend? (b) "Dividends must be paid in cash." Do you agree? Explain.
2. Sue DeVine maintains that adequate cash is the only requirement for the declaration of a cash dividend. Is Sue correct? Explain.
3. **(a)** Three dates are important in connection with cash dividends. Identify these dates, and explain their significance to the corporation and its stockholders.
   (b) Identify the accounting entries that are made for a cash dividend and the date of each entry.
4. Conger Inc. declares a $45,000 cash dividend on December 31, 2010. The required annual dividend on preferred stock is $10,000. Determine the allocation of the dividend to preferred and common stockholders assuming the preferred stock is cumulative and dividends are 1 year in arrears.
5. Contrast the effects of a cash dividend and a stock dividend on a corporation's balance sheet.
6. Todd Huebner asks, "Since stock dividends don't change anything, why declare them?" What is your answer to Todd?
7. Meenen Corporation has 30,000 shares of $10 par value common stock outstanding when it announces a 2-for-1 stock split. Before the split, the stock had a market price of $120 per share. After the split, how many shares of stock will be outstanding? What will be the approximate market price per share?
8. The board of directors is considering either a stock split or a stock dividend. They understand that total stockholders' equity will remain the same under either action. However, they are not sure of the different effects of the two types of actions on other aspects of stockholders' equity. Explain the differences to the directors.
9. What is a prior period adjustment, and how is it reported in the financial statements?
10. KSU Corporation has a retained earnings balance of $210,000 on January 1. During the year, a prior period adjustment of $50,000 is recorded because of the understatement of depreciation in the prior period. Show the retained earnings statement presentation of these data.
11. What is the purpose of a retained earnings restriction? Identify the possible causes of retained earnings restrictions.
12. How are retained earnings restrictions generally reported in the financial statements?
13. Identify the events that result in debits and credits to retained earnings.
14. Juan Ortega believes that both the beginning and ending balances in retained earnings are shown in the stockholders' equity section. Is Juan correct? Discuss.
15. Gene Remington, who owns many investments in common stock, says, "I don't care what a company's net income is. The stock price tells me everything I need to know!" How do you respond to Gene?
16. What is the unique feature of a corporation income statement? Illustrate this feature, using assumed data.
17. Why must preferred stock dividends be subtracted from net income in computing earnings per share?
18. PEPSICO What were the amounts of the dividends PepsiCo declared per share of common stock in the years 2003 to 2007? Is the trend in dividends consistent with the company's net income trend during the period?

The Navigator

BRIEF EXERCISES

BE14-1 Eidman Corporation has 80,000 shares of common stock outstanding. It declares a $1 per share cash dividend on November 1 to stockholders of record on December 1. The dividend is paid on December 31. Prepare the entries on the appropriate dates to record the declaration and payment of the cash dividend.

Prepare entries for a cash dividend.
(SO 1)

BE14-2 Tidwell Corporation has 50,000 shares of $10 par value common stock outstanding. It declares a 10% stock dividend on December 1 when the market value per share is $16. The dividend shares are issued on December 31. Prepare the entries for the declaration and payment of the stock dividend.

Prepare entries for a stock dividend.
(SO 1)

BE14-3 The stockholders' equity section of O'Vear Corporation consists of common stock ($10 par) $2,000,000 and retained earnings $500,000. A 10% stock dividend (20,000 shares) is declared when the market value per share is $14. Show the before and after effects of the dividend on the following.

Show before and after effects of a stock dividend.
(SO 1)

(a) The components of stockholders' equity.
(b) Shares outstanding.
(c) Par value per share.

BE14-4 For the year ending December 31, 2010, Kerns Inc. reports net income $140,000 and dividends $85,000. Prepare the retained earnings statement for the year assuming the balance in retained earnings on January 1, 2010, was $220,000.

Prepare a retained earnings statement.
(SO 2)

BE14-5 The balance in retained earnings on January 1, 2010, for Persinger Inc, was $800,000. During the year, the corporation paid cash dividends of $90,000 and distributed a stock dividend of $8,000. In addition, the company determined that it had understated its depreciation expense in prior years by $50,000. Net income for 2010 was $120,000. Prepare the retained earnings statement for 2010.

Prepare a retained earnings statement.
(SO 2)

BE14-6 SUPERVALU, one of the largest grocery retailers in the United States, is headquartered in Minneapolis. The following financial information (in millions) was taken from the company's 2007 annual report. Net sales $37,406; net income $452; beginning stockholders' equity $2,619; ending stockholders' equity $5,306. Compute the return on common stockholders' equity ratio.

Calculate the return on common stockholders' equity.
(SO 3)

BE14-7 Fuentes Corporation reported net income of $152,000, declared dividends on common stock of $50,000, and had an ending balance in retained earnings of $360,000. Stockholders' equity was $700,000 at the beginning of the year and $820,000 at the end of the year. Compute the return on common stockholders' equity.

Compute return on common stockholders' equity.
(SO 3)

BE14-8 The following information is available for Dixen Corporation for the year ended December 31, 2010: Cost of goods sold $205,000; Sales $450,000; Other revenues and gains $50,000; Operating expenses $75,000. Assuming a corporate tax rate of 30%, prepare an income statement for the company.

Prepare a corporate income statement.
(SO 4)

BE14-9 Quayle Corporation reports net income of $380,000 and a weighted average of 200,000 shares of common stock outstanding for the year. Compute the earnings per share of common stock.

Compute earnings per share.
(SO 5)

BE14-10 Income and common stock data for Quayle Corporation are presented in BE14-9. Assume also that Quayle has cumulative preferred stock dividends for the current year of $20,000 that were declared and paid. Compute the earnings per share of common stock.

Compute earnings per share with cumulative preferred stock.
(SO 5)

DO IT! REVIEW

DO IT! 14-1 Mensa Corporation has 3,000 shares of 7%, $100 par value preferred stock outstanding at December 31, 2010. At December 31, 2010, the company declared a $105,000 cash dividend. Determine the dividend paid to preferred stockholders and common stockholders under each of the following scenarios.

Determine dividends paid to preferred and common stockholders.
(SO 1)

1. The preferred stock is noncumulative, and the company has not missed any dividends in previous years.

2. The preferred stock is noncumulative, and the company did not pay a dividend in each of the two previous years.
3. The preferred stock is cumulative, and the company did not pay a dividend in each of the two previous years.

Determine effects of stock dividend and stock split.
(SO 1)

DO IT! 14-2 Riff CD Company has had 4 years of retained earnings. Due to this success, the market price of its 400,000 shares of $3 par value common stock has increased from $12 per share to $51. During this period, paid-in capital remained the same at $2,400,000. Retained earnings increased from $1,800,000 to $12,000,000. CEO Josh Borke is considering either (1) a 15% stock dividend or (2) a 2-for-1 stock split. He asks you to show the before-and-after effects of each option on (a) retained earnings and (b) total stockholders' equity.

Prepare a retained earnings statement.
(SO 2)

DO IT! 14-3 Alpha Centuri Corporation has retained earnings of $3,100,000 on January 1, 2010. During the year, Alpha Centuri earned $1,200,000 of net income. It declared and paid a $150,000 cash dividend. In 2010, Alpha Centuri recorded an adjustment of $110,000 due to the overstatement (from mathematical error) of 2009 depreciation expense. Prepare a retained earnings statement for 2010.

Compute return on stockholders' equity and EPS and discuss changes in each.
(SO 3, 5)

DO IT! 14-4 On January 1, 2010, Tuscany Corporation purchased 1,000 shares of treasury stock. Other information regarding Tuscany Corporation is provided below.

	2009	2010
Net income	$200,000	$210,000
Dividends on preferred stock	$30,000	$30,000
Dividends on common stock	$20,000	$25,000
Weighted average number of common shares outstanding	10,000	9,000
Common stockholders' equity beginning of year	$600,000	$750,000
Common stockholders' equity end of year	$750,000	$830,000

Compute (a) return on common stockholders' equity for each year and (b) earnings per share for each year, and (c) discuss the changes in each.

EXERCISES

PLUS

Journalize cash dividends; indicate statement presentation.
(SO 1)

E14-1 On January 1, Molini Corporation had 95,000 shares of no-par common stock issued and outstanding. The stock has a stated value of $5 per share. During the year, the following occurred.

Apr. 1 Issued 25,000 additional shares of common stock for $17 per share.
June 15 Declared a cash dividend of $1 per share to stockholders of record on June 30.
July 10 Paid the $1 cash dividend.
Dec. 1 Issued 2,000 additional shares of common stock for $19 per share.
15 Declared a cash dividend on outstanding shares of $1.20 per share to stockholders of record on December 31.

Instructions
(a) Prepare the entries, if any, on each of the three dividend dates.
(b) How are dividends and dividends payable reported in the financial statements prepared at December 31?

Allocate cash dividends to preferred and common stock.
(SO 1)

E14-2 Perez Corporation was organized on January 1, 2009. During its first year, the corporation issued 2,000 shares of $50 par value preferred stock and 100,000 shares of $10 par value common stock. At December 31, the company declared the following cash dividends: 2009, $6,000, 2010, $12,000, and 2011, $28,000.

Instructions
(a) Show the allocation of dividends to each class of stock, assuming the preferred stock dividend is 7% and not cumulative.
(b) Show the allocation of dividends to each class of stock, assuming the preferred stock dividend is 8% and cumulative.
(c) Journalize the declaration of the cash dividend at December 31, 2011, under part (b).

Journalize stock dividends.
(SO 1)

E14-3 On January 1, 2010, Deweese Corporation had $1,000,000 of common stock outstanding that was issued at par. It also had retained earnings of $750,000. The company issued 40,000 shares of common stock at par on July 1 and earned net income of $400,000 for the year.

Instructions
Journalize the declaration of a 15% stock dividend on December 10, 2010, for the following independent assumptions.

1. Par value is $10, and market value is $18.
2. Par value is $5, and market value is $20.

E14-4 On October 31, the stockholders' equity section of Huth Company consists of common stock $300,000 and retained earnings $900,000. Huth is considering the following two courses of action: (1) declaring a 5% stock dividend on the 30,000, $10 par value shares outstanding, or (2) effecting a 2-for-1 stock split that will reduce par value to $5 per share. The current market price is $14 per share.

Compare effects of a stock dividend and a stock split.
(SO 1)

Instructions
Prepare a tabular summary of the effects of the alternative actions on the components of stockholders' equity, outstanding shares, and par value per share. Use the following column headings: Before Action, After Stock Dividend, and After Stock Split.

E14-5 On October 1, Kosko Corporation's stockholders' equity is as follows.

Indicate account balances after a stock dividend.
(SO 1, 3)

Common stock, $5 par value	$400,000
Paid-in capital in excess of par value	25,000
Retained earnings	155,000
Total stockholders' equity	$580,000

On October 1, Kosko declares and distributes a 10% stock dividend when the market value of the stock is $15 per share.

Instructions
(a) Compute the par value per share (1) before the stock dividend and (2) after the stock dividend.
(b) Indicate the balances in the three stockholders' equity accounts after the stock dividend shares have been distributed.

E14-6 During 2010, Jester Corporation had the following transactions and events.

Indicate the effects on stockholders' equity components.
(SO 1, 2, 3)

1. Declared a cash dividend.
2. Issued par value common stock for cash at par value.
3. Completed a 2-for-1 stock split in which $10 par value stock was changed to $5 par value stock.
4. Declared a small stock dividend when the market value was higher than par value.
5. Made a prior period adjustment for overstatement of net income.
6. Issued the shares of common stock required by the stock dividend declaration in item no. 4 above.
7. Paid the cash dividend in item no. 1 above.
8. Issued par value common stock for cash above par value.

Instructions
Indicate the effect(s) of each of the foregoing items on the subdivisions of stockholders' equity. Present your answer in tabular form with the following columns. Use (I) for increase, (D) for decrease, and (NE) for no effect. Item no. 1 is given as an example.

	Paid-in Capital		
Item	**Capital Stock**	**Additional**	**Retained Earnings**
1	NE	NE	D

E14-7 Before preparing financial statements for the current year, the chief accountant for Reynolds Company discovered the following errors in the accounts.

Prepare correcting entries for dividends and a stock split.
(SO 1)

1. The declaration and payment of $50,000 cash dividend was recorded as a debit to Interest Expense $50,000 and a credit to Cash $50,000.
2. A 10% stock dividend (1,000 shares) was declared on the $10 par value stock when the market value per share was $18. The only entry made was: Retained Earnings (Dr.) $10,000 and Dividend Payable (Cr.) $10,000. The shares have not been issued.

3. A 4-for-1 stock split involving the issue of 400,000 shares of $5 par value common stock for 100,000 shares of $20 par value common stock was recorded as a debit to Retained Earnings $2,000,000 and a credit to Common Stock $2,000,000.

Instructions

Prepare the correcting entries at December 31.

Prepare a retained earnings statement.

(SO 2)

E14-8 On January 1, 2010, Felter Corporation had retained earnings of $550,000. During the year, Felter had the following selected transactions.

1. Declared cash dividends $120,000.
2. Corrected overstatement of 2009 net income because of depreciation error $40,000.
3. Earned net income $350,000.
4. Declared stock dividends $60,000.

Instructions

Prepare a retained earnings statement for the year.

Prepare a retained earnings statement.

(SO 2)

E14-9 Sasha Company reported retained earnings at December 31, 2009, of $310,000. Sasha had 200,000 shares of common stock outstanding throughout 2010.

The following transactions occurred during 2010.

1. An error was discovered: in 2008, depreciation expense was recorded at $70,000, but the correct amount was $50,000.
2. A cash dividend of $0.50 per share was declared and paid.
3. A 5% stock dividend was declared and distributed when the market price per share was $15 per share.
4. Net income was $285,000.

Instructions

Prepare a retained earnings statement for 2010.

Prepare stockholders' equity section.

(SO 3)

E14-10 Kelly Groucutt Company reported the following balances at December 31, 2009: common stock $400,000; paid-in capital in excess of par value $100,000; retained earnings $250,000. During 2010, the following transactions affected stockholder's equity.

1. Issued preferred stock with a par value of $125,000 for $200,000.
2. Purchased treasury stock (common) for $40,000.
3. Earned net income of $140,000.
4. Declared and paid cash dividends of $56,000.

Instructions

Prepare the stockholders' equity section of Kelly Groucutt Company's December 31, 2010, balance sheet.

Prepare a stockholders' equity section.

(SO 3)

E14-11 The following accounts appear in the ledger of Ortiz Inc. after the books are closed at December 31.

Common Stock, no par, $1 stated value, 400,000 shares authorized; 300,000 shares issued	$ 300,000
Common Stock Dividends Distributable	30,000
Paid-in Capital in Excess of Stated Value—Common Stock	1,200,000
Preferred Stock, $5 par value, 8%, 40,000 shares authorized; 30,000 shares issued	150,000
Retained Earnings	800,000
Treasury Stock (10,000 common shares)	74,000
Paid-in Capital in Excess of Par Value—Preferred Stock	344,000

Instructions

Prepare the stockholders' equity section at December 31, assuming retained earnings is restricted for plant expansion in the amount of $100,000.

Prepare an income statement and compute earnings per share.

(SO 4, 5)

E14-12 The following information is available for Patel Corporation for the year ended December 31, 2010: Sales $800,000; Other revenues and gains $92,000; Operating expenses $110,000; Cost of goods sold $465,000; Other expenses and losses $32,000; Preferred stock dividends $30,000. The company's tax rate was 20%, and it had 50,000 shares outstanding during the entire year.

Instructions

(a) Prepare a corporate income statement.

(b) Calculate earnings per share.

E14-13 In 2010, Mike Singletary Corporation had net sales of $600,000 and cost of goods sold of $360,000. Operating expenses were $153,000, and interest expense was $7,500. The corporation's tax rate is 30%. The corporation declared preferred dividends of $15,000 in 2010, and its average common stockholders' equity during the year was $200,000.

Prepare an income statement and compute return on equity.
(SO 3, 4)

Instructions

(a) Prepare an income statement for Mike Singletary Corporation.

(b) Compute Mike Singletary Corporation's return on common stockholders' equity for 2010.

E14-14 McCoy Corporation has outstanding at December 31, 2010, 50,000 shares of $20 par value, cumulative, 8% preferred stock and 200,000 shares of $5 par value common stock. All shares were outstanding the entire year. During 2010, McCoy earned total revenues of $2,000,000 and incurred total expenses (except income taxes) of $1,200,000. McCoy's income tax rate is 30%.

Compute EPS.
(SO 4, 5)

Instructions

Compute McCoy's 2010 earnings per share.

E14-15 The following financial information is available for Cheney Corporation.

Calculate ratios to evaluate earnings performance.
(SO 3, 5)

	2010	2009
Average common stockholders' equity	$1,200,000	$900,000
Dividends paid to common stockholders	50,000	30,000
Dividends paid to preferred stockholders	20,000	20,000
Net income	290,000	200,000
Market price of common stock	20	15

The weighted average number of shares of common stock outstanding was 80,000 for 2009 and 100,000 for 2010.

Instructions

Calculate earnings per share and return on common stockholders' equity for 2010 and 2009.

E14-16 This financial information is available for Hoyle Corporation.

Calculate ratios to evaluate earnings performance.
(SO 3, 5)

	2010	2009
Average common stockholders' equity	$1,800,000	$1,900,000
Dividends paid to common stockholders	90,000	70,000
Dividends paid to preferred stockholders	20,000	20,000
Net income	290,000	248,000
Market price of common stock	20	25

The weighted-average number of shares of common stock outstanding was 180,000 for 2009 and 150,000 for 2010.

Instructions

Calculate earnings per share and return on common stockholders' equity for 2010 and 2009.

E14-17 At December 31, 2010, Cali Corporation has 2,000 shares of $100 par value, 8%, preferred stock outstanding and 100,000 shares of $10 par value common stock issued. Cali's net income for the year is $241,000.

Compute earnings per share under different assumptions.
(SO 5)

Instructions

Compute the earnings per share of common stock under the following independent situations. (Round to two decimals.)

(a) The dividend to preferred stockholders was declared. There has been no change in the number of shares of common stock outstanding during the year.

(b) The dividend to preferred stockholders was not declared. The preferred stock is cumulative. Cali held 10,000 shares of common treasury stock throughout the year.

EXERCISES: SET B

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Exercise Set B.

PROBLEMS: SET A

Prepare dividend entries and stockholders' equity section.

(SO 1, 3)

P14-1A On January 1, 2010, Carolinas Corporation had the following stockholders' equity accounts.

Common Stock ($20 par value, 60,000 shares issued and outstanding)	$1,200,000
Paid-in Capital in Excess of Par Value	200,000
Retained Earnings	600,000

During the year, the following transactions occurred.

Feb. 1 Declared a $1 cash dividend per share to stockholders of record on February 15, payable March 1.
Mar. 1 Paid the dividend declared in February.
Apr. 1 Announced a 2-for-1 stock split. Prior to the split, the market price per share was $36.
July 1 Declared a 10% stock dividend to stockholders of record on July 15, distributable July 31. On July 1, the market price of the stock was $13 per share.
31 Issued the shares for the stock dividend.
Dec. 1 Declared a $0.50 per share dividend to stockholders of record on December 15, payable January 5, 2011.
31 Determined that net income for the year was $350,000.

Instructions

(a) Journalize the transactions and the closing entry for net income.
(b) Enter the beginning balances, and post the entries to the stockholders' equity accounts. (*Note*: Open additional stockholders' equity accounts as needed.)
(c) Prepare a stockholders' equity section at December 31.

(c) Total stockholders' equity $2,224,000

Journalize and post transactions; prepare retained earnings statement and stockholders' equity section.

(SO 1, 2, 3)

P14-2A The stockholders' equity accounts of Hashmi Company at January 1, 2010, are as follows.

Preferred Stock, 6%, $50 par	$600,000
Common Stock, $5 par	800,000
Paid-in Capital in Excess of Par Value—Preferred Stock	200,000
Paid-in Capital in Excess of Par Value—Common Stock	300,000
Retained Earnings	800,000

There were no dividends in arrears on preferred stock. During 2010, the company had the following transactions and events.

July 1 Declared a $0.50 cash dividend on common stock.
Aug. 1 Discovered $25,000 understatement of 2009 depreciation. Ignore income taxes.
Sept. 1 Paid the cash dividend declared on July 1.
Dec. 1 Declared a 10% stock dividend on common stock when the market value of the stock was $18 per share.
15 Declared a 6% cash dividend on preferred stock payable January 15, 2011.
31 Determined that net income for the year was $355,000.
31 Recognized a $200,000 restriction of retained earnings for plant expansion.

Instructions

(a) Journalize the transactions, events, and closing entry.
(b) Enter the beginning balances in the accounts, and post to the stockholders' equity accounts. (*Note*: Open additional stockholders' equity accounts as needed.)
(c) Prepare a retained earnings statement for the year.
(d) Prepare a stockholders' equity section at December 31, 2010.

(c) Ending balance $726,000
(d) Total stockholders' equity $2,914,000

Prepare retained earnings statement and stockholders' equity section, and compute earnings per share.

(SO 1, 2, 3, 5)

P14-3A The post-closing trial balance of Dold Corporation at December 31, 2010, contains the following stockholders' equity accounts.

Preferred Stock (15,000 shares issued)	$ 750,000
Common Stock (250,000 shares issued)	2,500,000
Paid-in Capital in Excess of Par Value—Preferred	250,000
Paid-in Capital in Excess of Par Value—Common	400,000
Common Stock Dividends Distributable	250,000
Retained Earnings	1,042,000

A review of the accounting records reveals the following.

1. No errors have been made in recording 2010 transactions or in preparing the closing entry for net income.
2. Preferred stock is $50 par, 6%, and cumulative; 15,000 shares have been outstanding since January 1, 2009.
3. Authorized stock is 20,000 shares of preferred, 500,000 shares of common with a $10 par value.
4. The January 1 balance in Retained Earnings was $1,170,000.
5. On July 1, 20,000 shares of common stock were issued for cash at $16 per share.
6. On September 1, the company discovered an understatement error of $90,000 in computing depreciation in 2009. The net of tax effect of $63,000 was properly debited directly to Retained Earnings.
7. A cash dividend of $250,000 was declared and properly allocated to preferred and common stock on October 1. No dividends were paid to preferred stockholders in 2009.
8. On December 31, a 10% common stock dividend was declared out of retained earnings on common stock when the market price per share was $16.
9. Net income for the year was $585,000.
10. On December 31, 2010, the directors authorized disclosure of a $200,000 restriction of retained earnings for plant expansion. (Use Note X.)

Instructions

(a) Reproduce the Retained Earnings account for 2010.
(b) Prepare a retained earnings statement for 2010.
(c) Prepare a stockholders' equity section at December 31, 2010.
(d) Compute the allocation of the cash dividend to preferred and common stock.
(e) Compute the earnings per share of common stock using 240,000 as the weighted average shares outstanding for the year.

(c) Total stockholders' equity, $5,192,000

Prepare the stockholders' equity section, reflecting dividends and stock split.

(SO 1, 2, 3)

P14-4A On January 1, 2010, Pattini Corporation had the following stockholders' equity accounts.

Common Stock (no par value, 90,000 shares issued and outstanding)	$1,400,000
Retained Earnings	500,000

During the year, the following transactions occurred.

Feb.	1	Declared a $1 cash dividend per share to stockholders of record on February 15, payable March 1.
Mar.	1	Paid the dividend declared in February.
Apr.	1	Announced a 4-for-1 stock split. Prior to the split, the market price per share was $36.
July	1	Declared a 5% stock dividend to stockholders of record on July 15, distributable July 31. On July 1, the market price of the stock was $13 per share.
	31	Issued the shares for the stock dividend.
Dec.	1	Declared a $0.50 per share dividend to stockholders of record on December 15, payable January 5, 2011.
	31	Determined that net income for the year was $350,000.

Instructions

Prepare the stockholders' equity section of the balance sheet at: (a) March 31, (b) June 30, (c) September 30, and (d) December 31, 2010.

(d) Total stockholders' equity $1,971,000

Prepare the stockholders' equity section, reflecting various events.

(SO 1, 3)

P14-5A On January 1, 2010, Yadier Inc. had the following stockholders' equity account balances.

Common Stock, no-par value (500,000 shares issued)	$1,500,000
Common Stock Dividends Distributable	200,000
Retained Earnings	600,000

During 2010, the following transactions and events occurred.

1. Issued 50,000 shares of common stock as a result of a 10% stock dividend declared on December 15, 2009.
2. Issued 30,000 shares of common stock for cash at $6 per share.
3. Corrected an error that had understated the net income for 2008 by $70,000.
4. Declared and paid a cash dividend of $80,000.
5. Earned net income of $300,000.

Total stockholders' equity $2,770,000

Instructions

Prepare the stockholders' equity section of the balance sheet at December 31, 2010.

PROBLEMS: SET B

Prepare dividend entries and stockholders' equity section.

(SO 1, 3)

P14-1B On January 1, 2010, Weiser Corporation had the following stockholders' equity accounts.

Common Stock ($5 par value, 200,000 shares issued and outstanding)	$1,000,000
Paid-in Capital in Excess of Par Value	200,000
Retained Earnings	840,000

During the year, the following transactions occurred.

Jan. 15 Declared a $1 cash dividend per share to stockholders of record on January 31, payable February 15.
Feb. 15 Paid the dividend declared in January.
Apr. 15 Declared a 10% stock dividend to stockholders of record on April 30, distributable May 15. On April 15, the market price of the stock was $15 per share.
May 15 Issued the shares for the stock dividend.
July 1 Announced a 2-for-1 stock split. The market price per share prior to the announcement was $17. (The new par value is $2.50.)
Dec. 1 Declared a $0.50 per share cash dividend to stockholders of record on December 15, payable January 10, 2011.
31 Determined that net income for the year was $250,000.

Instructions

(a) Journalize the transactions and the closing entry for net income.
(b) Enter the beginning balances, and post the entries to the stockholders' equity accounts. (*Note*: Open additional stockholders' equity accounts as needed.)
(c) Prepare a stockholders' equity section at December 31.

(c) Total stockholders' equity $1,870,000

Journalize and post transactions; prepare retained earnings statement and stockholders' equity section.

(SO 1, 2, 3)

P14-2B The stockholders' equity accounts of Holmes Inc., at January 1, 2010, are as follows.

Preferred Stock, $100 par, 7%	$600,000
Common Stock, $10 par	900,000
Paid-in Capital in Excess of Par Value—Preferred Stock	100,000
Paid-in Capital in Excess of Par Value—Common Stock	200,000
Retained Earnings	500,000

There were no dividends in arrears on preferred stock. During 2010, the company had the following transactions and events.

July 1 Declared a $0.50 cash dividend on common stock.
Aug. 1 Discovered a $72,000 overstatement of 2009 depreciation. Ignore income taxes.
Sept. 1 Paid the cash dividend declared on July 1.
Dec. 1 Declared a 10% stock dividend on common stock when the market value of the stock was $16 per share.
15 Declared a 7% cash dividend on preferred stock payable January 31, 2011.
31 Determined that net income for the year was $350,000.

Instructions

(a) Journalize the transactions and the closing entry for net income.
(b) Enter the beginning balances in the accounts and post to the stockholders' equity accounts. (*Note*: Open additional stockholders' equity accounts as needed.)

(c) Prepare a retained earnings statement for the year.
(d) Prepare a stockholders' equity section at December 31, 2010.

(c) Ending balance $691,000
(d) Total stockholders' equity $2,635,000

P14-3B The ledger of Yakima Corporation at December 31, 2010, after the books have been closed, contains the following stockholders' equity accounts.

Prepare retained earnings statement and stockholders' equity section, and compute earnings per share.

(SO 1, 2, 3, 5)

Preferred Stock (10,000 shares issued)	$1,000,000
Common Stock (400,000 shares issued)	2,000,000
Paid-in Capital in Excess of Par Value—Preferred	200,000
Paid-in Capital in Excess of Stated Value—Common	1,180,000
Common Stock Dividends Distributable	200,000
Retained Earnings	2,560,000

A review of the accounting records reveals the following.

1. No errors have been made in recording 2010 transactions or in preparing the closing entry for net income.
2. Preferred stock is 6%, $100 par value, noncumulative, and callable at $125. Since January 1, 2009, 10,000 shares have been outstanding; 20,000 shares are authorized.
3. Common stock is no-par with a stated value of $5 per share; 600,000 shares are authorized.
4. The January 1 balance in Retained Earnings was $2,450,000.
5. On October 1, 100,000 shares of common stock were sold for cash at $8 per share.
6. A cash dividend of $500,000 was declared and properly allocated to preferred and common stock on November 1. No dividends were paid to preferred stockholders in 2009.
7. On December 31, a 10% common stock dividend was declared out of retained earnings on common stock when the market price per share was $9.
8. Net income for the year was $970,000.
9. On December 31, 2010, the directors authorized disclosure of a $100,000 restriction of retained earnings for plant expansion. (Use Note A.)

Instructions

(a) Reproduce the Retained Earnings account (T-account) for 2010.
(b) Prepare a retained earnings statement for 2010.
(c) Prepare a stockholders' equity section at December 31, 2010.
(d) Compute the allocation of the cash dividend to preferred and common stock.
(e) Compute the earnings per share of common stock using 325,000 as the weighted average shares outstanding for the year.

(c) Total stockholders' equity: $7,140,000

P14-4B On January 1, 2010, Carne Corporation had the following stockholders' equity accounts.

Prepare the stockholders' equity section, reflecting dividends and stock split.

(SO 1, 2, 3)

Common Stock (no-par value, 100,000 shares issued and outstanding)	$2,800,000
Retained Earnings	1,000,000

During the year, the following transactions occurred.

Feb.	1	Declared a $1 cash dividend per share to stockholders of record on February 15, payable March 1.
Mar.	1	Paid the dividend declared in February.
Apr.	1	Announced a 4-for-1 stock split. Prior to the split, the market price per share was $36.
July	1	Declared a 5% stock dividend to stockholders of record on July 15, distributable July 31. On July 1, the market price of the stock was $13 per share.
	31	Issued the shares for the stock dividend.
Dec.	1	Declared a $0.50 per share dividend to stockholders of record on December 15, payable January 5, 2011.
	31	Determined that net income for the year was $700,000.

Instructions

Prepare the stockholders' equity section of the balance sheet at: (a) March 31, (b) June 30, (c) September 30, and (d) December 31, 2010.

(d) Total, stockholders' equity $4,190,000

P14-5B On January 1, 2010, Garcia Inc. had the following shareholders' equity balances.

Prepare the stockholders' equity section, reflecting various events.

(SO 1, 3)

Common Stock, no-par value (1,000,000 shares issued)	$3,000,000
Common Stock Dividends Distributable	400,000
Retained Earnings	1,200,000

During 2010, the following transactions and events occurred.

1. Issued 100,000 shares of common stock as a result of a 10% stock dividend declared on December 15, 2009.
2. Issued 60,000 shares of common stock for cash at $5 per share.
3. Corrected an error that had understated the net income for 2008 by $140,000.
4. Declared and paid a cash dividend of $300,000.
5. Earned net income of $600,000.

Total stockholders' equity $5,340,000

Instructions
Prepare the stockholders' equity section of the balance sheet at December 31, 2010.

PROBLEMS: SET C

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Problem Set C.

CONTINUING COOKIE CHRONICLE

(*Note:* This is a continuation of the Cookie Chronicle from Chapters 1 through 13.)

CCC14 After establishing their company's fiscal year end to be October 31, Natalie and Curtis began operating Cookie & Coffee Creations Inc. on November 1, 2010. On that date, they issued both preferred and common stock. After the first year of operations, Natalie and Curtis want to prepare financial information for the year.

Go to the book's companion website, **www.wiley.com/college/weygandt**, *to see the completion of this problem.*

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: PepsiCo, Inc.

BYP14-1 The financial statements of PepsiCo, Inc. are presented in Appendix A.

Instructions
Refer to PepsiCo's financial statements and answer the following questions.

(a) What amount did PepsiCo declare in dividends on common stock in the year ended December 29, 2007?

(b) How does this amount compare with dividends declared on common stock in the year ended December 30, 2006?

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

BYP14-2 PepsiCo's financial statements are presented in Appendix A. Financial statements of The Coca-Cola Company are presented in Appendix B.

Instructions

(a) Compute earnings per share and return on common stockholders' equity for both companies for the year ending December 31, 2007. Assume PepsiCo's weighted average shares were 1,625 million and Coca-Cola's weighted average shares were 2,313 million. Can these measures be used to compare the profitability of the two companies? Why or why not?

(b) What was the total amount of dividends paid by each company in 2007?

Exploring the Web

BYP14-3 Use the stockholders' equity section of an annual report and identify the major components.

Address: www.reportgallery.com, or go to **www.wiley.com/college/weygandt**

Steps

1. From Report Gallery Homepage, choose **Search by Alphabet**, and choose a letter.
2. Select a particular company.
3. Choose Annual Report.
4. Follow instructions below.

Instructions

Answer the following questions.

(a) What is the company's name?

(b) What classes of capital stock has the company issued?

(c) For each class of stock:

  (1) How many shares are authorized, issued, and/or outstanding?

  (2) What is the par value?

(d) What are the company's retained earnings?

(e) Has the company acquired treasury stock? How many shares?

CRITICAL THINKING

Decision Making Across the Organization

BYP14-4 The stockholders' equity accounts of Fernandez, Inc., at January 1, 2010, are as follows.

Preferred Stock, no par, 4,000 shares issued	$400,000
Common Stock, no par, 140,000 shares issued	700,000
Retained Earnings	500,000

During 2010, the company had the following transactions and events.

July 1	Declared a $0.50 cash dividend on common stock.
Aug. 1	Discovered a $72,000 overstatement of 2009 depreciation expense. (Ignore income taxes.)
Sept. 1	Paid the cash dividend declared on July 1.
Dec. 1	Declared a 10% stock dividend on common stock when the market value of the stock was $12 per share.
15	Declared a $9 per share cash dividend on preferred stock, payable January 31, 2011.
31	Determined that net income for the year was $320,000.

Instructions

With the class divided into groups, answer the following questions.

(a) Prepare a retained earnings statement for the year. There are no preferred dividends in arrears.

(b) Discuss why the overstatement of 2009 depreciation expense is not treated as an adjustment of the current year's income.

(c) Discuss the reasons why a company might decide to issue a stock dividend rather than a cash dividend.

Communication Activity

BYP14-5 In the past year, Cormier Corporation declared a 10% stock dividend, and Fegan, Inc. announced a 2-for-1 stock split. Your parents own 100 shares of each company's $50 par value common stock. During a recent phone call, your parents ask you, as an accounting student, to explain the differences between the two events.

Instructions

Write a letter to your parents that explains the effects of the two events to them as stockholders and the effects of each event on the financial statements of each corporation.

Ethics Case

BYP14-6 Garcia Corporation has paid 60 consecutive quarterly cash dividends (15 years). The last 6 months, however, have been a cash drain on the company, as profit margins have been greatly narrowed by increasing competition. With a cash balance sufficient to meet only day-to-day operating needs, the president, Tom Henson, has decided that a stock dividend instead of a cash dividend should be declared. He tells Garcia's financial vice president, Andrea Lane, to issue a press release stating that the company is extending its consecutive dividend record with the issuance of a 5% stock dividend. "Write the press release convincing the stockholders that the stock dividend is just as good as a cash dividend," he orders. "Just watch our stock rise when we announce the stock dividend; it must be a good thing if that happens."

Instructions

(a) Who are the stakeholders in this situation?
(b) Is there anything unethical about Henson's intentions or actions?
(c) What is the effect of a stock dividend on a corporation's stockholders' equity accounts? Which would you rather receive as a stockholder—a cash dividend or a stock dividend? Why?

"All About You" Activity

BYP14-7 In the **All About You** feature in this chapter (p. 624), you learned that in response to the Sarbanes-Oxley Act, many companies have implemented formal ethics codes. Many other organizations also have ethics codes.

Instructions

Obtain the ethics code from an organization that you belong to (e.g., student organization, business school, employer, or a volunteer organization). Evaluate the ethics code based on how clearly it identifies proper and improper behavior. Discuss its strengths, and how it might be improved.

Answers to Insight and Accounting Across the Organization Questions

p. 611 Why Companies Are Increasing Their Dividends

Q: What factors must management consider in deciding how large a dividend to pay?

A: *Management must consider the size of the company's retained earnings balance, the amount of available cash, the company's expected near-term cash needs, the company's growth opportunities, and what level of dividend the company will be able to sustain based upon its expected future earnings.*

p. 615 Would You Pay $133,900 for One Share of Stock?

Q: How does the effect on share price following a stock split compare to the effect on share price of treasury shares acquired?

A: *A stock split and the acquisition of treasury shares have the opposite effects on share price: A stock split* decreases *the share price, whereas the acquisition of treasury shares* increases *the share price.*

Authors' Comments on *All About You:* Corporations Have Governance Structures—Do You? (p. 624)

Before we address the usefulness of a student code of ethics, let's first ask whether a corporate code of ethics will ensure that employees no longer commit fraud. The answer is, "Clearly not." Does that mean a code of ethics is a waste of time? No. A code of ethics is a useful statement by the leaders of an organization about what kind of behavior is expected of the members of that organization. It provides a concrete reference point by which wrongdoing can be identified and evaluated.

Now, suppose that you were taking an exam and that you observed a number of people cheating. It would be very frustrating if you thought that your instructor, the school administrators, and other students didn't care that people were cheating. Ultimately this would encourage even more people to cheat. But if the school has defined unethical behavior, stated that it won't be tolerated, and created the necessary mechanisms for detecting and punishing unethical behavior, then it has begun the first steps in creating a more ethical environment. For an example of an ethics code for university students, see the ethics section of the Student Resources at **www.bus.wisc.edu/accounting**.

Answers to Self-Study Questions

1. a **2.** c **3.** c **4.** a **5.** d **6.** d **7.** c **8.** b **9.** d **10.** b **11.** b **12.** d **13.** c **14.** d **15.** b

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.