

CHAPTER 12

Income and Changes in Retained Earnings

After studying this chapter, you should be able to:

Learning Objectives

LO12-1

Describe how irregular income items, such as unusual and/or infrequent items and discontinued operations, are presented in the income statement.

LO12-2

Compute earnings per share.

LO12-3

Distinguish between basic and diluted earnings per share.

LO12-4

Account for cash dividends and stock dividends, and explain the effects of these transactions on a company's financial statements.

LO12-5

Describe and prepare a statement of retained earnings.

LO12-6

Define *prior period adjustments*, and explain how they are presented in financial statements.

LO12-7

Define *comprehensive income*, and explain how it differs from net income.

LO12-8

Describe and prepare a statement of stockholders' equity and the stockholders' equity section of the balance sheet.

LO12-9

Illustrate steps management might take to improve the appearance of the company's net income.



UNDER ARMOUR

UNDER ARMOUR, INC.

A company's pattern of sales and net income are important factors in evaluating its financial success. Consider Under Armour, Inc. whose principle business activities are the development, marketing and distribution of branded performance apparel, footwear and accessories for men, women, and youth. The company's products are sold worldwide and are worn by athletes at all levels, from youth to professional, on playing fields around the globe, as well as by consumers with active lifestyles.

One of the attributes of financially successful companies like Under Armour is their consistent strength over time in terms of primary measures of financial performance, such as net sales and net earnings. Under Armour's net revenues, which measures the value of merchandise sold, increased from \$2,332,051 thousand

in 2013 to \$3,084,370 thousand in 2014 to \$3,963,313 thousand in 2015. This represents an approximate 32 percent increase in 2014 and an approximate 28 percent increase in 2015, for a combined increase over the entire period of almost 70 percent. Net income, which starts with revenues and is reduced by various expenses required to generate those sales, increased from \$162,330 thousand in 2013 to \$208,042 thousand in 2014 (an approximate 28 percent increase) and to \$232,573 thousand in 2015 (an approximate 12 percent increase), or a combined increase for the two years of over 43 percent. These figures represent impressive and consistent financial performance in terms of the company's ability to provide goods to its customers and to operate in a manner that results in a profit that benefits the company's stockholders. ■

For investors seeking companies in which to place their funds, a pattern of increases in key performance figures such as sales and net income is very attractive. In this chapter, we look more closely at the income statement and learn about the useful information available in that financial statement for making important investment and credit decisions. In addition to learning more about how an income statement is prepared, you will learn about earnings per share, dividends, and other key factors that indicate the financial success of a company.

Reporting the Results of Operations

For many investors and creditors, among the most important aspects of corporate financial reporting is periodic earnings or net income. Both the market price of common stock and the amount of cash dividends per share are affected by current and future earnings of the corporation.

DEVELOPING PREDICTIVE INFORMATION

Revenue is a measure of the value of products and services that have been sold to customers. Revenue represents the increases in the company's assets that result from its profit-directed activities. Generally, revenue increases cash either at the time it is included in the income statement or at an earlier or later date. Expenses are measures of the cost of producing and distributing the products and services that are sold to customers. They represent decreases in the company's assets that result from its profit-directed activities. Expenses decrease cash at the time they are incurred, or at an earlier or later date. An income statement compares a company's revenues and expenses for a stated period of time, such as a quarter or year, leading to a final net income or net loss figure.

As this brief description of revenue and expenses indicates, the income statement provides important information for investors and creditors as they attempt to make estimates of future cash flows. Because of the importance of income reporting in making assessments about the future, events and transactions other than normal, recurring revenues and expenses require careful attention in the preparation and interpretation of an income statement.

For information about financial performance to be of maximum usefulness to investors, creditors, and other financial statement users, the results of items that are not likely to repeat on a regular basis are presented separately from the results of the company's normal, recurring activities. Two categories of events and transactions that require special treatment are (1) nonrecurring items that are unusual and/or infrequent and (2) discontinued operations in which a portion of the business has been eliminated. One of the challenges that has faced the accounting profession is to define these terms with sufficient clarity that users of financial statements can reliably compare the information provided by different companies and by the same company over time.

REPORTING IRREGULAR ITEMS: AN ILLUSTRATION

To illustrate the presentation of these irregular items in an income statement, assume that Farmer Corporation operates both a small chain of retail stores and two motels. During the current year, the company sells both motels to a national hotel chain. In addition, Farmer Corporation reports one unusual and infrequent item, a loss on the settlement of a lawsuit. An income statement illustrating the correct format for reporting these events appears in Exhibit 12-1.

CONTINUING OPERATIONS

The first section of the Farmer Corporation income statement contains only the results of the company's normal activities. The income tax expense shown in this section (\$300,000) relates only to continuing operations. The income taxes relating to the company's discontinued operations are shown separately in the income statement as adjustments to the amounts of these items.

Income from Continuing Operations The subtotal *income from continuing operations* presents the profitability of the company's ongoing operations. This subtotal is particularly helpful in making predictions of the company's future earnings because it is based on normal

FARMER CORPORATION
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2018

Net sales		
Cost and expenses		
Cost of goods sold		\$ 8,000,000
Selling expenses	\$ 4,500,000	
General and administrative expenses	1,500,000	
Loss on settlement of lawsuit	920,000	
Income before income taxes	<u>120,000</u>	
Income tax expense		<u>7,040,000</u>
Income from continuing operations		\$ 960,000
Discontinued operations		
Operating loss on motels (net of \$90,000 income tax benefit)		<u>300,000</u>
Gain on sale of motels (net of \$195,000 income tax expense)	\$ (210,000)	
	<u>455,000</u>	
Net income		<u>660,000</u>
		<u>245,000</u>
		<u>\$ 905,000</u>

EXHIBIT 12-1
Income Statement with
Nonrecurring Items

Notice the order in which the
irregular items are reported

operating activity that is expected to recur on a regular basis. For example, if we predict no significant change in the profitability of its retail stores, we would expect Farmer Corporation to earn a net income of approximately \$660,000 next year.

DISCONTINUED OPERATIONS

When management enters into a formal plan to sell or discontinue a **segment of the business**, the results of that segment's operations are shown separately in the income statement. Excluding the part of the business that will no longer affect the company's operations in the future enables users of the financial statements to better evaluate the performance of the company's ongoing (continuing) operations.

Two items are included in the **discontinued operations** section of the income statement: (1) the income or loss from *operating* the segment prior to its disposal and (2) the gain or loss on *disposal* of the segment. The income taxes relating to the discontinued operations are shown separately from the income tax expense relating to continuing business operations.

UNUSUAL AND/OR INFREQUENT GAINS AND LOSSES

Some transactions are not typical of normal operations and they do not recur often or in a predictable pattern. Examples of such events are losses incurred because of labor strikes, gains or losses resulting from sales of plant assets, and losses from storms and other natural disasters. Such items, if material, should be presented separately in the income statement, rather than being combined with other items in broad categories such as sales revenue or general and administrative expenses. Unusual and/or infrequent gains and losses are sometimes referred to as nonrecurring items.

In the income statement of Farmer Corporation (Exhibit 12-1), the \$120,000 loss resulting from the settlement of a lawsuit is an example of this type of item and is listed as a separate item in the income statement. This loss is important enough to bring to the attention of readers of the income statement by presenting it as a separate item, but it is not considered sufficiently unusual or infrequent to be presented in a separate section as is the case for discontinued operations. Also, these unusual and/or infrequent items are not presented on a net-of-tax basis. Any income tax effect of these items is combined with the

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LEARNING OBJECTIVE

Describe how irregular income items, such as unusual and/or infrequent items and discontinued operations, are presented in the income statement.

income tax on normal, recurring revenue and expenses and included in the item Income Tax Expense.

One type of unusual and infrequent items relates to the restructuring of operations. The restructuring of operations has become a common aspect of the American economy. As companies struggle to meet the competitive challenges of a global economy, they incur significant costs to close plants, reduce workforces, consolidate operating facilities, and take other steps to become more efficient.

Restructuring charges consist of items such as losses from write-downs or sales of plant assets, severance pay for terminated workers, and expenses related to the relocation of operations and remaining personnel. In determining a company's income before income taxes, they are presented in the company's income statement as a single item, similar to the loss from the settlement of a lawsuit in the Farmer Corporation income statement in Exhibit 12-1. If the restructuring involves discontinuing a segment of the business, the expenses related to that aspect of the restructuring are presented as discontinued operations.



YOUR TURN

You as an Investor

One of the most important determinants of a company's stock price is expected future earnings. Assume that you are considering investing in Worsham Corporation and are evaluating the company's profitability in the current year. The net income of the corporation, which amounted to \$4,000,000, includes the following items.

Loss on a discontinued segment of the business (net of income tax benefit)	\$750,000
Gain on the sale of Land to the City of Phoenix	300,000

Assume the gain on the sale of land is based on the total received and does not include income taxes, which are expected to be 30 percent. Adjust net income to develop a number that represents a starting point for predicting the future net income of Worsham Corporation. Explain the reason for each of the adjustments. Explain how this adjusted number may help you predict future earnings for the company.

(See our comments in Connect.)

L012-2

LEARNING OBJECTIVE
Compute earnings per share.

EARNINGS PER SHARE (EPS)

One of the most widely used accounting figures is **earnings per share** on common stock, which is often referred to as EPS. Investors who buy or sell stock in a corporation need to know the annual earnings per share. Stock market prices are quoted on a per-share basis. If you are considering investing in a company's stock at a price of \$50 per share, you need to know the earnings per share and the annual dividend per share to help you decide whether the price you will pay is likely to provide the return you expect to receive.

To compute earnings per share, the common stockholders' share of the company's net income is divided by the average number of common shares outstanding. Earnings per share applies only to common stock; preferred stockholders have no claim to earnings beyond the stipulated preferred stock dividends.

Computing earnings per share is easiest when the corporation has issued only common stock and the number of outstanding shares has not changed during the year. In this case, earnings per share is equal to net income divided by the number of shares outstanding.

In many companies, the number of shares of stock outstanding changes during the year. In some cases, additional shares are sold. Often shares of common stock are purchased and

Reporting the Results of Operations

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retired or held as treasury stock. In cases like these, computing earnings per share requires the computation of the weighted-average number of shares outstanding.¹

The weighted-average number of shares for the year is determined by multiplying the number of shares outstanding by the fraction of the year that number of shares outstanding remained unchanged. For example, assume a company had 80,000 shares of common stock outstanding during the first nine months of the current year. The company then sold 60,000 additional shares so that 140,000 shares were outstanding during the last three months of the year. The weighted-average number of shares outstanding for the year is 95,000, determined as follows.

80,000 shares × $\frac{9}{12}$ of a year	60,000
140,000 shares × $\frac{3}{12}$ of a year	35,000
Weighted-average number of common shares outstanding	<u>95,000</u>

If the company's net income for the year was \$250,000, earning per share is calculated as follows: $\$250,000 \div 95,000 \text{ shares} = \2.63 .

By using the weighted-average number of shares in calculating earnings per share, we recognize that the cash received from the sale of the 60,000 additional shares was available to management to generate earnings only during the last three months of the year.

Preferred Dividends and Earnings per Share When a company has preferred stock outstanding, the preferred stockholders participate in net income only to the extent of the preferred stock's stated dividend. To determine the earnings applicable to the common stock, we first deduct from net income the amount of current year preferred dividends. The annual dividend on cumulative preferred stock is always deducted, even if not declared by the board of directors for the current year. Even if there are preferred dividends in arrears, only the current year's cumulative preferred dividend is deducted in the earnings per share computation. Dividends on noncumulative preferred stock are deducted only if they have been declared by the board of directors.

To illustrate, we will assume that Perry Corporation has 200,000 shares of common stock and 12,000 shares of \$6 cumulative preferred stock outstanding throughout the year. Net income for the year totals \$595,000. Earnings per share of common stock would be computed as follows.

Net income	\$595,000
Less: Dividends on preferred stock (12,000 shares × \$6)	<u>72,000</u>
Earnings applicable to common stock	\$523,000
Weighted-average number of common shares outstanding	200,000
Earnings per share of common stock ($\$523,000 \div 200,000 \text{ shares}$)	<u>\$ 2.62</u>

Presentation of Earnings per Share in the Income Statement Publicly owned corporations are *required* to present earnings per share figures in their income statements.² If an income statement includes discontinued operations, per-share figures are shown for both income from continuing operations and net income. The per-share calculation for income from continuing operations is computed by substituting that amount for the net income figure in the preceding calculation.

¹ When the number of shares outstanding changes as a result of a stock split or a stock dividend (discussed later in this chapter), the computation of the weighted-average number of shares outstanding should be adjusted *retroactively* rather than weighted for the period the new shares were outstanding. This makes earnings per share data for prior years consistent in terms of the current capital structure.

² The FASB has exempted closely held corporations (those not publicly owned) from the requirement of computing and reporting earnings per share, although some do it voluntarily.

A=L+IOE
Earnings per share figures are required in the income statements of publicly owned companies

To illustrate all of the potential per-share computations, we expand our Perry Corporation example to include income from continuing operations. The condensed income statement shown in Exhibit 12-2 illustrates the proper format for presenting earnings per share figures and provides a review of the calculations. The net sales, costs and expenses, and loss from discontinued operations are assumed amounts, leading to the net income figure of \$595,000. For simplicity, in this example we present discontinued operations as a single amount.

EXHIBIT 12-2
Earning per Share
Presentation

PERRY CORPORATION CONDENSED INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2018	
Net sales	\$ 9,115,000
Costs and expenses (including tax on continuing operations)	8,310,000
Income from continuing operations	\$ 805,000
Loss from discontinued operations (net of income tax benefits)	(210,000)
Net income	<u>\$ 595,000</u>
Earnings per share of common stock:	
Earnings from continuing operations	\$3.67 ^a
Loss from discontinued operations	(1.05)
Net income	<u>\$2.62^b</u>

^a(\$805,000 - \$72,000 preferred dividends) ÷ 200,000 shares

^b(\$595,000 - \$72,000) ÷ 200,000 shares

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LEARNING OBJECTIVE
Distinguish between basic and diluted earnings per share.

BASIC AND DILUTED EARNINGS PER SHARE

A company may have outstanding agreements that allow investors to acquire shares of common stock as part of some other financial instrument or contractual arrangement. For example, assume that a company has an outstanding issue of preferred stock that allows the holder to convert each share of preferred stock into two shares of common stock. The conversion of this preferred stock would increase the number of common shares outstanding and may dilute (reduce) earnings per share. Investors interested in the trend of earnings per share need to know the possible effect this conversion of the preferred stock may have on earnings per share of common stock. Keep in mind that the decision to convert the preferred shares into common shares is made by the preferred stockholders, not the corporation.

In situations where a company's capital structure includes the potential for dilution of EPS, to inform investors of the potential dilution that might occur, two EPS figures are presented for each income number from the income statement. The first figure, called **basic earnings per share**, is based on the weighted-average number of common shares actually outstanding during the year. This figure is computed as illustrated earlier in this chapter. The second figure, called **diluted earnings per share**, incorporates the impact that conversion of the preferred stock would likely have on basic earnings per share.³

Convertible preferred stock is not the only potential diluter of earnings per share. Convertible debt instruments (e.g., convertible bonds) are another type of financial instrument that may reduce earnings per share. Similarly, stock options, which allow the holder to purchase shares of stock at a preset price, may reduce earnings per share if the holders choose to exercise them and purchase additional shares of stock.

In a circumstance where a company has both income from continuing operations and net income and also has outstanding the potential for dilution of EPS, the income statement

³ The detailed calculation of Diluted EPS can be quite complex and is beyond the scope of this text, primarily because it is based on assumptions regarding transactions that have not actually occurred. This subject is covered in greater depth in more advanced accounting courses.



PATHWAYS CONNECTION

Providing useful information to investors and creditors in the form of earnings per share figures is an important responsibility of accounting. One way earnings per share figures are used is to calculate the relationship of a company's earnings per share and its stock price. This relationship is often expressed as the **price-earnings (p/e) ratio**. This ratio is the current stock price divided by the earnings per share for the year. Price-earnings ratios are of such interest to investors that they are made available daily in various sources of financial information. Price-earnings ratios and other measures useful for evaluating financial performance are covered in Chapter 14.

Stock prices reflect investors' expectations of *future* earnings. The p/e ratio, however, is based on the earnings over the *past* year. If investors expect earnings to *increase* substantially from current levels, the p/e ratio may be quite high—perhaps 20, 30, or even more. But if investors are less optimistic and expect earnings to decline from current levels, the p/e ratio

may be quite low, say, 8 or less. A mature company with stable earnings expects its stock price to be between 10 and 20 times earnings, depending on current market conditions and investor sentiment. The p/e ratio is an important figure because it reflects investors' expectations of the company's future prospects.⁴

When using per-share information, it is important to know exactly which per-share statistic is being presented. For example, the price-earnings ratios (market price divided by earnings per share) for common stocks listed on major stock exchanges are reported in *The Wall Street Journal* and other financial publications. Which earnings per share figures are used in computing these ratios? If a company reports discontinued operations, the price-earnings ratio is computed using the per-share earnings from income from continuing operations. Otherwise, the ratio is based on net earnings.

⁴A word of caution—if current earnings are very low, the p/e ratio tends to be quite high regardless of whether future earnings are expected to rise or fall. In such situations, the p/e ratio is not a meaningful measurement.



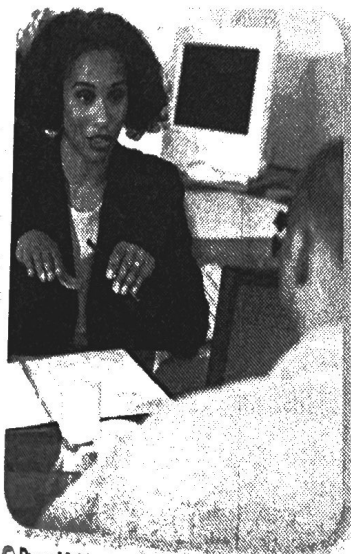
INTERNATIONAL CASE IN POINT

Valuation multiples such as price-earnings ratios are often used to estimate a firm's value. The use of price multiples to compare firms from different countries is challenging for many reasons. One important reason is that national differences in accounting principles are a source of cross-country differences. For example, research has shown that such differences in accounting principles cause p/e ratios in Japan to be generally lower than in the United States for comparable companies with similar financial results.



YOUR TURN

You as a Financial Analyst



You are working for a stock market research firm and your boss asks you to present an analysis of Foster, Inc.'s performance, focusing primarily on earnings per share. Her primary purpose for having you do this analysis is to consider whether Foster, Inc., is a good investment in terms of the company's expectations for future profitability. In analyzing Foster, Inc.'s income statement you determine the following.

	2018	2017	2016
Basic earnings per share on:			
Income from continuing operations	\$3.02	\$2.56	\$1.75
Discontinued operations	(1.90)	(1.05)	(0.15)
Net income	\$1.12	\$1.51	\$1.60

On the basis of only the limited information presented above, what is your recommendation to your boss regarding Foster, Inc.'s prospects for future profitability? Justify your conclusion.

(See our comments in Connect.)

would include four EPS figures: basic EPS on both income from continuing operations and net income, and diluted EPS on both income from continuing operations and net income. Each of these figures has a different significance. Earnings per share from continuing operations represents the results of continuing and ordinary business activity. This figure is the most useful one for predicting future operating results. EPS on net income, on the other hand, shows the overall operating results of the current year, including any discontinued operations. Basic EPS figures communicate the actual earnings on a per-share basis while diluted EPS figures communicate the possible dilution, or reduction, in EPS that may have occurred had additional shares of common stock been issued from convertible securities, stock options, or other contractual arrangements that allow the holders to acquire common stock.

Keep in mind that at the end of the accounting period, net income as determined in the income statement is transferred to the statement of financial position (balance sheet) as an addition to retained earnings. We now look at events and transactions other than net income that affect retained earnings.

Other Transactions Affecting Retained Earnings

CASH DIVIDENDS

Investors buy stock in a corporation with the expectation of getting their original investment back as well as earning a reasonable return on that investment. We described this earlier in this text as a return *of* their investment and a return *on* their investment. The return on a stock investment is a combination of the following: (1) the increase in value of the stock (stock appreciation) and (2) **cash dividends**.

Some profitable corporations do not pay dividends. For example, a corporation may be in an early stage of development and must conserve cash for the purchase of plant and equipment or for other needs of the company. These so-called growth companies may not be able to obtain sufficient financing at reasonable interest rates to finance their operations, so they must rely on their earnings to provide the cash and other resources they need. Often only after a significant number of years of profitable operations does the board of directors decide that paying cash dividends is appropriate.

The preceding discussion suggests the following three requirements for the payment of cash dividends.

1. **Retained earnings.** Since dividends are a distribution to stockholders of assets that represent earnings of the company, the theoretical maximum for dividends is the total of all undistributed net income of the company from prior years. This amount is represented by

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LEARNING OBJECTIVE

Account for cash dividends and stock dividends, and explain the effects of these transactions on a company's financial statements.

Other Transactions Affecting Retained Earnings

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the positive or credit balance in the Retained Earnings account. As a practical matter, many corporations limit dividends to amounts significantly less than the amount of net income, on the basis that a major portion of the net income must be retained in the business if the company is to grow and keep pace with its competitors.

2. *An adequate cash position.* The fact that the company reports earnings does not necessarily mean that it has a large amount of cash on hand. Cash generated from earnings may have been invested in new plant and equipment, or it may have already been used to pay off debts or to acquire a larger inventory. There is no direct, dollar-for-dollar, relationship between the balance in the Retained Earnings account and the balance in the Cash account. The common expression of "paying dividends out of retained earnings" is misleading. Cash dividends can be paid only out of cash.
3. *Dividend action by the board of directors.* Even though a company's net income is substantial and its cash position seemingly satisfactory, dividends are not paid automatically. A formal action by the board of directors is necessary to declare a dividend.

DIVIDEND DATES

Four significant dates are involved in the distribution of a dividend. These are as follows.

1. *Date of declaration.* On the day on which the dividend is declared by the board of directors, a liability to make the payment comes into existence.
2. *Ex-dividend date.* The **ex-dividend date** is significant for investors in companies whose stocks trade on stock exchanges. To permit the compilation of the list of stockholders as of the record date, it is customary for the stock to go *ex-dividend* three business days before the date of record (see following discussion). A person who buys the stock before the ex-dividend date is entitled to receive the dividend that has already been declared; conversely, a stockholder who sells shares before the ex-dividend date does not receive the dividend. A stock is said to be selling *ex-dividend* on the day that it loses the right to receive the latest declared dividend.
3. *Date of record.* The **date of record** follows the date of declaration, usually by two or three weeks, and is stated in the dividend declaration. To be eligible to receive the dividend, a person must be listed in the corporation's records as the owner of the stock on the date of record.
4. *Date of payment.* The declaration of a dividend includes an indication of the date of payment as well as the date of record. Usually the date of payment comes two to four weeks after the date of record.

Journal entries are required only on the dates of declaration and of payment, as these are the only transactions affecting the corporation declaring the dividend. These entries are illustrated as follows.

Dec. 15	Dividends	125,000	
	Dividends Payable		125,000
	To record declaration of a cash dividend of \$1 per share on the 125,000 shares of common stock outstanding. Payable Jan. 25 to stockholders of record on Jan. 10.		

A=L+LOE
Entries made on declaration date and ...

Jan. 25	Dividends Payable	125,000	
	Cash		125,000
	To record payment of \$1 per share dividend declared Dec. 15 to stockholders of record on Jan. 10.		

A=L+LOE
on payment date

No entries are made on either the ex-dividend date or the date of record. These dates are important only in determining who receives the dividend checks. From the stockholders' point of view, it is the ex-dividend date that determines who receives the dividend. The date of record is of significance primarily to the stock transfer agent and the stock registrar.

At the end of the accounting period, a closing entry is required to transfer the debit balance of the Dividends account into the Retained Earnings account. Some companies follow an alternative practice of debiting Retained Earnings when the dividend is declared instead of going through a Dividends account. Under either method, the balance of the Retained Earnings account ultimately is reduced by all dividends declared during the period.

LIQUIDATING DIVIDENDS

A *liquidating dividend* occurs when a corporation pays a dividend that exceeds the balance in the Retained Earnings account. This means that the dividend returns to stockholders all or part of their paid-in capital investment. Liquidating dividends usually are paid only when a corporation is going out of existence or is making a permanent reduction in the size of its operations. Stockholders may assume that a dividend represents a distribution of profits unless they are notified by the corporation that the dividend is a return of invested capital.

STOCK DIVIDENDS

Stock dividend is a term used to describe a distribution of additional shares of stock to a company's stockholders in proportion to their present holdings. The dividend that has been declared is satisfied by issuing additional shares of stock rather than being paid in cash. Most stock dividends consist of additional shares of common stock distributed to holders of common stock. Therefore, our discussion focuses on this type of stock dividend.

An important distinction exists between a cash dividend and a stock dividend. A *cash dividend* is a distribution of cash by a corporation to its stockholders. A cash dividend reduces both assets and stockholders' equity. In a *stock dividend*, however, no assets are distributed. A stock dividend results in no change in assets, liabilities, or total stockholders' equity. Each stockholder receives additional shares, but his or her percentage ownership in the corporation is no larger than before. The company's assets are not affected by the transaction, and each stockholder receives the same percentage increase in the number of shares. This is in contrast to a cash dividend in which the asset cash is reduced by the dividend. In fact, the rationale for declaring and distributing a stock dividend is to preserve the company's cash.

To illustrate this point, assume that a corporation with 2,000 shares of common stock outstanding is owned equally by James Davis and Susan Miller, each owning 1,000 shares of stock. The corporation declares a stock dividend of 10 percent and distributes 200 additional shares (10 percent of 2,000 shares), with 100 shares going to each of the two stockholders. Davis and Miller now hold 1,100 shares apiece, but each still owns one-half of the business. Furthermore, the corporation has not changed in size; its assets and liabilities and its total stockholders' equity are exactly the same as before the dividend.

Now let us consider the logical effect of this stock dividend on the market price of the company's stock. Assume that, before the stock dividend, the outstanding 2,000 shares in our example had a market price of \$110 per share. This price indicates a total market value for the corporation of \$220,000 (2,000 shares \times \$110 per share). Because the stock dividend does not change total assets or total stockholders' equity, we might expect the total market value of the corporation to remain \$220,000 after the stock dividend. Because 2,200 shares are now outstanding, the market price of each share should fall to \$100 (\$220,000 \div 2,200 shares). In other words, we might expect the market value of the stock to fall in proportion to the number of new shares issued. Often that is not the case and relatively small stock dividends have little, if any, impact on the market price of the stock. So while the investor who receives a stock dividend does not own any more of the company than before, he or she actually does receive value in the form of additional shares which may be held or sold.

Entries to Record a Stock Dividend In accounting for relatively small stock dividends (say, 2, 5, or even 10 percent of the outstanding stock), the market value of the new shares is transferred from the Retained Earnings account to the paid-in capital accounts. This process sometimes is called *capitalizing* retained earnings. The overall effect on stockholders' equity is the same as if the dividend had been paid in cash, and the stockholders had immediately

Other Transactions Affecting Retained Earnings

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reinvested the cash in the business in exchange for additional shares of stock. Of course, no cash actually changes hands—the new shares of stock are simply sent directly to the stockholders. To illustrate, assume that on June 1, Aspen Corporation has outstanding 100,000 shares of \$5 par value common stock with a market value of \$25 per share. On this date, the company declares a 10 percent stock dividend, distributable on July 15 to stockholders of record on June 20. The entry at June 1 to record the declaration of this dividend is as follows.

Retained Earnings	
Stock Dividend to Be Distributed	250,000
Additional Paid-in Capital: Stock Dividends	50,000
Declared a 10% stock dividend consisting of 10,000 shares (100,000 shares × 10%) of \$5 par value common stock, market price \$25 per share. Distributable July 15 to stockholders of record on June 20.	200,000

A-L-LOE

Stock dividend declared; use market price of stock

The Stock Dividend to Be Distributed account is not a liability because there is no obligation to distribute cash or any other asset. If a balance sheet is prepared between the date of declaration of a stock dividend and the date of distribution of the shares, this account, as well as the Additional Paid-in Capital: Stock Dividends account, will be presented in the stockholders' equity section of the balance sheet.

Notice that the Retained Earnings account was reduced by the market value of the shares to be issued (10,000 shares × \$25 per share = \$250,000). An important point is that no change occurs in the total amount of stockholders' equity. The amount removed from the Retained Earnings account is simply transferred into two other stockholders' equity accounts. On July 15, the entry to record the distribution of the dividend shares is as follows.

Stock Dividend to Be Distributed	50,000
Common Stock	50,000
Distributed 10,000-share stock dividend declared on June 1.	

A-L-LOE

Stock dividend distributed

Reasons for Stock Dividends Although stock dividends cause no change in total assets, liabilities, or stockholders' equity, they are popular both with management and with stockholders. Management often finds stock dividends appealing because they allow management to distribute something of perceived value to stockholders while conserving cash that may be needed for other purposes like expanding facilities and introducing new product lines.

Stockholders favor stock dividends because they receive more shares and for small stock dividends, often the stock price does *not* fall proportionately. Also, the dividend is not subject to income taxes (until the shares received are sold).

CASE IN POINT

An investor who purchased 100 shares of Home Depot, Inc., in 1985 would have paid about \$1,700. Fifteen years later, that stock was worth about \$273,000!

Does this mean that each share increased in value from \$17 to more than \$2,730? No—in fact, this probably couldn't happen. Investors like to buy stock in lots of 100 shares. At \$2,730 per share, who could afford 100 shares? Certainly not the average small investor.

Home Depot's board of directors wanted to attract small investors. These investors help create more demand for the company's stock—and in many cases, they also become loyal customers.

So as the price of Home Depot's stock rose with the success of the company, the board declared several stock splits and stock dividends. An investor who had purchased 100 shares in 1985 owned over 3,900 shares 15 years later without ever having had to purchase additional shares. Each share had a market value of \$70, a price considered affordable to the average investor.

Distinction between Stock Splits and Stock Dividends What is the difference between a stock dividend and a stock split (discussed in Chapter 11)? In some respects the two are similar. Both involve the distribution of shares of a company's own stock to its present stockholders without any payment by those stockholders to the company. Both stock dividends and stock splits increase the number of outstanding shares of stock in the company's stockholders' equity. The difference between a stock dividend and a stock split lies in the intent of management which, in turn, drives the size of the distribution. A stock dividend usually is intended to substitute for a cash dividend and is small enough that the market price of the stock is relatively unaffected. Stock dividends typically increase the number of outstanding shares by 2, 5, or 10 percent. Stock splits, on the other hand, are intended to reduce the market price of the stock to bring it down to a desired trading range. Stock splits typically represent much larger increases in the number of outstanding shares, such as 100 percent (2:1 split) or 200 percent (3:1 split).

The previous discussion focuses on the purposes and management intent of stock dividends and stock splits. Accounting for the two also varies. Stock dividends do not result in a change in the par value of the stock, and usually an amount equal to the market value of the shares issued is transferred from retained earnings to the par value and additional paid-in capital accounts. Stock splits, on the other hand, result in a pro rata reduction in the par value of the stock and no change in the actual dollar balances of the stockholders' equity accounts. Both stock dividends and stock splits are integral parts of management strategy with regard to the company's ownership, and the accounting differences parallel these differences in management intent.

STATEMENT OF RETAINED EARNINGS

The term *retained earnings* refers to the portion of stockholders' equity derived from profitable operations. Retained earnings is increased by the company earning net income and is reduced by the company incurring net losses and by the declaration of dividends. Prior period adjustments, discussed later in this chapter, may also increase or decrease retained earnings.

In addition to a balance sheet, an income statement, and a statement of cash flows, some companies present a **statement of retained earnings**, as illustrated in Exhibit 12-3.

LO12-5

LEARNING OBJECTIVE

Describe and prepare a statement of retained earnings.

EXHIBIT 12-3

Statement of Retained Earnings for Salt Lake Corporation

SALT LAKE CORPORATION STATEMENT OF RETAINED EARNINGS FOR THE YEAR ENDED DECEMBER 31, 2018	
Retained earnings, Dec. 31, 2017	\$ 750,000
Net income for 2018	280,000
Subtotal	<u>\$ 1,030,000</u>
Less dividends:	
Cash dividends on preferred stock (\$5 per share)	\$ 15,000
Cash dividends on common stock (\$2 per share)	59,600
10% stock dividend	140,000
	<u>214,600</u>
Retained earnings, Dec. 31, 2018	<u>\$ 815,400</u>

The 2018 net income is added to the beginning balance of retained earnings. Earlier in this text when we studied the accounting cycle, we learned that, as part of the end-of-period process of closing the books and preparing financial statements, the revenue and expense accounts are brought to a zero balance, and the net amount of these items (either net income or net loss) is added to or subtracted from owners' equity. For a corporation, net income or loss is added to or subtracted from the part of owners' equity titled retained earnings. Retained earnings is sometimes described as earned equity to distinguish it from paid-in capital, which represents equity that comes from the investments of owners. In the statement of retained

Other Transactions Affecting Retained Earnings

earnings, the beginning balance plus net income is reduced by the amounts of cash dividends declared during the year, as well as the amount of any stock dividend that was declared.

PRIOR PERIOD ADJUSTMENTS

A company may discover that a material error was made in the measurement of net income in a prior year. Because net income is closed into the Retained Earnings account, an error in reported net income causes an error in the amount of retained earnings shown in all subsequent balance sheets. When such errors are discovered, they must be corrected. The correction, called a **prior period adjustment**, is shown in the statement of retained earnings as an adjustment to the balance of retained earnings at the beginning of the current year. The amount of the adjustment is shown net of any related income tax effects.

To illustrate, assume that late in 2018 Salt Lake Corporation discovers that it failed to record depreciation on certain assets in 2017. After considering the income tax effects of this error, the company finds that the net income reported in 2017 was overstated by \$35,000. The beginning 2018 balance of the Retained Earnings account (\$750,000 at December 31, 2017) also is overstated by \$35,000. The statement of retained earnings in 2018 must include a correction of the retained earnings at the beginning of the year. (See the illustration in Exhibit 12-4.)

LO12-6

LEARNING OBJECTIVE

Define *prior period adjustments*, and explain how they are presented in financial statements.

**SALT LAKE CORPORATION
STATEMENT OF RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 2018**

Retained earnings, Dec. 31, 2017	
As originally reported	\$750,000
Less: Prior period adjustment for error in recording 2017 depreciation expense (net of \$15,000 income taxes)	35,000
As restated	\$715,000
Net income for 2018	280,000
Subtotal	\$995,000
Less dividends:	
Cash dividends on preferred stock (\$5 per share)	\$ 15,000
Cash dividends on common stock (\$2 per share)	59,600
10% stock dividend	140,000
Retained earnings, Dec. 31, 2018	<u>214,600</u> <u>\$780,400</u>

EXHIBIT 12-4

Statement of Retained Earnings with Prior Period Adjustment

AEL-10E

Adjust beginning retained earnings for correction

Prior period adjustments rarely appear in the financial statements of large publicly owned corporations. The financial statements of these corporations are audited annually by certified public accountants and are not likely to contain material errors that subsequently will require correction by prior period adjustments. If errors are found in the course of an audit, the financial records are corrected before they are made public. Prior period adjustments are more likely to appear in the financial statements of closely held corporations that are not audited on an annual basis.

From time to time companies make accounting changes that may be confused with prior period adjustments. For example, we have learned that depreciation is based on the estimated useful life of an asset. At some point in the life of an asset management may determine that the useful life will be longer or shorter than originally expected. When this occurs, prior periods are not adjusted. Instead, the book value of the asset at the time of the change is simply depreciated over the new remaining life of the asset. If the asset's life is reduced, depreciation each year will be increased for the (shorter) remaining life of the asset. If the asset's life is extended, depreciation each year will be reduced for the (longer) remaining life of the asset.

Restrictions of Retained Earnings Some portion of retained earnings may be restricted because of various contractual agreements. A restriction of retained earnings prevents a company from declaring a dividend that would cause retained earnings to fall below a designated

Chapter 12 Income and Changes in Retained Earnings

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level. Most companies disclose restrictions of retained earnings in notes accompanying the financial statements. For example, a company with total retained earnings of \$10 million might include the following note in its financial statements.

Note 7: Restriction of retained earnings

As of December 31, 2018, certain long-term debt agreements prohibit the declaration of cash dividends that would reduce the amount of retained earnings below \$5,200,000. Retained earnings in excess of this restriction total \$4,800,000.

A-L • LOE
Note disclosure of restrictions placed on retained earnings

LO12-7

LEARNING OBJECTIVE
Define *comprehensive income*, and explain how it differs from net income.

COMPREHENSIVE INCOME

The Financial Accounting Standards Board (FASB) has identified certain changes in financial position that should be recorded but should not enter into the determination of net income. One way to describe these events is that they are *recognized* (that is, recorded and incorporated in the financial statements) but not *realized* (that is, not included in the determination of the company's net income). We have studied one of these items earlier in this text—the change in market value of available-for-sale debt and equity investments.

Recall from Chapter 7 the way changes in value for various types of investments are recorded. Those investments classified as available-for-sale are revalued to their current market value at the end of each accounting period. These changes in value are accumulated and reported in a separate stockholders' equity account. The change in value does not enter into the determination of net income as it would had investments been sold. The change in market value of available-for-sale investments adds to the amount of stockholders' equity as the value of the investments goes up. The amount of stockholders' equity goes down as the value of the investments goes down. This adjustment is described as an element of other comprehensive income.

Comprehensive income is a term that identifies the total of net income plus or minus the elements of other comprehensive income. Comprehensive income may be displayed to users of financial statements in one of two ways.

- *As a second income statement.* One income statement displays the components of net income, as illustrated throughout this chapter. The second income statement displays the components of comprehensive income, one element of which is net income. If this option is selected, in the company's annual report, the Statement of Comprehensive Income must immediately follow the Income Statement that shows the determination of net income.
- *As a single income statement* that includes both the components of net income and the components of other comprehensive income.

In addition to the presentation of each year's changes in the elements of other comprehensive income, the accumulated amount of these changes is an element in the stockholders' equity section of the balance sheet. The components of comprehensive income are presented net of income tax, much like an extraordinary item.

Home Depot, Inc., whose financial statements for 2015 are included in Appendix A of this text, follows the first of these alternatives and presents Consolidated Statements of Earnings followed immediately by Consolidated Statements of Comprehensive Income. For each of the three years presented, the primary adjustments to Comprehensive Income, other than the company's annual net earnings, relate to the company's foreign operations. These are considered part of the company's overall income history, but are not part of its net income that is presented in the income statement.

STATEMENT OF STOCKHOLDERS' EQUITY

Many corporations expand their statement of retained earnings to show the changes during the year in all of the stockholders' equity accounts. This expanded statement, called a **statement of stockholders' equity**, is illustrated in Exhibit 12-5 for Salt Lake Corporation.

The top line of the statement includes the beginning balance of each major category of stockholders' equity. Notice that the fourth column, Retained Earnings, includes the same information as the statement of retained earnings for Salt Lake Corporation that was presented

LO12-8

LEARNING OBJECTIVE
Describe and prepare a statement of stockholders' equity and the stockholders' equity section of the balance sheet.

Other Transactions Affecting Retained Earnings

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in Exhibit 12-4. We have added several other stock transactions to illustrate the full range of information you will typically find in a statement of stockholders' equity:

- Issuance of common stock for \$260,000 (resulting in an increase in both common stock and additional paid-in capital).
- Conversion of shares of preferred stock into common stock at \$100,000, resulting in a decrease in 5 percent convertible preferred stock and an increase in common stock and additional paid-in capital.
- Purchase of \$47,000 of treasury stock, increasing the amount of treasury stock and decreasing the total of stockholders' equity (as discussed in Chapter 11).

STOCKHOLDERS' EQUITY SECTION OF THE BALANCE SHEET

The stockholders' equity section of Salt Lake Corporation's balance sheet for the year ended December 31, 2018, is shown in Exhibit 12-6. Note that these figures are taken directly from the last line of the statement of stockholders' equity as illustrated in Exhibit 12-5. You should be able to explain the nature and origin of each account and disclosure printed in red as a result of having studied this chapter.

The published financial statements of leading corporations indicate that there is no one standard arrangement for the various items making up the stockholders' equity section. Variations occur in the selection of titles, in the sequence of items, and in the extent of detailed classification. Many companies, in an effort to avoid excessive detail in the balance sheet, combine several related ledger accounts into a single balance sheet item with details disclosed in notes to the financial statements.

EXHIBIT 12-5 Statement of Stockholders' Equity

SALT LAKE CORPORATION STATEMENT OF STOCKHOLDERS' EQUITY FOR THE YEAR ENDED DECEMBER 31, 2018

	5% Convertible Preferred Stock (\$100 par value)	Common Stock (\$10 par value)	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balances, Dec. 31, 2017	\$400,000	\$200,000	\$300,000	\$750,000	\$ -0-	\$1,650,000
Prior period adjustment (net of \$15,000 taxes)				(35,000)		(35,000)
Issued 5,000 common shares @ \$52		50,000	210,000			260,000
Conversion of 1,000 preferred into 3,000 common shares	(100,000)	30,000	70,000			
Distributed 10% stock dividend (2,800 shares at \$50; market price)		28,000	112,000	(140,000)		
Purchased 1,000 shares of common stock held in treasury at \$47 a share					(47,000)	(47,000)
Net income				280,000		280,000
Cash dividends:						
Preferred (\$5 a share)				(15,000)		(15,000)
Common (\$2 a share)				(59,600)		(59,600)
Balances, Dec. 31, 2018	<u>\$300,000</u>	<u>\$308,000</u>	<u>\$692,000</u>	<u>\$780,400</u>	<u>\$(47,000)</u>	<u>\$2,033,400</u>

Note: The numbers that are not bracketed represent positive stockholders' equity amounts. The bracketed numbers represent negative stockholders' equity amounts.

EXHIBIT 12-6
Stockholders' Equity
Section of Balance Sheet

Stockholders' Equity	
Capital stock:	
5% convertible preferred, \$100 par value, 3,000 shares authorized and issued	\$ 300,000
Common stock, \$10 par value, 100,000 shares authorized, issued 30,800 (of which 1,000 are held in treasury)	308,000
Additional paid-in capital:	
From issuance of common stock	\$580,000
From stock dividends	112,000
Total paid-in capital	692,000
Retained earnings	\$1,300,000
Subtotal	780,400
Less: Treasury stock (1,000 shares at \$47 per share)	\$2,080,400
Total stockholders' equity	47,000
	<u>\$2,033,400</u>



ETHICS, FRAUD, & CORPORATE GOVERNANCE

As discussed in this chapter, the most important aspect of periodic reporting for many investors is the reporting of net income. Investors often are attracted to companies that report increasing income each year. As a result, overstating net income is the most common practice for engaging in inappropriate financial reporting.

The Securities and Exchange Commission (SEC) brought a series of enforcement actions against **Just for Feet, Inc.**, its former employees, and employees of former vendors related to the overstatement of Just for Feet's reported income. Although Just for Feet overstated its income through a number of different techniques, two prominent techniques used to overstate income related to fictitious co-op revenue and fictitious "booth" income.

LO12-9

LEARNING OBJECTIVE

Illustrate steps management might take to improve the appearance of the company's net income.



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Just for Feet was a national retailer of athletic and outdoor footwear and apparel. Just for Feet filed for bankruptcy protection, and it began the process of liquidating its assets and settling its liabilities.

Just for Feet incurred large amounts of advertising expenses. A vendor (e.g., **Adidas, Fila, Nike**) would often reduce the amount that Just for Feet owed for merchandise purchases if a particular advertisement featured the vendor's products. These reductions in amounts owed were referred to as "advertising co-op" or "vendor allowances." These vendor allowances were unwritten and not guaranteed. Just for Feet sent vendors copies of advertisements placed, and the vendor determined whether to grant an advertising allowance.

In one fiscal year, Just for Feet recorded \$19.4 million in co-op receivables and recognized an equal amount of revenue

that was not earned. The fictitious revenue of over \$19 million was a substantial percentage of Just for Feet's reported income of \$43 million.

One important facet of the Just for Feet fraud is that the SEC brought enforcement actions against a number of vendor representatives for providing false confirmations to Just for Feet's auditor. When fraud exists, management at the company committing the fraud may try to convince customers to falsely confirm to the auditors that they owe amounts that are in fact not owed. Such behavior represents a crime. It is worth noting that the criminal penalties for lying to external auditors have been substantially increased under the Sarbanes-Oxley Act, and that the SEC and the U.S. Justice Department are more likely to prosecute individuals for this type of behavior than was true in the past. Individuals in sales and marketing positions are often targets for requests to falsely confirm facts to external auditors (i.e., to lie to the auditors). Substantial civil and criminal penalties can result from lying to auditors.

Concluding Remarks

We have now discussed various aspects of stockholders' equity, focusing first on paid-in capital in Chapter 11 and then on earned capital in Chapter 12. These discussions complete our detailed coverage of assets, liabilities, and stockholders' equity, which began in Chapter 7 and included financial assets, inventories, plant and intangible assets, liabilities, and, finally, stockholders' equity. While these chapters generally follow a balance sheet organization, in Chapter 12 we also covered the income statement, including the presentation of irregular income items and earnings per share.

In the next chapter, we turn our attention to the statement of cash flows. Companies present four primary financial statements to their stockholders, creditors, and other interested parties—a statement of financial position or balance sheet, an income statement, a statement of comprehensive income, and a statement of cash flows. We delayed the detailed coverage of the statement of cash flows to this point in this textbook because of the importance of the material we have now covered, particularly in Chapters 7 to 12, for a full understanding of that financial statement.