

CHAPTER 14

Corporations: Retained Earnings and the Income Statement

Chapter Overview

This chapter continues the presentation of shareholders' equity by examining the Retained Earnings account and the transactions affecting Retained Earnings. Stock dividends and stock splits are described and compared. The authors introduce repurchased shares by first explaining why companies buy back their own previously issued shares. Entries illustrate the repurchase of shares, and the chapter discusses the ethical issues associated with such a repurchase. Variations in reporting shareholders' equity are described. The general teaching format of the shareholders' equity section of the balance sheet is compared to the real-world format.

The chapter then focuses on the corporate income statement. Continuing operations and discontinued operations are discussed. Earnings per share (EPS) is introduced; calculations are first presented for a corporation that has only common shares and then for a corporation that has both common and preferred shares. Students learn how to calculate the weighted-average number of common shares outstanding. Dilution of EPS is mentioned briefly. The statement of retained earnings and statement of shareholders' equity are described and illustrated. Accounting errors, and policy and circumstance changes resulting in adjustments to the statement of retained earnings for prior periods are explained. The chapter concludes with discussions on restrictions on retained earnings, and the impact of IFRS on the income statement and statement of shareholders' equity.

Try It! questions appear at the end of each Learning Objective for students to test their understanding of the Learning Objective just completed. The answers appear at the end of the chapter and on MyLab Accounting.

Students should be directed to MyLab for extra practice. Also included on MyLab are Excel templates for Exercises 14-12, 14-15, and 14-20, Problems 14-3A and 14-3B.

The **Assignment Grid** recommends "Pre-Test" problems in MyLab that can be assigned before a test or exam to ensure students understand the topics, as well as "Post-Test" problems that students can complete after a test or exam to check understanding before moving on.

Connecting Learning Objectives and Key Questions

	Learning Objective	Key Question
1	Account for stock dividends and stock splits	How do we account for stock dividends and stock splits?
2	Account for repurchased shares	Why are shares repurchased, and how do we account for them?
3	Prepare a detailed corporate income statement	How do we prepare a corporate income statement?
4	Prepare a statement of retained earnings and a statement of shareholders' equity	How do we prepare a statement of retained earnings and a statement of shareholders' equity?
5	Account for errors and changes in accounting policy and circumstances	How do we record and report errors or changes?
6	Identify the impact of IFRS on the income statement and the statement of shareholders' equity	What is the impact of IFRS on the income statement and the statement of shareholders' equity?

Suggested Priority of Chapter Topics

Must cover

- Retained Earnings
- Stock dividends
- Stock splits
- Repurchase of its shares by a corporation
- The corporate income statement
- Statement of retained earnings
- Statement of shareholders' equity
- Changes in financial statements

Recommended

- Restrictions on retained earnings
- Impact of IFRS on the income statement and the statement of shareholders' equity

Chapter Outline

Retained Earnings is the account that accumulates the income that has been retained in the business; that is, not paid out in dividends to shareholders.

1. Retained earnings = Net income minus net losses minus dividends declared.
2. A negative balance in Retained Earnings is called a **deficit**.
3. **Net income** is closed into Retained Earnings with this entry:

Income Summary	XX	
Retained Earnings		XX

4. **Net loss** is closed into Retained Earnings with this entry:

Retained Earnings	XX	
Income Summary		XX

5. Credits to Retained Earnings result only from net income.
6. Retained Earnings is *not a fund of cash*; it is a shareholders' equity account.

Learning Objective 1: Account for stock dividends and stock splits (How do we account for stock dividends and stock splits?)

A **stock dividend** is a proportional distribution by a corporation of its own shares to its shareholders.

- A. Stock dividends *do not* transfer assets to shareholders; they affect only shareholders' equity accounts. Stock dividends capitalize retained earnings because they transfer an amount from retained earnings to contributed capital (see Exhibit 14-1).

- B. The **reasons** that corporation might choose to distribute a stock dividend are:

1. To conserve cash but continue dividends.
2. To reduce the market price per share.

- C. The entries to record a stock dividend are:

Declaration date:

Retained Earnings	XX	
Common Stock Dividend Distributable		XX

Distribution date:

Common Stock Dividend Distributable	XX	
Common Shares		XX

Teaching Tip

Students often use the word “Payable” instead of “Distributable” in the account name. Stress that no cash is paid in a stock dividend. Thus “Distributable” is more appropriate.

- D. A **stock split** is an increase in the number of shares authorized and issued, coupled with a proportionate reduction in the book value of the share. Exhibit 14-2 shows the effect of a stock split on the total number of shares issued.
- E. Stock splits are recorded with a **memorandum entry** because no account balances are affected.
- F. A stock split *reduces the market price* of the share; a **reverse split (consolidation)** increases the market price of the share by decreasing the number of shares on the market. Reverse splits are rare, but are sometimes done to allow a company to continue trading on a stock exchange that requires a minimum share price when the company’s share price falls below the minimum.

Teaching Tip

Use examples of stock dividends or splits in the news to show students the impact of such transactions in real business cases. A company familiar to students would be Google, whose stock in April 2014. This was a 1 for 1 split, meaning for each share of AAPL owned pre-split, the shareholder now owned 2 shares. For example, an 8,000-share position pre-split, became a 16,000 share position following the split.

- G. A comparison of stock dividends and stock splits reveals the following similarities and differences:
1. Both increase the number of shares owned per shareholder.
 2. Both increase the number of shares outstanding.
 3. Stock splits do not create taxable income to the investors; however, stock dividends are taxable even though no cash is received.
 4. Only a stock dividend shifts some retained earnings to share capital, leaving the book value per share unchanged.
 5. Only a stock split affects the book value.
 6. Neither a stock dividend nor a stock split affects total shareholders’ equity.
- H. Exhibit 14-3 shows the effect of both cash and stock dividends and stock splits on total shareholders’ equity.

Learning Objective 2: Account for repurchased shares

(Why are shares repurchased, and how do we account for them?)

A. **Repurchased shares** are issued shares that have been later reacquired by the issuing corporation.

B. Reasons for repurchasing shares include:

1. To give to employees as part of their compensation package.
2. To help support the share's current market price.
3. To try to avoid a takeover.

C. For companies incorporated under the *Canada Business Corporations Act*, the repurchased shares are cancelled. They are then treated as authorized but unissued. The repurchase of shares is recorded with a debit to Common Shares and a credit to cash.

1. The *average issue price* is used to account for repurchased-share transactions. Common Shares is debited by the average issue price times the number of shares repurchased. When the repurchase is for an amount less than the original issue price, the difference is credited to Contributed Surplus—Share Repurchase. When the repurchase is for an amount greater than the original issue price, the difference is debited to Contributed surplus—Share Repurchase, if it exists. Any remaining debit is to Retained Earnings.
2. Since repurchased shares are cancelled, they do not vote, receive dividends, or share in assets if the corporation is wound up.

Teaching Tip

Students often get confused as to what amount they should use in journalizing the repurchase transaction. Point out that:

- The debit to Common Shares is always at average issue price therefore track the changing average issue price, and
- The credit to Cash is for the market (repurchase) price of the shares.

D. Under the *Canada Business Corporations Act*, any subsequent sales of repurchased shares are treated the same way as a normal sale of authorized but unissued shares. They increase both assets and shareholders' equity.

Cash	XX
Common Shares	XX

E. The purchase and sale of repurchased shares *do not affect net income*. No “gain” or “loss” is recorded on the sale of repurchased shares.

F Please see Exhibit 14-4 for “Summary of Journal Entries for Share Repurchases”.

Learning Objective 3: Prepare a detailed corporate income statement

(How do we prepare a corporate income statement?)

- A. The corporate income statement can be used to determine the *trend of earnings* and the *components of net income*. The various sections of the corporate income statement are illustrated in Exhibit 14-5.
1. The income statement is the most important of the financial statements.
 2. In order to evaluate the company's net income, it is important to examine the various types of income that make up the total.
- B. *Income (loss) from continuing operations* measures the profitability of the ongoing operations and is useful for making projections about future earnings.
- C. *Discontinued operations* are **segments of a business** that have been sold. Discontinued operations are made up of two components:
1. The *after-tax operating income or loss* of the discontinued segment.
 2. The *after-tax gain or loss* from the sale of the segment.

Teaching Tip

Students who have taken accounting courses before may wonder about extraordinary items. If questions are asked, inform them that the new accounting standards for private enterprises (ASPE) no longer require extraordinary items to be reported on the income statement.

D. **Earnings per share (EPS)** is the amount of a company's net income per common share.

1. It is presented on the income statement after net income.
2. EPS figures are provided for income before discontinued operations and for net income.
3. EPS is based on a *weighted-average number of common shares outstanding* during the entire year.
4. The basic formula for EPS is:
$$\frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted-average number of common shares outstanding}}$$
5. Two sets of EPS figures, **basic** and **fully diluted EPS**, are presented for companies that have potentially dilutive securities (such as convertible preferred shares).
6. The topic of dilution is complex and is covered in intermediate accounting texts.

Learning Objective 4: Prepare a statement of retained earnings and a statement of shareholders' equity

(How do we prepare a statement of retained earnings and a statement of shareholders' equity?)

- A. A *statement of retained earnings* reports changes in retained earnings over a period of time, usually due to net income or loss, and dividends. (Refer to Exhibit 14-6.) Exhibit 14-7 illustrates how a company may report a *combined statement of income and retained earnings*.
- B. **statement of shareholders' equity** presents changes in all components of equity, including information affecting contributed capital (sales and repurchases of shares) and retained earnings (net income/loss and dividends). Refer to Exhibit 14-8. This statement includes information that would be presented in a statement of retained earnings. Thus, a separate statement of retained earnings would not be required.
- C. Variations in reporting shareholders' equity are common. See Exhibit 14-9 for a comparison of the general teaching format and a real-world format for shareholders' equity.
 - 1. In the real world, similar accounts are often combined for simplification.
 - 2. Different terminology is often used.
- D. *Adjustments* are made to opening retained earnings to correct errors in calculating income from previous periods or to reflect changes in accounting policy or circumstances.

Learning Objective 5: Account for errors and changes in accounting policy and circumstances

How do we record or report errors or changes?

- A. Errors from prior periods are reported as adjustments to the beginning retained earnings balance, as well as to the related asset or liability account.
 - 1. The correction is shown on the statement of retained earnings.
 - 2. Changes in accounting policy should be applied retroactively, with prior periods restated to reflect the change and the facts given in the notes to the financial statements. This is known as **retrospective** treatment.
 - 3. If there is a change in circumstances regarding estimates made about many items on the financial statements (e.g. warranties on bad debts, inventory obsolescence, or the useful life of assets for amortization), the changes are made to the current year and all future financial statements. This **prospective** treatment is in response to new information and is done to make the information more useful.
- B. *Restrictions and appropriations of retained earnings* are actions that classify a portion of retained earnings as being unavailable for dividends and stock repurchases.
 - 1. *Restrictions* are usually reported in the notes to the financial statements.
 - 2. **Appropriations** require a formal journal entry. This entry segregates a portion of retained earnings for some specific use.

Learning Objective 6: Identify the impact on the income statement and the statement of shareholders' equity of international financial reporting standards (IFRS)

(What is the impact of IFRS on the income statement and the statement of shareholders' equity?)

- A. Income statement preparation is very similar under ASPE and IFRS. One main difference is that IFRS requires companies to disclose EPS information on the income statement while ASPE does not.
- B. *Other comprehensive income* arises from a number of sources including unrealized gains and losses on certain classes of investment securities and is required by IFRS to be reported on the statement of comprehensive income. ASPE does not have the same requirement. This topic is covered in more advanced accounting courses.
- C. Retained earnings are governed by very comparable standards. IFRS requires a Statement of Changes in Equity, which is similar to the Statement of Shareholders' Equity described in this chapter for companies reporting under ASPE.

Assignment Grid (2nd column: * = Excel Template available; W = writing required)

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
Starter 14-1		Interpreting retained earnings	1	5	Easy	
Starter 14-2		Recording a stock dividend	1	5-10	Easy	
Starter 14-3	W	Comparing and contrasting cash dividends and stock dividends	1	5-10	Easy	
Starter 14-4		Accounting for a stock split	1	5-10	Easy	
Starter 14-5		Stock dividend and repurchase	1, 2	10	Easy	
Starter 14-6		Accounting for the repurchase of common shares	2	10	Easy	
Starter 14-7		Share repurchase entries	2	5-10	Easy	
Starter 14-8		Preparing a corporate income statement	3	5-10	Medium	
Starter 14-9	W	Explaining the items on a complex corporate income statement	3	10	Easy	
Starter 14-10		Preparing a corporate income statement	3	10-15	Medium	
Starter 14-11		Reporting earnings per share	3	10-15	Medium	
Starter 14-12		Calculating earnings per share	3	10	Medium	
Starter 14-13		Calculating earnings per share when there is a stock split	3	10	Medium	
Starter 14-14		Complete a statement of shareholders' equity	4	5-10	Medium	
Starter 14-15		Creating a statement of shareholders' equity	4	10-15	Medium	
Starter 14-16	W	Interpreting a restriction of retained earnings	4	5	Easy	
Starter 14-17		Prior-period adjustments	5	5-10	Medium	
Starter 14-18		Reporting the correction of a prior-period error	4	5-10	Medium	
Starter 14-19		Describing accounting changes	5	10-15	Medium	
Starter 14-20	W	Reporting under IFRS	6	5	Easy	
Starter 14-21	W	Comparing IFRS and ASPE	6	5	Easy	
Starter 14-22		Preparing a statement of comprehensive income	6	5	Medium	
E14-1		Journalizing a stock dividend and reporting shareholders' equity	1	10-15	Easy	
E14-2		Journalizing equity transactions	1	10-15	Easy	
E14-3		Journalizing dividends and reporting shareholders' equity	1	10-15	Easy	
E14-4		Reporting shareholders' equity after a stock split	1	10-15	Easy	
E14-5	W	Accounting for a reverse stock split (consolidation)	1	5-10	Easy	
E14-6	W	Using a stock split or a stock dividend to decrease the market price of a share	1	5-10	Medium	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
E14-7	W	Effects of share issuance, dividends, and share repurchase transactions	1, 2	10-15	Medium	
E14-8		Journalizing share repurchase transactions	2	10-15	Easy	
E14-9		Journalizing repurchase of company shares and reporting shareholders' equity	2	10-15	Easy	
E14-10	W	Accounting for the repurchase of preferred shares	2	5-10	Easy	
E14-11		Preparing a single-step income statement	3	10-15	Medium	
E14-12	*W	Preparing a multiple-step income statement	3	10-15	Medium	
E14-13		Computing earnings per share	3	5	Medium	
E14-14		Computing earnings per share	3	10-15	Medium	
E14-15	*	Preparing a statement of retained earnings	4	10	Easy	
E14-16		Preparing a statement of shareholders' equity	4	15-20	Medium	
E14-17		Prepare the shareholders' equity section of a balance sheet	4	15-20	Medium	
E14-18		Reporting a retained earnings restriction	4	10-15	Medium	
E14-19		Explain the impact of a prior-period error	5	5	Easy	
E14-20	*	Preparing a statement of retained earnings with a correction of a prior-period adjustment	4, 5	10	Easy	
E14-21		Journalizing and reporting share sale and repurchase transactions	2	15-20	Medium	
E14-22		Analyzing stock split and share repurchase transactions—Challenge Exercise	2	15-20	Medium	
E14-23		Recording a stock dividend and preparing a statement of retained earnings—Challenge Exercise	1, 4	15-20	Difficult	
BN14-1	W	Reporting special items	2, 3	20-30	Medium	
EI14-1	W	Ethical Issue	n/a			
P14-1A	W	Using a stock split to fight off a takeover of the corporation	1	30-40	Medium	
P14-2A		Journalizing shareholders' equity transactions	1, 2	15-20	Easy	
P14-3A	*	Journalizing dividend and share-repurchase transactions, reporting shareholders' equity, and calculating earnings per share	1, 2, 3	50-60	Medium	
P14-4A		Preparing a single-step income	1, 2, 3	40-50	Medium	Pre-Test

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
		statement				
P14-5A		Accounting for stock dividends, stock splits, share transactions, and the statement of shareholders' equity	1, 2, 4	30-50	Difficult	Pre-Test
P14-6A		Journalizing dividend and share-repurchase transactions; reporting shareholders' equity; calculating earnings per share	1, 2, 3, 4	30-45	Medium	Pre-Test
P14-7A		Computing earnings per share and reporting a retained earnings restriction	3	20-25	Difficult	Pre-Test
P14-8A		Preparing a corrected combined statement of income and retained earnings	3, 4, 5	30-40	Medium	
P14-9A		Accounting for stock dividends, stock splits, and errors from a prior period; preparing a combined statement of income and retained earnings; calculating earnings per share	1, 3, 4, 5	40-60	Difficult	
P14-1B	W	Repurchasing shares to fight off a takeover of the corporation	2	15-30	Medium	
P14-2B		Journalizing shareholders' equity transactions	1, 2	15-20	Easy	
P14-3B	*	Journalizing dividend and share-repurchase transactions, reporting shareholders' equity	1, 2, 3	50-60	Medium	
P14-4B		Preparing a single-step income statement	3	40-50	Medium	Post-Test
P14-5B		Accounting for stock dividends, stock splits, share transactions, and the statement of shareholders' equity	1,2,3,4	30-50	Difficult	Post-Test
P14-6B		Journalizing dividends and share-repurchase transactions; reporting shareholders' equity	1, 2, 3, 4	40-45	Medium	Post-Test
P14-7B		Computing earnings per share and reporting a retained earnings restriction	3, 4	20-25	Medium	Post-Test
P14-8B		Preparing a corrected combined statement of income and retained earnings	3, 4, 5	30-40	Medium	
P14-9B		Accounting for stock dividends, stock splits, and prior-period adjustments; preparing a combined statement of income and retained earnings; calculating earnings per share	1, 3, 4, 5	40-60	Difficult	
P14-1C	W	Explaining the effects of a share repurchase	2	15-25	Medium	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
DP14-1	W	Analyzing cash dividends and stock dividends	1	15-20	Difficult	
FSC14-1	W	Corporate income statement and earnings per share	3, 4, 5	10-15	Medium	
FSC14-12	W	Understanding the financial statements, and the effects of reporting under IFRS	2, 3, 4, 5	15-20	Medium	

CHAPTER 14
TEN-MINUTE QUIZ

Circle the letter of the best response.

1. Which of the following statements is *false*?
 - A. Debits to Retained Earnings can result from either net losses or declaration of dividends.
 - B. A stock dividend is a proportional distribution of the corporation's own shares to its shareholders.
 - C. The Retained Earnings account balance will not necessarily be equal to the Cash account balance.
 - D. When a company suffers a net loss, it is recorded with a credit to Retained Earnings.

2. The journal entry to record the declaration of a stock dividend would include all the following *except*:
 - A. Dividends Payable, credit
 - B. The market value of the dividend shares multiplied by the number of shares to be distributed.
 - C. Common Share Dividend Distributable, credit
 - D. Retained Earnings, debit

3. Which one of the following statements is true?
 - A. A stock split increases the market price of a share.
 - B. A stock dividend increases the number of shares issued, but a stock split does not.
 - C. Both stock dividends and stock splits have no effect on total shareholders' equity.
 - D. A stock split creates taxable income for the investor receiving the shares.

4. On July 1, 2019, Moody Corporation was authorized to issue 200,000 common shares and issued 70,000 shares. On July 2, Moody Corporation declared a 50% stock dividend to be distributed on July 31. On September 1, Moody Corporation declared a 2-for-1 stock split. How many common shares were outstanding at September 2, 2019?
 - A. 400,000
 - B. 260,000
 - C. 210,000
 - D. 140,000

5. Which of the following would not affect the balance in Retained Earnings?
 - A. An adjustment for an error made in a prior period
 - B. A stock split
 - C. A stock dividend
 - D. An appropriation of retained earnings

6. MSN Inc. repurchased 1,000 of its own common shares for \$15 per share. Later, MSN Inc. sold 200 shares for \$16 per share. The entry to record the sale of the 200 shares is:

- | | | |
|-----------------------------------|-------|-------|
| A. Cash | 3,200 | |
| Common Shares | | 3,200 |
| | | |
| B. Cash | 3,000 | |
| Common Shares | | 3,000 |
| | | |
| C. Cash | 3,200 | |
| Common Shares | | 3,000 |
| Contributed Surplus, Gain on Sale | | 200 |
| | | |
| D. Cash | 3,200 | |
| Common Shares | | 3,000 |
| Gain on Sale of Shares | | 200 |

7. Which of the following would *not* require an inflow or outflow of cash?

- A. Declaration of cash dividends.
- B. Issuance of preferred shares.
- C. Repurchase of a company's own shares.
- D. Sale of shares.

8. Which of the following statements related to corporations is correct?

- A. A corporation can increase its net income by repurchasing its shares at a low price and selling shares later at a higher price.
- B. Operating income on the income statement might include the sale of a segment of the business at a loss.
- C. Discontinued Operations should not be shown net of tax.
- D. A major error in a period prior to the current period is recorded as an adjustment to the beginning balance in the Retained Earnings account to reflect the error.

9. On January 1, Metro Inc. has authorized 100,000 common shares. On February 1, 10,000 shares are issued at \$20 per share. On August 1, 500 shares are repurchased from shareholders at a price of \$25 per share and cancelled. What is the balance in Common Shares on August 1?

- A. \$187,500
- B. \$190,000
- C. \$237,500
- D. \$250,000

10. Alice Corp. was organized on January 1 of the current year with 200,000 common shares authorized; 100,000 shares were issued on that date at \$8 per share. On April 1, an additional 20,000 shares were issued at \$9 per share. Net income for the year was \$420,000. What was the earnings per share reported on the income statement for the current year ended on December 31?

- A. \$2.10
- B. \$3.50
- C. \$3.65
- D. Some other amount

Answer Key to Chapter 14 Quiz:

1. D 2. A 3. C 4. C 5. B 6. A 7. A 8. D 9. B 10. C