Chapter 16
Stockholders’ Equity: Retained Earnings

LECTURE OUTLINE

The material in this chapter is straight-forward and can be covered in two class periods. Students are often not familiar with dividend distributions other than cash. Emphasize the distinction between stock splits and stock dividends and the different accounting procedures for large and small stock dividends.

A. Retained Earnings—the basic source of retained earnings is income from operations.

1. Items that increase or decrease retained earnings are given below in T-account form.

<table>
<thead>
<tr>
<th>Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Net loss</td>
</tr>
<tr>
<td>2. Prior period adjustments (error corrections) and certain changes in accounting principle.</td>
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<tr>
<td>3. Cash dividends or scrip dividends.</td>
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<td>4. Stock dividends.</td>
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<td>5. Property dividends.</td>
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<td>6. Some treasury stock transactions.</td>
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<table>
<thead>
<tr>
<th>Retained Earnings</th>
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<tbody>
<tr>
<td>1. Net income.</td>
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<tr>
<td>2. Prior period adjustments (error corrections) and certain changes in accounting principle.</td>
</tr>
<tr>
<td>3. Adjustment due to quasi-reorganization.</td>
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B. Dividend Policy.

1. Few firms pay out dividends in amounts equal to their retained earnings available for dividends. Among the reasons: reinvestment of earnings in assets, the desire to build up a cushion, and the "smoothing out" of dividend payments.

2. Legality of dividends: The legality of a dividend can be determined by the applicable state laws.

3. Financial condition of the firm: Before dividends are declared the availability of funds to pay the dividend should be considered.
C. Types of Dividends.

**Teaching Tip**
Use Illustration 16-1 to emphasize the importance of various dates in distributing dividends and to summarize the various types of dividend distributions.

1. Cash dividends. Once declared, a dividend (except a stock dividend) is a liability (usually current). Dividends should not be declared and paid on treasury stock.

2. Property dividends. These are dividends payable in assets of the corporation other than cash. The **fair value** principle is used in valuing the dividend.

3. Scrip dividends. Instead of paying the dividend now, the firm elects to pay it at some later date. The scrip issued to stockholders is merely a **special form of notes payable**.

4. Liquidating dividends. Dividends not based on earnings are liquidating dividends, which reduce paid-in capital.

5. Stock dividends. No assets are distributed and each stockholder retains the **same proportionate** interest in the corporation.
   a. Small (ordinary) stock dividends. The **market value** of the stock issued should be transferred from retained earnings if the dividend is less than 20-25% of outstanding shares.

   b. Large stock dividends. If the dividend is more than 20-25%, then the **par value** of the stock issued should be transferred from retained earnings.
6. Stock splits. No entry is made, only a memorandum note to indicate that the **par value of the shares has changed**.

<table>
<thead>
<tr>
<th>Teaching Tip</th>
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<tbody>
<tr>
<td><strong>Illustration 16-2</strong> summarizes the differences between stock splits and stock dividends.</td>
</tr>
</tbody>
</table>

7. Dividends paid to common and preferred shareholders are affected by the **dividend preferences** of the preferred stock. Preferred stock can be:

   a. Cumulative or noncumulative.

   b. Fully participating, partially participating, or non-participating.

D. Appropriations of Retained Earnings—a reclassification of retained earnings for a specific purpose. Although appropriations are acceptable, costs and losses **cannot** be charged to such appropriations. Reasons for appropriations include:

1. Legal restrictions—for example, with treasury stock.

2. Contractual restrictions—for example, with bond covenants.

3. Existence of possible or expected loss—for example, with contingencies.

4. Protection of working capital position.

E. Terminology. Current preferred usage include:

   1. Retained earnings instead of surplus.
2. Additional paid-in capital instead of capital surplus.

3. Appropriated retained earnings instead of reserve.

F. Presentation and Analysis of Stockholders’ Equity

1. Presentation
      (1) Capital stock.
      (2) Additional paid-in-capital in excess of par (or stated) value.
      (3) Retained earnings or deficit.
   b. On the statement of retained earnings—the basic format is usually:
      (1) Beginning balance.
      (2) Additions.
      (3) Deductions.
      (4) Ending balance.

Teaching Tip

Illustration 16-3 presents the details of changes in stockholders’ equity accounts taken from the annual report of PepsiCo. Inc.

2. Analysis. Several ratios use stockholders’ equity amounts to evaluate a company’s profitability and long-term solvency.

   a. Rate of return on common stock equity
      \[
      \text{Rate of return on common stock equity} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common stockholders’ equity}}
      \]
(1) **Trading on the equity at a gain.** When the return on total assets is lower than the rate of return on the common stockholders’ investment.

b.  **Payout ratio** = \[ \text{Cash dividends} \over \text{Net income} - \text{preferred dividends} \]

c.  **Price earnings ratio** = \[ \text{Market price of stock} \over \text{Earnings per share} \]

d.  **Book value per share** = \[ \text{Common stockholders’ equity} \over \text{Outstanding shares} \]

**Teaching Tip**

Illustration 16-4 presents the ratios using stockholders’ equity amounts used to measure profitability and long-term solvency.

G. **Appendix 16 A.** Quasi-Reorganization. A procedure which eliminates an accumulated deficit and permits a firm to proceed on much the same basis as if it had been legally reorganized, without the difficulty and expenses of an actual reorganization. It permits the firm to resume payment of dividends.

1. Factors leading toward quasi-reorganization.
   
a. Negative retained earnings (deficit).
   
b. Good future prospects.
   
c. Need for capital to take advantage of future prospects.
   
d. Inability to obtain capital because of inability to pay cash dividends.

2. Quasi-reorganization steps.
a. Assets revalued at their current value and liabilities at their present value.

   (1) Net of these adjustments recorded in the retained earnings.

b. Par value reduced.

c. Deficit written off against paid-in capital.

3. Subsequent disclosures.