Chapter 18 Shareholders' Equity

RETAINED EARNINGS

The balance in retained earnings represents an accumulation of the following common items from the inception date of the business:

- Add: net income
- Subtract: net losses
- Subtract: dividends.

The following is a complete T-account analysis of all possible transactions that can go through the retained earnings account.

RETAINED EARNINGS

DEBIT	CREDIT
Net loss	Net income
Prior period adjustments	Prior period adjustments
Certain changes in accounting principle	Certain changes in accounting principle
Cash or scrip dividends	Adjustments due to quasi-reorganization
Stock dividends	
Property dividends	
Some treasury stock transactions	

Many corporations choose to retain earnings for future investment and/or expansion rather than paying dividends. This is called internal financing and is appropriate as long as the return to the corporation and thus the stockholders exceeds the return the individual investors might be able to obtain from other sources.

Legality of Dividends

The legal aspects of dividend distributions are governed by state law. The state in which the corporation is domiciled will dictate any restrictions that might apply to dividend distributions. The purpose of state mandated restrictions is to protect creditors and/or non-management shareholders.

Financial Condition and Dividend Distributions

In the past many corporations paid dividends on a regular basis. For investors on a fixed income this was a steady source of revenue. If a corporation has traditionally paid dividends the discontinuance or temporary interruption of dividend payments will indicate to investors that the corporation is either short of cash or has chosen to reinvest all of its retained earnings. There are occasions where a corporation incurs a loss but continues to pay the traditional dividends. This provides a signal to the market that management believes that profitability is expected in the future. The important thing to remember is that a corporation cannot continue to pay dividends unless it has cash. Startup and growing corporations typically do not pay dividends because they need to internally finance growth. In the long run this is better for the company and the stockholders.

Types of Dividends

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Although the most common type of dividend distribution is in the form of cash, there are a number of alternative forms of distributions. With the exception of stock dividends, all dividends reduce total stockholders' equity.

Cash Dividends

Only the board of directors can authorize the payment of cash dividends. There are three dates that are important from an accounting perspective.

1. **Date of declaration**-this is the date that the board of directors declares a cash dividend
2. **Date of record**-all stockholders as of this date will receive the cash dividends
3. **Date of payment**-this is the date that the payment is made to the stockholders of record

For example, Spencer Company has issued and outstanding 10,000 shares of common stock. On February 14, 2001 the board of directors takes a vote and declares a dividend of $2 per share payable on April 1, 2001 to all shareholders of record on March 25, 2001. The journal entries are as follows:

DATE OF DECLARATION (February 14, 2001)

ACCOUNT	DEBIT	CREDIT
Retained earnings	20,000	
Dividends payable		20,000

DATE OF RECORD (March 25, 2001)

ACCOUNT	DEBIT	CREDIT
NO ENTRY		

DATE OF PAYMENT (April 1, 2001)

ACCOUNT	DEBIT	CREDIT
Dividends payable	20,000	
Cash		20,000

Based upon your knowledge of cash dividends, answer the following question.

Question

On what date does a corporation become liable for a cash dividend? Explain.

Answer

A dividend becomes a corporate liability on the date of declaration. At this point, the corporation has made a promise to pay the stockholders and is legally liable for payment.

Property Dividends

"A property dividend is a nonreciprocal transfer of non-monetary assets between an enterprise and its owners." All property dividends are measured at the fair market value of the property at the date of declaration. This requires the corporation to record a gain or loss prior to the actual distribution.

For example, on May 1, 2001 the board of directors of Spencer Company voted to distribute property (equipment) with a book value of $25,000 (original cost $100,000, accumulated depreciation $75,000) to the stockholders of record on May 25, 2001. The distribution is to take place on June 5, 2001. An appraisal of the equipment establishes the fair market value at $15,000. The journal entries to record this property dividend are as follows:

DATE OF DECLARATION (May 1, 2001)

ACCOUNT	DEBIT	CREDIT
Loss on disposition of equipment	10,000	
Accumulated depreciation		10,000
Retained earnings	15,000	
Dividends payable		15,000

DATE OF RECORD (May 25, 2001)

ACCOUNT	DEBIT	CREDIT
NO ENTRY		

DATE OF PAYMENT (June 5, 2001)

ACCOUNT	DEBIT	CREDIT
Dividends payable	15,000	
Accumulated depreciation	85,000	
Equipment		100,000

Based upon your knowledge of property dividends, answer the following question.

Question

Why are property dividends recorded at fair value?

Answer

Fair value reflects the value of the resource that is given up by the corporation.

Liquidating Dividends

If a corporation distributes legal dividends and does not have a positive balance in retained earnings, the dividend distributions reduce additional paid-in capital. Because these dividends are based on paid-in capital instead of retained earnings they are called liquidating dividends. It is a return of the stockholders' original investment rather than a distribution of earnings.

Example: On January 1, 2002 Spencer Corporation has the following balances in its capital accounts:

Common stock (50,000 shares)	$500,000
Additional paid-in capital-common stock	975,000
Retained earnings	200,000

On January 15, 2002 the board of directors declares a dividend of $6 per common share, payable on March 15, 2002 for shareholders of record on February 20, 2002. This dividend distribution will be a partial cash dividend and a partial liquidating dividend. The journal entries are as follows:

DATE OF DECLARATION (January 15, 2002)

ACCOUNT	DEBIT	CREDIT
Retained earnings	200,000	
Additional paid-in capital-common stock	100,000	
Dividends payable		300,000

DATE OF RECORD (February 20,2002)

ACCOUNT	DEBIT	CREDIT
NO ENTRY		

DATE OF PAYMENT (March 15, 2002)

ACCOUNT	DEBIT	CREDIT
Dividends payable	300,000	
Cash		300,000

Stock Dividends

In a stock dividend no assets are actually distributed. All management is doing is cutting the equity of the company into smaller pieces. This is done frequently if the per share stock price rises too high in managements estimation. It is much easier to sell $25 per share stock then it is to sell $125 per share stock. By declaring a stock dividend the number of shares increases and the price per share decreases proportionately. There are two kinds of stock dividends; small (ordinary) stock dividends and stock splits.

Small (ordinary) Stock Dividends

If the stock dividend is 20-25% of the common shares outstanding at the time that the dividend is declared, it is recorded as a stock dividend. The fair market value of the stock issued is removed from retained earnings and transferred into the paid-in capital accounts.

For example, on November 1, 2001 the board of directors of Spencer Company declares a 10% stock dividend. At that date there are 10,000 shares of $5 par value common stock issued and outstanding. The fair market value of the stock on November 1, 2001 was $125 per share. The stock dividend is to be distributed on December 31, 2001 to stockholders' of record on December 25, 2001. The following journal entries reflect this stock dividend:

DATE OF DECLARATION (November 1, 2001)

ACCOUNT	DEBIT	CREDIT
Retained earnings	125,000	
Common stock dividend distributable		5,000
Additional paid-in capital-common stock		120,000

DATE OF RECORD (December 25,2001)

ACCOUNT	DEBIT	CREDIT
NO ENTRY		

DATE OF PAYMENT (December 31, 2001)

ACCOUNT	DEBIT	CREDIT
Common stock dividend distributable	5,000	
Common stock		5,000

Note that the total stockholders' equity does not change. The board of directors authorized the capitalization of earnings. This means that some of the retained earnings are moved to the paid-in capital section of the balance sheet. Based upon the journal entries for the previous example, prepare the "after" column indicating the new balances in Common stock, Additional paid-in capital, and Retained earnings. Recalculate Total Paid-in Capital and Total Stockholders Equity. Again, note that total stockholders equity does not change.

Stockholders' Equity	**Before**	**After**
Common stock, $5 par value, 10,000 shares authorized, issued and outstanding	50,000	**?**
Additional paid-in capital	20,000	**?**
Total paid-in capital	70,000	**?**
Retained earnings	900,000	**?**
Total stockholders equity	970,000	**?**

Answer:

Stockholders' Equity	**Before**	**After**
Common stock, $5 par value, 10,000 shares authorized, issued and outstanding	50,000	55,000
Additional paid-in capital	20,000	140,000
Total paid-in capital	70,000	195,000
Retained earnings	900,000	775,000
Total stockholders equity	970,000	970,000

Large Stock Dividend

In contrast to an ordinary stock dividend, if a corporation declares a large stock dividend, more than 20-25%, then the only capital account affected is the common stock account. The company is capitalizing the par or stated value but not the full market price of the stock.

For example, on September 1, 2001 the board of directors of Spencer Company declares a 30% stock dividend. At that date there are 10,000 shares of $5 par value common stock issued and outstanding. The fair market value of the stock on November 1, 2001 was $125 per share (not relevant). The stock dividend is to be distributed on October 31, 2001 to stockholders' of record on October 15, 2001. The following journal entries reflect this stock dividend:

DATE OF DECLARATION (September 1, 2001)

ACCOUNT	**DEBIT**	**CREDIT**
Retained earnings	15,000	
Common stock dividend distributable		15,000

Analysis of Dividend:		
Shares outstanding before declaration	10,000	
Large stock dividend percentage	30%	
Large stock dividend	3,000	
Par value of stock	5	
Amount of common stock dividend distributable		15,000

DATE OF RECORD (October 15,2001)

ACCOUNT	**DEBIT**	**CREDIT**
NO ENTRY		

DATE OF PAYMENT (October 31, 2001)

ACCOUNT	**DEBIT**	**CREDIT**
Common stock dividend distributable	15,000	
Common stock		15,000

Stock Split

If the company has accumulated a sizable amount in retained earnings, it is likely that the market price of the stock has increased as well. In order to keep the price within a reasonable trading range the board of directors may want to increase the total number of shares outstanding so that the market price per share will decreased. This is accomplished with a stock split. There are no journal entries with a stock split. The corporation increases the number of shares outstanding by issuing more shares to the existing shareholders and reduces the par value of the stock by a proportionate amount.

For example, on March 15, 2001 the board of directors of Spencer Corporation declares a 4:1 stock split. The additional shares are to be distributed on June 1, 2001 to stockholders of record on May 15, 2001. The par value of the stock is $5 per share and the market price is $200 per share. This split will probably drop the market price to about $50 per share. Although there is no journal entry, on June 1, 2001 the corporation will enter into the stock records that there are now 40,000 shares of $1.25 par value stock. The following reflects the balance sheet presentation before and after the 4:1 stock split.

Stockholders' Equity	**Before**
Common stock, $5 par value, 10,000 shares authorized, issued and outstanding	50,000
Additional paid-in capital	20,000
Total paid-in capital	70,000
Retained earnings	900,000
Total stockholders equity	970,000

Stockholders' Equity	**After**
Common stock, $1.25 par value, 40,000 shares authorized, issued and outstanding	50,000
Additional paid-in capital	20,000
Total paid-in capital	70,000
Retained earnings	900,000
Total stockholders equity	970,000

Effects of Dividend Preferences

One feature that may be part of the preferred stock contract is the obligation of the corporation to pay prior year dividends before distributing current year dividends. If a corporation misses the payment of a preferred dividend and the preferred stock contract calls for the continuation of this obligation the dividends are called dividends in arrears. If and when the corporation does pay dividends it must first pay all of the dividends in arrears before paying any current year dividends.

Preferred stockholders also have preference over common stockholders when it comes to the distribution of dividends in the current year. If there is not enough money to pay all the dividends desired, the preferred stockholders receive their specified dividend payment before any payments are made to the common stockholders.

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In certain circumstances, preferred stock has an additional feature. The preferred stockholders may be allowed to participate in dividends along with common stockholders above and beyond the specified preferred dividend. This is called participation. The preferred stockholders may be partially or fully participating in dividends.

The following fact pattern will be used to demonstrate each of these circumstances. Spencer Company has the following equity accounts on December 31, 2001.

Stockholders' equity	
Common stock, $5 par value, 150,000 shares authorized, issued and outstanding	750,000
Preferred stock, $100 par value, 5,000 share authorized, issued and outstanding	500,000
Additional paid-in capital, common stock	250,000
Additional paid-in capital, preferred stock	50,000
Total paid-in capital	1,550,000
Retained earnings	350,000
Total stockholders' equity	1,900,000

All stock has been issued and outstanding since January 1, 1999. The company declared and paid no dividends in 1999 or 2000. In 2001, there was $200,000 available for dividend distributions. The following examples demonstrate each one of the possible scenarios based on the features attributed to the preferred stock.

Dividend Distribution, 6%, Noncumulative and Nonparticipating Preferred Stock	**Preferred**	**Common**	**Total**
Preferred dividends:			
2001 dividends			
5,000 shares * $100 * 6%	30,000		30,000
Remainder to common stockholders		170,000	170,000
	30,000	170,000	200,000

Dividend Distribution, 6%, Cumulative and Nonparticipating Preferred Stock with Dividends in Arrears	**Preferred**	**Common**	**Total**
Preferred dividends			
1999 dividends in arrears (5,000 shares * $100 * 6%)	30,000		30,000
2000 dividends in arrears (5,000 shares * $100 * 6%)	30,000		30,000
2001 dividends (5,000 shares * $100 * 6%)	30,000		30,000
Remainder to common stockholders		110,000	110,000
	90,000	110,000	200,000

Dividend Distribution, 6%, Noncumulative and Fully Participating Preferred Stock	**Preferred**	**Common**	**Total**
Preferred dividends			
2001 dividends			
5,000 shares * $100 * 6%	30,000		30,000
Participation	50,000		50,000
Common dividends			
150,000 shares * $5 * 6%		45,000	45,000
Participation		75,000	75,000
	80,000	120,000	200,000

Analysis of Participation:		**%**	**Amount**	**Allocation**
Total available	200,000			
Preferred dividend	(30,000)			
Common dividends based on preferred percentage	(45,000)			
Available for participation	125,000			
Allocation of participation:				
Common stock (750,000 / 1,250,000 = 60%)	750,000	60%	$ 125,000	75,000
Preferred stock (500,000 / 1,250,000 = 40%)	500,000	40%	$ 125,000	50,000
Total par value	1,250,000			125,000

Dividend Distribution, 6%, Cumulative and Partially Participating Preferred Stock (>10%)	**Preferred**	**Common**	**Total**
Preferred dividends			
1999 dividends in arrears (5,000 shares * $100 * 6%)	30,000		30,000
2000 dividends in arrears (5,000 shares * $100 * 6%)	30,000		30,000
2001 dividends (5,000 shares * $100 * 6%)	30,000		30,000
Participation	14,000		14,000
Common dividends			
150,000 shares * $5 * 10%		75,000	75,000
Participation		21,000	21,000
	104,000	96,000	200,000

Analysis of Participation:		**Percentage**	**Amount**	**Allocation**
Total available	200,000			
Preferred dividend	(90,000)			
Common dividends based on preferred percentage	(75,000)			
Available for participation	35,000			
Allocation of participation:				
Common stock (750,000 / 1,250,000 = 60%)	750,000	60%	$ 35,000	21,000
Preferred stock (500,000 / 1,250,000 = 40%)	500,000	40%	$ 35,000	14,000
Total par value	1,250,000			35,000

Self-Assessment quiz 6.2

1. An entry is NOT made on the
   a. date of declaration.
   b. date of record.
   c. date of payment.
   d. An entry is made on all of these dates.

2. A scrip dividend results in a debit to retained earnings and a credit to a(n)
   a. asset account.
   b. liability account.
   c. stockholders' equity account.
   d. expense account.

3. A dividend which is a return to stockholders of a portion of their original investments is
   a. a liquidating dividend.
   b. a property dividend.
   c. a liability dividend.
   d. a participating dividend.

4. Declaration and issuance of a dividend in stock
   a. increases the current ratio.
   b. decreases the amount of working capital.
   c. decreases total stockholders' equity.
   d. has no effect on total assets, liabilities, or stockholders' equity.

5. If management wishes to "capitalize" part of the earnings, it may issue a
   a. scrip dividend.
   b. stock dividend.
   c. property dividend.
   d. liquidating dividend.

Solutions:

1	b
2	b
3	a
4	d
5	b

Appropriation of Retained Earnings
The appropriation of retained earnings is nothing more than a reclassification. Many times the board of directors wants to restrict the use of a certain amount of retained earnings for some specific project, such as the building of a new manufacturing plant. This puts the stockholders on notice that the board plans to reinvest retained earnings in company activities. The textbook suggests that there are several reasons for the appropriation of retained earnings.

1. Legal restrictions
2. Contractual restrictions
3. Existence of possible or expected loss
4. Protection of working capital position

Recording Appropriation of Retained Earnings
The regular retained earnings account is essentially un-appropriated retained earnings. In other words, the corporation can use the equity for any legal purpose. Appropriated retained earnings restrict the use of some of the retained earnings for a specific project or purpose. For example, the board of directors of Spencer Company voted to appropriate $750,000 of retained earnings for the building of a new facility in the next five years. The journal entry to record this event is as follows:

ACCOUNT	DEBIT	CREDIT
Retained earnings	750,000	
Appropriated retained earnings-new plant		750,000

The restrictions associated with appropriated retained earnings would be disclosed in the notes to the financial statements.

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Presentation
The stockholders’ equity section of the balance sheet is comprised of three sections; legal capital, additional paid-in capital, and retained earnings. The following is an example of the equity section of a balance sheet for Spencer Company.

Stockholders' Equity		
Capital stock		
Preferred stock, $100 par value, 6% cumulative, 10,000 shares authorized, 5,000 shares issued and outstanding		50,000
Common stock, $5 par value, 1,000,000 authorized, 50,000 shares issued and 49,000 shares outstanding		250,000
Total capital stock		300,000
Additional paid-in capital		
Additional paid-in capital, preferred stock	5,000	
Additional paid-in capital, common stock	500,000	505,000
Total paid-in capital		805,000
Retained earnings:		
Appropriated retained earnings-new plant	750,000	
Unappropriated retained earnings	200,000	950,000
Total paid-in capital and retained earnings		1,755,000
Less: treasury stock (1,000 shares of common stock at cost)		(160,000)
Total stockholders' equity		1,595,000

Statement of Stockholders’ Equity
In many small, closely-held companies the only changes in stockholders’ equity from one period to the next is the change in retained earnings. If this is the case we often include the statement of changes in retained earnings at the bottom of the income statement.

In larger more complex organizations there are significant changes in many of the components of stockholders’ equity. In these types of situations a comprehensive presentation of changes in stockholders’ equity will be required.