Chapter 14 — Corporations: Retained Earnings and the Income Statement

CHAPTER OVERVIEW

In Chapter 13 you learned about share capital, cash dividends, share values, corporate income taxes, and other topics related to corporations. We expand those topics in this chapter and learn about stock dividends, share repurchases, and a corporation income statement, among other topics. The learning objectives for this chapter are to

1. Account for stock dividends.
2. Distinguish stock splits from stock dividends.
3. Account for repurchased shares.
5. Analyze a corporate income statement
6. Prepare a statement of retained earnings.

CHAPTER REVIEW

Retained Earnings is the account that holds all of the corporation’s net income less net losses and less dividends declared, accumulated over the life of the business. A deficit or debit balance means net losses have exceeded net income. Income Summary is closed to Retained Earnings at the end of each period. Retained Earnings is not a fund of cash.

Objective 1 - Account for stock dividends.

Corporations declare stock dividends instead of cash dividends when they want to conserve cash or reduce the market price per share. Unlike cash dividends, stock dividends are not distributions of corporate assets. A stock dividend is a proportional distribution of the corporation’s shares to its shareholders. Thus, a stock dividend affects only a corporation’s shareholders’ equity accounts; the result of a stock dividend is a reduction in Retained Earnings, an increase in Common Shares, and no change in total shareholders’ equity.

The effect of declaring a stock dividend is to capitalize or transfer a portion of Retained Earnings to Common Shares. The entry is:

\[
\begin{align*}
\text{Retained Earnings} & \quad \text{XX} \\
\text{Common Stock Dividend Distributable} & \quad \text{XX}
\end{align*}
\]
The amount of the debit to Retained Earnings is equal to:

\[
\text{Number of Shares Outstanding} \times \text{Dividend \%} \times \text{Market Price per Share}
\]

The credit to Common Stock Dividend Distributable is the same amount.

On the date of distribution, the value of the issued shares is transferred from the dividend distributable account to the shares account:

```
Common Stock Dividend Distributable    XX
Common Shares            XX
```

A stock split increases the number of outstanding shares and proportionately reduces the book value per share. No account balances are affected.

**Objective 2 - Distinguish stock splits from stock dividends.**

Both stock splits and stock dividends increase the number of shares outstanding and may decrease the market price per share. The difference between stock splits and stock dividends is that a stock dividend requires a transfer from Retained Earnings while a stock split requires no journal entry.

Income Trusts are a new investment vehicle that have gained popularity since the mid 1990’s. They involve converting shares into “trust units” which provide the unit holders with the opportunity to receive monthly cash payments while maintaining their equity position in the company.

Carefully review Exhibit 14-3 in your text for a summary of the shareholders’ equity effects of cash dividends, stock dividends, and stock splits.

**Objective 3 - Account for repurchased shares.**

Corporations may repurchase shares from shareholders for a variety of reasons, one of which may be to keep the market price of the shares up by decreasing the supply of shares available to the public.

The Canadian Business Corporations Act requires that a corporation that purchases its own shares cancel the shares bought. These shares normally revert to authorized but unissued status and may be issued in a normal way at some later date.

The CICA Handbook requires that a company that purchases its own shares at a price equal to or greater than the average issue price to debit Common Shares (or Preferred Shares, as the case may be) for the average issue price; any excess should be debited to Retained Earnings. When the shares are purchased for less than the average issue price, the purchase price is credited to Contributed Surplus—Share Repurchase.

Note that the repurchase of its own shares does not create a gain or loss for the corporation. A share repurchase affects balance sheet accounts, not income statement accounts. See Exhibit 14-4 for an example of the affect of a share repurchase on corporate equity.

**Objective 4 - Report restrictions on retained earnings.**
Many corporations obtain financing through long-term loans. Creditors wish to ensure that funds will be available to repay these loans. Thus, loan agreements frequently restrict the amount of retained earnings that can be used to pay dividends and repurchase shares. These restrictions are usually reported in notes to the financial statements.

A corporation may also appropriate a portion of retained earnings for a specific purpose by debiting Retained Earnings and crediting Retained Earnings Appropriated.

Review Exhibit 14-5 in your text so you understand how a detailed shareholders’ equity presentation can be condensed.

**Objective 5 – Analyze a corporate income statement.**

Investors may want to examine the trend of a company’s earnings and the makeup of its net income. Therefore, the corporation income statement starts with income from continuing operations, follows with income or loss from special items, and concludes with earnings per common share. See Exhibit 14-6 in your text.

**Continuing operations** are expected to continue in the future. Income from continuing operations helps investors make predictions about future earnings. Income from continuing operations is shown both before and after income tax has been deducted.

When a corporation sells one of its segments, the sale is reported in a section of the income statement called **discontinued operations**. Such sales are viewed as one-time transactions, and are therefore not a future source of income. Discontinued operations are separated into an operating component and a disposal component. Each is shown net of its related tax effect.

**Extraordinary gains and losses** are both unusual and infrequent, and are reported net of tax. Examples are natural disasters and expropriations by foreign governments of business assets.

**Earnings per share** of common shares is computed for each source of income or loss. To compute EPS divide net income by the weighted average number of common shares outstanding.

\[
\text{Weighted Average} = \text{Shares outstanding} \times \text{Fraction of year that shares were held}
\]

Review the example in your text to be certain that you understand how to compute the weighted average number of shares.

When preferred dividends exist, they must be subtracted from income subtotals (income from continuing operations, income before extraordinary items and cumulative effect of accounting change, and net income) in the computation of EPS. Preferred dividends are not subtracted from income or loss from discontinued operations, and they are not subtracted from extraordinary gains and losses.

**Dilution** must be considered if preferred shares can be converted into common shares because there is the potential for more common shares to be divided into net income. Corporations therefore provide **basic EPS** and **diluted EPS** information.

**Objective 6 - Prepare a statement of retained earnings.**
Retained earnings may be a significant portion of a corporation’s shareholders’ equity. The year’s income increases the retained earnings balance and losses and dividends decrease it.

The opening balance for retained earnings is corrected if the corporation has accounting errors from previous years or if the corporation has made changes to its accounting policies. These prior period adjustments take the form of a debit or credit to retained earnings and a debit or credit to the appropriate asset or liability account.
All the self-testing materials in this chapter focus on information and procedures that your instructor is likely to test in quizzes and examinations.

I. Matching  
Match each numbered term with its lettered definition.

<table>
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<tr>
<th>Numbered Term</th>
<th>Lettered Definition</th>
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<tbody>
<tr>
<td>1. stock dividend</td>
<td>A. a correction to Retained Earnings for an error of an earlier period</td>
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<td>2. earnings per share (EPS)</td>
<td>B. gain or loss that is both unusual for the company, nonrecurring and not determined by a management decision</td>
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<td>3. extraordinary item</td>
<td>C. a significant part of a business</td>
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<td>4. prior period adjustments</td>
<td>D. income from the part of the business that is expected to continue from period to period</td>
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<td>5. discontinued operations</td>
<td>E. a segment of the business that will generate no income in the future</td>
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<td>6. appropriation of retained earnings</td>
<td>F. a proportional distribution by a corporation of its own shares that affects only the owners’ equity section of the balance sheet</td>
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<td>7. date of record</td>
<td>G. amount of a company’s net income per share of its outstanding common shares</td>
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<td>8. declaration date</td>
<td>H. an increase in the number of outstanding shares coupled with a proportionate reduction in the average book value per share</td>
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<td>9. continuing operations</td>
<td>I. date on which the board of directors announces the intention to pay a dividend</td>
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<td>10. segment of a business</td>
<td>J. date on which the owners of shares to receive a dividend are identified</td>
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<td>11. stock split</td>
<td>K. restriction of retained earnings that is recorded by a formal journal entry</td>
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<td>12. share repurchases</td>
<td>L. the shares that a corporation issues and later reacquires</td>
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<td>13. deficit</td>
<td>M. when a corporation has outstanding equity which may be converted to common shares</td>
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<td>14. dilution</td>
<td>N. a debit balance in Retained Earnings</td>
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II. Multiple Choice  
Circle the best answer.

1. The correct order for pertinent dividend dates is:
   A. declaration date, record date, payment date
   B. record date, declaration date, payment date
   C. declaration date, payment date, record date
   D. record date, payment date, declaration date

2. The transfer from retained earnings to common shares for a common stock dividend is normally recorded at:
   A. liquidation value
   B. market value
   C. book value
   D. carrying value

3. The market price of a share of Royal Corporation’s common shares is $60. If Royal declares and issues a 50% stock dividend, the market price will adjust to approximately:
A. $30  
B. $12  
C. $90  
D. $40

4. The Common Stock Dividend Distributable account is reported in which section of the balance sheet?

A. current liabilities  
B. long-term liabilities  
C. current assets  
D. shareholders’ equity

5. The repurchase of shares will:

A. decrease assets  
B. increase liabilities  
C. increase shareholders’ equity  
D. have no effect on shareholders’ equity

6. The repurchase of shares decreases the number of:

A. authorized shares  
B. issued shares  
C. appropriated shares  
D. both B and C

7. A company may determine its business segments on the basis of:

A. geographic area or major product lines  
B. geographic area only  
C. production costs  
D. major product lines only

8. An appropriation of retained earnings will:

A. decrease total retained earnings  
B. increase total retained earnings  
C. not affect total retained earnings  
D. increase total assets

9. All of the following would usually be reported as extraordinary items on the income statement except:

A. a flood loss  
B. the loss on assets taken by a foreign Government  
C. the loss from a strike by workers  
D. a tornado loss

10. Prior period adjustments are found on the:

A. balance sheet  
B. income statement  
C. cash flow statement  
D. statement of retained earnings

III. Completion  Complete each of the following statements.

1. Earnings per share is calculated by dividing __________________ by _____________________.

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2. When shares are repurchased at a price less than the average issue price, the excess of the average issue price over the purchase price is _______________________________.

3. Extraordinary gains and losses on the income statement are both ____________________ and ____________________.

4. A corporation may repurchase shares in order to:
___________________________________________________________________________
___________________________________________________________________________
___________________________________________________________________________

5. Corporations normally disclose any______________________________ in the notes to the financial statements.

6. The P/E is the acronym for the ___________________________.

7. The denominator for the P/E ratio is ___________________________.

8. A(n) ___________________________ occurs when a shareholder returns shares to the corporation and receives more shares in the exchange.

9. An error affecting net income in a previous accounting period is called a _________________.

10. The denominator in the basic earnings per share calculation is the _______________________.

IV. Daily Exercises

1. Number the following income statement categories to show the order in which they should appear. Use * to indicate those categories that should be shown net of tax.

   _____ A. Discontinued Operations
   _____ B. Continuing Operations
   _____ C. Extraordinary Items
   _____ D. Earnings per Share

2. A shareholder owns 8,000 shares of Vitabark. If the company declares and issues a 25% stock dividend, how many shares will the shareholder own?

3. Examine the information in Daily Exercise #2 above, but assume a 5 for 4 stock split. How many shares will be owned after the split?
4. A corporation’s equity includes the following:

Preferred Shares 1,600,000

The company decides to purchase and retire its outstanding preferred shares and is able to do so for a total of $1,500,000. Record the journal entry to purchase the preferred shares.

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5. Review the information in Exercise #4 above, but assume the cost to purchase and retire the preferred shares is $1,700,000. Record the journal entry to purchase the preferred shares.

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6. Regency Inc. had 900,000 common shares outstanding on January 1. On April 1, an additional 300,000 shares were issued, and on September 15, 150,000 more shares were issued. Assuming Regency’s net income for the year was $981,750, calculate earnings per share.
V. Exercises

1. Indicate the effect of each of the following transactions on Assets, Liabilities, Contributed Capital, and Retained Earnings. Use + for increase, - for decrease, and 0 for no effect.

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<td>C. Declaration of a stock dividend</td>
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<td>D. Issuance of a stock dividend</td>
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<td>E. A stock split</td>
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<td>F. Cash repurchase of Common shares</td>
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<td>G. Cash sale of common shares</td>
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2. Provincial Corporation had 600,000 shares totaling of $1,800,000 outstanding on May 1. Prepare journal entries for the following transactions:

May 15    Declared a 10% stock dividend. The market price was $10 per share.

July 30    Issued the stock dividend.

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3. Organics Inc. had 100,000 common shares with an average price of $50.00 per share outstanding on Feb. 1. Prepare journal entries for the following transactions:

Mar. 1    Declared a 20% stock dividend. The market price was $60 per share.

Apr. 30    Distributed the stock dividend.

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4. Prepare journal entries for the following transactions:

Mar. 10   Repurchased 800 common shares for $24 per share. The average issue price was $20.00 per share.
Aug. 1    Sold 500 common shares for $28 per share.
Nov. 12   Sold 300 common shares for $24 per share.

5. Use the following information to present the shareholders’ equity section in good form:

   Common shares, 4,000,000 shares authorized, 2,410,000 issued                      13,650,000
   Preferred shares, $1.00, 100,000 shares authorized, 50,000 issued                500,000
   Retained earnings                                                               10,418,000
   Contributed Surplus—Common Shares Repurchase                                   180,000
6. Using the information in Exercise #5 above, calculate book value assuming the preferred shares have a liquidation value of $14 a share.

VI. Beyond the Numbers

Review the facts in Exercise #3 with the following changes:

May 1 Declared a 2 for 1 stock split. The market price was $60 per share.
Aug. 30 Issued the shares.

Present the journal entries, if any, that are required for the above stock split.

______________________________________________________________________________
______________________________________________________________________________
______________________________________________________________________________
______________________________________________________________________________

VII. Demonstration Problems

Demonstration Problem #1

Cyber Systems, Inc. reported the following shareholders’ equity:

Shareholders’ equity:
  Preferred shares, $2.00
    Authorized - 1,000,000 shares
    Issued 150,000 shares $  3,750,000
  Common shares
    Authorized - 5,000,000 shares
    Issued - 800,000 shares 6,800,000
    Retained earnings 6,855,180
  Total shareholders’ equity $17,405,180

Required: (Work space to complete each of these questions is provided on the following pages.)

1. What was the average issue price per share of the common shares?
2. What was the average issue price per share of the preferred shares?
3. Assume that net income for the year was $825,000 and that issued shares of both common and preferred shares remained constant during the year. Journalize the entry to close net income to Retained Earnings. What was the amount of earnings per share?
4. Journalize the issuance of 10,000 additional common shares at $22.50 per share. Use the same account titles as shown in the problem.
5. How many common shares are outstanding after the 10,000 additional shares have been sold?
6. How many common shares would be outstanding after the corporation split its common shares 2 for 1? What is the new average issue price?
7. Journalize the declaration of a stock dividend when the market price of the common shares is $22.50 per share. Consider each of the following stock dividends independently:
   a. Cyber Systems, Inc., declares a 10% common stock dividend on shares outstanding after the 2-for-1 split.
   b. Determine the average issue price per common share.
8. Journalize the following common shares transactions in the order given:
   a. Cyber Systems, Inc., purchases 2,500 of its common shares at $25 per share.
   b. One month later, the corporation sells 1,000 of its common shares for $27 per share.
   c. An additional 1,000 of its common shares are sold for $22 per share.
9. The board of directors has voted to appropriate $800,000 of retained earnings for future expansion of foreign operations. Prepare the journal entry to record this event.
10. Set up the balances in the following T-accounts using the information provided in the Shareholders’ Equity section for Cyber Systems, Inc.
11. Post the journal entries from instructions 3, 4, 7a, 8a, 8b, 8c, and 9 to the T-accounts above.
12. Prepare a current Shareholders’ Equity section for Cyber Systems, Inc. The stock dividend in 7a. has not yet been distributed.
### Requirement 4

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### Requirement 5

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### Requirement 6

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### Requirement 7

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Requirement 8

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Requirements 10 and 11

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Requirement 12
Demonstration Problem #2

The following items, listed alphabetically, were taken from the records of Mastek Manufacturing Inc., for the year ended December 31, 2009.

- Administrative expenses: 370,000
- Cost of goods sold: 5,296,000
- Extraordinary loss, before tax: (592,000)
- Gain on sale of equipment: 96,000
- Gain on sale of discontinued operations, before tax: 274,800
- Operating loss - discontinued operations, before tax: (183,360)
- Sales (net): 10,028,400
- Selling expenses: 610,000

Mastek Manufacturing Inc. is subjected to a combined 45% tax rate.

Required

1. Present the income statement in good form for Mastek Manufacturing Inc.
2. Assume Mastek began the year with 225,000 common shares outstanding. On March 1, the corporation issued 75,000 additional common shares. On October 1, Mastek repurchased 50,000 shares. Present earnings per share information.

Requirement 1 (income statement)
Requirement 2 (earnings per share)

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SOLUTIONS

I. Matching

1. F
2. G
3. B
4. A
5. E
6. K
7. J
8. I
9. D
10. C
11. H
12. L
13. N
14. M

II. Multiple Choice

1. A The board of directors declares a dividend on the declaration date, to shareholders of record on the record date that is paid on the payment date.
2. A The Canada Business Corporations Act suggests market value is most appropriate
3. D If the market price for one share of pre-dividend shares is $60, then approximately the same market value will apply to the 1.5 shares of post-dividend shares since the shareholder’s percentage ownership in the corporation has not changed. $60 / 1.5 shares = $40 per share.
4. D Common Stock Dividend Distributable represents the new shares that will be issued as a result of the declaration of the stock dividend.
5. A Repurchased shares are acquired by purchasing them; cash is decreased and shareholders’ equity is decreased
6. B Repurchased shares have been and normally remain authorized, but they are no longer issued.
7. A The CICA Handbook outlines specific guidelines for the determination of a business segment. Generally speaking, the segment can be derived on a geographic or product lines basis.
8. C Appropriating retained earnings has no effect on total retained earnings. It merely indicates that some retained earnings are not available for dividends.
9. C To be treated as an extraordinary item on the income statement an event must be unusual, infrequent and not be determined by a management decision. In today’s business environment worker strikes would not qualify, whereas the other listed items can be considered both.
10 D By its definition, prior period adjustments are corrections to retained earnings for errors of an earlier period.

III. Completion

1. net income less preferred dividends; weighted average number of common shares outstanding
2. credited to Contributed Surplus—Shares Repurchase
3. unusual in nature; infrequent in occurrence. (Note that extraordinary items must be unusual and infrequent.)
4. avoid a takeover; support the market price of the shares; distribute to employees; buy low and sell high
5. retained earnings restrictions
4. Preferred Shares 1,600,000
   Cash 1,500,000
   Contributed Surplus—Shares Repurchase 100,000

5. Preferred Shares 1,600,000
   Retained Earnings 100,000
   Cash 1,700,000

6. 900,000 \times 3/12 = 225,000
   1,200,000 \times 5.5/12 = 550,000
   1,350,000 \times 3.5/12 = 393,750
   \text{Total} = 1,168,750

   \text{EPS} = \$981,750 \div 1,168,750 = \$0.84
V. Exercises

1. | A. Declaration of a cash dividend | Assets | Liabilities | Contributed Capital | Retained Earnings |
   |                                | 0     | +           | 0                | -               |
   | B. Payment of a cash dividend   | -     | -           | 0                | 0               |
   | C. Declaration of a stock dividend | 0     | 0           | +                | -               |
   | D. Issuance of a stock dividend | 0     | 0           | 0                | 0               |
   | E. A stock split               | 0     | 0           | 0                | 0               |
   | F. Cash repurchase of common shares | -     | 0           | -                | 0               |
   | G. Cash sale of common shares  | +     | 0           | +                | -               |

2. | Date     | Account and Explanation       | PR | Debit       | Credit       |
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<tr>
<td>May 15</td>
<td>Retained Earnings</td>
<td>1,200,000</td>
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<tr>
<td></td>
<td>(600,000 × 0.10 × $20)</td>
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<tr>
<td></td>
<td>Common Stock Dividend</td>
<td></td>
<td>1,200,000</td>
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<td>Distributable</td>
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<tr>
<td>Jul. 30</td>
<td>Common Stock Dividend</td>
<td></td>
<td></td>
<td>60,000</td>
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<td></td>
<td>Distributable</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Common Shares</td>
<td></td>
<td>60,000</td>
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3. | Date     | Account and Explanation       | PR | Debit       | Credit       |
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<td>Mar. 1</td>
<td>Retained Earnings</td>
<td>1,200,000</td>
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<tr>
<td></td>
<td>Common Stock Dividend</td>
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<td>1,200,000</td>
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<tr>
<td></td>
<td>Distributable</td>
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<tr>
<td></td>
<td>(100,000 × 20% × $60)</td>
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<tr>
<td>Apr. 30</td>
<td>Common Stock Dividend</td>
<td></td>
<td>100,000</td>
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<tr>
<td></td>
<td>Distributable</td>
<td></td>
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<tr>
<td></td>
<td>Common Shares</td>
<td></td>
<td>100,000</td>
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4. | Date     | Account and Explanation       | PR | Debit       | Credit       |
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<tbody>
<tr>
<td>Mar.10</td>
<td>Common Shares (800 × $20)</td>
<td>16,000</td>
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<tr>
<td></td>
<td>Retained Earnings</td>
<td>3,200</td>
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<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>19,200</td>
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</table>
Aug. 1 | Cash | 14,000
| Common Shares (500 × $28) | 14,000
Nov. 12 | Cash | 7,200
| Common Shares (300 × $24) | 7,200

5. Contributed Capital

Preferred Shares, $1.00 100,000 shares authorized, 50,000 issued $ 500,000
Common Shares, 4,000,000 shares authorized, 2,410,000 issued 13,650,000
Contributed Surplus—Shares Repurchase 180,000
Total Contributed Capital 14,330,000
Retained Earning 10,418,000
Total Shareholders’ Equity $24,748,000

6. Book Value = Total Shareholders’ Equity - Preferred Equity

\[
\text{Preferred Equity} = \text{# of shares outstanding} \times \text{Liquidation Value} \\
= 50,000 \times \$14/\text{share} = \$700,000
\]

\[
\text{Book Value} = (\$24,748,000 - \$700,000) \div 2,410,000 \\
= \$24,048,000 \div 2,410,000 = \$9.98 \text{ (rounded)}
\]

VI. Beyond the Numbers

No journal entries are required when a company declares a stock split. The outstanding shares are returned to the company and replaced with new shares. The total share capital remains unchanged. The market price will drop proportionately (to $30 per share).

Demonstration Problem #1 Solved and Explained

1. Average issue price of the common shares was $8.50 per share:

\[
\text{Common shares (}$1 \times 800,000 \text{ shares)$} \times \frac{\$6,800,000}{800,000} = \$8.50
\]

2. Average issue price of the preferred shares was $25 per share:

\[
\text{Preferred shares (}$25 \times 150,000 \text{ shares)$} \div 150,000 = \$25.00
\]

3. Income Summary 825,000
Retained Earnings 825,000

Earnings per share is $0.66:
Net income $825,000
Less: Preferred dividends (150,000 × $2) 300,000
Net income available to common shares $525,000
÷ average outstanding shares ÷800,000
Earnings per share (rounded) $0.66

4. Cash (10,000 shares × $22.50 selling price) 225,000
   Common Shares (10,000 × $1) 225,000
To issue common shares

5. Shares outstanding = 810,000

6. Shares outstanding after 2-for-1 split = 1,620,000:
   810,000 shares outstanding immediately before split × 2/1 = 1,620,000 shares outstanding
   The new average price is $4.34 (($6,800,000+$225,000)/1,620,000)

7. a. Retained Earnings (1,620,000 outstanding shares × 10% × $22.50) 3,645,000
    Common Stock Dividend Distributable 3,645,000
To declare a 10% stock dividend.

    b. Total common shares $10,670,000
       ÷# of Common Shares Outstanding 1,782,000
       Average Issue Price $ 5.99

8. a. Common Shares (2,500 × $5.99) 14,975
    Retained Earnings 47,525
    Cash 62,500
To purchase 2,500 common shares at $25 per share.

    b. Cash (1,000 × $27) 27,000
    Common Shares 27,000
To sell 1,000 common shares at $27 per share.

    c. Cash (1,000 × $22) 22,000
    Common Shares (1,000 × $22) 22,000
To sell 1,000 common shares at $22 per share.

9. Retained Earnings 800,000
Retained Earnings Appropriated
for Future Expansion
800,000

To appropriate retained earnings for future expansion of foreign operations.

10 & 11.

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<thead>
<tr>
<th>Preferred Shares</th>
<th>Common Shares</th>
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<tr>
<td></td>
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<tr>
<td>Bal. 3,750,000</td>
<td>Bal. 6,800,000</td>
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<td></td>
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<tr>
<td>(8a) 14,975</td>
<td>(4) 225,000</td>
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<tr>
<td>(8b) 27,000</td>
<td>(8c) 22,000</td>
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<td>Bal. 7,059,025</td>
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<thead>
<tr>
<th>Retained Earnings</th>
<th>Retained Earnings Appropriated</th>
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<tbody>
<tr>
<td>(7a) 3,645,000</td>
<td>(9) 800,000</td>
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<tr>
<td>(8a) 47,525</td>
<td></td>
</tr>
<tr>
<td>(9) 800,000</td>
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<td>Bal. 3,187,655</td>
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<tr>
<th>Common Stock Dividend Distrib.</th>
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<tr>
<td>(7a) 3,645,000</td>
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12.

Shareholders’ Equity:
Preferred shares, $2.00

- Authorized - 1,000,000 shares
  - Issued 150,000 shares
  - Total contributed capital $3,750,000

Common shares

- Authorized - 5,000,000 shares
- Issued - 1,620,000 shares
- Total contributed capital $7,059,025

Common stock dividend distributable $3,645,000

Retained earnings

- Appropriated $800,000
- Unappropriated 3,187,655
- Total retained earnings 4,987,655

Total shareholders’ equity $14,691,680
Explanation:

All the amounts were taken directly from the ending T-account balances. These ending balances are the result of requirements a and b. Remember, the common shares split 2 for 1. When the common stock dividend of 162,000 shares is distributed, the total number of issued shares will increase to 1,782,000 (1,620,000 + 162,000).

Demonstration Problem #2 Solved and Explained

Requirement 1 (income statement)

Mastek Inc.
Income Statement
December 31, 2009

Sales $10,028,400
Cost of goods sold 5,296,000
Gross margin $ 4,732,400
Less: Operating expenses
  Selling $610,000
  Administrative 370,000 980,000
Operating income $ 3,752,400
Other gains (losses)
  Gain on sales of equipment 96,000
Income from continuing operations before income tax $ 3,848,400
Income tax expense 1,731,780
Income from continuing operations $2,116,620

Discontinued Operations:
  Operating Loss $183,360, less income tax savings of $82,512 $(100,848)
  Gain on Sale, $274,800, less income tax of $123,660 151,140
Income before extraordinary items 2,166,912
Extraordinary loss, $592,000, less income tax saving of $266,400 (325,600)

Net income $1,841,312

Requirement 2 (earning per share)

Weighted average # of shares outstanding =
  225,000 × 2/12 = 37,500
  300,000 × 7/12 = 175,000
  250,000 × 3/12 = 62,500
  275,000
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<th>Description</th>
<th>Amount</th>
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<tr>
<td>Income from continuing operations</td>
<td>$7.70</td>
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<tr>
<td>Income from discontinued operations</td>
<td>0.18</td>
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<tr>
<td>Income before extraordinary loss</td>
<td>$7.88</td>
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<tr>
<td>Extraordinary loss</td>
<td>(1.18)</td>
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<tr>
<td>Net income</td>
<td>$6.70 (rounded)</td>
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**Study Tip:** Proof = $1,841,312 ÷ 275,000 = $6.70