ANSWERS TO QUESTIONS FOR GROUP LEARNING

Q12-1 Retained earnings are not assets. They represent sources of assets from the earnings process: they are undistributed earnings from regular operations and gains.

Q12-2 (a) Retained earnings: cumulative net income minus net losses and dividends declared. (b) Restricted retained earnings: retained earnings earmarked to show that they are not available for dividends. (c) Deficit: an excess of past dividends and losses over past net income. A deficit is represented by a debit balance in the Retained Earnings account.

Q12-3 (a) A cash dividend is the distribution of the earnings of the corporation to its stockholders in the form of a cash payment. A stock dividend is the issuance by a corporation of additional shares of its stock without additional investment by the stockholders. (b) Book value per share is the amount that a stockholder would receive on a per share basis in the theoretical event that all assets were sold at no gain or loss. Market value per share is the current selling price of the share of capital stock. (c) Cumulative stock is a type of preferred stock on which undeclared dividends are accumulated and must be paid together with the current dividends before any dividend payment can be made on common stock. Noncumulative stock is a type of preferred stock on which a dividend is not declared (passed) in any one year is lost. (d) Restricted retained earnings is the portion of retained earnings not available for dividends. Unrestricted retained earnings are undistributed earnings less any losses or dividends since the company began operations. (e) Stock dividend is the issuance by a corporation of additional shares of its authorized stock without additional investment by the stockholders. Stock split is an increase in the number of shares of stock outstanding without a change in the total par or total stated value of the outstanding shares.

Q12-4 The use of this note informs readers of the intent to restrict retained earnings from payment as dividends. The footnote is significant to long-term creditors who wish to see funds conserved for the payment of long-term debts when they mature rather than being paid out in the form of dividends.
Q12-5 a. The term stock dividend refers to the issuance by a corporation of additional shares of its authorized stock without payment by the stockholders. A stock dividend requires the capitalization of retained earnings.
b. A stock dividend is prompted by a variety of company goals including a need to conserve available cash, a desire to reduce the market price of the stock, and a desire to increase the paid-in capital of the company.

Q12-6 A stock dividend: (a) does not change the total stockholders equity; (b) has no effect on total assets; (c) reduces the book value per share; and (d) generally reduces proportionately the market price per share.

Q12-7 a. Treasury stock is a company’s own stock that it has reacquired by purchase, gift, or in settlement of a debt and is holding for resale or cancellation.
b. A corporation may purchase its own stock to bolster a sagging market, to acquire shares at a favorable price, or to meet the needs of a stock option plan.
c. Acquisition of treasury stock reduces assets and stockholders’ equity.

Q12-8 a. The acquisition of treasury stock reduces assets and stockholders equity. The restriction is to prevent reacquisition of shares by a corporation in financial difficulty, thereby reducing assets and stockholders’ equity, and the amount of assets available for creditors.
b. We record the purchase of treasury stock by a debit to Treasury Stock for the cost of the shares acquired.
c. We record the sale of treasury stock by a credit to Treasury Stock for the cost of the shares. We credit the difference between the cost and sale price, if sold above cost, to Paid-in Capital from Treasury Stock Transactions. If we sell it below cost, we debit the “loss” to Paid-in Capital from Treasury Stock Transactions if available, or any other paid-in capital account arising from the same class of stock. In the absence of such accounts, we debit the difference to Retained Earnings.
d. The sale of treasury stock increases assets and stockholders’ equity. The sale does not affect the income statement.

Q12-9 The market value and book value are not usually equal. Book value is based on the historical value of items in the balance sheet. Therefore, book value does not equal the current market value of the assets and liabilities on the balance sheet. The market value of a firm’s stock is affected by many factors. One of the key factors is investors’ expectations about the future earnings potential of the company. Book value does not show this.

Q12-10 The purpose of intraperiod tax allocation is to present a more meaningful income statement. We do this by showing the income taxes related to normal and nonrecurring items with those items on the income statement. By showing the separate components of income net of taxes, users of financial statements can better see the after-tax impact of normal and nonrecurring revenues and losses. For example, income tax expense is the tax expense on income from continuing operations. Discontinued operations, extraordinary items, and cumulative effects of a change in accounting principle are shown net of related income taxes.
Q12-11 Extraordinary items are gains and losses that are both unusual and infrequent taking into account the environment in which the firm operates. Extraordinary items are shown between discontinued operations and cumulative effect of a change in accounting principle on the income statement. They are nonrecurring items on the income statement and are not included as part of income from continuing operations.

Q12-12 To compute basic earnings per share for a simple capital structure, we divide net income less dividends on preferred stock by the weighted average number of common shares outstanding during the period. A complex capital structure requires the presentation of two figures: basic earnings per share and diluted earnings per share. To compute basic earnings per share, we divide net income less dividends on preferred stock by the weighted average number of common shares outstanding during the period. To compute diluted earnings per share, we must assume that any convertible securities not previously converted are now converted into shares of common stock.

Q12-13 For preferred stocks that are not convertible into shares of common stock, we deduct the dividend requirements on the preferred stocks from net income in computing both basic and diluted earnings per share.

Q12-14 For preferred stocks that are convertible into shares of common stock, we deduct the dividend requirements on the preferred stocks from the net income in computing basic earnings per share. For diluted earnings per share, we do not deduct the dividends on the preferred. We increase the number of common shares by the assumed conversion of the preferred for the calculation of diluted earnings per share.

**SOLUTIONS TO EXERCISES**

**E12-15 Determining the Effect of Transactions on Retained Earnings**

LG 1

a. Decrease  
b. No effect  
c. No effect  
d. No effect  
e. No effect  
f. No effect  
g. No effect  
h. No effect  
i. No effect  
j. No effect
E12-16  Recording Cash Dividends
LG 2

GENERAL JOURNAL

2011
Jun. 5  Dividends—Common  20,000
         Dividends Payable—Common  20,000
To record the declaration of a $0.20 cash
dividend payable on July 10, 2011 to
stockholders of record on June 24, 2011.

24  No entry.

Jul. 10 Dividends Payable—Common  20,000
        Cash  20,000
To record payment on dividends declared
on June 5, 2011.

E12-17  Calculating Dividends
LG 2

Amount available for dividends  $ 120,000
Dividend to preferred shareholders:
   In arrears (14% x $200,000)  $ 28,000
   Current year’s dividend (14% x $200,000)  28,000
   Total to preferred stockholders  $ 56,000
Dividend to common stockholders—the remainder  $ 64,000

E12-18  Recording a Small Stock Dividend
LG 3

1.

GENERAL JOURNAL

2011
Aug. 2  Stock Dividends—Common  570,000
  Stock Dividends to Be Issued—
  Common  150,000
  Paid-in Capital—Excess over Par
  Value on Stock Dividends  420,000
To record the declaration of a 10% stock dividend to be issued on
September 5, 2011 to stockholders of record on August 21, 2011
[(300,000 shares x 0.10) x $19 = $570,000].

21  No entry.
E12-18  (continued)

Sep. 5  Stock Dividends to Be Issued—Common
       Common Stock
       To record issuance of common stock dividend.

150,000
150,000

2.

Assuming no net income or net loss is reflected, the total stockholders’ equity would remain the same as it was, $3,500,000.

E12-19  Effects of Stock Dividends and Stock Splits

LG 3

1. a. Stock dividend:

   Stock Dividends—Common
   Common Stock
   To record declaration and issuance of 100% stock dividend.

   200,000
   200,000

b. Stock split:

   Common Stock ($1 par value)
   Common Stock ($0.50 par value)
   To record 2-for-1 split, increasing the number of outstanding shares from 200,000 to 400,000 and reducing par value from $1 to $0.50 per share.

   200,000
   200,000

2.

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<td>Total stockholders’ equity</td>
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<td>e. $30 per share.</td>
<td>$30 per share.</td>
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</table>
E12-20  Recording Treasury Stock Transactions
LG 4

GENERAL JOURNAL

a.  Cash  160,000
    Common Stock  40,000
    Paid-in Capital—Excess over Par Value, Common  120,000
    To record the issuance of 20,000 shares of $2 par value common at $8 per share.

b.  Treasury Stock—Common  3,600
    Cash  3,600
    To record the reacquisition of 400 common shares to be held in the treasury.

c.  Cash  4,000
    Treasury Stock—Common  3,600
    Paid-in Capital from Treasury Stock Transactions, Common  400
    To record the reissuance of 400 treasury common shares at $10 per share.
2011
Jul.  7  Treasury Stock—Common
       Cash
       To record the reacquisition of 1,000 common shares as treasury stock.

Aug. 12  Cash
       Treasury Stock—Common
       Paid-in Capital from Treasury Stock Transactions, Common
       To record the reissuance of 200 treasury common shares at $26 per share.

Aug. 23  Cash
       Paid-in Capital from Treasury Stock Transactions, Common
       Treasury Stock—Common
       To record the reissue of 200 treasury common stock at $20 per share.

30  Cash
    Paid-in Capital from Treasury Stock Transactions, Common
    Treasury Stock—Common
    To record the reissue of 600 treasury shares to employees at $22 per share.
E12-22  Recording Stock and Cash Dividends with Treasury Stock
LG 2, 3

GENERAL JOURNAL

a.  Stock Dividends—Common 120,000
    Stock Dividends to Be Issued—Common 15,000
    Paid-in Capital—Excess over Par Value, Common 105,000
    To record the declaration of a 15% stock dividend.
    (100,000 shares x 0.15 = 15,000 shares
    x $8 = $120,000)

b.  Stock Dividends to Be Issued—Common Stock 15,000
    Common Stock 15,000
    To record the issuance of 15,000 shares
    for the 15 percent stock dividend declared
    previously.

c.  Treasury Stock—Common 2,000
    Cash 2,000
    To record the purchase of 200 shares of
    treasury common stock.

d.  Cash 1,200
    Treasury Stock—Common 1,000
    Paid-in Capital from Treasury Stock Transactions, Common 200
    To record the reissuance of the 100
    treasury shares at $12 per share.

e.  Dividends—Common 22,980
    Dividends Payable—Common 22,980
    To record the declaration of a $0.20 per
    share dividend on common stock.
    (100,000 shares + 15,000 shares
    - 200 shares + 100 shares
    = 114,900 shares)

f.  Dividends Payable—Common 22,980
    Cash 22,980
    To record the payment of the $0.20 per
    share cash dividend.
Calculating Book Value per Share

1.

Total stockholders’ equity $520,000
Deduct: Liquidating value of preferred $100,000
Stockholders’ equity applicable to common stock $420,000

Book value per common share: $420,000 ÷ 300,000 shares = $1.40

2.

Total stockholders’ equity $520,000
Deduct: Liquidating value of preferred + dividends $124,000
Stockholders’ equity applicable to common stock $396,000

Book value per common share: $396,000 ÷ 300,000 shares = $1.32

Preparing a Stockholders’ Equity Section

JAMES COMPANY
Partial Balance Sheet
December 31, 2011

Stockholders’ Equity

Paid-in capital

Stock:
Preferred stock, $100 par value, 12%
cumulative, 50,000 authorized shares,
9,600 shares issued $960,000
Common stock, no par value, $5 stated value,
300,000 shares authorized, 48,000 shares
issued (600 shares held in treasury) $240,000
Total stock $1,200,000

Additional paid-in capital:
Paid-in capital—excess over stated value, common $96,000
Paid-in capital from treasury stock transactions, common $22,000
Total additional paid-in capital $118,000
Total paid-in capital $1,318,000

Retained earnings
Total paid-in capital and retained earnings $1,798,000
Deduct: Cost of treasury stock—common $28,000
Total stockholders’ equity $1,770,000
FELIX COMPANY
income Statement
For the Year Ended December 31, 2011

Net sales $1,700,000
Costs and expenses 1,400,000
Income from continuing operations before income taxes $ 300,000
Income tax expense 90,000
Income from continuing operations $ 210,000
Discontinued operations:
   Income from operations of discontinued segment $ 63,000
   (net of $27,000 income taxes)
   Loss on disposal of discontinued operations (14,000) 49,000
   Income before extraordinary items $ 259,000
Extraordinary item:
   Gain on lawsuit (net of $30,000 income taxes) 70,000
Net income $ 329,000

E12-26  Calculating Earnings per Share for a Simple Capital Structure
LG 7

Net income $ 86,000
Deduct: Dividends on nonconvertible preferred stock
   (0.05 x $100 x 4,000 shares) 20,000
Net income less preferred dividends $ 66,000

Weighted average common shares outstanding:

January 1, 2011, through June 30, 2011,
   (20,000 shares x ½ year) 10,000
July 1, 2011, through December 31, 2011
   (28,000 shares x ½ year) 14,000
Weighted average common shares outstanding during 2011 24,000

Earnings per share = $66,000 ÷ 24,000 shares = $2.75 per share.
Basic Earnings per Share:
Net income $247,800
Deduct: Dividends on nonconvertible preferred stock
(0.12 x $100 x 2,000 shares) 24,000
Dividends on convertible preferred stock
(0.11 x $100 x 1,000 shares) 11,000
Net income less preferred dividends $212,800

Weighted average common shares outstanding:
January 1, 2011 through September 30, 2011,
(30,000 shares x 3/4 year) 22,500
October 1, 2011, through December 31, 2011,
(38,000 shares x 1/4 year) 9,500
Weighted average common shares outstanding during 2011 32,000

Basic earnings per share = $212,800 ÷ 32,000 shares = $6.65 per share.

Diluted Earnings per Share:
Net income $247,800
Deduct: Dividends on nonconvertible preferred stock
(0.12 x $100 x 2,000 shares) 24,000
Net income less preferred dividends $223,800

Weighted average common shares outstanding during 2011 32,000
Add: Common shares for preferred shares assumed converted
(1,000 shares x 8) 8,000
Total shares 40,000

Diluted earnings per share = $223,800 ÷ 40,000 shares = $5.595 per share.
P12-28  Journalizing Various Stockholders' Equity Transactions
LG 1-4

GENERAL JOURNAL

2011
Jan.  1 Memorandum entry: Fred Company received its charter today authorizing the issuance of 50,000 shares of no-par common stock and 12,000 shares of 12 percent cumulative preferred, $50 par value.

a.  
Cash  
   Common Stock  104,000  80,000
   Paid-in Capital—Excess over Stated Value, Common  24,000
   To record the issuance of 8,000 shares of common stock at $13 per share.

b.  
Cash  60,000  50,000
   Preferred Stock  
   Paid-in Capital—Excess over Par Value, Preferred  10,000
   To record the issuance of 1,000 shares of preferred stock at $60 per share.

c.  
Treasury Stock—Common  4,000  4,000
   Cash  
   To record the purchase of 400 shares of common stock from estate of deceased stockholder.

d.  
Cash  5,600  4,000
   Treasury Stock—Common  
   Paid-in Capital from Treasury Stock Transactions, Common  1,600
   To record the reissue of 400 treasury common shares.

e.  
Dividends—Preferred  6,000  6,000
   Dividends Payable—Preferred  
   To record declaration of annual preferred dividend.

f.  
Dividends Payable—Preferred  6,000  6,000
   Cash  
   To record payment of preferred dividends.
P12-28 (continued)

g. Stock Dividends—Common 12,000
   Stock Dividends to Be Issued—Common 8,000
   Paid-in Capital—Excess over Stated Value, Common 4,000
   To record declaration of 800-share common stock dividend.

h. Stock Dividends to Be Issued—Common 8,000
   Common Stock 8,000
   To record issuance of common stock dividends.

i. Income Summary 150,000
   Retained Earnings 150,000
   To close net income to Retained Earnings.

P12-29 Journalizing Various Stockholders’ Equity Transactions and Preparing a Stockholders’ Equity Section

LG 1, 2, 4

Requirement 1.

GENERAL JOURNAL Page 162

2011

a. Dividends—Preferred 371 45,000
   Dividends—Common 372 55,000
   Dividends Payable—Preferred 45,000
   Dividends Payable—Common 55,000
   To record the declaration of an annual dividend on preferred and common stock.

b. Dividends Payable—Preferred 45,000
   Dividends Payable—Common 55,000
   Cash 100,000
   To record payment of dividends previously declared.

c. Treasury Stock—Common 367 14,000
   Cash 14,000
   To record purchase of 2,000 common shares for the treasury at $7 per share.
P12-29  (continued)

d. Cash
   Treasury Stock—Common 367 5,000 3,500
   Paid-in Capital from Treasury
   Stock Transactions, Common 345 1,500
   To record the reissue of 500 treasury
   shares at $10 per share.

e. Cash
   Treasury Stock—Common 367 3,200 2,800
   Paid-in Capital from Treasury Stock
   Transactions, Common 345 400
   To record the reissue of 400 treasury
   shares at $8 per share.

f. Income Summary
   Retained Earnings 360 200,000 200,000
   To close net income to Retained
   Earnings.

   Retained Earnings 360 100,000
   Dividends—Preferred 371 45,000
   Dividends—Common 372 55,000
   To close the dividends accounts.

Requirement 2.

GENERAL LEDGER

Preferred Stock  Acct. No. 321

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Common Stock  Acct. No. 331

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Paid-in Capital—Excess over Par Value, Common  
Acct. No. 341

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Paid-in Capital from Treasury Stock Transactions, Common  
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Retained Earnings  
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### Dividends—Preferred

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### Dividends—Common

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<td>2011 Dec.</td>
<td>a</td>
<td>J162</td>
<td>55,000</td>
<td>55,000</td>
<td>55,000</td>
</tr>
<tr>
<td></td>
<td>f</td>
<td>J162</td>
<td>55,000</td>
<td>0</td>
<td>55,000</td>
</tr>
</tbody>
</table>

### Requirement 3.

**GEORGE CORPORATION**

**Partial Balance Sheet**

**December 31, 2011**

**Stockholders’ Equity**

**Paid-in capital**

Stock:
- Preferred stock, 15%, $50 par value, 6,000 shares authorized and issued $300,000
- Common stock, $4 par value, 150,000 shares authorized and issued (1,100 shares held in treasury) 600,000
- Total stock $900,000

Additional paid-in capital:
- Paid-in capital—excess over par value, common $85,000
- Paid-in capital from treasury stock transactions, common 1,900
- Total additional paid-in capital 86,900
- Total paid-in capital $986,900

**Retained earnings**

- Total paid-in capital and retained earnings 900,000
- Deduct: Cost of treasury stock, common, 1,100 shares 7,700
- Total stockholders' equity $1,879,200
Requirement 1.

Total stockholders’ equity $550,000
Deduct: Liquidation value of preferred stock 100,000
   Stockholders’ equity applicable to common stock $450,000

Book value per share of common stock:
$450,000 ÷ 25,000 shares = $18.00 per share.

Requirement 2.

Total stockholders’ equity $550,000
Deduct: Liquidation value of preferred stock + dividends 130,000
   Stockholders’ equity applicable to common stock $420,000

Book value per share of common stock:
$420,000 ÷ 25,000 shares = $16.80 per share.

Requirement 3.

Book value per share is of limited significance. It represents the amount of cash a stockholder would receive if the corporation were liquidated at net proceeds equal to book value. This is an unlikely event. Investors, however, still calculate book value and compare it with the estimated market value of the specific assets held by the corporation. They use this figure and other related data in determining limits to a possible price per share that they may be willing to offer for the stock.

Requirement 4.

There is little relationship between book value per share and market value per share. If the book value approximates the market value of the net assets, then the book value per share might establish a bedrock minimum market price per share. Current and expected profitability influence the market price per share more than does book value.
**BUKA COMPANY**  
*Income Statement*  
*For the Year Ended December 31, 2011*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Costs and expenses</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>60,000</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$ 140,000</td>
</tr>
<tr>
<td>Discontinued operations:</td>
<td></td>
</tr>
<tr>
<td>Income from operations of discontinued segment (net of $180,000 income taxes)</td>
<td>$ 420,000</td>
</tr>
<tr>
<td>Gain on disposal of discontinued operations (net of $90,000 income taxes)</td>
<td>210,000</td>
</tr>
<tr>
<td>Income before extraordinary items</td>
<td>630,000</td>
</tr>
<tr>
<td>Extraordinary item:</td>
<td></td>
</tr>
<tr>
<td>Loss on lawsuit (net of $60,000 income taxes)</td>
<td>(140,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 630,000</td>
</tr>
</tbody>
</table>

**Earnings per common share (100,000 shares outstanding)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$ 1.40</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>6.30</td>
</tr>
<tr>
<td>Extraordinary gain</td>
<td>(1.40)</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 6.30</td>
</tr>
</tbody>
</table>

**Requirement 2.**

Overall, the results for 2011 look impressive if the focus is on the final net income. Net income of $630,000 represents 35.0% of sales revenue for the year. However, a look at the breakdown of the net income figure shows that income from continuing operations of $140,000 is only 7.8% of sales revenue for the year. For 2011, Buka Company's net income is affected by nonrecurring items. As a result, the operating results for 2011 are not as impressive when we eliminate nonrecurring items.
P12-32 Calculating Earnings per Share for a Simple Capital Structure
LG 7

Income before extraordinary items $180,000
Deduct: Dividends on nonconvertible preferred stock
(0.12 x $100 x 5,000 shares) 60,000
Income less preferred dividends $120,000

Weighted Average Common Shares Outstanding:
January 1, 2011, through June 30, 2011
(40,000 shares x ½ year) 20,000
July 1, 2011, through September 30, 2011
(52,000 shares x ¼ year) 13,000
October 1, 2011, through December 31, 2011
(48,000 shares x ¼ year) 12,000
Weighted average common shares outstanding during 2011 45,000

Earnings per share:
Income before extraordinary items
($180,000 ÷ 45,000 shares) $4.00 per share
Extraordinary gain ($18,900 ÷ 45,000 shares) 0.42 per share
Net income ($198,900 ÷ 45,000 shares) $4.42 per share

P12-33 Calculating Earnings per Share for a Complex Capital Structure
LG 7

Requirement 1.

Basic Earnings per Share:
Net income $174,000
Deduct: Dividends on nonconvertible preferred stock
(0.12 x $50 x 4,000 shares) 24,000
Dividends on convertible preferred stock
(0.10 x $100 x 1,000 shares) 10,000
Net income less preferred dividends $140,000

Weighted average common shares outstanding:
January 1, 2011, through June 30, 2011
(60,000 shares x ½ year) 30,000
July 1, 2011, through December 31, 2011
(80,000 shares x ½ year) 40,000
Weighted average common shares outstanding during 2011 70,000

Basic earnings per share = $140,000 ÷ 70,000 shares = $2.00 per share.
P12-33  (continued)

Requirement 2.

Diluted Earnings per Share:
Net income $174,000
Deduct: Dividends on nonconvertible preferred stock (0.12 x $50 x 4,000 shares) $24,000
Net income less preferred dividends $150,000

Weighted average common shares outstanding:
January 1, 2011, through June 30, 2011 (60,000 shares x ½ year) 30,000
July 1, 2011, through December 31, 2011 (80,000 shares x ½ year) 40,000
Weighted average common shares outstanding during 2011 70,000
Add: Common shares for preferred shares assumed converted (1,000 shares x 17) 17,000
Total shares 87,000

Diluted earnings per share = $150,000 ÷ 87,000 shares = $1.72 per share.

SOLUTION TO PRACTICE CASE

LG 1-5  Corporations: Retained Earnings, Dividends, Treasury Stock, and Book Value

Requirement 1.

GENERAL JOURNAL

2011
Feb. 7  Stock Dividends—Common 94,500
    Stock Dividends to Be Issued—Common 13,500
    Paid-In Capital—Excess over Par Value, Common 81,000
    To record declaration of stock dividend [(90,000 shares x 0.15) x $7 = $94,500].

Mar. 14  Stock Dividends to Be Issued—Common 13,500
    Common Stock 13,500
    To record issuance of stock dividend.

Apr. 19  Treasury Stock—Common 72,000
    Cash 72,000
    Purchased 12,000 shares of own common stock at $6 per share.
As of December 31, 2011, the total balance in retained earnings is $367,050. Of this amount, $54,000 is restricted due to purchases of treasury stock in this amount and is not available for distribution as dividends. Unrestricted retained earnings is $313,050.

**SOLUTION TO BUSINESS DECISION AND COMMUNICATION PROBLEM**

LG 8  Comprehensive Comparison of Target Corp. and Wal-Mart Stores

*Following is a typical student response to this communications problem; actual responses may vary in content and style but should contain as much of this basic information as possible.*

TO:  Pat Burns
FROM:  Student
SUBJECT:  Comparison of Target and Wal-Mart

I have reviewed the information you provided. Overall, I believe that both companies are attractive. My conclusion is that Wal-Mart might be a better investment at this point. In this memo, I will provide support for this assessment.

1. **Performance Measurements**
   a. Book value per common share
      (total stockholders’ equity ÷ outstanding shares)
      \[ \text{TARGET} \quad \text{WAL-MART} \]
      \[ 18.22 \quad 16.63 \]
   b. Dividend yield percent
      (dividend per share ÷ market price per share)
      \[ 2.1\% \quad 2.2\% \]
   c. Profit margin % (net income ÷ net sales)
      \[ 3.5\% \quad 3.3\% \]
   d. Return on assets (ROA)
      (net income ÷ average total assets)
      \[ 5.0\% \quad 8.2\% \]
   e. Price earnings (P/E) ratio
      (market price per share ÷ earnings per share)
      \[ \text{times} \quad \text{times} \]

2. **Differences Between Target and Wal-Mart**
   a. **Overall Observations**: Both companies have relatively low par values per share. Target’s book value per share is slightly higher than Wal-Mart’s. The common stocks of both companies are selling for more than book value. Both companies currently are paying a dividend of about 2%.
   b. **Performance Evaluation**: Target has a profit margin percent of 3.5% (versus 3.3% for Wal-Mart) and a return on assets of 5.0% (versus 8.2% for Wal-Mart). In terms of total sales, Wal-Mart is much larger than Target. Currently, the price earnings (P/E) ratio of Target is 10.9 times earnings versus 13.9 times earnings for Wal-Mart. Investors are currently willing to pay a higher P/E for Wal-Mart. Wal-Mart’s size, higher return on assets, and higher investor expectations are reasons for my choice.
3. Impact of Future Treasury Stock Purchase
   The impact of purchasing treasury stock on the items you listed are:
   a. Total stockholders' equity: Decrease as a result of cost treasury shares now
deducted from total stockholders' equity.
   b. Number of common shares issued: No change since treasury shares do not
change the number of shares issued.
   c. Number of common shares outstanding: Decrease since treasury shares are
deducted from issued shares to compute outstanding shares.
   d. Total Retained Earnings: No change since treasury shares do not change the
amount of retained earnings.

SOLUTION TO ETHICAL DILEMMA

Proposed Change in Accounting Methods to Increase Net Income

Individual responses to ethical dilemmas will vary. The technical and ethical issues
raised in the following response are central to this dilemma; look for them in students’
answers and be prepared to discuss them with students in class.

Recurring and nonrecurring items are reported separately on the income statement.
Therefore, financial statement users can easily see the sources of net income for the year
and the reasons for the change from the previous year. Thus changing accounting methods
would not itself be misleading to users.

Accounting methods should not be changed unless management can show that the change
makes the presentation of results and information more correct. Increasing reported net
income is not an adequate reason to change accounting methods. The president should
decide to sell the segment in light of the overall goals of the company. If the segment
represents an area the company wants to expand in the future, selling the segment to
achieve a current-period gain may not be a good business decision. For this reason,
changing accounting methods simply to increase short-term income could undermine
investor confidence in the business, and perhaps in the industry itself.
Income Statement Responses:
1. Total revenues in 2008 ($48,296,000,000) are lower than the total for 2006 ($48,371,000,000).

2. The percent decrease in total revenues from 2006 to 2008 is:
   \[
   (0.2)\% = 100 \times \frac{$(75,000,000)^*}{$48,371,000,000} 
   \]
   \[
   \times $48,296,000,000 - $48,371,000,000
   \]
   Total revenues decreased (0.2)\% from 2006 to 2008.

3. The cost of goods sold percent increased from 15.8\% in 2006 to 16.8\% in 2008. The gross margin percent decreased from 84.2\% in 2006 to 83.2\% in 2008. This is an **unfavorable** trend.

4. The percentage of total operating expenses to total revenues decreased from 59.1\% in 2006 to 58.9\% in 2008. This is **favorable**. The operating income percent decreased from 25.1\% in 2006 to 24.3\% in 2008. This is an **unfavorable** trend.

5. The percent of net income to total revenues decreased from 40.0\% in 2006 to 16.8\% in 2008. This is an **unfavorable** trend.

Balance Sheet Responses:
6. Total assets at December 31, 2008 ($111,148,000,000) are lower than the total at December 31, 2006 ($114,837,000,000).

7. The percent decrease to total assets from December 31, 2006 to December 31, 2008 is:
   \[
   (3.2)\% = 100 \times \frac{$(3,689,000,000)^*}{$114,837,000,000} 
   \]
   \[
   \times $111,148,000,000 - $114,837,000,000
   \]
   As with total revenues, total assets have decreased over the three-year period.

8. The largest asset investment for the company is intangibles and goodwill. These items makes up 35.3\% of the company's assets at the end of the most recent year.

9. The percent decrease in intangibles and goodwill between 2006 and 2008 is:
   \[
   (13.4)\% = 100 \times \frac{$(6,041,000,000)^*}{$45,226,000,000} 
   \]
   \[
   \times $39,185,000,000 - $45,226,000,000
   \]
   Intangibles and goodwill decreased by (13.4)\% compared to a decrease in total revenues of (0.2)\%. This is **favorable**. Intangibles and goodwill are decreasing at a higher rate than total revenues.
Solution to Comprehensive Analysis Case (continued)

10. On the balance sheet, refer to the common-size percent for total liabilities each year. The percent of liabilities has increased from 37.9% of total assets in 2006 to 48.2% in 2008. This is unfavorable.

Integrative Income Statement and Balance Sheet:

11. This company is operating more efficiently in 2008 than in 2007. We conclude this by comparing the total asset turnover for the two years that were 0.42 times in 2007 and 0.43 times in 2008. Each dollar of investment in assets generated more revenue in 2008 than in 2007. This is favorable.

Ratio Analysis Responses:

12. The current ratio is lower in 2008 than in 2006.


14. For the year ended December 31, 2008, the accounts receivable turnover ratio 1 is worse this year compared to the previous year. In 2008, the accounts receivable turnover ratio 1 is 4.05 times. This is a decrease from 5.03 times in 2007. This is unfavorable.

15. For the year ended December 31, 2008, the accounts receivable turnover ratio 2 (based on year-end receivables) is worse at 3.45 times compared to the 2008 accounts receivable turnover ratio 1 (based on average receivables) at 4.05 times.

16. For the year ended December 31, 2008, the inventory turnover ratio 1 is worse this year compared to the previous year. In 2008, the inventory turnover ratio 1 is 1.63 times. This is a decrease from 3.83 times in 2003. This is unfavorable.

17. For the year ended December 31, 2008, the inventory turnover ratio 2 (based on year-end inventory) is better at 1.79 compared to the 2008 inventory turnover ratio 1 (based on average inventory) at 1.63 times.

18. The return on total assets (ROA) ratio is better in 2008 than in 2007. In 2008, the ROA is 7.16%. This is an increase from 7.08% in 2007. This is favorable.

Stockholders' Equity Responses:

19. If Pfizer acquires 100,000 shares of its own common stock (treasury stock) on January 1, 2009, it would increase the total debt ratio. Acquiring treasury stock would decrease total assets, the denominator, with no change in total debt.

20. If Pfizer acquires 100,000 shares of its own common stock (treasury stock) on January 1, 2009, it would not effect on retained earnings. The acquisition of treasury stock would decrease assets and increase the owner's equity contra account, treasury stock. This increase to the contra account decreases owner's equity.
Solution to Comprehensive Analysis Case (continued)

21. If Pfizer acquires 100,000 shares of its own common stock (treasury stock) on January 1, 2009, it would decrease total stockholders' equity. The acquisition of treasury stock would increase the contra-equity account, thus decreasing total stockholder's equity.

22. If Pfizer acquires 100,000 shares of its own common stock (treasury stock) on January 1, 2009, it would decrease total assets. The acquisition of treasury stock would decrease assets and decrease stockholder's equity.