Blue Diamond

John Smith is completing an internship at Blue Diamond, a high-end retailer of fine jewelry. John has been working directly with the company's controller to help prepare financial statements. John, in particular, has been focused on the company's equity accounts and providing advice and input on how different equity transactions would affect Blue Diamond's financial statements. The controller has been very impressed by John's knowledge of how equity accounts work and the potential impact of various equity transactions the company is evaluating. Specifically, the company is looking at how stock splits and stock dividends would affect the company's equity accounts.

Question 1.1 of 6

John has been asked to prepare a statement of changes in equity. Which accounts are typically presented on the statement of changes in equity? Provide a brief description of each type of equity account.

Explanation:

Preferred Stock: Contributed capital for non-voting stock which generally carries a stated dividend rate that will be paid first in the event the organization declares a dividend.

Common Stock: Usually carried at par value unless the stock is "no par" stock, in which case the entire amount paid for the stock is classified as common stock. Dividends are not predetermined like preferred stock and are only paid when declared and only then, after the preferred shareholders receive their stated dividend. Last in line for preference in the case of bankruptcy or other liquidation.

Additional Paid-In Capital: Amount received by the organization for stock over the par value of the shares. Can be affected by various equity transactions, including stock dividends, resales of treasury stock, and issuance of options and warrants.

Treasury Stock: Amount paid by the organization to repurchase its own stock. Shown as contra equity, or a reduction to the equity section.

Retained Earnings: Net income or loss for the organization is ultimately recorded in retained earnings. Dividends declared are a reduction to retained earnings.

Accumulated Other Comprehensive Income: Other comprehensive income or loss for the organization is ultimately recorded in Accumulated Other Comprehensive Income. Items accumulated here are not part of the calculation of net income.

Non-Controlling Interest: When an organization has a controlling interest in another entity, but not complete ownership, 100% of the assets and liabilities of the subsidiary are included in the balance sheet of the organization and the portion of the subsidiary that is owned by third parties is segregated as a separate component of equity.

Question 1.2 of 6

If Blue Diamond decided to split its stock in a 2-for-1 stock split, explain how this would affect its equity accounts and if any journal entries would be needed.

Explanation:

A stock split generally has no impact on any of the equity accounts as long as the par value is also changed to reflect the new share size. For example, if 100 shares of $1 par common stock undergo a 2-for-1 stock split, the result would be 200 shares of $0.50 par common stock. Common stock is $100 before the split (100 × $1) and is still $100 after the split (200 × $0.50) so no journal entry is needed.

Question 1.3 of 6

Consider that Blue Diamond has 100,000 common shares outstanding with a $1 par value and a market value of $15. Also, consider that Blue Diamond is planning on declaring a 23% stock dividend.

What is the impact on the various equity accounts if the transaction is considered a small stock dividend? What is the impact on the various equity accounts if the transaction is considered a large stock dividend?

Explanation:

A small stock dividend is recorded at fair value. 23,000 new shares are issued (100,000 × 23%) and the fair value of $345,000 is taken from retained earnings (23,000 × $15), common stock is increased by $23,000 (23,000 × $1) to reflect the par value of the new shares, and the balance of $322,000 ($345,000 − $23,000) is recorded as an increase to additional paid-in capital.

A large stock dividend is recorded at par value. 23,000 new shares are issued (100,000 × 23%) and the par value of $23,000 is taken from retained earnings (23,000 × $1) and common stock is increased for the same amount.

Douglas Blake

Douglas Blake is working in a local CPA firm for his junior year internship. His second assignment was to prepare a classified income statement, statement of changes to equity, a balance sheet, and an indirect cash flow statement from an adjusted trial balance for the end of this period and the end of the previous period. It has been several years since Douglas took financial accounting and he was embarrassed to tell his supervisor that he did not remember how to perform this task.

When he arrived home that evening, Douglas sent an email to his internship advisor, who also happened to be his accounting professor from Principles of Accounting, asking him how the financial statements are related, how they are prepared, and what are the major classifications in the income statement, balance sheet, and statement of cash flows (indirect method).

Question 2.1 of 6

Explain to Douglas how an income statement, a balance sheet, a statement of changes to equity, and an indirect cash flow statement are prepared.

Explanation:

The income statement is prepared first, and it is prepared using only the trial balance at the end of the period. The elements of the income statement are revenues and expenses only. Assets, liabilities, and equity accounts should not appear on the income statement. First, calculate total revenues by listing all of the revenue accounts and totaling their balances. Then calculate total expenses by listing all of the expense accounts and totaling their balances. Net income is then calculated as total revenues minus total expenses.

The next statement prepared is the statement of changes to equity. This is because the calculation of net income is used in the statement of changes to equity. This statement will look slightly different if it is prepared for a corporation, sole proprietorship, or partnership. For a corporation, the statement of changes to equity details all issuances of common stock, purchases of treasury stock, stock dividends and stock splits, net income, and dividends to calculate the ending balance of equity. The statement of changes to equity for a sole proprietorship details all owner investments and withdrawals as well as net income. The statement of changes to equity for a partnership details the investments, withdrawals, and share of net income recorded for each partner. The statement of changes to equity is prepared after the income statement because the statement of changes to equity requires the calculation of net income.

After the statement of changes to equity is prepared, the balance sheet is then constructed. The elements of the balance sheet are assets, liabilities, and equity. Revenues and expenses are ignored in the preparation of the balance sheet. First, all asset accounts are listed and added together to calculate total assets. Then, liability and equity accounts are listed, using the ending equity balance calculated from the statement of changes to equity. If prepared correctly, total assets on the balance sheet will equal total liabilities plus equity.

To prepare an indirect cash flow statement, calculate the differences between the ending and beginning balances for all balance sheet accounts. Begin with net income and add or subtract all of the changes to asset and liability accounts (except cash) to calculate the change in cash. The change in cash added to the beginning cash balance should equal the ending cash balance.