S 9-3 (5-10 min)

1. **The *common shareholders* are the real owners of a corporation.**

2. **Preferred shareholders have priority over common shareholders in (1) receipt of *dividends* and (2) receipt of *assets* if the corporation liquidates.**

3. ***Common* shareholders benefit more from a successful corporation because the preferred shareholders' dividends are limited to a specified amount. The common shareholders take more risk so their potential for gains through an increase in the company's share price is unlimited.**

S 9-5 (10 min)

1. **Increase in common shares = $82,968 – $64,968 = $18,000**
   Selling price = $18,000 ÷ 10,000 shares
   = $1.80 per share

2.

Journal

DATE	ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2011			
June 30	Cash……	18,000	
	Common Shares…….....		18,000
	Issued 10,000 common shares at $1.80 per share.		

3. **GPI had a profit during 2011, as indicated by the formula:**
   RE beg + Net income – Dividends = RE end
   Net income = RE end – RE beg + Dividends
   = $80,435 – $78,881 + $4,096
   = $5,650

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S9-10 (10 min)

Journal

DATE	ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
2010			
Dec. 15	Retained Earnings		
	($10,000 × $0.50) + (25,000 × $0.60)	20,000	
	Dividends Payable.....		20,000
	Declared a cash dividend.....		
2011			
Jan. 4	Dividends Payable	20,000	
	Cash.....		20,000
	Paid the cash dividend.		

During 2010, Retained Earnings increased by $50,000 (net income of $70,000 – dividends of $20,000).

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S 9-14 (5-10 min)

(a) $$\text{Rate of return on total assets} = \frac{\text{Net income + Interest expense}}{\text{Average total assets}}$$

(b) $$\text{Rate of return on common shareholders' equity} = \frac{\text{Net income – Preferred dividends}}{\text{Average common shareholders' equity}}$$

1. **Creditors have loaned money to the company and earn interest. Shareholders have invested in the corporation's shares and thus own the company's net income. The sum of interest expense plus net income is the return to the two groups that have financed the company's assets.**

2. **Preferred shareholders have the first claim to the company's net income through preferred dividends. Therefore, preferred dividends are subtracted from net income to compute ROE.**

   Preferred dividends are *not* subtracted in computing ROA because the preferred shareholders have invested in the company. Net income includes both the preferred shareholders' and the common shareholders' returns on their investments.

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E 9-19 (10-15 min)

Shareholders' Equity

Preferred shares, $4.50, 5,000 shares authorized, 300 shares issued	**$ 20,000**
Common shares, 10,000 shares authorized, 5,000 shares issued	**74,000***
Retained earnings	**49,000**
Total shareholders' equity	**$143,000**

***Computation:**

Sept. 23: 1,000 shares × $16 = ……	**$16,000**
Oct. 12: 4,000 shares issued for inventory of $15,000 and equipment of $43,000 = ……	**58,000**
	$74,000

Journal entries (not required):

Sept.	**23**	**Cash**	**16,000**	
		Common Shares		**16,000**
Oct.	**2**	**Cash**	**20,000**	
		Preferred Shares		**20,000**
	12	**Inventory**	**15,000**	
		Equipment	**43,000**	
		Common Shares		**58,000**

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E 9-25 (20-30 min)

Req. 1

Conversion of preferred shares into common shares
Retirement of preferred shares

Req. 2

Issuance of common shares:

a. To preferred shareholders who converted their preferred shares into common shares
b. For cash or other assets
c. Stock dividend

Req. 3 (All amounts except per share price in millions)

	(Millions of shares of stock) **Dec. 31, 2011**
Common shares issued……	**564**

Req. 4

Retained Earnings *(Millions)*

Dividends during 2011	***136***	**Dec. 31, 2010**	**Bal.**	**5,006**
		Net income 2011		**1,410**
		Dec. 31, 2011	**Bal.**	**6,280**

Omit Requirement 5

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E 9-29 (10-15 min)

Shareholders' equity:

	Millions
Common shares, 1 billion shares	
(500 million × 2) authorized,	
880 million shares (440 million × 2) issued	**$ 318**
Contributed surplus	**44**
Retained earnings	**2,393**
Total shareholders' equity	**$2,755**

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E 9-31 (10-15 min)

$$\text{Rate of return on assets} = \frac{\text{Net income + Interest expense}}{\text{Average total assets}} = \frac{\$1,486 + \$219}{(\$15,695 + \$13,757) / 2} = \frac{\$1,705}{\$14,726} = 0.116$$

$$\text{Rate of return on common shareholders' equity} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shareholders' equity}} = \frac{\$1,486 - \$0}{(\$8,648^{*} + \$7,604^{**}) / 2} = \frac{\$1,486}{\$8,126} = 0.183$$

*$43 + $8,605 = $8,648
**$388 + $7,216 = $7,604

These profitability measures suggest strength because (1) Lexington's 18.3% return on equity is very good and (2) it exceeds return on assets by a wide margin.

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P 9-63A (15-25 min)

Req. 1

Steeltrap Security has these shares outstanding:

- **$5.00 cumulative preferred shares**
- **$2.50 cumulative preferred shares**
- **common shares**

Req. 2

Steeltrap Security issued the $2.50 cumulative preferred shares at $25. This can be determined by dividing the balance of the $2.50 cumulative preferred share account by the number of shares issued ($100,000 ÷ 4,000).

Req. 3

Steeltrap would have to pay preferred dividends in arrears before paying dividends to the common shareholders because the preferred shares are *cumulative*.

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P 9-63A (continued)

Req. 4

Steeltrap must pay preferred dividends of $22,500 each year to avoid having preferred dividends in arrears.

Computation:

$5.00 Preferred:	**2,500 shares × $5.00**	**=**	**$12,500**
$2.50 Preferred:	**4,000 shares × $2.50**	**=**	**10,000**
Total preferred dividends……...			**$22,500**

Req. 5

Journal

DATE	ACCOUNT TITLES AND EXPLANATION	DEBIT	CREDIT
	Retained Earnings.....	**50,000**	
	Dividends Payable, $5.00 Preferred		
	(2,500 shares × $5.00 × 2).....		**25,000**
	Dividends Payable, $2.50 Preferred		
	(4,000 × $2.50 × 2)		**20,000**
	Dividends Payable, Common		
	($50,000 – $25,000 – $20,000)		**5,000**

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