Financial Accounting

Sixth Edition

Stockholders' Equity

CHAPTER 10

Spiceland • Thomas • Herrmann

Illustration 10-1

Accounting Equation and Components of Stockholders' Equity

Assets	=	Liabilities	+	Stockholders' Equity
(resources)		(creditors' claims)		(owners' claims)

Primary Components of Stockholders' Equity

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1. **Paid-in capital** is the amount stockholders have invested in the company.
2. **Retained earnings** is the amount of earnings the company has kept or retained—that is, the earnings not distributed in dividends to stockholders over the life of the company.
3. **Treasury stock** is a company's own issued stock that it has repurchased.

PART A

INVESTED CAPITAL

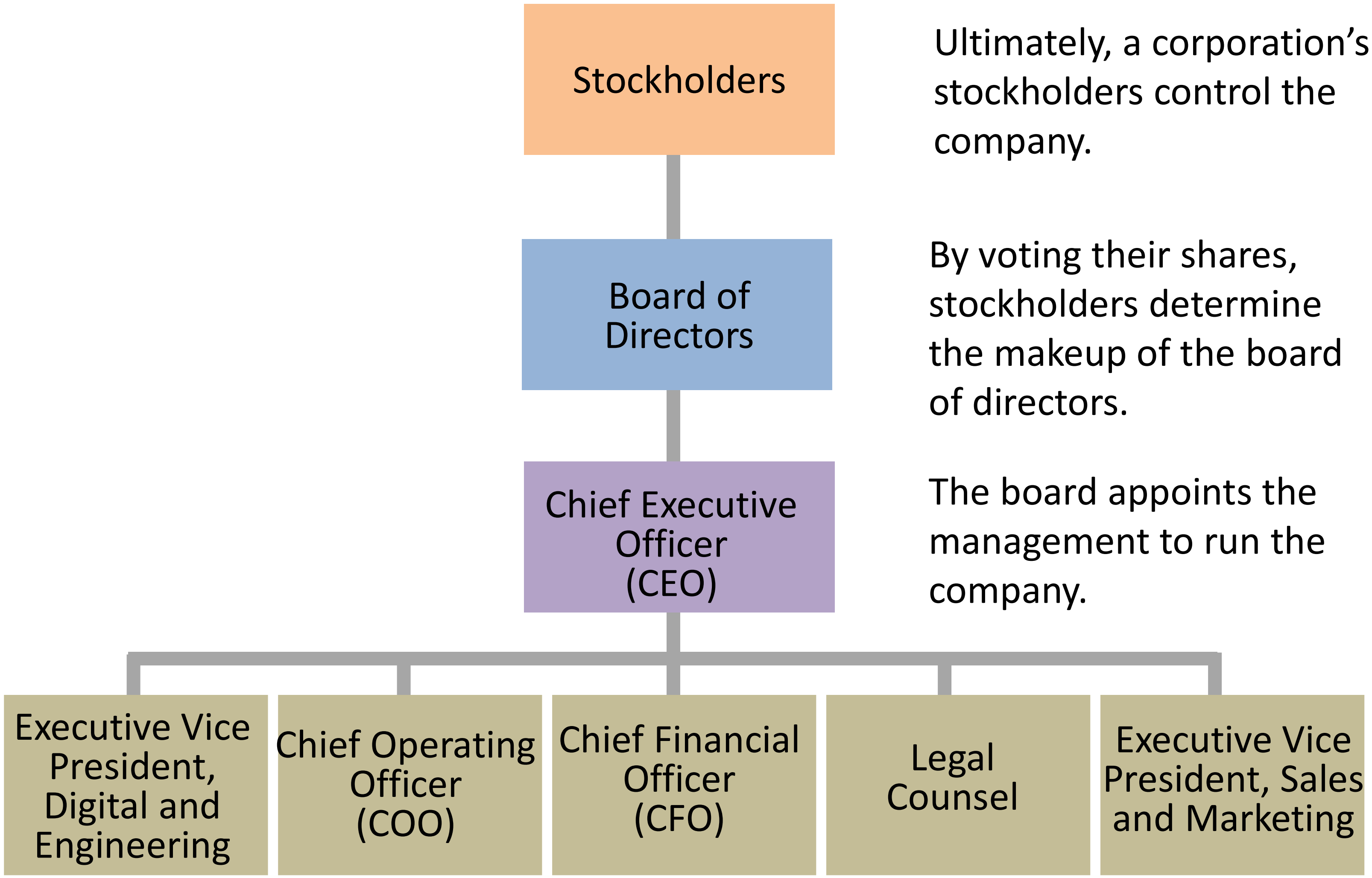
Learning Objective 1

LO10–1 Identify the advantages and disadvantages of the corporate form of ownership.

Invested Capital

- **Paid-in capital** (or invested capital) is the amount of money paid into a company by its owners.
- Types of business entities:
  - A sole proprietorship is a business owned by one person.
  - A partnership is a business owned by two or more persons.
  - A **corporation** is an entity that is legally separate from its owners and even pays its own income taxes.

Illustration 10–2
Organization Chart

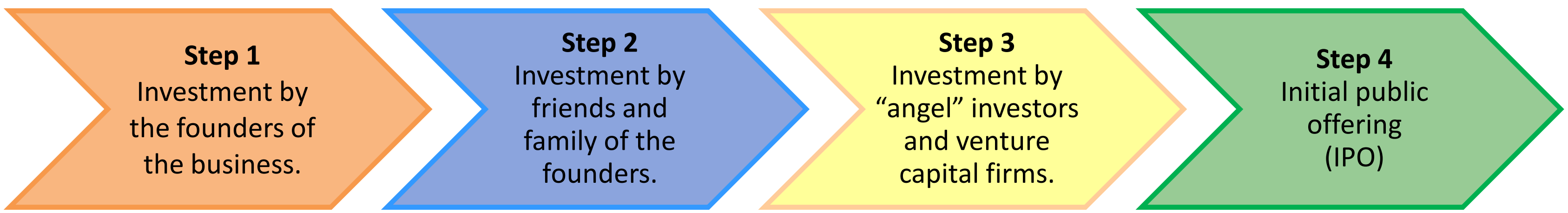


Ultimately, a corporation's stockholders control the company.

By voting their shares, stockholders determine the makeup of the board of directors.

The board appoints the management to run the company.

Illustration 10–3
Stages of Equity Financing



Corporations

- Corporations first raise money from founders of the business, friends, and family
- To grow, companies seek investments from:
  - **Angel investors –** Wealthy investors, like those featured on the television show *Shark Tank*
  - **Venture capital firms –** Provide additional funding and business expertise
  - **Initial public offering (IPO) –** The first time a corporation issues stock to the general public

Public or Private

Publicly Held Corporation	Privately Held Corporation
• Allows public investment • More stockholders • Regulated by the SEC • Examples: Wal-Mart, ExxonMobil, General Electric, Apple, Microsoft, and Intel	• No public investment • Fewer stockholders • Not regulated by the SEC • Examples: Cargill (agricultural commodities) Koch Industries (oil and gas), and Mars (food and candy)

Illustration 10–4

Stockholder Rights

Right to Vote

- Stockholders vote on matters, including the election of corporate directors.

Right to Receive Dividends

- Stockholders share in profits when the company declares dividends. The percentage of shares a stockholder owns determines his or her share of the dividends distributed.

Right to Share in the Distribution of Assets

- Stockholders share in the distribution of assets if the company is dissolved. The percentage of shares a stockholder owns determines his or her share of the assets, which are distributed after creditors and preferred stockholders are paid.

Illustration 10–5

Advantages and Disadvantages of a Corporation

Advantages	Disadvantages
Limited liability A stockholder can lose no more than the amount invested.	**Additional taxes** Corporate earnings are taxed twice—at the corporate level and individual stockholder level.
Ability to raise capital and transfer ownership Attracting outside investment and transferring ownership is easier for a corporation.	**More paperwork** Federal and state governments impose additional reporting requirements.

Key Point

- The primary advantages of the corporate form of business are limited liability and the ability to raise capital.
- The primary disadvantages are additional taxes and more paperwork.

Concept Check 10–1

Which of the following is a primary advantage of forming a corporation?

a. Unlimited liability

b. Double taxation

c. Ability to raise capital and transfer ownership

d. Fewer state and federal reporting requirements

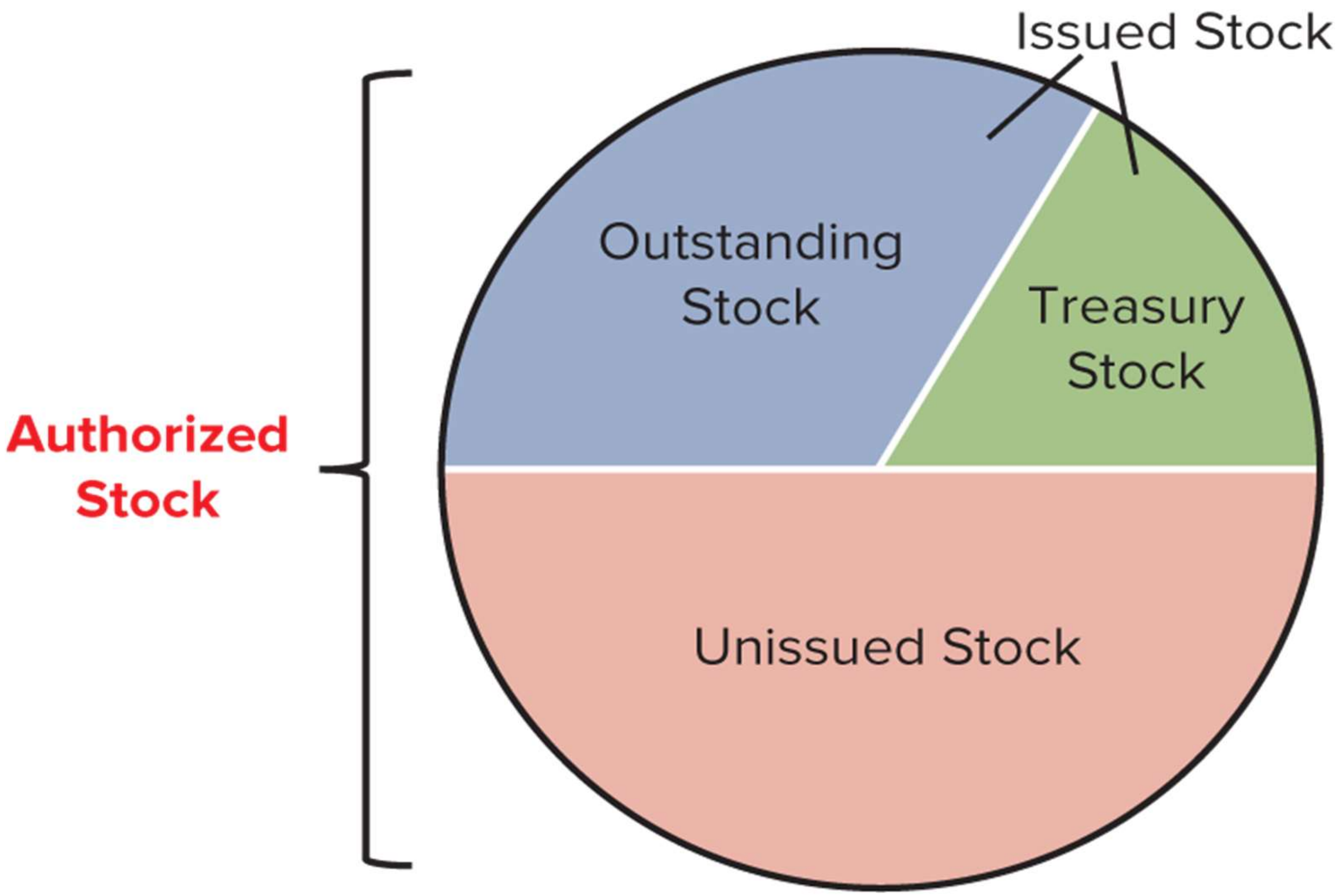
A corporation offers two primary advantages over sole proprietorships and partnerships: limited liability and ability to raise capital and transfer ownership.

Learning Objective 2

LO10–2 Record the issuance of common stock.

Illustration 10–6

Authorized, Issued, Outstanding, and Treasury Stock



Types of Common Stock

Type of Stock	Definition
Authorized	Shares available to sell (= Issued + Unissued)
Issued	Shares actually sold (= Outstanding + Treasury)
Outstanding	Shares issued and held by investors
Treasury	Shares issued and repurchased by the company.

Par Value

- **Legal capital** per share of stock that’s assigned when the corporation is first established
- Par value has no relationship to the market value of the common stock

Common Mistake

Some students confuse par value with market value.

- Par value is the legal capital per share that is set when the corporation is first established and actually is unrelated to “value.”
- The market value per share is equal to the current share price.
- In most cases, the market value per share will far exceed the par value.

Accounting for Common Stock

Assume Canadian Falcon issues 1,000 shares of **no-par** common stock at $30 per share.

	Debit	Credit
Cash (= 1,000 shares × $30)	**30,000**	
Common Stock		**30,000**
(Issue no-par value common stock)		

Assume Canadian Falcon issues 1,000 shares of **$0.01 par value** common stock at $30 per share.

	Debit	Credit
Cash (= 1,000 shares × $30)	**30,000**	
Common Stock (= 1,000 shares × $0.01)		**10**
Additional Paid-in Capital (difference)		**29,990**
(Issue common stock above par)		

Key Point

- If no-par value stock is issued, the corporation records the full amount to Cash and credits Common Stock.
- If par value or stated value stock is issued, the corporation records two equity accounts—Common Stock at the par value or stated value per share and Additional Paid-in Capital for the portion above par or stated value.

Concept Check 10–2

Company A issues 20,000 shares of $5 par common stock at $12.50 per share. The entry to record the issuance would include which of the following?

a. Debit to cash of $100,000

b. Credit to Common Stock of $250,000

c. Credit to Additional Paid-in Capital of $150,000

d. Credit to Additional Paid-in Capital of $250,000

The company debits Cash for the amount received of $250,000 (20,000 shares × $12.50), credits Common Stock for the par value of $100,000 (20,000 shares × $5), and credits Additional Paid-in Capital for the difference of $150,000.

Learning Objective 3

LO10–3 Understand unique features and recording of preferred stock.

Preferred Stock

Preferred stock is "preferred" over common stock in two ways:

1. Preferred stockholders usually have first rights to a specified amount of dividends (a stated dollar amount per share or a percentage of par value per share). If the board of directors declares dividends, preferred shareholders will receive the designated dividend before common shareholders receive any.
2. Preferred stockholders receive preference over common stockholders in the distribution of assets in the event the corporation is dissolved.

Accounting for Preferred Stock Issues

Assume Canadian Falcon issues 1,000 shares of $30 par value preferred stock for $40 per share.

	Debit	Credit
Cash (= 1,000 shares × $40)	**40,000**	
Preferred Stock(= 1,000 shares × $30)		**30,000**
Additional Paid-in Capital (difference)		**10,000**
(Issue preferred stock above par)		

Illustration 10–7

Stockholders' Equity Section of the Balance Sheet

CANADIAN FALCON Balance Sheet (partial)	
Stockholders' equity:	
Preferred stock, $30 par value; 100,000 shares authorized; 1,000 shares issued and outstanding	$ 30,000
Common stock, $0.01 par value; 1 million shares authorized; 1,000 shares issued and outstanding	$10
Additional paid-in capital	39,990
Total paid-in capital	70,000
Retained earnings	30,000
Total stockholders' equity	$100,000

Features of Preferred Stock

Convertible	Shares can be exchanged for common stock.
Redeemable	Shares can be returned to the corporation at a fixed price.
Cumulative	Shares receive priority for future dividends if dividends are not paid in a given year.

Illustration 10–8

Comparison of Financing Alternatives

Factor	Common Stock	Preferred Stock	Bonds
Voting rights	Yes	Usually no	No
Risk to the investor	Highest	Middle	Lowest
Expected return to the investor	Highest	Middle	Lowest
Preference for dividends/interest	Lowest	Middle	Highest
Preference in distribution of assets	Lowest	Middle	Highest
Tax deductibility of payments	No	Usually no	Yes

Illustration 10–9

Allocate Dividends Between Preferred and Common Stock

If the preferred stock is *cumulative*:

Preferred dividends in arrears for 2022 and 2023	$ 4,800
Preferred dividends for 2024 (1,000 shares × 8% × $30 par value)	2,400
Remaining dividends to common stockholders	2,800
Total dividends paid in 2024	$10,000

If the preferred stock is *noncumulative*:

Preferred dividends in arrears for 2022 and 2023	—
Preferred dividends for 2024 (1,000 shares × 8% × $30 par value)	$ 2,400
Remaining dividends to common stockholders	7,600
Total dividends paid in 2024	$10,000

Key Point

Preferred stock has preference over common stock in receiving dividends and in the distribution of assets in the event the corporation is dissolved.

We record the issuance of preferred stock similar to the way we did for the issuance of common stock.

Some preferred stock is cumulative, meaning any dividends not declared in a given year accumulate to be paid in a later year.

Concept Check 10–3

Which of the following is a primary advantage of owning preferred stock?

a. Preferential voting rights in most cases

b. Tax deductibility of dividend payments

c. Preference over common stockholders in the distribution of assets in the event of dissolution

d. Higher risk to investors than owning common stock

Preferred stock is "preferred" over common stock in two ways:

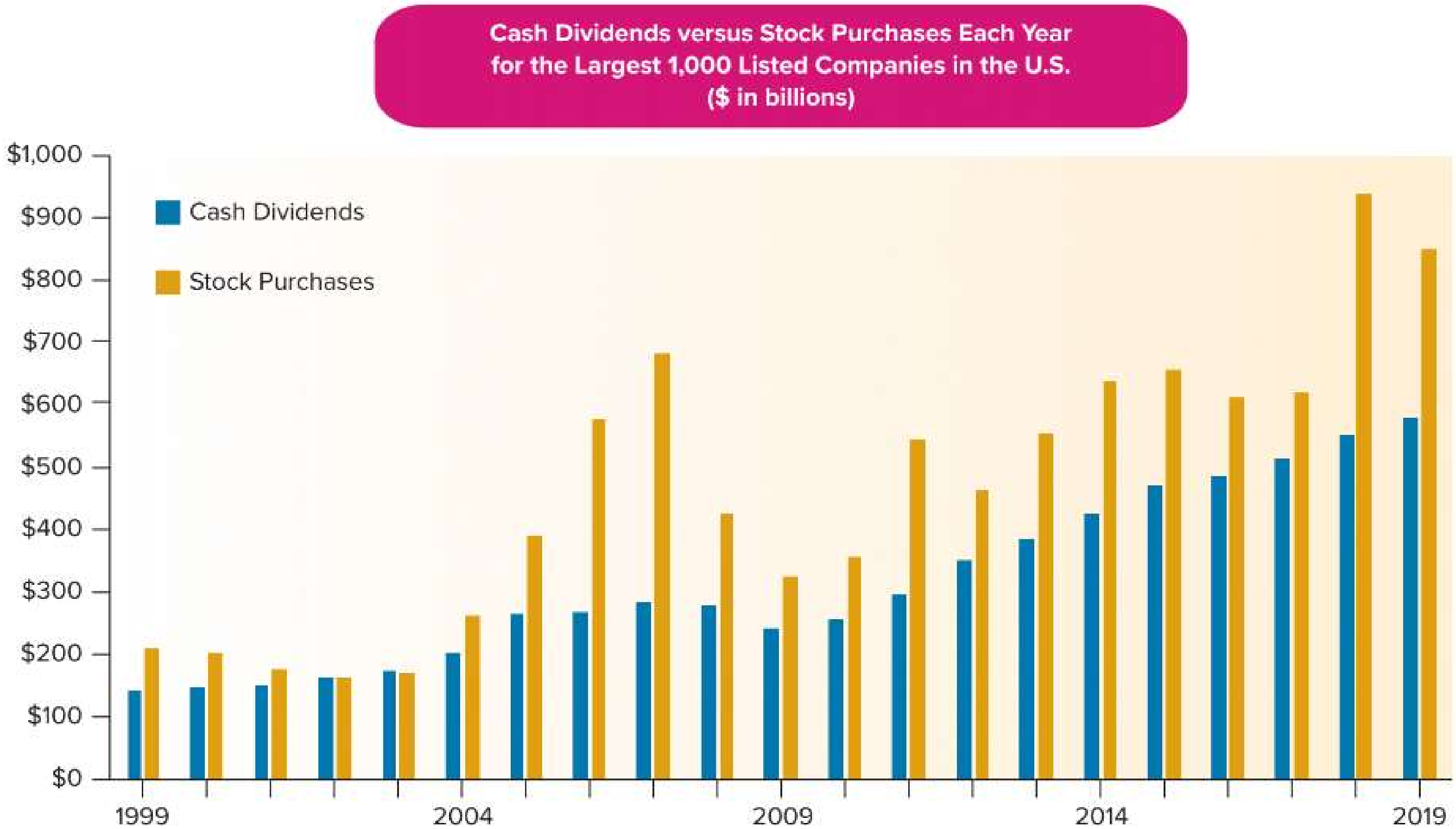
1. Preferred stockholders usually have first rights to a specified amount of dividends. If the board of directors declares dividends, preferred shareholders will receive the designated dividend before common shareholders receive any.
2. Preferred stockholders receive preference over common stockholders in the distribution of assets in the event the corporation is dissolved.

Learning Objective 4

LO10–4 Account for treasury stock.

Illustration 10–10

Dividends versus Stock Buybacks



Source: Standard & Poor's

Treasury Stock

Companies buy back their own stock for various reasons:

- To boost underpriced stock
- To distribute surplus cash without paying dividends
- To boost earnings per share
- To satisfy employee stock ownership plans

Accounting for Treasury Stock

- Treasury stock is the purchase of a company's own issued stock.
- Just as issuing shares increases stockholders' equity, buying back those shares decreases stockholders' equity.
- Rather than reducing the stock accounts directly, though, we record treasury stock as a separate "negative" or "contra" account.

Common Mistake

Sometimes students confuse the purchase of treasury stock with investments in another company.

- An equity investment is the purchase of stock *in another corporation,* and we record it as an increase in assets.
- Treasury stock is the purchase of a *corporation's own stock,* and we record it as a reduction in stockholders' equity. It is not an asset; a company cannot invest in itself.

Purchase of Treasury Stock

Canadian Falcon repurchases 100 shares of its own $0.01 par value common stock at $30 per share.

	Debit	Credit
Treasury Stock (= 100 shares × $30)	**3,000**	
Cash		**3,000**
(Purchase treasury stock)		

Illustration 10–11

Stockholders' Equity before and after Purchase of Treasury Stock

CANADIAN FALCON Balance Sheet (partial)		
Stockholders' equity:	**Before**	**After**
Preferred stock, $30 par value; 100,000 shares authorized; 1,000 shares issued and outstanding	$ 30,000	$30,000
Common stock, $0.01 par value; 1 million shares authorized; 1,000 shares issued and 900 shares outstanding	10	10
Additional paid-in capital	39,990	39,990
Total paid-in capital	70,000	70,000
Retained earnings	30,000	30,000
Treasury stock, 100 shares	**0**	**(3,000)**
Total stockholders' equity	$100,000	$97,000

Resale of Treasury Stock (above cost)

Canadian Falcon resells the 100 shares of treasury stock for $35. Recall that these shares originally were purchased for $30 per share.

	Debit	Credit
Cash (= 100 shares × $35)	**3,500**	
Treasury Stock (= 100 shares × $30)		**3,000**
Additional Paid-in Capital (= 100 shares × $5)...		**500**
(Resell treasury stock above cost)		

When we resell the treasury shares at $35, we must reduce the Treasury Stock account at the same $30 per share. We record the $500 difference (= 100 shares × $5 per share) as a credit to Additional Paid-in Capital.

Illustration 10–12

Stockholders' Equity before and after Sale of Treasury Stock

CANADIAN FALCON
Balance Sheet (partial)

Stockholders' equity:	**Before**	**After**
Preferred stock, $30 par value; 100,000 shares authorized; 1,000 shares issued and outstanding	$ 30,000	$30,000
Common stock, $0.01 par value; 1 million shares authorized; 1,000 shares issued and 900 shares outstanding	10	10
Additional paid-in capital	**39,990**	**40,490**
Total paid-in capital	70,000	70,500
Retained earnings	30,000	30,000
Treasury stock, 100 shares	**(3,000)**	**0**
Total stockholders' equity	$97,000	$100,500

Resale of Treasury Stock (below cost)

Assume Canadian Falcon resells the 100 shares of treasury stock for only $25 rather than $35. Recall that these shares originally were purchased for $30 per share.

	Debit	Credit
Cash (= 100 × $25)	**2,500**	
Additional Paid-in Capital (= 100 × $5)	**500**	
Treasury Stock (= 100 × $30)		**3,000**
(Resell treasury stock below cost)		

When we resell the treasury shares for $25, we must reduce the Treasury Stock account at the same $30 per share. We record the $500 difference (= 100 shares × $5 per share) as a decrease to Additional Paid-in Capital.

Key Point

We include treasury stock in the stockholders' equity section of the balance sheet as a reduction in stockholders' equity (increases in treasury stock will decrease stockholders' equity).

When we resell treasury stock, the amount of the sale price above (below) the stock's original purchase cost is reported as an increase (decrease) in additional paid-in capital.

Concept Check 10–4

Treasury Stock:

a. Normally has a credit balance.

b. Decreases stockholders' equity.

c. Is recorded as an investment.

d. Increases stockholders' equity.

Treasury Stock is a contra equity account so it has a debit balance. It decreases stockholders' equity.

PART B

EARNED CAPITAL

Learning Objective 5

LO10–5 Describe retained earnings and record cash dividends.

Retained Earnings

- Earnings retained in the corporation and not paid out as dividends
- Equals all net income less all dividends, since the company began operations
- Has a normal credit balance

Illustration 10–13

Retained Earnings over a Four-Year Period

	Net Income (Net Loss)	Dividends	Balance in Retained Earnings
Year 1	$(1,000)	$ 0	$(1,000)
Year 2	3,000	0	2,000
Year 3	4,000	1,000	5,000
Year 4	10,000	3,000	12,000

- The balance of Retained Earnings equals **all net income minus all dividends** to date over the life of the company.
- In Year 1, the company shows an **accumulated deficit.**

Common Mistake

Some students think, incorrectly, that retained earnings represents a *cash* balance set aside by the company.

In fact, the size of retained earnings can differ greatly from the balance in the Cash account.

Key Point

Retained earnings represent all net income, less all dividends, since the company began operations.

Cash Dividends

- Distributions by a corporation to its stockholders
- A change in a quarterly or annual cash dividend paid by a company can provide useful information about future prospects
- Not all companies pay dividends; for example, growth companies prefer to reinvest earnings rather than distribute them

Illustration 10-14

Facebook's Dividend Policy

FACEBOOK, INC.
Notes to the Financial Statements (excerpt)

We have never declared or paid cash dividends on our capital stock. We currently intend to retain any future earnings to finance the operation and expansion of our business, and we do not expect to declare or pay any cash dividends in the foreseeable future. As a result, you may only receive a return on your investment in our Class A common stock and, if issued, our Class C capital stock if the trading price of your shares increases.

Source: Facebook, Inc.

Dividend Dates

- **Declaration date**: Date on which board of directors announces the next dividend to be paid.
- **Record date**: The date on which the company looks at its records to determine who the stockholders of the company are.
- **Payment date**: The date of the actual distribution of dividends.

Common Mistake

Some students incorrectly calculate dividends based on the number of issued shares.

Dividends are based on the number of outstanding shares since dividends are not paid on treasury stock.

Recording Cash Dividends

On March 15, Canadian Falcon declares a $0.25 per share dividend on its 2,000 outstanding shares.

March 15 (declaration date)	Debit	Credit
Dividends (= 2,000 shares × $0.25)	**500**	
Dividends Payable		**500**
(Declare cash dividends)		

The dividend declared by Canadian Falcon is paid on April 15.

April 15 (payment date)	Debit	Credit
Dividends Payable (= 2,000 shares × $0.25)	**500**	
Cash		**500**
(Pay cash dividends)		

Key Point

The declaration of cash dividends decreases Retained Earnings and increases Dividends Payable.

The payment of cash dividends decreases Dividends Payable and decreases Cash.

The net effect, then, is a reduction in both Retained Earnings and Cash.

Concept Check 10–5

On which date would a company record a debit to Dividends and a credit to Dividends Payable?

a. Date of declaration

b. Date of record

c. Date of payment

d. Settlement date

For companies that do pay dividends, the date the board of directors announces the next dividend to be paid is known as the declaration date. The declaration of a dividend creates a binding legal obligation for the company declaring the dividend.

Learning Objective 6

LO10–6 Explain the effect of stock dividends and stock splits.

Stock Dividends and Stock Splits

Stock dividends or stock splits

- Additional shares of stock distributed by corporations to stockholders rather than cash

You own 100 shares and assume a:	You will receive:
10% stock dividend	10 additional shares
20% stock dividend	20 additional shares
100% stock dividend	100 additional shares

- Large stock dividends (25% or more of the shares outstanding) and stock splits are declared primarily due to the effect they have on stock prices.

Stock Splits

- **Stock split**
  - A large stock dividend that includes a reduction in the par or stated value per share.

When a company declares a stock split, we do not record a transaction.

Assume Canadian Falcon declares a 2-for-1 stock split on its 1,000 shares of $0.01 par value common stock.

- The balance in the Common Stock account is 1,000 shares times $0.01 par value per share, which equals $10.
  - With no journal entry, the balance remains $10 despite the number of shares doubling.
- The par value per share is reduced by one-half to $0.005.

Large Stock Dividends

- **Large stock dividends**
  - Records a decrease in retained earnings and an increase in common stock; recorded at par value.

	Debit	Credit
Stock Dividends* (= 1,000 shares x $0.01)	10	
Common Stock		10
(Record 100% [large] stock dividend)		

*Debiting Stock Dividends reduces Retained Earnings.

Illustration 10-15

Stockholders' Equity before and after a 2-for-1 Stock Split Accounted for as a 100% Stock Dividend

CANADIAN FALCON
Balance Sheet (partial)

	Before 100% Stock Dividend	After 100% Stock Dividend
Stockholders' equity:		
Preferred stock, $30 par value	$ 30,000	$ 30,000
Common stock, $0.01 par value	**10**	**20**
Additional paid-in capital	40,490	40,490
Total paid-in capital	70,500	70,510
Retained earnings	**29,500**	**29,490**
Total stockholders' equity	$ 100,000	$ 100,000
Common shares outstanding	1,000	2,000
Par value per share	$ 0.01	$ 0.01
Share price	$ 30	$ 15

Illustration 10–16

Effects of a Stock Split and a Stock Dividend

	Stock Split	Stock Dividend
Total stockholders’ equity	No change	No change
Common stock	No change	Increase
Retained earnings	No change	Decrease
Par value per share	Decrease	No change

Illustration 10–17

American Eagle's Stock Split

APPLE INC.

The Board of Directors has also approved a four-for-one stock split to make the stock more accessible to a broader base of investors. Each Apple shareholder of record at the close of business on August 24, 2020, will receive three additional shares for every share held on the record date, and trading will begin on a split-adjusted basis on August 31, 2020.

Source: Apple Inc.

Small Stock Dividends

- Recorded at market value, not par value.
- Do not change total assets, total liabilities, or total stockholders' equity.
- Decreases one equity account, Retained Earnings, increases two other equity accounts, Common Stock and Additional Paid-in Capital.

	Debit	Credit
Stock Dividends (= 1,000 × 10% × $30)	**3,000**	
Common Stock (= 1,000 × 10% × $0.01)		**1**
Additional Paid-in Capital (difference)		**2,999**
(Distribute 10% [small] stock dividend)		

Key Point

Declaring stock dividends and stock splits is like cutting a pizza into more slices.

Everyone has more shares, but each share is worth proportionately less than before.

Concept Check 10–6

A company has 1,000 shares of $20 par stock outstanding and issues a 2-for-1 split. How many shares are outstanding after the split?

a. 1,000
b. 2,000
c. 3,000
d. 500

A company that had 1,000 shares outstanding and issued a 2-for-1 split would have 2,000 shares outstanding after the split, but each share would be worth half as much.

PART C

REPORTING STOCKHOLDERS' EQUITY

Learning Objective 7

LO10–7 Prepare and analyze the stockholders' equity section of a balance sheet and the statement of stockholders' equity.

Illustration 10-18
Stockholders' Equity Section for Citigroup

CITIGROUP ($ and shares in millions)	
Preferred stock ($1.00 par value, issued shares)	$ 17,980
Common stock ($0.01 par value, issued shares: 3,099,602,856)	31
Additional paid-in capital	107,840
Retained earnings	165,369
Treasury stock, at cost: 985,479,501 shares	(61,660)
Accumulated other comprehensive income (loss)	(36,318)
Total stockholders' equity	$193,242

Illustration 10–19
Stockholders’ Equity Section—Canadian Falcon

CANADIAN FALCON Balance Sheet (partial) December 31, 2024	
Stockholders’ equity:	
Preferred stock, $30 par value; 100,000 shares authorized; 1,000 shares issued and outstanding	$ 30,000
Common stock, $0.01 par value; 1 million shares authorized; 2,000 shares issued and outstanding	20
Additional paid-in capital	40,490
Total paid-in capital	70,510
Retained earnings	29,490
Treasury stock	–0–
Total stockholders’ equity	$100,000

Illustration 10–20

Statement of Stockholders' Equity—Canadian Falcon

CANADIAN FALCON
Statement of Stockholders' Equity
For the year ended December 31, 2024

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, January 1	$ –0–	$ –0–	$ –0–	$ –0–	$ –0–	$ –0–
Issue common stock		10	29,990			30,000
Issue preferred stock	30,000		10,000			40,000
Repurchase treasury stock					(3,000)	(3,000)
Resell treasury stock			500		3,000	3,500
Cash dividends				(500)		(500)
100% stock dividend		10		(10)		–0–
Net income				30,000		30,000
Balance, December 31	**$30,000**	**$ 20**	**$40,490**	**$29,490**	**$ –0–**	**$100,000**

Key Point

The stockholders' equity section of the balance sheet presents the balance of each equity account *at a point in time.*

The statement of stockholders' equity shows the change in each equity account balance *over time.*

Concept Check 10–7

How does the stockholders’ equity section of the balance sheet differ from the statement of stockholders' equity?

a. The stockholders' equity section shows the balances at a point in time and the statement of stockholders' equity shows activity over time.
b. The stockholders' equity section shows the activity over time and the statement of stockholders' equity shows the balances at a point in time.
c. There are no differences.
d. The stockholders' equity section is more detailed.

ANALYSIS

EQUITY ANALYSIS

Learning Objective 8

LO10–8 Evaluate company performance using information on stockholders' equity.

Return on Equity

Measures the ability of company management to generate earnings from the resources that owners provide

$$\textbf{Return on equity} = \frac{\textbf{Net income}}{\textbf{Average stockholders' equity}}$$

Illustration 10–21

Selected Financial Data for Zoom and Microsoft

$ in millions except share data	Zoom	Microsoft
Net sales	$ 623	$143,015
Net income	$ 22	$ 44,281
Total liabilities	$ 456	$183,007
Stockholders' equity, beginning	$ –7	$102,330
Stockholders' equity, ending	$ 834	$118,304
Stock price, ending	$76.30	$ 203.51
Dividends per share	$ 0	$ 1.99
Average shares outstanding	234 million	7,610 million

Illustration 10–22

Return on Equity for Zoom and Microsoft

	Net Income	÷	Average Stockholders' Equity	=	Return on Equity
Zoom	$ 22	÷	($–7 + $834)/2	=	5.3%
Microsoft	$44,281	÷	($102,330 + $118,304)/2	=	40.1%

Dividend Yield

Measures how much a company pays out in dividends relative to its share price

$$\textbf{Dividend yield} = \frac{\textbf{Dividends per share}}{\textbf{Stock price}}$$

Illustration 10–23
Dividend Yield for Zoom and Microsoft

	Dividends Per Share	÷	Stock Price	=	Dividend Yield
Zoom	$0.00	÷	$ 76.30	=	0.0%
Microsoft	$1.99	÷	$203.51	=	1.0%

Earnings per Share

Measures net income earned per share of common stock

$$\textbf{Earnings per share} = \frac{\textbf{Net income – Dividends on preferred stock}}{\textbf{Average shares of common stock outstanding}}$$

Price-Earnings Ratio (PE ratio)

Indicates how the stock is trading relative to current earnings

$$\textbf{Price-earnings ratio} = \frac{\textbf{Stock price}}{\textbf{Earnings per share}}$$

Illustration 10–24

Price-Earnings Ratios for Zoom and Microsoft

	Stock Price	÷	Earnings per Share	=	Price-Earnings Ratio
Zoom	$ 76.30	÷	$22/234	=	811.6
Microsoft	$203.51	÷	$44,281/7,610	=	35.0

Key Point

- The return on equity measures the ability to generate earnings from the owners' investment.
  - It is calculated as net income divided by average stockholders' equity.
- The dividend yield measures how much a company pays out in dividends in relation to its stock price.
- Earnings per share measures the net income per share of common stock.
- The price-earnings ratio indicates how the stock is trading relative to current earnings.

Concept Check 10–8

The PE ratio:

a. Typically is more than 100.

b. Equals the stock price divided by net income.

c. Typically is less than 1.

d. Indicates how a stock is trading relative to current earnings.

The PE Ratio indicates how a stock is trading relative to current earnings. The PE Ratio equals the stock price divided by earnings per share. Price-earnings ratios commonly are in the range of 20 to 25 in recent years.

End of Chapter 10