What is the Statement of Retained Earnings?

The statement of retained earnings is a financial statement that is prepared to reconcile the beginning and ending retained earnings balances. Retained earnings are the profits or net income that a company chooses to keep rather than distribute it to the shareholders.

In other words, assume a company makes money (has net income) for the year and only distributes half of the profits to its shareholders as a distribution. The other half of the profits are considered retained earnings because this is the amount of earnings the company kept or retained.

The retained earnings calculation or formula is quite simple. Beginning retained earnings corrected for adjustments, plus net income, minus dividends, equals ending retained earnings. Just like the statement of shareholder's equity, the statement of retained is a basic reconciliation. It reconciles how the beginning and ending RE balances. In other words, how did the RE balance on January 1 turn into the RE balance on December 31?

Although this statement is not included in the four main general-purpose financial statements, it is considered important to outside users for evaluating changes in the RE account. This statement is often used to prepare before the statement of stockholder's equity because retained earnings is needed for the overall ending equity calculation.

Format

This statement has five main sections:

- — Beginning RE
- — Prior Period Adjustments
- — Additions
- — Subtractions
- — Ending Balance

The beginning equity balance is always listed on its own line followed by any adjustments that are made to retained earnings for prior period errors. These adjustments could be caused by improper accounting methods used, poor estimates, or even fraud. The sum or difference is usually subtotaled at this point.

Next, additions and subtractions are listed. Additions include net income if the company is profitable. If the company is not profitable, net loss for the year is included in the subtractions along with any dividends to the owners. Dividends are always subtracted from RE because once dividends are declared, the company owes its shareholders the funds and must take these funds out of its retained earnings even if they are simply declared and not paid.

The last line on the statement sums the total of these adjustments and lists the ending retained earnings balance.

Like all financial statements, the retained earnings statement has a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Paul's Guitar Shop, Inc. would have the following heading:

- Paul's Guitar Shop, Inc.
- Statement of Retained Earnings
- For the Year Ended December 31, 2015

Example

Here is an example of how to prepare a statement of retained earnings from our unadjusted trial balance and financial statements used in the accounting cycle examples for Paul's Guitar Shop.

As you can see, the beginning retained earnings account is zero because Paul just started the company this year. There were no retained earnings in prior years. Likewise, there were no prior period adjustments since the company is brand new.

Paul's net income at the end of the year increases the RE account while his dividends decrease the overall the earnings that are kept in the business.

This ending retained earnings balance can then be used for preparing the statement of shareholder's equity and the balance sheet.

Source: https://www.myaccountingcourse.com/financial-statements/retained-earnings-statement