Statement of Retained Earnings

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The statement of retained earnings is the second financial statement prepared. It is prepared after the income statement and before the balance sheet. So, what is the purpose of the statement of retained earnings? The statement of retained earnings explains the changes in retained earnings from net income (or loss) and from any dividends over a period of time. This means that the statement of retained earnings reports the change in retained earnings from the beginning to end of a time period, usually a year.

Before we can being preparing a statement of retained earnings, we need to understand what retained earnings is. So, let's start by reviewing stockholders' equity, because retained earnings is part of equity. Stockholders equity refers to the owners claims on the corporations and is made of two parts: common stock and retained earnings. The statement of retained earnings specifically reports on the changes in retained earnings.

Retained earnings of a company refers to income that is not distributed to the stockholders. You can think of retained earnings as the amount of income that is left in the company.
Retained earnings is increased by net income or decreased by net loss, and decreased by dividends. Remember that dividends are the distributions made to the stockholders.

Now that we understand what retained earnings is. Let's discuss the steps to prepare the statement of retained earnings. In step 1, we will prepare the heading, step 2, list beginning retained earnings, step 3, add or subtract net income/loss, step 4, subtract dividends, and step 5, calculate ending retained earnings.

Here's an example of a statement of retained earnings for Runners World. Let's look at each step individually.

Step 1 – Record the statements heading
Notice that the heading includes the name of the company, Runners World, the name of the statement – statement of retained earnings, and the time period, for the year ending December 31, 2008. Remember that a statement of retained earnings always represents a period of time which is why the statement of retained earnings includes for the wording year or for the month ending.

Step 2 – List Beginning Retained Earnings. Beginning retained earnings is equal to ending retained earnings of the previous year. So, the retained earnings at December 31, 2007 is the retained earnings at January 1, 2008. Also, it's ok for beginning retained earnings to equal zero. That just means that the company is a brand new company or the company has a retained earnings balance of zero.

Step 3 – Add Net Income or Subtract Net Loss. In step 3 we add net income or subtract net loss from the beginning retained earnings number. But where does net income come from? Well, it is found on the Income Statement, the statement that is prepared before this statement, the statement of retained earnings.

In step 4 of preparing the statement of retained earnings, we will subtract dividends. Remember that dividends represent payments or distributions to owners and decrease retained earnings.

In the last step, step 5, calculate ending retained earnings.

Let’s review the steps for the statement of retained earnings one more time. Step 1, prepare the heading and then step 2, start with beginning retained earnings. Step 3, Add net income or subtract net loss. Step 4, Subtract dividends. And step 5, determine ending retained earnings.