

CBSB

Contingent Liabilities: Potential liability that depends on future outcome of past events. (Obligations due within one year or within the operating cycle if longer than a year)

A) Current liabilities of known amount include:

1. Accounts payable
2. Short-term notes payable
3. Sales tax payable
4. Accrued liabilities
5. Payroll liabilities
6. Unearned revenues
7. Current portion of long-term debt

Short-term notes payable: Due within one year, Used to borrow cash or purchase asset, Company must accrue interest expense and interest payable at the end of the period

Accrued Liabilities: Result from expenses incurred but not yet paid
Salaries and Wages Payable

Interest Payable
Income Taxes Payable

Payroll Liabilities: called employee compensation
Major expense of most companies
Many different forms: Salary, Wage
Commission, Bonus

Unearned Revenues = deferred revenues and revenues collected in advance. Business receives cash before earning revenue
Results in a liability Obligation to provide goods or services.

Current Portion of Long-Term Debt = current maturity or current installment = Amount of principal payable within one year

B) Current Liabilities That Must Be Estimated:

Estimated Warranty Payable: Warranty period may extend for 90 days to a year
Company must record warranty expense in same period that business records sales revenue (expense recognition principle).

Contingent Liabilities: Potential liability that depends on future outcome of past events. Accounting could be Accrue, Disclose, or Neither, if unlikely.

1. Accrue if the loss/expense is probable AND the amount can be reasonably estimated.
2. Disclose if it is reasonably possible (less than probable but more than remote) that a loss/expense will occur.
3. If the loss/expense is unlikely to occur, there is no need to report or disclose.

*** Interest Rates & Bond Prices**

- Bonds always sold at market price (Bond's present value),
- Two interest rates set bond price
 - Stated interest rate (coupon rate)
 - Market interest rate (effective interest rate)

* Stated rate usually differs from market rate

Types of Bonds: Term, Secured, Serial, Unsecured.

Three main ways to finance operations:

1. Retained earnings
2. Issuing equity (stock)
3. Issuing bonds (or notes) payable

CBS10 Stockholders' Equity

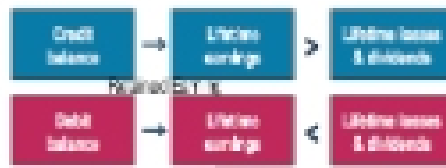
* The main purpose of Stockholders' Equity is to report reasons for changes in the equity account.

Paid-in Capital= contributed capital: Amount of equity stockholders have contributed

Retained Earnings: Increased by earnings through profitable operations, and Reduced by dividends declared.

Classes of Stock

- **Common:** Basic form of stock, Has four basic rights, Shareholders benefit most if corporation succeeds, Take more risk.



Question 2: ANSWER: The purchase of treasury stock by a corporation increases total assets and stockholders' equity.

EMBI Decreases total assets and decreases stockholders' equity.

Question 3: ANSWER: Wolverine Corporation issued 1,000 shares of its \$1 par value common stock in payment for attorney services of \$40,000. Wolverine stock has been actively trading at \$20 per share. This transaction would include a:

- A) debit to Legal Expense \$100,000.
- B) debit to Legal Expense \$40,000.
- C) credit to Common Stock \$200,000.
- D) credit to Common Stock \$40,000.

The Home Depot, Inc.
Stockholders' Equity
January 28, 2012

On call note	Mark 15, Treasury 200,000, Preferred *	
Common stock		87
Paid-in Capital		6,995
Retained earnings		17,248
Accumulated other comprehensive income		280
Treasury stock (100,000,000 shares)		(6,000)
Total stockholders' equity		\$ 27,610

2012	Account	Debit	Credit
	Treasury Stock	4,000,000,000	
	Cash		4,000,000,000

	Account	Debit	Credit
Jun 19	Retained Earnings	50,000	
	Dividends Payable		50,000
	(Debit for a debit dividend)		
	Declared Dividend / Cash Dividends		

	Account	Debit	Credit
Jul 16	Dividends Payable	50,000	
	Cash		50,000
	(Paid cash dividend)		
	Payment Date / Cash Dividends		

	Account	Debit	Credit
Jan 5	Cash (10,000,000 x \$10)	100,000,000	
	Common Stock		100,000
	Paid-in Capital		99,900,000
	To issue common stock		

	Account	Debit	Credit
Aug 14	Cash	15,422	
	Common Stock		15,422
	To issue 4.2-par treasury stock		
	No Par Common Stock		

Illustration
Kaleep Company's balance sheet reports the following:

Preferred stock, \$20 par, 2%, 11,000 shares issued	\$220,000
Common stock, \$2.50 par, 1,100,000 shares issued	2,750,000
Treasury stock, common, 100,000 shares at cost	400,000
July 31, 2014, Kaleep Company earned net income of \$6,200,000.	
Compute earnings per share for 2014. (Round cents to two decimal places.)	

Preferred Dividend → 220,000 × 2% = \$4,400

Weighted-average common shares outstanding → 1,100,000 - 100,000 = 1,000,000

Net income - Preferred dividends = Earnings Per Share

$$\frac{\$6,200,000 - \$4,400}{1,000,000} = \$6.19$$

bottom line.

Operating Income (Earnings)

Improving operating earnings in relation to net sales reflects increasing earnings quality- Operating income is a function of all of its individual ingredients: Sales revenue & Cost of goods sold & Gross margin (gross profit) & Operating expenses.

Earnings per share (EPS) - Earnings per share of common stock- Preferred stockholders have first claim on dividends- Preferred dividends: Must be subtracted from net income and all income subtotal starting with income from continuing operations to compute EPS- Not subtracted from discontinued operations or extraordinary items.

Preferred: Advantages: Receive dividends first, Receive assets first in liquidation, Shareholders earn a fixed dividend, Few corporations issue.

Par Value and No-Par: Arbitrary amount assigned to share of stock, Usually set low to avoid legal issues, No-par stock, May have a stated value.

Authorized: Maximum number of shares the company can issue under its charter

Issued: Number of shares the company has issued to its stockholders

Outstanding: Number of shares that stockholders own (number of shares in the hands of stockholders)

TREASURY STOCK: Treasury Stock called contra-stockholders' equity // Increases assets and equity
Issued shares reacquired by the company. **Reasons:** Make shares available for employee stock purchase plans, Plan to "buy low" and "sell high", Avoid takeover, Increase earnings per share, Use in share repurchase program
How is Treasury Stock Recorded? Recorded at cost (Net par value), Classified as a contra-stockholders' equity account (Debit balance).

ACCOUNT FOR RETAINED EARNINGS, DIVIDENDS, AND SPLITS

- **Retained Earnings =** (Net income (-) Less net losses (-) Less declared dividends) Accumulated over corporation's lifetime

- **Dividends:** Distribution by a corporation to its stockholders, Usually take one of three forms:

- Cash, Stock, or Noncash assets.

- Company must have both:
 - + Enough Retained Earnings to declare the dividend
 - + Enough Cash to pay the dividend

- Board of directors has authority to declare a dividend
Company not obligated to pay dividend until declared

Three relevant dates:

- Declaration date: the date when a cash dividend becomes a legal obligation.
- Date of record (no entry)
- Payment date

Stock Dividends: Increase stock account and decrease Retained Earnings, Total equity is unchanged.

Size of stock dividend

25% or less, recorded at market value

Greater than 25%, recorded at par value

Stock Splits: Increase in shares with a proportionate reduction in par value, Decreases market price of shares, No accounts affected.

Statement of Cash Flows: Financing transactions that affect both cash and equity fall into three main categories: Issuance of stock, Treasury stock, Dividends

Chapter 11: Operating and Other Expenses: Largest operating expenses include salaries, wages, utilities, and supplies- The lower the cost relative to sales, the more efficiently management is operating the business- Cutting costs can either help or hurt the

Management's Responsibility: Issues report on and declares responsibility for internal control over financial reporting. States if has conducted an assessment of internal controls based on developed framework. Internal controls determined to be effective. Internal controls audited by outside auditors.

Earnings Per Share Dilution: When preferred is converted to common, EPS is diluted—reduced. Corporations with complex capital structures present two sets of EPS figures: 1- **Basic EPS:** Based on actual outstanding common shares. 2- **Diluted EPS:** Based on outstanding common shares plus additional shares that can arise from conversion of preferred stock into common stock or other dilutive securities.

Auditor's Report: CPAs examine financial statements of publicly-traded companies. Auditors determine if statements comply with GAAP. Decide if internal controls meet standards. Combined report issued on financial statements and system of internal controls. Audit adds credibility to financial statements and internal control system.

CH12 Statement of cash flows: Reports cash flows: 1. Cash receipts. 2. Cash payments. Covers a span of time (month, quarter, year). Includes cash equivalents.

CH13 PERFORMS HORIZONTAL ANALYSIS: Study of percentage changes from year-to-year. Two steps: 1- Compute dollar amount of change from one period to the next. 2- Divide dollar amount of change by base-period amount.

***INCOME STATEMENT** – divide every # by NET SALES.

***BALANCE SHEET** – divide every # by TOTAL ASSETS

Prepare common size financial statements: Report only percentages (no dollar amounts). Assists in the comparison of different companies. Expresses financial results in terms of a common denominator.

Cash flow signs of a healthy company: Net cash flow provided by operating activities exceeds net income. Operations are the major source of cash. Investing activities include more purchases than sales of long-term assets. Financing activities are not dominated by borrowing. **Ability to Pay Current Liabilities:** Working Capital- current Ratio- Quick (Acid-test) Ratio.

Limitations of Ratio Analysis: To be useful, ratios should be analyzed over a period of years to consider all relevant factors. Any one year, or even any two years, may not represent the company's performance over the long term.

Perform vertical analysis: shows relationship of a financial statement item to its base. Income statement, base is total revenue. Balance sheet, base is total assets. **Vertical analysis % = Each income statement item / Net sales (revenue).**

Ability to Pay Current Liabilities:

Working Capital = Current assets – Current liabilities

Current Ratio = Current assets / Current liabilities.

Quick (Acid-test) Ratio = (Cash and cash equivalents + short-term investments + net current receivables) / Current liabilities.

Turnover and Cash Conversion Cycle:

Inventory Turnover = Cost of goods sold / Average inventory

Days' Inventory Outstanding (DIO) = 365 / Turnover

Accounts Receivable Turnover = Net sales / Average net accounts receivable

Days' Sales Outstanding (DSO) = 365 / Turnover

Accounts Payable Turnover = Cost of goods sold / Average accounts payable.

Days' Payables Outstanding (DPO) = 365 / Turnover

Cash Conversion Cycle = DIO + DSO – DPO.

Leverage – Overall Ability to Pay Debts:

Debt Ratio = Total liabilities / Total assets

Times-Interest-Earned Ratio = Income from operations / Interest expense.

Income from operating = income before income taxes + Interest Expense

Profitability:

Gross Margin % = Gross margin / Net sales

Operating Income % = Operating income / Net sales

Rate of Return on Sales (ROS) = (Net income – Preferred dividends) / Net sales

Asset Turnover Ratio = Net sales / Average total assets

Rate of Return on Assets (ROA) = Rate of return on sales x Asset turnover.

Leverage (Equity Multiplier) Ratio = Average total assets / Average common stockholders' equity.

Rate of Return on Common Stockholders' Equity (ROE) = (Net income – Preferred dividends) / Average common stockholders' equity.

Earnings Per Share (EPS) = (Net income – Preferred dividends) / Average number of shares of common stock outstanding.

Analyzing Stock Investments:

Price-Earnings Ratio = Market price per share of common stock / Earnings per share.

Revenue Recognition

Revenue is recognized when it is earned



EVALUATE QUALITY OF EARNINGS

Components of Earnings Quality



Investing Activities	
Positive Items	Negative Items
Sale of plant assets	Acquisition of plant assets
Sale of investments in fixed assets	Purchase of investments that are not cash equivalents
Collection of loans receivable	Making loans to others

Financing Activities	
Positive Items	Negative Items
Issuing stock	Payment of dividends
Selling treasury stock	Purchase of treasury stock
Borrowing money	Payment of principal amounts of debts

Operating Activities	
Positive Items	Negative Items
Net income	Net loss
Depreciation and amortization	Gain on sale of long-term assets
Loss on sale of long-term assets	Increase in current assets other than cash
Decreases in current assets other than cash	Decrease in current liabilities
Increase in current liabilities	

Dividend Yield on Common Stock = Dividend per share of common stock / Market price per share of common stock.
Book Value Per Share of Common Stock = (Total stockholders' equity – Preferred equity) / Number of shares of common stock outstanding (Basic).

Exhibit 14-6 How Did It Turn Out? and What It Turned Out to Be for the Year

Case A	Case B	Market Price	Dividend	Book Value
Speedy Service, Inc. (a) (b) (c) (d) (e) (f) (g) (h) (i) (j) (k) (l) (m) (n) (o) (p) (q) (r) (s) (t) (u) (v) (w) (x) (y) (z)

Proforma Factory, Inc. (PFI)
Statement of Cash Flows for the Year Ended December 31, 2014

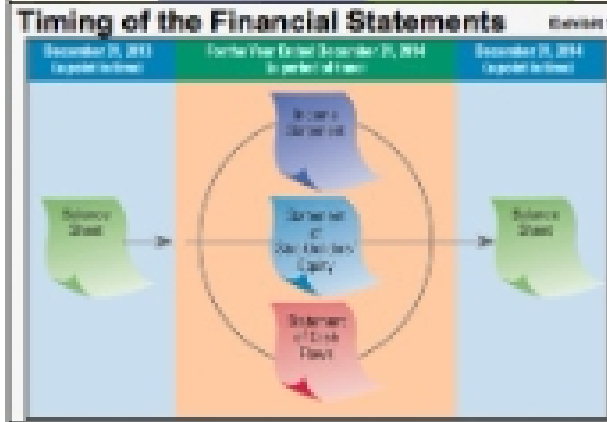
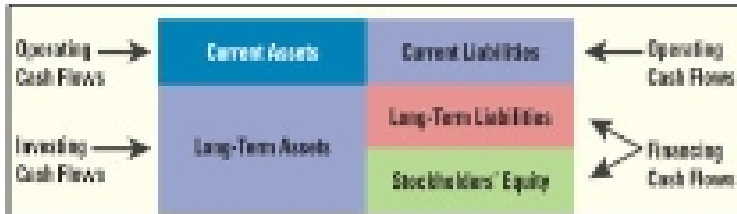
1	Cash flows from operating activities:
2	Net income
3	Adjustments to reconcile net income to net cash provided by operating activities:
4	+ Depreciation expense
5	+ Loss on sale of long-term assets
6	+ Gain on sale of long-term assets
7	+ Increase in current assets other than cash
8	+ Decrease in current assets other than cash
9	+ Increase in current liabilities
10	+ Decrease in current liabilities
11	+ Decrease in current liabilities
12	+ Increase in current liabilities
13	+ Decrease in current liabilities
14	+ Increase in current liabilities
15	Cash flows from investing activities:
16	Acquisition of plant assets
17	Acquisition of investments
18	Acquisition of investments
19	Acquisition of investments
20	Acquisition of investments
21	Acquisition of investments
22	Acquisition of investments
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99	Acquisition of investments
100	Acquisition of investments

Investing Activities

1	Acquisition of plant assets	(100)
2	Acquisition of investments	(200)
3	Acquisition of investments	(300)
4	Acquisition of investments	(400)
5	Acquisition of investments	(500)
6	Acquisition of investments	(600)
7	Acquisition of investments	(700)
8	Acquisition of investments	(800)
9	Acquisition of investments	(900)
10	Acquisition of investments	(1,000)
11	Acquisition of investments	(1,100)
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20	Acquisition of investments	(2,000)
21	Acquisition of investments	(2,100)
22	Acquisition of investments	(2,200)
23	Acquisition of investments	(2,300)
24	Acquisition of investments	(2,400)
25	Acquisition of investments	(2,500)
26	Acquisition of investments	(2,600)
27	Acquisition of investments	(2,700)
28	Acquisition of investments	(2,800)
29	Acquisition of investments	(2,900)
30	Acquisition of investments	(3,000)
31	Acquisition of investments	(3,100)
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35	Acquisition of investments	(3,500)
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57	Acquisition of investments	(5,700)
58	Acquisition of investments	(5,800)
59	Acquisition of investments	(5,900)
60	Acquisition of investments	(6,000)
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68	Acquisition of investments	(6,800)
69	Acquisition of investments	(6,900)
70	Acquisition of investments	(7,000)
71	Acquisition of investments	(7,100)
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79	Acquisition of investments	(7,900)
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96	Acquisition of investments	(9,600)
97	Acquisition of investments	(9,700)
98	Acquisition of investments	(9,800)
99	Acquisition of investments	(9,900)
100	Acquisition of investments	(10,000)

Financing Activities

1	Issuance of common stock	100
2	Issuance of common stock	200
3	Issuance of common stock	300
4	Issuance of common stock	400
5	Issuance of common stock	500
6	Issuance of common stock	600
7	Issuance of common stock	700
8	Issuance of common stock	800
9	Issuance of common stock	900
10	Issuance of common stock	1,000
11	Issuance of common stock	1,100
12	Issuance of common stock	1,200
13	Issuance of common stock	1,300
14	Issuance of common stock	1,400
15	Issuance of common stock	1,500
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17	Issuance of common stock	1,700
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21	Issuance of common stock	2,100
22	Issuance of common stock	2,200
23	Issuance of common stock	2,300
24	Issuance of common stock	2,400
25	Issuance of common stock	2,500
26	Issuance of common stock	2,600
27	Issuance of common stock	2,700
28	Issuance of common stock	2,800
29	Issuance of common stock	2,900
30	Issuance of common stock	3,000
31	Issuance of common stock	3,100
32	Issuance of common stock	3,200
33	Issuance of common stock	3,300
34	Issuance of common stock	3,400
35	Issuance of common stock	3,500
36	Issuance of common stock	3,600
37	Issuance of common stock	3,700
38	Issuance of common stock	3,800
39	Issuance of common stock	3,900
40	Issuance of common stock	4,000
41	Issuance of common stock	4,100
42	Issuance of common stock	4,200
43	Issuance of common stock	4,300
44	Issuance of common stock	4,400
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46	Issuance of common stock	4,600
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50	Issuance of common stock	5,000
51	Issuance of common stock	5,100
52	Issuance of common stock	5,200
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67	Issuance of common stock	6,700
68	Issuance of common stock	6,800
69	Issuance of common stock	6,900
70	Issuance of common stock	7,000
71	Issuance of common stock	7,100
72	Issuance of common stock	7,200
73	Issuance of common stock	7,300
74	Issuance of common stock	7,400
75	Issuance of common stock	7,500
76	Issuance of common stock	7,600
77	Issuance of common stock	7,700
78	Issuance of common stock	7,800
79	Issuance of common stock	7,900
80	Issuance of common stock	8,000
81	Issuance of common stock	8,100
82	Issuance of common stock	8,200
83	Issuance of common stock	8,300
84	Issuance of common stock	8,400
85	Issuance of common stock	8,500
86	Issuance of common stock	8,600
87	Issuance of common stock	8,700
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91	Issuance of common stock	9,100
92	Issuance of common stock	9,200
93	Issuance of common stock	9,300
94	Issuance of common stock	9,400
95	Issuance of common stock	9,500
96	Issuance of common stock	9,600
97	Issuance of common stock	9,700
98	Issuance of common stock	9,800
99	Issuance of common stock	9,900
100	Issuance of common stock	10,000



Cash flow from investing activities	
Purchase of equipment	\$ (10,000)
Proceeds from sale of land	20,000
Net cash provided by (used for) investing activities	(10,000)
Cash flow from financing activities	
Purchase of treasury stock	(5,000)
Proceeds from issuance of common stock	20,000
Payment of note payable	(2,000)
Payment of dividends	5,000
Net cash provided by (used for) financing activities	(5,000)
Net increase (decrease) in cash	\$ 0

IDENTIFY THE PURPOSES OF THE STATEMENT OF CASH FLOWS

Serves these purposes:

- Predicts future cash flows
- Evaluates management decisions
- Determines ability to pay dividends and interest
- Shows relationship of net income to cash flows

COMPUTE EARNINGS PER SHARE

Net Income - Preferred dividends

Weighted-average number of common shares outstanding

Earnings per share (EPS)

- Key measure of earnings success
- Two EPS calculations:
 - Basic
 - Diluted

If contingent liability, amount recorded in the account

- A. if the amount can be reasonably estimated.
- B. if the amount is likely to occur with no gain.
- C. if the liability is a present obligation.
- D. both A and C.
- E. both A and D.

Cost of Goods Sold and Gross Profit

Sign of increasing earnings quality

- Steadily increasing gross profit as a percentage of net sales revenue
- Steadily decreasing cost of goods sold as a percentage of net sales revenue

Two Formats for Operating Activities

- Indirect** → Reconciles from net income to net cash provided by operating activities
- Direct** → Reports all cash receipts and cash payments from operating activities

Stockholders' Rights

Three types:

- Operating** → VOTE → Right to voting or influence for electing or re-electing directors
- Investing** → Dividends → Right to receive a proportionate part of any dividend
- Financial** → Liquidation → Right to receive a proportionate share of any assets remaining after corporate debts are paid in liquidation
- Financial** → Preemption → Right to purchase more proportionate amount of new shares

Benchmarking

- Compares company to a standard set by others
- Facilitated by common-size statements
- Has goals

USE RATIOS TO MAKE BUSINESS DECISIONS

- Measuring ability to pay current liabilities
- Measuring turnover and cash conversion cycle
- Measuring leverage
- Measuring profitability
- Analyzing stocks as an investment