CH#9

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

Ch#10 Stockholders' Equity

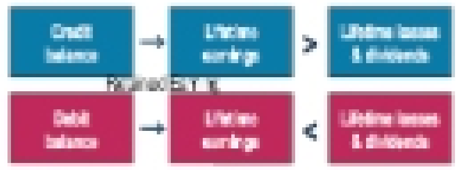
* The main purpose of Stockholders' Equity is to report reasons for changes in the equity account.

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

FALSE Decreases total assets and decreases stockholders' equity.

Question 3: ANSWER: Wolverine Corporation issued 5,000 shares of its $5 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 $100,000.

D) credit to Common Stock $40,000.

The Home Depot, Inc. Stockholders' Equity January 29, 2012	
(In millions) How is Treasury Stock Recorded?	
Common stock	87
Paid-in Capital	6,966
Retained earnings	17,246
Accumulated other comprehensive income	293
Treasury stock (105,000,000 shares)	(6,694)
Total stockholders' equity	$ 17,898
also How to Calculate Stockholders' Equity	

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

	Account	Debit	Credit
Jun 19	Retained Earnings	50,000	
	Dividends Payable		50,000
	Declared a cash dividend		
	Declaration Date/ cash Dividends		

	Account	Debit	Credit
Jul 15	Dividends Payable	50,000	
	Cash		50,000
	Paid cash dividend		
	Payment Date / Cash Dividends		

	Account	Debit	Credit
Jan 8	Cash (10,000,000 x $10)	100,000,000	
	Common Stock		500,000
	Paid-in Capital Common Stock Above Par		99,500,000
	To issue common stock		

	Account	Debit	Credit
Aug 14	Cash	10,422	
	Common Stock		10,422
	To issue no-par common stock		
	No Par Common Stock		

Illustration

Kalispell 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, 120,000 shares at cost	480,000

During 2015, Kalispell Company earned net income of $5,200,000. Compute earnings per share for 2015. (Round EPS to two decimal places.)

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

Weighted-average common shares outstanding → 1,100,000 − 120,000 = 980,000

$$\frac{\text{Net Income} - \text{Preferred dividends}}{\text{Weighted-average number of common shares outstanding}} = \text{Earnings Per Share}$$

$$\frac{\$5,200,000 - \$4,400}{980,000} = \$5.30$$

- **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 (Not 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, Decrease 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

Chapter11: 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 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 subtotals starting with income from continuing operations to compute EPS- Not subtracted from discontinued operations or extraordinary items.

Management's Responsibility: Issues report on and declares responsibility for internal control over financial reporting- States it has conducted an assessment of internal controls based on developed frameworks- 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 dilutivesecurities.
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.
CH#12 Statement of cash flows: Reports cash flows: 1.Cash receipts. 2.Cash payments- Covers a span of time (month, quarter, year)- Includes **cash equivalents.**
CH#13 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 STMT** – 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:

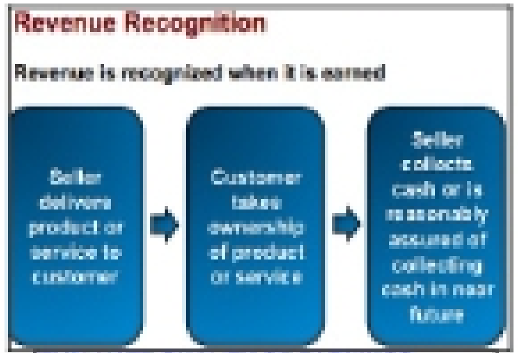
Debt Ratio = Total liabilities / Total assets
Times-Interest-Earned Ratio = Income from operations / Interest expense.
Income from operating = income before income taxes + Interest Expense

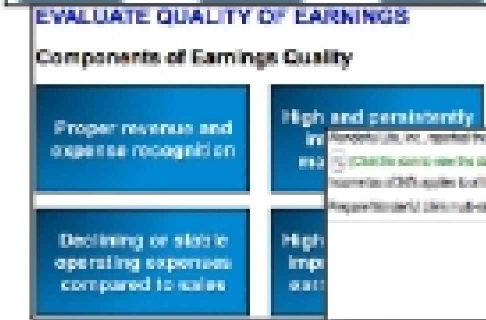
Profitability:

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.





Investing Activities

Positive Items	Negative Items
Sale of plant assets	Acquisition of plant assets
Sale of investments that are not cash equivalents	Purchase of investments that are not cash equivalents
Collections of loans receivable	Making loans to others

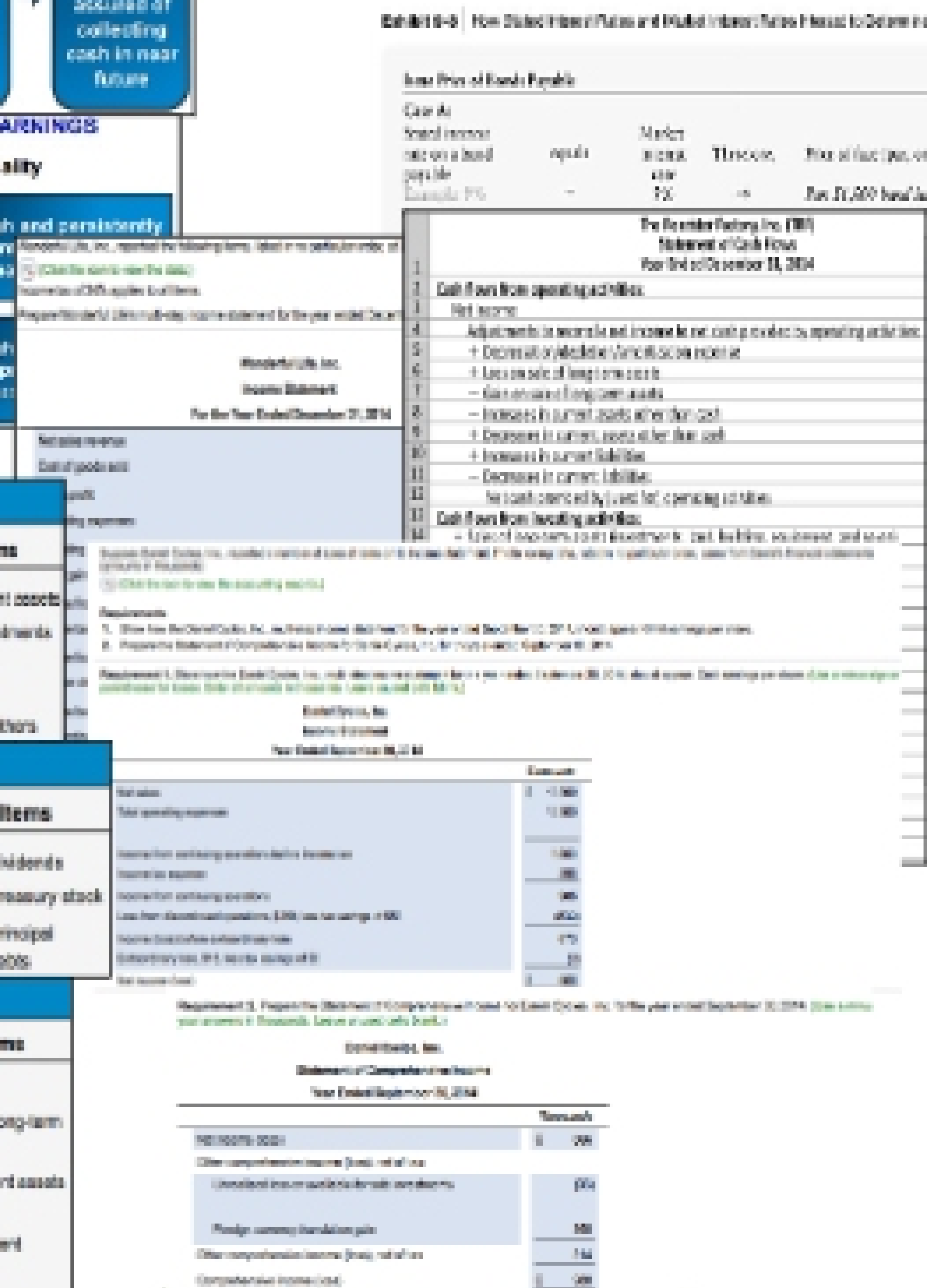
Financing Activities

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

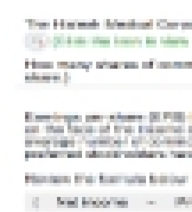
Operating Activities

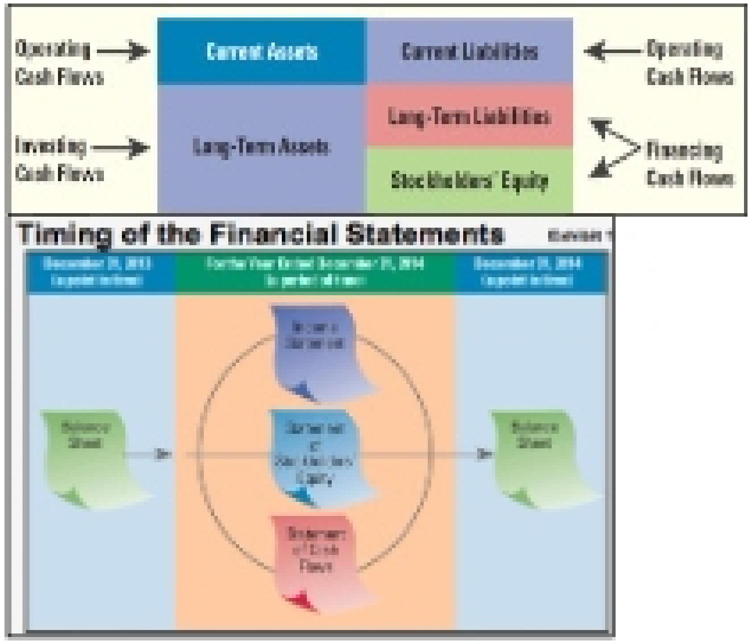
Positive Items	Negative Items
Net income	Net loss
Depreciation and amortization	Gain on sale of long-term assets
Loss on sale of long-term assets	Increase in current assets other than cash
Decrease in current assets other than cash	Decrease in current liabilities
Increase in current liabilities	

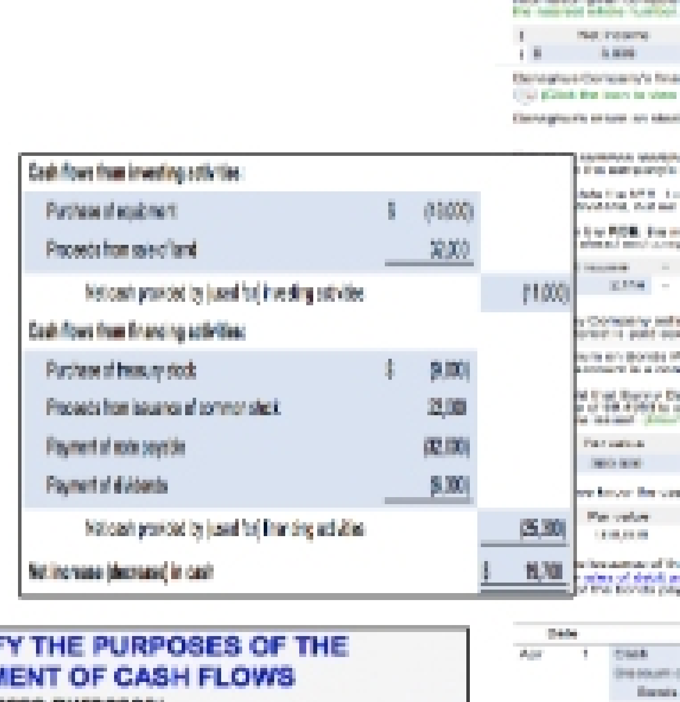
Dividend Yield on Common Stock = Dividend per share of common stock / Market price per share of common stock.
Book Value Per Share of Common Stock = (Total stockholders' equity – Preferred equity) / Number of shares of common stock outstanding (basic).

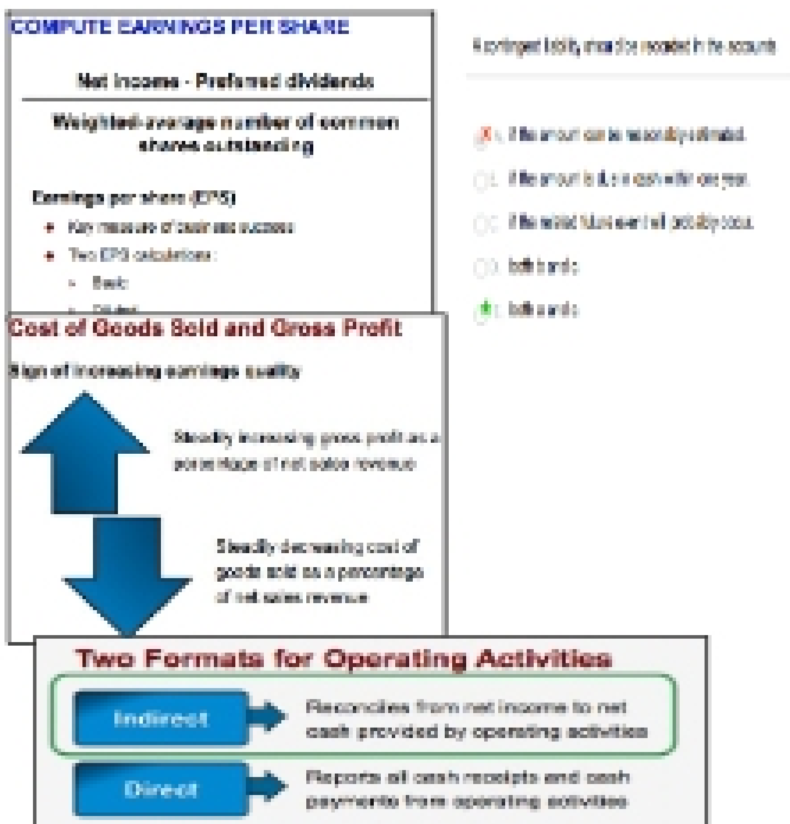


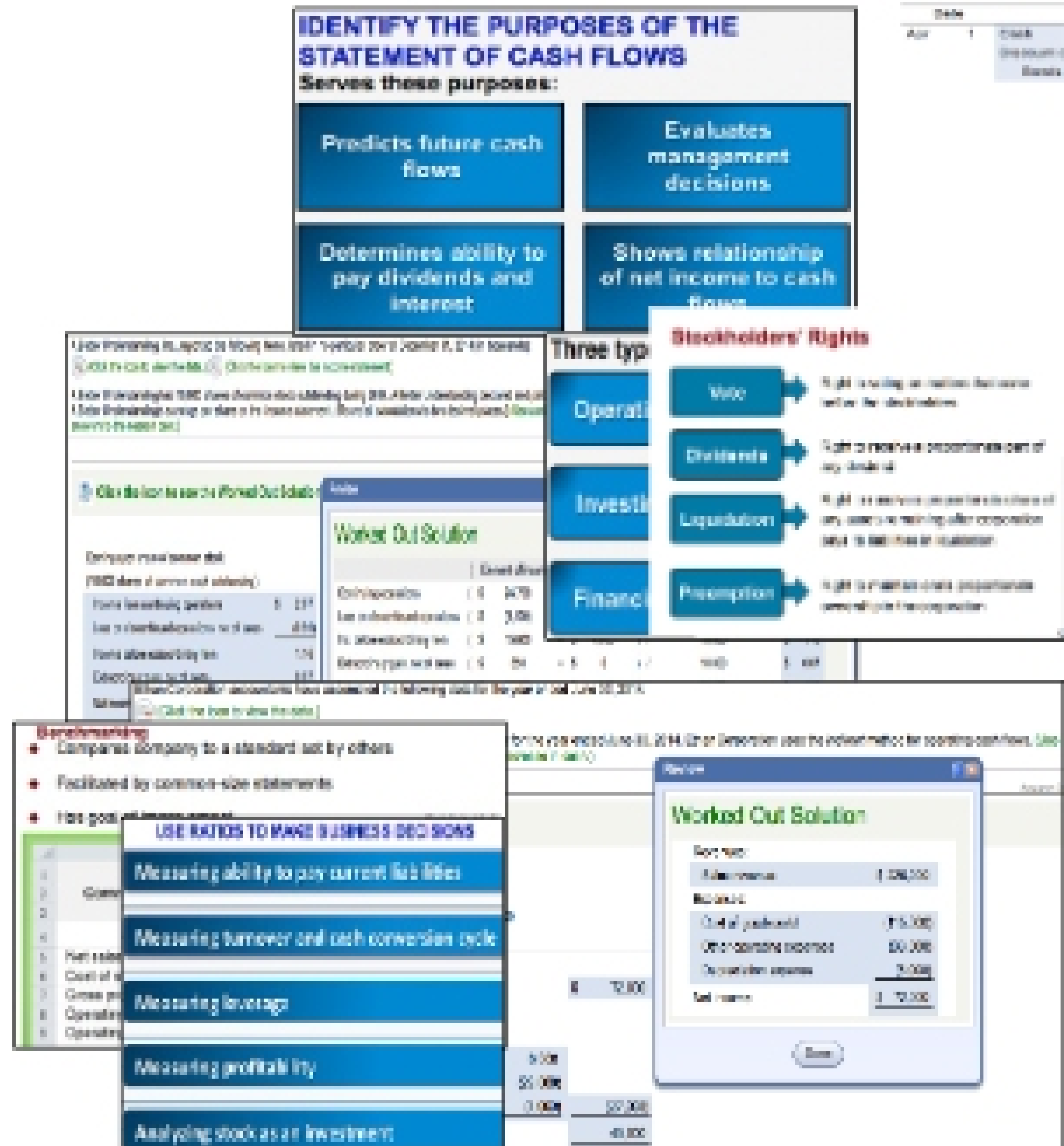
	Thousands
Noncash investing and financing activities:	
Acquisition of building by issuing common stock	$ 300
Acquisition of land by issuing note payable	70
Payment of long-term debt by issuing common stock	100
Total noncash investing and financing activities	$ 470




Operating Cash Flows
Current Assets
Current Liabilities
Operating Cash Flows
Investing Cash Flows
Long-Term Assets
Long-Term Liabilities
Stockholders' Equity
Financing Cash Flows
Timing of the Financial Statements


Cash flows from investing activities:
Purchase of equipment
Proceeds from sale of land
Cash flows from financing activities:
Purchase of treasury stock
Proceeds from issuance of common stock
Payment of note payable
Payment of dividends
Net increase (decrease) in cash


COMPUTE EARNINGS PER SHARE
Net Income - Preferred dividends
Weighted-average number of common shares outstanding
Earnings per share (EPS)
Cost of Goods Sold and Gross Profit
Sign of increasing earnings quality
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


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
Stockholders' Rights
Vote
Dividends
Liquidation
Preemption
Worked Out Solution
Benchmarking
Compares company to a standard set by others
Facilitated by common-size statements
USE RATIOS TO MAKE BUSINESS DECISIONS
Measuring ability to pay current liabilities
Measuring turnover and cash conversion cycle
Measuring leverage
Measuring profitability
Analyzing stock as an investment
Worked Out Solution