Survey of Accounting, 9e

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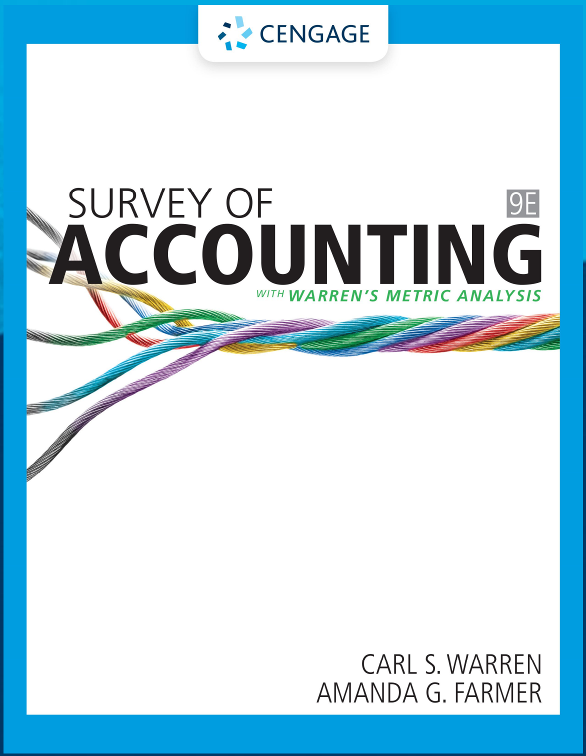

Chapter 8

Liabilities and Stockholders' Equity

Learning Objectives

- Describe how corporations finance their operations and its impact on earnings per share
- Describe and illustrate the accounting for current liabilities, notes payable, and payroll
- Describe the accounting for bonds payable
- Describe types of contingent liabilities and the related accounting
- Describe and illustrate transactions involving stock

Learning Objectives (continued)

- Describe and illustrate the accounting for cash and stock dividends
- Describe and illustrate stock splits
- Describe and illustrate the reporting of liabilities and stockholders’ equity
- Describe and illustrate the debt and price-earnings ratios

Learning Objective 1

Describe how corporations finance their operations and its impact on earnings per share

Financing Corporations

- Sources used to finance operations
  - Short-term debt
  - Long-term debt
    - **Bond**
  - Equity
    - Common stock
    - Preference stock
- **Earnings per share (EPS)**
  - Influences a company's decisions on financing operations using debt or equity

$$\text{Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Number of Common Shares Outstanding}}$$

Exhibit 1: Reedy Corporation Financing Alternatives

	Alternative One		Alternative Two		Alternative Three	
	Amount	Percent	Amount	Percent	Amount	Percent
Issue 12% bonds	—	0%	—	0%	$2,000,000	50%
Issue preferred 9% stock, $50 par value	—	0	$2,000,000	50	1,000,000	25
Issue common stock, $10 par value	$4,000,000	100	2,000,000	50	1,000,000	25
Total amount of financing	$4,000,000	100%	$4,000,000	100%	$4,000,000	100%

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Exhibit 2: Earnings per Share $800,000*

	Alternative One	Alternative Two	Alternative Three
12% bonds	—	—	$2,000,000
Preferred 9% stock, $50 par	—	$2,000,000	1,000,000
Common stock, $10 par	$4,000,000	2,000,000	1,000,000
Total	$4,000,000	$4,000,000	$4,000,000
Earnings before interest and income tax	$ 800,000	$ 800,000	$ 800,000
Deduct interest on bonds	—	—	(240,000)[a]
Income before income tax	$ 800,000	$ 800,000	$ 560,000
Deduct income tax	(320,000)[b]	(320,000)[b]	(224,000)[b]
Net income	$ 480,000	$ 480,000	$ 336,000
Dividends on preferred stock	—	(180,000)[c]	(90,000)[c]
Available for dividends on common stock	$ 480,000	$ 300,000	$ 246,000
Shares of common stock outstanding	÷ 400,000[d]	÷ 200,000[d]	÷ 100,000[d]
Earnings per share on common stock	$ 1.20	$ 1.50	$ 2.46

[a]$2,000,000 bonds × 12%
[b]Income before income tax × 40%
[c]Preferred stock × 9%
[d]Common stock ÷ $10 par value per share

* Earnings before interest and income tax

Exhibit 3: Earnings per Share $440,000*

	Alternative One	Alternative Two	Alternative Three
12% bonds	—	—	$2,000,000
Preferred 9% stock, $50 par	—	$2,000,000	1,000,000
Common stock, $10 par	$4,000,000	2,000,000	1,000,000
Total	$4,000,000	$4,000,000	$4,000,000
Earnings before interest and income tax	$ 440,000	$ 440,000	$ 440,000
Deduct interest on bonds	—	—	(240,000)
Income before income tax	$ 440,000	$ 440,000	$ 200,000
Deduct income tax	(176,000)	(176,000)	(80,000)
Net income	$ 264,000	$ 264,000	$ 120,000
Dividends on preferred stock	—	(180,000)	(90,000)
Available for dividends on common stock	$ 264,000	$ 84,000	$ 30,000
Shares of common stock outstanding	÷ 400,000	÷ 200,000	÷ 100,000
Earnings per share on common stock	$ 0.66	$ 0.42	$ 0.30

* Earnings before interest and income tax

Learning Objective 2

Describe and illustrate the accounting for current liabilities, notes payable, and payroll

Liabilities

- Debts owed to **creditors**
- Types
  - **Current liabilities**
  - **Long-term liabilities**

Accounts Payable and Accruals

Accounts payable transactions

- Involve a variety of purchases on account, including the purchase of merchandise and supplies

Accrued liabilities

- Obligation to pay current assets in the future
- Recorded at the end of an accounting period as part of the adjustment process

Notes Payable

- Issued to:
  - Satisfy an account payable
  - Purchase merchandise or other assets
- Borrower: Issuer of the note
- Lender: Party receiving the note

Issuing and Paying Notes

- A business issues a 90-day, 6% note for $1,000, dated August 1, 20Y5, to satisfy an account payable that is due on October 30
  - Issuing notes payable

	BALANCE SHEET			
	Assets =	Liabilities		+ Stockholders' Equity
		Accounts Payable	+ Notes Payable	
Aug. 1.		(1,000)	1,000	

STATEMENT OF CASH FLOWS

INCOME STATEMENT

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Issuing and Paying Notes (continued)

- A business issues a 90-day, 6% note for $1,000, dated August 1, 20Y5, to satisfy an account payable that is due on October 30
  - Paying of note

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Notes Payable	+	Retained Earnings
Oct. 30.	(1,015)		(1,000)		(15)

STATEMENT OF CASH FLOWS

Oct. 30. Operating	(1,015)

INCOME STATEMENT

Oct. 30. Interest expense	(15)

Transaction Metric Effects

- Profitability metric: Earnings per share
- Solvency metric is used rather than a liquidity metric
- Effects of issuing and paying the $1,000 note payable, including interest

SOLVENCY	
Net Assets	
Issuing note payable	No Effect
Paying note payable	$(15)

PROFITABILITY	
Earnings per Share	
Issuing note payable	No Effect
Paying note payable	Decreases

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Payroll

- Amount paid to employees for the services they provide during a period
- **Gross pay**: Total earnings of an employee for a payroll period
  - Includes bonuses and overtime pay
- **Net pay** is obtained after subtracting one or more deductions
  - FICA tax: Contributes to Social Security and Medicare
  - Medical insurance, contributions to pensions, and items authorized by individual employees

Recording the Payroll of McDermott Co.

- McDermott Co. had a gross payroll of $13,800 for the week ending April 11
  - FICA tax: 7.5% of the gross payroll
  - Federal and state withholding: $1,655 and $280

BALANCE SHEET

	Assets =	Liabilities			+ Stockholders' Equity
	Cash =	FICA Tax Payable	+ Employee Federal Income Tax Payable	+ Employee State Income Tax Payable +	Retained Earnings
Apr. 11.	(10,830)*	1,035**	1,655	280	(13,800)

STATEMENT OF CASH FLOWS

Apr. 11. Operating	(10,830)

INCOME STATEMENT

Apr. 11. Wages and salary exp.	(13,800)

*$13,800 – $1,035 – $ 1,655 – $280 = $10,830
**$13,800 x 7.5% = $1,035

Recording Payroll: Transaction Metric Effects

- Effect of the payroll tax liabilities on the solvency and profitability metrics

SOLVENCY	
Net Assets	$(10,380)

PROFITABILITY	
Earnings per Share	Decrease

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Payroll: Employer Expenses

- Federal, state, and local (if applicable) income taxes
- Also include FICA, FUTA, and SUTA taxes
  - FICA: Employer portion
  - FUTA: Federal Unemployment Tax Act
  - SUTA: State Unemployment Tax Acts
- Taxes paid by employers are an operating expense for the business

Recording Employer Payroll Taxes of McDermott Co.

- Employer’s social security payroll tax: $1,035
- FUTA tax: $145
- SUTA tax: $25

BALANCE SHEET

	Assets =	Liabilities			+	Stockholders' Equity
		FICA Tax Payable +	FUTA Tax Payable +	SUTA Tax Payable	+	Retained Earnings
Apr. 11.		1,035	145	25		(1,205)

STATEMENT OF CASH FLOWS

INCOME STATEMENT

Apr. 11. Payroll tax exp.	(1,205)

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Recording Payroll Taxes: Transaction Metric Effects

- Effect of the payroll tax liabilities on the solvency and profitability metrics

SOLVENCY		PROFITABILITY	
Net Assets	$(1,205)	Earnings per Share	Decrease

Fringe Benefits

- Recognized as expenses when employer pays part or all of the cost of the fringe benefits
- Recorded during the period in which the employee earns the benefit
  - Estimated cost of the benefits should be recorded as an expense along with any related liability

Learning Objective 3

Describe the accounting for bonds payable

Bond

- Form of an interest-bearing note
- **Bond indenture**: Contract between the company issuing the bonds and the bondholders
- Bond issue is divided into several individual bonds
  - Interest may be payable annually, semiannually, or quarterly

Selling Price of Bonds: Determining Factors

- Face amount of the bonds due at the maturity date
- Periodic interest to be paid on the bonds
  - Identified in the bond indenture
  - Expressed as the **contract rate** or coupon rate
- **Market rate of interest** (effective rate of interest)
  - Bonds are sold at their face amount if the contract rate of interest is the same as the market rate of interest

Bonds Payable: Illustration

- A business issues $100,000 of 6%, 5-year bonds
  - Interest payable semiannually: $3,000
  - Market rate of interest when the bonds are issued: 6%
- Issuing bonds on January 1

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Bonds Payable		
Jan. 1.	100,000		100,000		

STATEMENT OF CASH FLOWS

Jan. 1. Financing	100,000

INCOME STATEMENT

Bonds Payable: Illustration (continued 1)

- Payment of semiannual interest on June 30
  - Interest = \$100,000 × 0.06 × ½ = \$3,000

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=			Retained Earnings
June 30.	(3,000)				(3,000)

STATEMENT OF CASH FLOWS

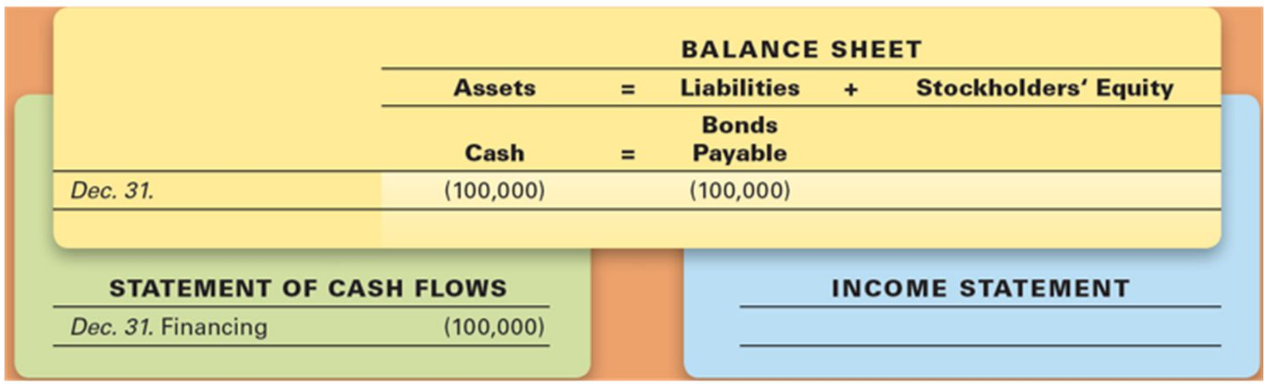
June 30. Operating	(3,000)

INCOME STATEMENT

June 30. Interest expense (3,000)

Bonds Payable: Illustration (continued 2)

- Payment of face value of $100,000 bond at maturity



	BALANCE SHEET				
	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Bonds Payable		
Dec. 31.	(100,000)		(100,000)		

STATEMENT OF CASH FLOWS	
Dec. 31. Financing	(100,000)

INCOME STATEMENT

Bonds Payable: Transaction Metric Effects

- Effects of the bond payable transactions on the solvency and profitability metrics

SOLVENCY	
Net Assets	
Issuing bonds payable	No Effect
Payment of interest	$(3,000)
Paying note payable	No Effect

PROFITABILITY	
Earnings per Share	
Issuing bonds payable	No Effect
Payment of interest	Decrease
Paying note payable	No Effect

Selling Price of Bonds

- Market Rate = Contract Rate
  - Selling Price = Face Amount of Bonds
- Market Rate of Interest > Contract Rate
  - Selling Price < Face Amount of Bonds
    - **Discount on Bonds Payable** = Face Amount − Selling Price
- Market Rate < Contract Rate
  - Selling Price > Face Amount of Bonds
  - **Premium on Bonds Payable** = Selling Price − Face Amount

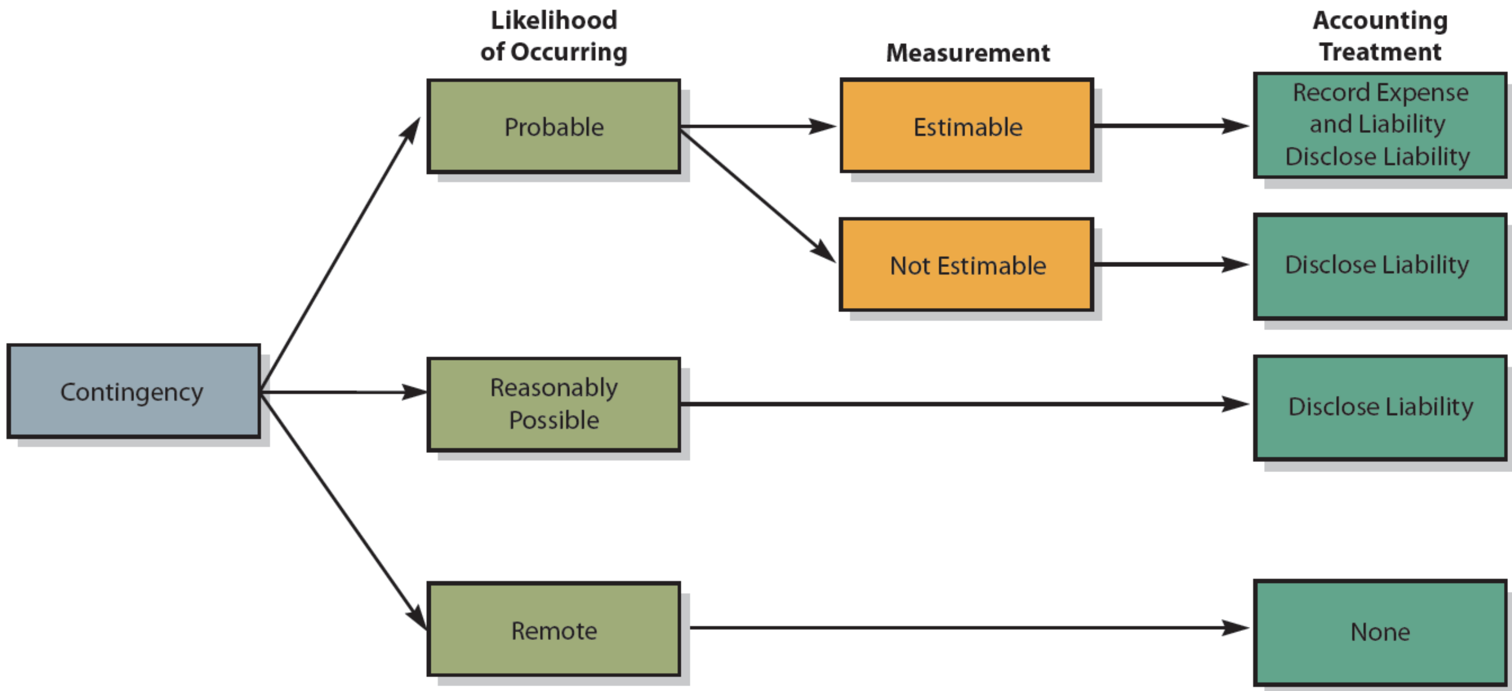
Learning Objective 4

Describe types of contingent liabilities and the related accounting

Contingent Liabilities

- Potential liabilities that may arise from past transactions if certain events occur in the future
- Accounting depends on the following factors:
  - Likelihood of the potential liability occurring
    - Classified as probable, reasonably possible, or remote
  - Ability to measure the potential liability
    - Classified as estimable or not estimable
- Professional judgment is necessary in distinguishing among classes of contingent liabilities

Exhibit 4: Accounting for Contingent Liabilities



Learning Objective 5

Describe and illustrate transactions involving stock

Exhibit 5: Authorized, Issued, and Outstanding Shares of Stock

Shares of Stock

- Issued with or without par value
  - **Par**: Monetary value stated on stock certificate
  - No-par stock: Some states might require the board of directors to assign a **stated value** to no-par stock
- Legal capital
  - Minimum stockholder contribution required by some states to protect creditors

Stock Rights

- Right to vote in matters concerning the corporation
- Right to share in distributions of earnings
- Right to share in assets upon liquidation

Common and Preferred Stock

Common stock

- When only one class of stock is issued
- Each share has equal rights

Preferred stock

- May or may not be issued
- Has preference rights over common stock
- Dividend rights are stated as dollars per share or as a percent of par

Issuance of Stock

- Price at which a stock sells depends on the following factors:
  - Financial condition, earnings record, and dividend record of the corporation
  - Investor expectations of the corporation’s potential earning power
  - General business and economic conditions and prospects
- Stocks are issued:
  - At a **premium**
  - In exchange for cash or other assets

Issuance of Stock by Caldwell Company

- C ansrsourc14 Company issues 2,000 shares of $1 par common stock for cash at $55 per share on November 1

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity	
	Cash	=			Common Stock +	Paid-In Capital in Excess of Par
Nov. 1.	110,000				2,000	108,000

STATEMENT OF CASH FLOWS

Nov. 1.	Financing	110,000

INCOME STATEMENT

- Transaction metric effects

SOLVENCY

Net Assets	$110,000

PROFITABILITY

Earnings per Share	Decrease

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Slide 41

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ansrsourc14 The edit suggested to this slide has not been made, since the indicated piece information in already included in the notes to slide 40.

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Treasury Stock

- Stock that a corporation has issued and then reacquired
- Balance at the end of the year is reported as a reduction of stockholders' equity
- Corporation may reacquire (purchase) its own stock to:
  - Provide shares for resale to employees
  - Reissue as bonuses to employees
  - Support the market price of the stock

Treasury Stock: Hoffman Inc.

- Purchases 10,000 shares of its outstanding common stock for $150,000

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=			Treasury Stock
Feb. 6.	(150,000)				(150,000)

STATEMENT OF CASH FLOWS

Feb. 6. Financing	(150,000)

INCOME STATEMENT

- Transaction metric effects

SOLVENCY

Net Assets	$(150,000)

PROFITABILITY

Earnings per Share	Increase

Learning Objective 6

Describe and illustrate the accounting for cash and stock dividends

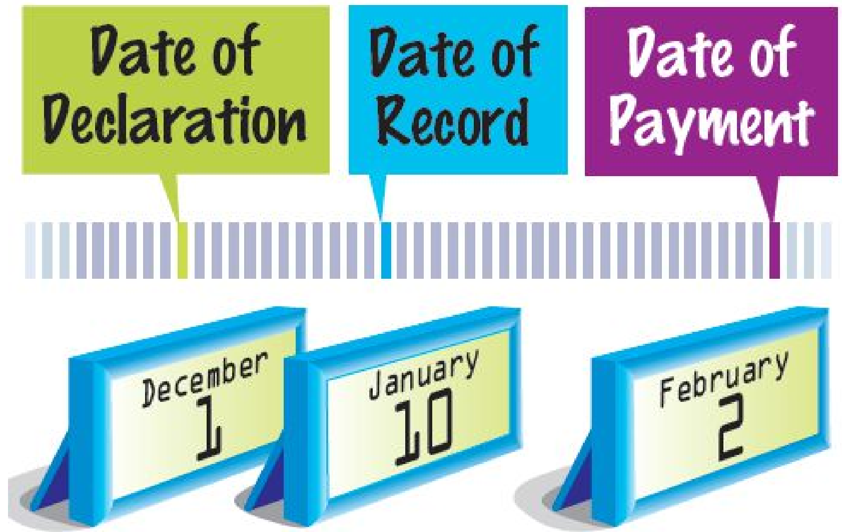
Dividends

- Declaring a dividend decreases the retained earnings of the corporation
- Types of dividend declared by the board of directors
  - Cash dividend
  - Stock dividend

Cash Dividends

- Cash distribution of earnings by a corporation to its shareholders
- Conditions for a cash dividend
  - Sufficient retained earnings
  - Sufficient cash
  - Formal action by the board of directors
- Special or extra dividends
  - Paid when a corporation experiences higher than normal profits
- Dividends are not paid on the treasury shares

Exhibit 6: Cash Dividend Dates



Board of directors takes action to declare dividends.

Owners of the shares on this date receive dividends.

Dividend is paid.

Declaration of Cash Dividends

- On December 1, Hiber Corporation's board of directors declares the cash dividends of $42,500
  - Date of record: January 10
  - Date of payment: February 2

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity
			Dividends Payable	+	Retained Earnings
Dec. 1.			42,500		(42,500)

STATEMENT OF CASH FLOWS

INCOME STATEMENT

Payment of Cash Dividends

- Payment of dividend on February 2

BALANCE SHEET	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Dividends Payable		
Feb. 2.	(42,500)		(42,500)		

STATEMENT OF CASH FLOWS	
Feb. 2. Financing	(42,500)

INCOME STATEMENT

- Transaction metric effects of the declaration and purchase

SOLVENCY Net Assets	
Declaring cash dividend	$(42,500)
Payment of cash dividend	No Effect

PROFITABILITY Earnings per Share	
Declaring cash dividend	No Effect
Payment of cash dividend	No Effect

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Stock Dividends

- Distribution of shares of stock to stockholders
- Transfer retained earnings to paid-in capital
- Do not change the assets, liabilities, or total stockholders' equity of a corporation
  - Individual stockholder's proportionate interest (equity) is also not changed

Stock Dividends (continued)

- A stockholder owns 1,000 of a corporation's 10,000 shares outstanding
  - If the corporation declares a 6% stock dividend, the stockholder's proportionate interest will not change as shown below

	Before Stock Dividend	After Stock Dividend
Total shares issued	10,000	10,600 [10,000 + (10,000 × 6%)]
Number of shares owned	1,000	1,060 [1,000 + (1,000 × 6%)]
Proportionate ownership	10% (1,000/10,000)	10% (1,060/10,600)

- Do not affect the solvency and profitability metrics

Learning Objective 7

Describe and illustrate stock splits

Stock Split

- Process by which a corporation reduces the par or stated value of its common stock and issues a proportionate number of additional shares
- Objective
  - To reduce a stock's market price per share in order to attract more investors
- Does not affect any financial statement accounts, since only the par value and number of shares outstanding change

Stock Split Before and After

- Rojek Corporation has 10,000 shares of $100 par common stock outstanding with a current market price of $150 per share
  - Stock split declared by the board of directors
    - Each common shareholder will receive five shares for each share held
    - Par of each share of common stock will be reduced to $20

	Before Split	After Split
Number of shares	10,000	50,000
Par value per share	× $100	× $20
Total	$1,000,000	$1,000,000

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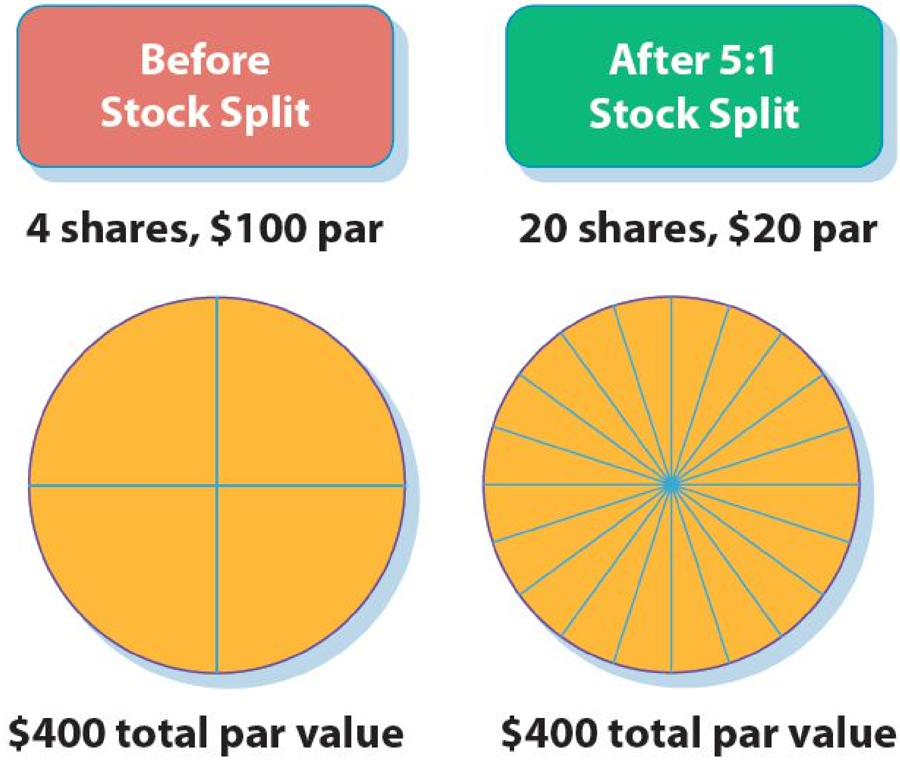
Exhibit 8: Stock Split Before and After



Learning Objective 8

Describe and illustrate the reporting of liabilities and stockholders' equity

Reporting Liabilities and Stockholders' Equity

- Liabilities expected to be paid within one year
  - Presented in the Current Liabilities section of the balance sheet
- Contingent liabilities that are probable but cannot be reasonably estimated or are only possible
  - Disclosed in the notes to the financial statements
- Changes in common stock, preferred stock, treasury stock, paid-in capital, and retained earnings
  - Reported in a separate statement of stockholders' equity

Exhibit 9: Partial Balance Sheet with Liabilities and Stockholders' Equity

Bergstom Corporation
Balance Sheet
December 31, 20Y8

Liabilities		
Current liabilities:		
Accounts payable	$ 488,200	
Notes payable (9% due on March 1, 20Y9)	250,000	
Accrued interest payable	15,000	
Accrued salaries and wages payable	13,500	
Other accrued liabilities	9,850	
Total current liabilities		$ 776,550
Long-term liabilities:		
Debenture 8% bonds payable, due in 15 years (Market value, $950,000)		1,000,000
Total liabilities		$1,776,550

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Exhibit 9: Partial Balance Sheet with Liabilities and Stockholders' Equity (continued)

Stockholders' Equity		
Paid-in capital:		
Preferred 10% stock, $50 par (20,000 shares authorized and issued)	$1,000,000	
Common stock, $20 par (250,000 shares authorized, 100,000 shares issued)	2,000,000	
Paid-in capital in excess of par	400,000	
Paid-in capital from treasury stock	120,000	
Total paid-in capital	$3,520,000	
Retained earnings	4,580,500	
Total	$8,100,500	
Deduct treasury stock (1,000 shares at cost)	(75,000)	
Total stockholders' equity		8,025,500
Total liabilities and stockholders' equity		$9,802,050

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Exhibit 10: Statement of Stockholders' Equity

Bergstom Corporation
Statement of Stockholders' Equity
For the Year Ended December 31, 20Y8

	Preferred Stock	Common Stock	Paid-In Capital in Excess of Par—Common Stock	Paid-In Capital From Treasury Stock	Retained Earnings	Treasury (Common) Stock	Total
Balance, January 1	$1,000,000	$1,750,000	$350,000	$120,000	$3,900,500	$(45,000)	$7,075,500
Net income					860,000		860,000
Dividends on preferred stock					(100,000)		(100,000)
Dividends on common stock.....................................					(80,000)		(80,000)
Issuance of additional common stock		250,000	50,000				300,000
Purchase of treasury stock......						(30,000)	(30,000)
Balance, December 31	$1,000,000	$2,000,000	$400,000	$120,000	$ 4,580,500	$(75,000)	$8,025,500

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Learning Objective 9

Describe and illustrate the debt and price-earnings ratios

Debt Ratio

- Solvency metric

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

- Measures the percent of a company's total assets financed by debt
  - Shows how the company is using debt to generate income

Debt Ratio (continued)

- The following data (in millions) were taken from recent financial statements of Apple Inc. (AAPL) and Microsoft (MSFT)

	Assets	Total Liabilities	Stockholders' Equity
Apple	$375,319	$241,272	$134,047
Microsoft	258,848	176,130	82,718

- Debt ratios (rounded to one decimal place) of the companies

Apple:	64.3% ($241,272 ÷ $375,319)
Microsoft:	68.0% ($176,130 ÷ $258,848)

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Price-Earnings Ratio (P/E)

- Indicates the market's assessment of the future earnings potential of a company

$$\text{Price-Earnings Ratio} = \frac{\text{Market Price per Share of Common Stock}}{\text{Earnings per Share of Common Stock}}$$

- The higher a company's price-earnings ratio, the more favorable the market's assessment of the future earnings potential and the growth of the company

EPS and P/E for Apple Inc. and Microsoft

	Year 3	Year 2	Year 1
Apple Inc.			
Earnings per share	$ 9.27	$ 8.35	$ 9.28
Common stock price at end of year*	167.90	113.09	100.54
Microsoft			
Earnings per share	2.15	3.29	2.59
Common stock price at end of year*	98.61	68.93	51.16

* Adjusted for dividends and stock splits.

	Year 3	Year 2	Year 1
Apple Inc.			
$167.90 ÷ $9.27	18.1		
$113.09 ÷ $8.35		13.5	
$100.54 ÷ $9.28			10.8
Microsoft			
$98.61 ÷ $2.15	45.9		
$68.93 ÷ $3.29		21.0	
$51.16 ÷ $2.59			19.8

End of Chapter 8