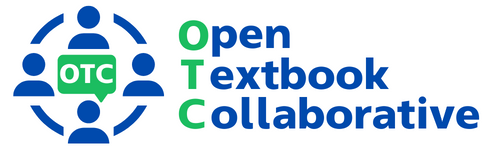


Introduction to Financial Accounting II

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The courses align to [career pathways in New Jersey’s growth industries](https://middlesexcc.libguides.com/OTCProject/about#s-lg-box-wrapper-30684127), including health services, technology, energy, and global manufacturing and supply chain management as identified by the New Jersey Council of Community Colleges.

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**Chapter 11**

**Partnerships**

**Learning Outcomes:**

1. Understand the characteristics of the partnership form of business.
2. Develop the journal entries required when creating a partnership.
3. Calculate each partner’s share of net income and allocate to their respective capital accounts.
4. Develop the journal entries required for the admission of new partners via a personal transaction.
5. Develop the journal entries required for the withdrawal of partners from the partnership via a personal transaction.
6. Understand the steps for liquidating a partnership and distributing cash to each partner.

**(Learning Outcome 1)**

**Understand the characteristics of the partnership form of business**

Anyone starting a business must first decide on the type of business: service, merchandising, manufacturing, or a combination of both. The next step is deciding what form of business to use, such as a sole proprietorship, partnership, corporation, or limited liability company. Each form has its own unique characteristics. In this chapter we will concentrate exclusively on the partnership.

A partnership is a form of business consisting of two or more individuals who combine their skills, talents, and resources to conduct a business. The partnership itself can be a general partnership or a limited type partnership:

**General Partnership**

In this form of partnership, each partner is a part owner of the business. General partners are personally liable for partnership liabilities and share in the profits and losses of the business.

**Limited Partnership**

In this form of business, there is at least one general partner who is personally and totally liable for partnership liabilities. The other, non-general partners are considered limited partners and have limited liability for partnership debt, up to the amount of their individual investments in the partnership.

**Limited Liability Partnership (LLP)**

In this form of business, each partner (usually general partners) has liability protection from the wrongful acts of other partners. LLPs are normally found in medical, law, and accounting firms.

**Partnership Characteristics**

1. While not mandatory, a written agreement should form the basis for all partnerships. A written agreement can be developed to establish the rules under which the partnership will operate. Such a document will, and should, include elements like the following:

* name, address, etc. of the partnership and partners
* individual partner investments and responsibilities
* how decisions on behalf of the partnership will be made (see “Mutual Agency” below)
* how profits will be shared among partners
* requirements for admitting new partners
* means by which existing partners may withdraw
* how unforeseen circumstances (e.g. death of a partner) will be handled
* the procedure for dissolving the partnership

A limited partnership especially should be based on a written agreement defining the limited liability of such partners to their investment in the partnership. It merits noting that absent a written agreement, the laws of the state prevail, though they may not be what the partners intended.

1. **Limited Life**

Like sole proprietorships, partnerships have a limited life. For example, the death of a partner ends the partnership. It should be noted that ending a partnership does not necessarily mean its liquidation. To alleviate this type of situation, the written partnership agreement should describe how the death of a partner will be addressed by the partnership. Absent this, state law will prevail, and the partnership may be dissolved.

1. **Mutual Agency**

Mutual agency applies to general partners. It means that an individual general partner may enter the partnership into business contracts without the knowledge of other general partners. However, for mutual agency to be enforced, the individual general partner must have acted within the normal business practices of the partnership. The example below should clarify what is normally a complicated topic:

**Example 1**:

A general partner in a storefront pizzeria takes it upon himself to purchase new tables and chairs because he thought the old ones were “falling apart.” The other partners were unaware of this and, had they been asked, would not have made the purchase. Since tables and chairs are a normal part of this business, mutual agency is applicable, and the company must keep the new furniture and pay for it.

**Example 2:**

A general partner in a storefront pizzeria takes it upon himself to purchase a nearby residential building to generate rental income, without consulting the other partners. Had the other general partners been asked, they would not have purchased the building. Since owning a residential building is not a normal practice for this type of business, mutual agency does not apply.

Mutual agency is certainly a topic that should be specifically addressed in a written partnership agreement.

1. **Unlimited Liability**

As in a sole proprietorship, general partners have unlimited liability for all partnership debts. Limited partners are only liable to the extent of their investments.

1. **Co-ownership of Property**

When a partnership is formed, any property (cash, receivables, equipment, etc.) transferred by the partners into the partnership becomes the property of the partnership as a whole. It does not go back to the original partner(s), should the original partner(s) decide to leave the partnership.

1. **No Partnership Income Tax**

A partnership does not pay income taxes on its profits. All profits and losses are passed on a prorated basis to the individual partners, who then include their respective share in their own personal income tax returns. However, the partnership does file an *information only* tax return for the business as a whole.

The table below summarizes the above discussion into a partnership’s advantages and disadvantages:

|  |  |
| --- | --- |
| **Advantages** | **Disadvantages** |
|  |  |
| Easy to create | Unlimited liability of general partners |
| Combines partners’ talents, abilities, and resources | Mutual agency |
| Does not pay income taxes | Limited life |
| Less government regulation |  |

**(Learning Outcome 2)**

**Develop the journal entries required when creating a partnership**

##### The journal entries required when forming a partnership, while similar in some respect to those required of a sole proprietor, are a bit more complicated. The basic rules are best learned by example, as shown below:

Bill Dewey owns and operates an accounting and tax service company. His friend, Frank Howe, owns and operates a book keeping firm. Both are sole proprietors. On January 1, they merge their companies to form the D & H partnership. Their respective sole proprietorship balance sheet accounts—as they appeared just before forming the new partnership—are shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Balance Sheet Accounts** | **Dewey** |  | **Howe** |
| Cash | $15,000 |  | $12,000 |
| Accounts receivable | 4,800 |  | 4,000 |
| Allowance for doubtful accounts (AFDA) | 500 |  | 500 |
| Inventory | 4,000 |  | 3,000 |
| Equipment | 7,500 |  | 6,000 |
| Accumulated Depreciation - Equipment | 1,500 |  | 1,200 |
| Accounts payable | 4,500 |  | 4,000 |
| Notes payable | 7,000 |  | 3,800 |
| Salaries and wages payable | 2,400 |  | 1,800 |

Dewey and Howe agree on the following fair market values for the assets shown below:

|  |  |  |
| --- | --- | --- |
|  | **Dewey** | **Howe** |
| Net Accounts Receivable | $3,800 | $4,000 |
| Inventory | 3,500 | 2,400 |
| Equipment | 6,400 | 5,400 |

They also agree that the partnership will continue to pay all liabilities.

**Instructions:**

Develop the required journal entries to form the new partnership.

**Solution:**

Developing the journal entry for each partner is a 3-step process applied to each individual partner:

1. Determine which of their respective sole proprietorship accounts will transfer into the partnership.
2. Determine the various accounts’ respective values (balances).
3. Calculate each partner’s capital in the new partnership.
4. Not all accounts are transferred into the new partnership. However, those accounts that do transfer do so at their respective fair market values. In some cases, the fair market value is determined by the partners.

To determine which accounts transfer over, you mustlearn the rules for transferring accounts from a sole proprietorship into a partnership. These are:

1. **Some accounts transfer over into the partnership at their sole proprietor values.**

In the example above, these would be the cash, the A/R (gross), and the liability accounts (unless the problem states otherwise).

1. **Some accounts may change in value, as long as the partners agree on the new values.**

In the example above**,** these would be the tangible assets (inventory and equipment), and the allowance for doubtful accounts (AFDA). A change to the AFDA affects the net receivable (see below).

1. **Some accounts are completely disregarded.**

In the example above, this would be the accumulated depreciation account. The partnership begins with zero accumulated depreciation and begins to depreciate the applicable long-term tangible asset accounts all over again.

1. **All accounts are journalized on their normal balance sides (the side the account goes up** **on).** Recall that asset accounts go up on their debit (left) sides, liability and capital accounts go up on their credit (right) sides. Contra asset accounts go up on their credit sides.

An account that sometimes gives students trouble is accounts receivable, especially when the term *net receivables* is used. For clarity, let’s discuss the difference between account receivables and net receivables.

The accounts receivable for the Dewey and Howe balance sheets above refers to the *gross receivables*: that is, the total amount owed by customers. To find the net receivables (i.e., what is expected to be collected), you must subtract the amount shown in the allowance for doubtful accounts (AFDA) from the gross receivables. That is:

**Net receivables = A/R - AFDA**

When developing the journal entry to form a partnership, you must always remember to transfer the gross receivables into the partnership at the exact value that appears on the sole proprietorship balance sheet. Any change (adjustment) to the gross receivables is done thru the AFDA account, which can be changed by the partners**.**

As an example, let’s assume a sole proprietorship has gross receivables (A/R) of $100,000 and an AFDA of $5,000. In this case, the sole proprietorship has net receivables (amount they expect to collect) of:

Net receivables = A/R – AFDA

Net receivables = $100,000 − $5,000

Net receivables = $95,000

Thus, in this example, the partnership expects to collect $95,000 of the $100,000 in gross receivables.

As another example, let’s say the partners agree that the receivables expected to be collected in the partnership is $88,000 instead of the $100,000 in gross receivables.

When you create the journal entry in the formation of the partnership, do not value the A/R account at $88,000. You must still value it at its gross amount of $100,000. After all, if customers owed the sole proprietor $100,000 in accounts receivable, the same customers are still going to owe the partnership the same $100,000. It’s just that the partners have agreed that only $88,000 of the gross receivables is expected to be collected. Thus, this $88,000 is really the net accounts receivable.

To resolve this, just transfer the full $100,000 into the A/R account, and change the AFDA account to $12,000.

Once you do this, the new net accounts receivable will be:

Net receivables = A/R – AFDA

Net receivables = $100,000 - $12,000 (the new AFDA agreed to by the partners)

Net receivables = $88,000

Note that the A/R is still shown as $100,000, but the AFDA changes from the $5,000 value in the sole proprietorship to the $12,000 value in the new partnership. Thus, the amount expected to be collected is $88,000.

1. Determining the various accounts’ respective values means (more specifically):
2. Cash comes over at the value shown on the sole proprietor’s balance sheet, unless the problem states otherwise.
3. A/R and AFDA should be treated as discussed above. Note that the AFDA can change.
4. The values of inventory and equipment can be changed by the partners. New values will be provided.
5. The accumulated depreciation account is totally ignored. It will not be transferred over into the partnership.
6. All liabilities, such as A/P, notes payable, and salaries & wages payable, transfer over at the values shown on the sole proprietor’s balance sheet, unless the problem states otherwise.
7. Show all accounts on their normal balance sides.
8. To calculate a partner’s new capital balance in the partnership, simply look at the journal entry thus far, add up accounts with debit balances, and subtract all accounts with credit balances.

**Thus, for Dewey, the journal entry becomes:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment(s)** |
|  |  |  |  |  |
| 1/1 | Cash |  |  | Carries over at its sole proprietorship value |
|  | A/R |  |  | Gross amount of A/R carries over as is |
|  | Inventory |  |  | Revalued by partners |
|  | Equipment |  |  | Revalued by partners |
|  | AFDA |  |  | Adjusted to get net receivables |
|  | A/P |  |  | Carries over as is unless problem states otherwise |
|  | Notes Payable |  |  | Carries over as is unless problem states otherwise |
|  | Salaries & Wages Payable |  |  | Carries over as is unless problem states otherwise |
|  | Dewey, Capital |  |  | Debits minus credits |
|  | To record investment by Dewey |  |  |  |

*Note.* Accumulated depreciation is not shown because it does not transfer into the partnership. The partnership gets to start depreciation of the depreciable long-term assets all over again.

**For Howe, the journal entry becomes:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment(S)** |
|  |  |  |  |  |
| 1/1 | Cash |  |  | Carries over at its sole proprietorship value |
|  | A/R |  |  | Gross amount of A/R carries over as is |
|  | Inventory |  |  | Revalued by partners |
|  | Equipment |  |  | Revalued by partners |
|  | AFDA |  |  | Adjusted to get net receivables |
|  | A/P |  |  | Carries over as is unless problem states otherwise |
|  | Notes Payable |  |  | Carries over as is unless problem states otherwise |
|  | Salaries & Wages Payable |  |  | Carries over as is unless problem states otherwise |
|  | Howe, Capital |  |  | Debits minus credits |
|  | To record investment by Howe |  |  |  |

*Note*. Accumulated depreciation is not shown.

And there you have it. This is how you go about developing the accounting journal entries when sole proprietorships merge to form a partnership.

**(Learning Outcome 3)**

**Calculate each partner’s share of net income and allocate to their respective capital accounts**

In a sole proprietorship, any net income or loss is transferred into the single owner’s capital account through the closing process. In a partnership, the process is the same. However, since there is more than one owner, a method must be employed to determine each partner’s share of the partnership net income or loss. We refer to this as “allocating net income or loss among partners.”

To allocate net income or loss among the partners, you need to consider three things (in the order shown below):

1. **Has any partner received a salary allowance?**

A salary allowance is a portion of net income or loss assigned to a specific partner(s), usually because the partner is an owner and works for the partnership.

1. **Has any partner received an interest allowance?**

An interest allowance is a portion of net income or loss assigned to each partner based on their respective investment in the partnership. It is usually a percentage of the partner’s initial or average capital balance.

1. **Is there any remainder?**

The total of the salary and interest allowance is compared to the net income or loss for the period. If the total of the salary allowance and interest allowance equals the net income or loss for the period, then the remainder is zero. However, if the total of the salary and interest allowance does not equal the net income or loss for the period, then there is a remainder. The remainder can be positive or negative, and it is only used to adjust the total of the salary and interest allowances so that it is equal to the net income or loss for the period. This remainder must be allocated to the partners in accordance with the partners’ *income sharing ratios*.

**Example 1**

The partnership of Henry and James had net income of $60,000. Each partner shares income equally.

Allocate the net income among the partners, and show the closing journal entry for transferring each partner’s share to their respective capital account.

**Solution:**

In this exercise there is no salary or interest allowance. Since there are only two partners who share net income equally, each is entitled to $30,000. Recalling that positive net income increases owner’s capital, the journal entry is:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | **Credit** | | **Comment(S)** |
|  | Income Summary | | | 60,000 | |  |  |
|  | Henry, Capital | | |  | | 30,000 |  |
|  | James, Capital | | |  | | 30,000 |  |
|  | To allocate net income among partners. | | |  | |  |  |

**Example 2**

Cather, Elliot, and Williams share income on the basis of 3:4:3. During the year, Cather and Elliot received a salary allowance of $20,000 and $15,000, respectively. If the net income for the year was $80,000, calculate how much net income should be allocated to each partner, and show the closing journal entry for transferring each partner’s share to their respective capital account.

**Solution:**

This exercise is a bit more complicated. Note that there is a salary allowance but no interest allowance. Also note that the total of the salary allowance equals $35,000—well below the net income amount. This indicates that there is a positive remainder of $45,000 ($80,000 − $35,000), which is shared in accordance with the partners’ income sharing ratio. Thus, the remainder will be shared as follows:

Cather: 3/10 x $45,000 = $13,500

Elliot: 4/10 x $45,000 = $18,000

Williams: 3/10 x $45,000 = $13,500

The table below shows the allocation of the $80,000 of net income among the three partners.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Net Income = **$80,000** | | | | |
|  | **Cather** | **Elliot** | **Williams** | **Total** |
|  |  |  |  |  |
| Salary Allowance | $20,000 | $15,000 |  | $35,000 |
| Remainder = $45,000 | 13,500 | 18,000 | 13,500 | 45,000 |
| Totals | $35,500 | $33,000 | $13,500 | **$80,000** |

Since the individual partners’ totals are positive, their respective capital accounts will increase as shown by the journal entry below:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | **Credit** | | **Comment(S)** |
|  | Income Summary | | | 80,000 | |  |  |
|  | Cather, Capital | | |  | | 35,500 |  |
|  | Elliot, Capital | | |  | | 33,000 |  |
|  | Williams, Capital | | |  | | 13,500 |  |
|  | To allocate net income among partners. | | |  | |  |  |

**Example 3**

The partnership of Ashley, Bruno, and Castro shares income based on a 5:3:2 ratio. During the year, the partners received salary allowances of $40,000; $35,000; and $30,000, respectively. They also received a 10% interest allowance on the basis of their beginning capital balances, which were $100,000; $75,000; and $60,000, respectively. If the net income for the year was $100,000, calculate how much net income should be allocated to each partner, and show the closing journal entry for transferring each partner’s share to their respective capital account.

**Solution:**

This exercise is a bit more complicated. Note that there is a salary allowance and an interest allowance. Also note that the sum of the salary allowance and the interest allowance equals $128,500—well above the net income amount. This indicates that there is a negative remainder of −$28,500 ($100,000 − $105,000 − $23,500) which must be shared in accordance with the partners’ income sharing ratio. Thus, the remainder will be shared as follows:

Ashley: 5/10 x $28,500 = $14,250

Bruno: 3/10 x $28,500 = $8,550

Castro: 2/10 x $28,500 = $5,700

The table below shows the allocation of the $100,000 of net income among the three partners:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Net Income = **$100,000** | | | | | |
|  | **Ashley** | **Bruno** | **Castro** | **Total** |
|  |  |  |  |  |
| Salary Allowance | $40,000 | $35,000 | $30,000 | $105,000 |
| Interest Allowance | 10,000 | 7,500 | 6,000 | 23,500 |
| Remainder = −$28,500 | −14,250 | −8,550 | −5,700 | −28,500 |
| Totals | $35,750 | $33,950 | $30,300 | **$100,000** |

Since the individual partners totals are positive, their respective capital accounts will increase as shown by the journal entry below:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | **Credit** | | **Comment(S)** |
|  | Income Summary | | | 100,000 | |  |  |
|  | Ashley, Capital | | |  | | 35,750 |  |
|  | Bruno, Capital | | |  | | 33,950 |  |
|  | Williams, Capital | | |  | | 30,300 |  |
|  | To allocate net income among partners. | | |  | |  |  |

**Partnership Financial Statements**

At the end of the accounting period, the partnership prepares the four basic financial statements that other companies prepare (in the following order):

* 1. Income statement
  2. Partner’s capital statement
  3. Balance sheet
  4. Statement of cash flow

However, there are some features related to 1, 2, and 3 that merit noting.

**Income Statement**

The income statement for a partnership will include a section on the division of net income (see above) after the net income has been determined.

|  |  |
| --- | --- |
| **Statement Heading** | |
| Total Revenue | $320,000 |
| Total Expenses | −$180,000 |
| Net Income or Loss | $140,000 |
| **Allocation of Net Income or Loss** | |
| Partner A | $80,000 |
| Partner B | $40,000 |
| Partner C | $20,000 |
| Total Net Income or Loss Allocated to Partners | $140,000 |

**Partners’ Capital Statement**

The purpose of the partnership capital statement is to show each partner’s capital at the beginning of each accounting period and how it changed during the period as a result of profits or losses, additional investments, and withdrawals, if any. In a sense, the partner’s capital statement is similar to the statement of owner’s equity for a sole proprietorship, except that it includes results for individual partners.

|  |
| --- |
| **Statement Heading** |
|  | **Partner A** | **Partner B** | **Partner C** |
| Beginning Capital | $100,000 | $60,000 | $40,000 |
| Plus/minus net income/loss | $80,000 | $40,000 | $20,000 |
| Plus additional investments |  |  |  |
| Minus Withdrawals | - $12,000 | - $8,000 | - $10,000 |
| Ending Capital | $168,000 | $92,000 | $50,000 |

**Balance Sheet**

Shown below is a typical format for a simple partnership balance sheet. Note that each general partner’s ending capital (from the partnership capital statement) is shown, as well as the total partnership ending capital as of the end of the accounting period.

|  |  |  |  |
| --- | --- | --- | --- |
| **Name of Partnership**  **Balance Sheet**  **Date** | | | |
|  |  |  |  |
| Assets |  | Liabilities and Owners’ Capital |  |
|  |  | Liabilities |  |
| Cash |  | A/P |  |
| A/R, net |  | Notes Payable |  |
| Inventory |  |  |  |
| Equipment, net |  | Owners’ Capital |  |
|  |  | Partner A |  |
|  |  | Partner B |  |
|  |  | Partner C |  |
|  |  |  |  |
| **Total Assets** |  | **Total Liabilities and Owner’s Capital** |  |

**(Learning Outcome 4)**

**Develop the Journal Entries for the Admission of New Partners via a Personal Transaction**

**Key Concepts:**

1. This is strictly a personal transaction between partners. The partnership is not involved.
2. Total partnership equity and cash **do not change.**
3. The amount of money given by a new partner coming in—or the amount given to a withdrawing partner—is not included in the journal entry (remember: the money doesn’t matter).
4. Only the respective owner’s capital account changes.
5. The journal entry only shows affected partners’ capital accounts.
6. As always, capital increases on the right (credit) and decreases on the left (debit)

**Admission of a New Partner via a Personal Transaction**

**Example 1:**

Assume three partners with capital balances as shown below:

Thomas, Capital Williams, Capital Jones, Capital

20,000 30,000 25,000

Say Ortiz is joining the partnership, and that Thomas agrees to sell one half (50%) of his capital to Ortiz for $30,000.

**Analysis:**

Thomas is giving up 50% of his capital or (50%) x $20,000 = $10,000. Thomas will have to debit his capital account to reduce it by this amount. On the other hand, Ortiz is getting this $10,000 capital credit from Thomas. Therefore, Ortiz will credit his capital account by the same amount. The journal entry becomes:

Thomas, Capital 10,000

Ortiz, Capital 10,000

To record admission of a new partner via a personal transaction

Note that the amount of cash exchanged does not get recorded, because this is a personal transaction. The fact that Thomas is receiving $30,000 in cash for only $10,000 of his capital credit is irrelevant to the journal entry. This cash is not going to the partnership. It is going to Thomas.

After the transaction is journalized, the partnership accounts are as follows:

Thomas, Capital Williams Capital Jones, Capital Ortiz, Capital

10,000 30,000 25,000 10,000

*Note.* The total partnership capital does not change as a result of a personal transaction. It is still $75,000 total for the (now) four partners.

**Example 2:**

Assume the same three partners with capital balances as shown below:

Thomas, Capital Williams, Capital Jones, Capital

20,000 30,000 25,000

Say Ortiz is joining the partnership, and that Williams and Jones each agree to sell Ortiz one quarter (25%) of their capital balances for $12,000 and $9,000, respectively.

**Analysis:**

In this example, Williams is giving up 25% of his capital (25% x $30,000 = $7,500), and Jones is giving up 25% of his capital (25% x $25,000 = $6,250). Both Williams and Jones will have to debit their respective capital accounts to reduce them by their respective amounts. On the other hand, Ortiz is getting a capital credit equal to $7,500 + $6,250, or $13,750. As a result, Ortiz will credit his capital account by this amount. The journal entry becomes:

Williams, Capital 7,500

Jones, Capital 6,250

Ortiz, Capital 13,750

To record admission of a new partner via a personal transaction

*Note.* The amount of cash being received by each partner does not get recorded, because this is a personal transaction. This cash is not going to the partnership. It is going to Williams and Jones, who in turn are giving up some of their capital to Ortiz.

After the transaction is journalized, the partnership accounts are as follows:

Thomas, Capital Williams Capital Jones, Capital Ortiz, Capital

20,000 22,500 18,750 13,750

*Note.* As before, the total partnership capital does not change as a result of the personal transaction and remains at $75,000 for the four partners.

**(Learning Outcome 5)**

**Develop the Journal Entries for the Withdrawal of Partners from the Partnership via a Personal Transaction**

**Key Concepts:**  (*Note, the concepts applied in the Admission case above, also apply to the Withdrawal case*)**:**

1. This is strictly a personal transaction between partners. The Partnership is NOT involved.
2. Total partnership equity and cash **DO NOT CHANGE.**
3. The amount of money given by a new partner coming in, or given to a withdrawing partner is not included in the journal entry (*remember: the money doesn’t matter*).
4. Only the respective owner’s capital account changes.
5. The journal entry only shows affected partner(s) capital accounts.
6. As always, capital increases on the right (credit) and decreases on the left (debit)

**Withdrawal of an Existing Partner via a Personal Transaction**

**Example 1:**

Assume 3 partners with capital balances as shown below:

Sam, Capital Molly, Capital Oda Mae, Capital

20,000 30,000 25,000

Say Oda Mae decides to leave the partnership, and Sam agrees to buy out her capital interest for $40,000.

**Analysis:**

Since Oda Mae is leaving the partnership, she is giving up her entire capital credit of $25,000. Oda Mae will have to debit her capital account to reduce it by this amount. On the other hand, Sam will be gaining $25,000 in additional capital credit because he is paying her for it. Remember, this is a personal transaction; Sam will credit his capital account by the $25,000 capital credit Oda Mae is giving up. The journal entry becomes:

Oda Mae, Capital 25,000

Sam, Capital 25,000

To record withdrawal of an old partner via a personal transaction

*Note*. As before, the amount of cash exchanged does not get recorded, because the partnership is not getting the cash involved in the personal transaction.

After the transaction is journalized the partnership accounts are as follows:

Sam, Capital Molly, Capital

45,000 30,000

*Note.* As before, the total partnership capital does not change as a result of the personal transaction and remains at $75,000 for two remaining partners.

**Example 2:**

Assume the same 3 partners with capital balances as shown below:

Sam, Capital Molly, Capital Oda Mae, Capital

20,000 30,000 25,000

In this example, Sam decides to leave the partnership, and Molly and Oda Mae each agree to give Sam $12,500 for his capital interest. Molly and Oda Mae each receive 50% of Sam’s capital interest.

**Analysis:**

Since Sam is leaving the partnership, he is giving up his entire capital credit of $20,000. Thus, Sam will have to debit his capital account to reduce it in its entirety. Molly and Oda Mae will each receive 50% ($10,000) of Sam’s capital, and both will also have to credit their respective capital accounts for the additional capital they are receiving. Disregard the amounts of cash being exchanged. The journal entry becomes:

Sam, Capital 20,000

Molly, Capital 10,000

Oda Mae, Capital 10,000

To record withdrawal of an old partner via a personal transaction

*Note.* Again, the amount of cash exchanged does not get recorded, because this is a personal transaction.

After the transaction is journalized, the partnership accounts are as follows:

Molly, Capital Oda Mae, Capital

40,000 35,000

*Note.* Again, the total partnership capital does not change and remains at $75,000.

**(Learning Outcome 6)**

**Understand the steps in liquidating a partnership and distributing cash to each partner**

Liquidating a partnership means terminating it. Liquidation is a 4-step process performed in sequential steps. Each step requires a journal entry:

1. Sell all noncash assets and realize a gain or a loss on the sale.
2. Allocate the gain or loss to the partners in accordance with their income sharing ratios.
3. Pay all partnership liabilities.
4. Distribute remaining cash to partners in accordance with their capital balances. This assumes the capital balances are on the credit side. If any partners’ capital balances are on the debit side, the remaining cash cannot be distributed until the partners with the debit balances have had their debit balances zeroed out. The method for doing this may be found below.

However, before step four can be completed, you have to check to see if any partner has a debit balance in his capital account. If he does, this condition is known as a *capital deficiency* and must be resolved before any cash can be distributed to any partner.

Resolving the capital deficiency depends on how the partner with the deficiency intends to correct it.

He can do so in one of two ways:

1. He can invest additional cash into the partnership, equal to the

amount of the capital deficiency. In this case, the following

journal entry is made:

Cash debit

Deficient Partner, Capital credit

To record investment to eliminate capital deficiency

At this point, the partnership cash balance will be equal to the sum of the remaining partners’ capital balances and can be distributed to them only. The partner with the capital deficiency does not receive any cash.

1. If the partner with the capital deficiency is unwilling to contribute any cash into the partnership to eliminate his capital deficiency, the remaining partners must reduce their capital balances, prorated in accordance with their income sharing ratios, so that the capital deficiency is eliminated. In this case, the following journal entry is made:

Non deficient Partner 1, Capital debit

Non deficient Partner N, Capital debit

Deficient Partner, Capital credit

To record investment to eliminate capital deficiency

At this point, the partnership cash balance will be equal to the sum of the remaining partners’ capital balances and can be distributed to them only.

As such, there are four major journal entries and the possibility of a fifth (but only if there is a capital deficiency).

Let’s work out a couple of examples. The first where there is a capital gain from the sale of noncash assets.

**Example 1** (with gain on sale of noncash assets; If there is any capital deficiency, assume it will be resolved by the partners without the deficiency):

The balance sheet for the KSU (Kirk, Spock, Uhura) partnership is shown below, just before liquidation. The partners’ income sharing ratio is 5:3:2. Develop a partnership liquidation schedule and all appropriate journal entries, assuming the noncash assets are sold for $100,000 and all liabilities are paid.

**KSU Partnership**

Balance Sheet

December 31, 2018

**Assets Liabilities & Owners Capital**

Cash $6,000 Accounts Payable $20,000

A/R 30,000 Notes Payable 9,500

AFDA (1,500) Kirk, Capital 27,000

Merchandise Inventory 15,000 Spock, Capital 25,000

Supplies 5,000 Uhura, Capital 3,000

Equipment 40,000

Accumulated Depr. – Equip. (10,000)

$84,500 $84,500

**Solution:**

**Step 1:** Sell all noncash assets and realize a gain or a loss on the sale.

To complete this step, you must determine the book value (B/V) of the noncash assets. You do this by adding up the values of the noncash asset accounts and subtracting the values of the contra asset accounts. In the above example,

B/V of noncash assets = **A/R – AFDA + Merchandise Inventory + Supplies + Equipment – Accumulated Depr.**

B/V of noncash assets = $30,000 – $1,500 + $15,000 + $5,000 +$ 40,000 – $10,000

**Book Value of noncash assets** = $78,500

If you sell the noncash assets for more than their book value, you have a gain. Alternately, if you sell the noncash assets for less than their book value, you have a loss.

In this example the noncash assets were sold for $100,000, which is significantly greater than their book value. As such, there is **a gain on sale:**

**Gain on sale = Cash received from sale of noncash assets – book value of noncash assets**

**Gain on sale = $100,000 - $78,500 = $21,500**

Now we’re ready for our first journal entry. This journal entry will show the elimination of all noncash assets and any contra asset accounts. Let’s discuss the journal entry first, and then show it.

First, you should remember that the values shown for the noncash assets are normally found on the account’s normal balance side. This is the side the account goes up on. Recall that the normal balance side for asset accounts is the debit (left) side. For contra asset accounts it’s the credit (right) side. Since we’re eliminating assets, we’ll have to credit them. And since we’re eliminating contra asset accounts as well, we’ll have to debit these, so that the journal entry becomes:

| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
| --- | --- | --- | --- | --- |
|  |  |  |  |  |
| 12/31 | Cash | 100,000 |  | Amount received from sale of noncash assets |
|  | AFDA | 1,500 |  | A contra asset account. Debit to zero out. |
|  | Accumulated Depreciation – Equip. | 10,000 |  | A contra asset account. Debit to zero out. |
|  | A/R |  | 30,000 | Credit to zero out. |
|  | Merchandise Inventory |  | 15,000 | Credit to zero out. |
|  | Supplies |  | 5,000 | Credit to zero out. |
|  | Equipment |  | 40,000 | Credit to zero out. |
|  | Gain on Sale |  | 21,500 | Gains are credited because they increase equity. |
|  | To record sale of noncash assets and record gain on sale | | |  |

*Note*. In the account “Gain on Sale,” the gains are credited. Had there been a loss, the account would have been called “Loss on Sale,” and it would have been debited.

Also note that the gain on sale has not been allocated to the partners. That’s the second step in the sequence.

**Step 2:** Allocate the gain or loss to the partners in accordance with their income sharing ratios.

To complete this step, you need to know the amount of the gain (or loss, as the case may be) and the partners’ income sharing ratio.

In this case, the gain was calculated as **$21,500** and

the partners’ income sharing ratio was given as **5:3:2.**

Each partner will be allocated his or her respective pro rata share of the gain:

Kirk: 5/10 x $21,500 = $10,750

Spock: 3/10 x $21,500 = $6,450

Uhura: 2/10 x $21,500 = $4,300

This is how the gains (or losses) are allocated among the partners.

Since there is a gain, each partner’s capital account increases. As a result, each partner’s capital account is going to get credited. The gain on sale account, since it is also being eliminated in this step, will be debited. Thus, the journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | Gain on Sale | 21,500 |  | Debit Gain on Sale to zero it out |
|  | Kirk, Capital |  | 10,750 | Credit Capital to increase |
|  | Spock, Capital |  | 6,450 | Credit Capital to increase |
|  | Uhura, Capital |  | 4,300 | Credit Capital to increase |
|  | To allocate gain among partners and zero out Gain on Sale account. | | | |

**Step 3:** Pay all partnership liabilities.

The partnership has two liability accounts:

A/P of $20,000 and

Notes Payable of $9,500

The normal balance side for these two liability accounts is the credit (right) side.

Therefore, the liability accounts will be debited when they are paid off, and the cash account will be credited since it is being decreased.

The journal entry for paying off the liabilities is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | A/P | 20,000 |  | Debit to zero out |
|  | Notes Payable | 9,500 |  | Debit to zero out |
|  | Cash |  | 29,500 | Credit to zero out |
|  | To record payment of liabilities. | | |  |

**Step 4:** Distribute remaining cash to partners in accordance with their capital credit.

But wait. Remember, before you distribute the remaining cash, to check to see if any partner’s capital account has a debit balance, which would mean there is a capital deficiency. In this example there is no capital deficiency. That makes it a little easier.

At this stage, the only remaining accounts look like this:

Cash Kirk, Capital Spock, Capital Uhura, Capital

6,000 29,500 27,000 25,000 3,000 100,000 10,750 6,450 4,300

**76,500 = Bal.** **37,750 = Bal. 31,450 = Bal. 7,300 = Bal**.

Since all capital accounts have credit balances, there is no capital deficiency, and

**Total Partnership Capital = $27,750 + $31,450 + $7,300 = $76,500**

which is exactly the amount of remaining cash.

**Total cash = beginning cash + cash received from sale of noncash assets – cash payments to eliminate liabilities.**

Total Cash = $6,000 + $100,000 - $29,500

**Total Cash = $76,500 as shown in the T-account above.**

Now you can distribute the remaining cash in accordance with each partner’s capital balance**,** thus zeroing out the capital balances.

**Remember:**

Final distribution of cash is always done on the basis of the partners’ capital account balances, not on the basis of the income sharing ratio.

The final journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | Kirk, Capital | 37,750 |  | Debit to zero out Kirk |
|  | Spock, Capital | 31,450 |  | Debit to zero out Spock |
|  | Uhura, Capital | 7,300 |  | Debit to zero out Uhura |
|  | Cash |  | 76,500 | Credit to zero out Cash |
|  | To record final distribution of cash to remaining partners. | | | |

The partnership is now liquidated.

**Example 2** (with a loss on sale of noncash assets):

Using the balance sheet from Example 1 above, assume the noncash assets are sold for $60,000 and the partners income sharing ratio remains at 5:3:2. Develop a partnership liquidation schedule and all appropriate journal entries.

**Solution:**

**Step 1:** Sell all noncash assets and realize a gain or a loss on the sale.

To complete this step, you must determine the book value (B/V) of the noncash assets. You do this by adding up the values of the noncash asset accounts and subtracting the values of the contra asset accounts. In the above example,

B/V of noncash assets = A**/R – AFDA + Merchandise Inventory + Supplies + Equipment – Accumulated Depreciation**

B/V of noncash assets = $30,000 – $1,500 + $15,000 + $5,000 +$ 40,000 – $10,000

**Book Value of noncash assets** = $78,500

If you sell the noncash assets for less than their book value, you have a loss.

In this example the noncash assets were sold for $60,500, which is significantly less than their book value. Therefore, there is a loss on sale:

**Loss on sale = Cash received from sale of noncash assets – book value of noncash assets**

**Loss on sale = $60,500 − $78,500 = −$18,000**

Now we’re ready for our first journal entry. This journal entry will show the elimination of all noncash assets and any contra asset accounts. Let’s discuss the journal entry first, and then show it.

First, you should remember that the values shown for the noncash assets are normally found on the account’s normal balance side. This is the side the account goes up on. Recall the normal balance side for asset accounts is the debit (left) side. For contra asset accounts it’s the credit (right) side. Since we’re eliminating assets, we’ll have to credit them. And since we’re eliminating contra asset accounts as well, we’ll have to debit these, so that the journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | Cash | 60,500 |  | Amount received from sale of noncash assets |
|  | AFDA | 1,500 |  | A contra asset account. Debit to zero out. |
|  | Accumulated Depreciation – Equip. | 10,000 |  | A contra asset account. Debit to zero out. |
|  | Loss on Sale | 18,000 |  |  |
|  | A/R |  | 30,000 | Credit to zero out. |
|  | Merchandise Inventory |  | 15,000 | Credit to zero out. |
|  | Supplies |  | 5,000 | Credit to zero out. |
|  | Equipment |  | 40,000 | Credit to zero out. |
|  | To record sale of noncash assets and record loss on sale | | |  |

Note the account “Loss on Sale.” Losses are debited.

Also note that the Loss on Sale has not been allocated to the partners. That’s the second step in the sequence.

**Step 2:** Allocate the loss to the partners in accordance with their income sharing ratios.

To complete this step, you need to know the amount of the loss, and the partners’ income sharing ratio.

In this case, the loss was calculated as $18,000,and

the partners’ income sharing ratio was given as **5:3:2.**

Each partner will be allocated his or her respective pro rata share of the loss:

Kirk: 5/10 x - $18,000 = $9,000

Spock: 3/10 x - $18,000 = $5,400

Uhura: 2/10 x - $18,000 = $3,600

This is how losses (or gains) are allocated among the partners.

Since there is a loss, each partner’s capital account decreases. As a result, each partner’s capital account is going to get debited. The loss on sale account, since it is also being eliminated in this step, will be credited. Thus, the journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | Kirk, Capital | 9,000 |  | Debit Capital to decrease |
|  | Spock, Capital | 5,400 |  | Debit Capital to decrease |
|  | Uhura, Capital | 3,600 |  | Debit Capital to decrease |
|  | Loss on Sale |  | 18,000 | Credit Loss on Sale to zero it out |
|  | To allocate loss among partners and zero out Loss on Sale account. | | | |

**Step 3:** Pay all partnership liabilities.

The partnership has two liability accounts:

A/P of $20,000, and

Notes Payable of $9,500

The normal balance side for these two liability accounts is the credit (right) side.

Therefore, the liability accounts will be debited when they are paid off, and the cash account will be credited since it is being decreased.

The journal entry for paying off the liabilities is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | A/P | 20,000 |  | Debit to zero out |
|  | Notes Payable | 9,500 |  | Debit to zero out |
|  | Cash |  | 29,500 | Credit to zero out |
|  | To record payment of liabilities. | | |  |

**Step 4:** Distribute remaining cash to partners in accordance with their capital credit.

But wait. Remember, before you distribute the remaining cash, to check to see if any partner’s capital account has a debit balance, which would mean there is a capital deficiency. In this example there is no capital deficiency. That makes it a little easier.

At this stage, the only remaining accounts look like this:

Cash Kirk, Capital Spock, Capital Uhura, Capital

6,000 29,500 9,000 27,000 5,400 25,000 3,600 3,000 60,500

**Bal. = 37,000** **Bal. = 18,000 Bal. = 19,600 Bal**. **=** **600**

*Note*. Uhura’s capital account has a debit balance, whereas Kirk and Spock have credit balances.

Whenever any partner has a debit balance, the condition is known as a capital deficiency, and the remaining cash cannot be distributed to any partner until the capital deficiency has been eliminated.

Since remaining cash must be distributed on the basis of capital balances, it cannot be distributed at this time. Kirk’s and Spock’s capital balances add up to $37,600 ($18,000 + $19,600) whereas there is only $37,000 in cash. This imbalance is due to Uhura’s capital deficiency, which must be addressed before any cash can be distributed to Kirk and Spock.

**Eliminating Capital Deficiencies:**

As previously stated, there are two ways to eliminate a capital deficiency:

1. The partner with the capital deficiency contributes an amount of cash equal to the capital deficiency.
2. The partners with credit balances reduce their respective capital balances proportionately, in accordance with their income ratios.

**Method 1:**

The partner with the capital deficiency contributes an amount of cash equal to the capital deficiency. This method is the more straightforward one.

Assume Uhura contributes $600 of her personal cash to the partnership, thus resulting in the following journal entry:

|  |  |  |
| --- | --- | --- |
| **Account** | **Debit** | **Credit** |
|  |  |  |
| Cash | 600 |  |
| Uhura Capital |  | 600 |
| To eliminate capital deficiency. | | |

Cash Kirk, Capital Spock, Capital Uhura, Capital

6,000 29,500 9,000 27,000 5,400 25,000 3,600 3,000 60,500 600

600

**Bal. = 37,600** **Bal. = 18,000 Bal. = 19,600 Bal**. **=** **0**

After Uhura’s contribution, her capital balance becomes zero, and the remaining cash becomes $37,600, which is now equal to the sum of Kirk’s and Spock’s capital balances ($18,000 + $19,600). At this point, the remaining cash is distributed in accordance with the capital balances of the partners with credit balances. Kirk will receive $18,000, and Spock will receive $19,600, thus zeroing out their respective capital balances, as shown by the following journal entry:

|  |  |  |  |
| --- | --- | --- | --- |
| **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |
| Kirk, Capital | 18,000 |  | Debit to zero out Kirk |
| Spock, Capital | 19,600 |  | Debit to zero out Spock |
| Cash |  | 37,600 | Credit to zero out Cash |
| To record final distribution of cash to remaining partners. | | | |

Because Uhura has a zero-capital credit balance, she does not receive any final cash distribution.

The partnership is now dissolved.

**Method 2:**

The partners with credit balances reduce their respective capital balances proportionately, in accordance with their income ratios. This method assumes that Uhura is unable or unwilling to eliminate her $600 capital deficiency. As a result, the partners with capital credit balances must reduce their capital credit balances proportionately in accordance with their income ratios, as follows:

Kirk: 5/8 x $600 = $375

Spock: 3/8 x $600 = $225

|  |  |  |
| --- | --- | --- |
| **Account** | **Debit** | **Credit** |
|  |  |  |
| Kirk, Capital | 375 |  |
| Spock, Capital | 225 |  |
| Uhura, Capital |  | 600 |
| To eliminate Uhura’s capital deficiency |  |  |

The capital balances at this point are as follows:

Cash Kirk, Capital Spock, Capital Uhura, Capital

6,000 29,500 9,000 27,000 5,400 25,000 3,600 3,000 60,500 375 225 600

**Bal. = 37,000** **Bal. = 17,625 Bal. = 19,375 Bal**. **=** **0**

*Note.* After Kirk and Spock reduce their capital balances, Uhura’s capital balance is now zero, and the remaining cash is equal to the sum of Kirk’s and Spock’s capital balances, which is $37,000 ($17,625 + $$19,375).

Now you can distribute the remaining cash in accordance with each partner’s capital balance**,** thus zeroing out the capital balances.

**Remember:**

Final distribution of cash is always done on the basis of the partners’ capital account balances, not on the basis of the income sharing ratio.

The final journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** | **Comment** |
|  |  |  |  |  |
| 12/31 | Kirk, Capital | 17,625 |  | Debit to zero out |
|  | Spock, Capital | 19,375 |  | Debit to zero out |
|  | Cash |  | 37,000 | Credit to zero out |
|  | To record final distribution of cash to remaining partners. | | | |

The partnership is now liquidated.

**Exercises:**

**Exercise 11.1**

On January 9th, Steve and Josh form a partnership to provide snow shoveling services to the county area. Steve contributes $4,000 cash as well as a piece of equipment valued at $3,680. Josh contributes $8,820 cash as well as a vehicle valued at $9,800. The partnership also assumes responsibility for Josh's long-term note payable of $2,300 related to the vehicle.

1. Prepare the journal entry to record Steve's initial capital investment.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | | **Credit** | **Comment(S)** |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |

1. Prepare the journal entry to record Josh's initial capital investment.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | | **Credit** | **Comment(S)** |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |

1. If net income is $42,000, prepare the journal entry to allocate income between the two partners (assume the partnership agreement states that net income should be divided 1/3 for Steve and 2/3 for Josh).

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | | **Credit** | **Comment(S)** |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |

**Exercise 11.2**

At the beginning of 2021, Steve has a capital balance of $60,000, and Josh has a capital balance of $90,000. The partnership of Steve and Josh earns a total net income of $100,000 in 2021.

Prepare a schedule to show the division of net income among two partners. Prepare a single journal entry to allocate net income between the two partners if the partners have agreed on the following:

* + Steve and Josh will receive annual salary allowances of $50,000 and $30,500, respectively.
  + A 1% interest allowance will be paid on each partner's beginning capital balance.
  + Remainder will be shared equally.

**Exercise 11.3**

On January 3, Steve agrees to sell Josh 50% of his capital, which is $42,000 of his partnership interest, for $25,000 cash. This is a personal transaction between the partners, but the other existing partners of the firm agree with this arrangement. Prepare the journal entry for this transaction.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Date** | | **Account** | **Debit** | | | **Credit** | **Comment(S)** |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |
|  |  | | |  |  | |  |

# Financial Accounting II

## Chapter 11 Test

### Partnerships

#### True / False

1. T F All partnership agreements must be in writing.
2. T F A partnership is considered an accounting entity for financial reporting purposes.
3. T F The concept of mutual agency applies to limited partners.
4. T F Specific assets contributed to a partnership by a specific partner are returned to that partner upon

his withdrawal from the partnership.

1. T F Mutual agency is a major disadvantage of the sole proprietorship form of business.
2. T F Since partnerships pay income taxes on partnership income, individual partners do not pay

personal income taxes on their share of the partnership income.

1. T F The income summary account is used to close out the net income of a sole proprietorship but not

a partnership net income.

1. T F The last step in liquidating a partnership is to distribute cash to the partners on the basis of their

income ratios.

1. T F The partnership capital balance is equal to the sum of the individual partners’ capital balances.
2. TFIndividuals and sole proprietors may join together and form a partnership

##### Multiple Choice

1. Jack and Jill invest $50,000 and $80,000, re­spectively, and form the J&J partnership. They agree to divide net income to provide salary allowances of $15,000 and $25,000, respectively; an interest allowance of 10% on their original investments; and the remainder to be divided equally. What would be Jack’s share of a net income if the partnership earns $60,000 in net income?
2. $20,000
3. $23,500
4. $33,000
5. $36,500
6. Robert and Alvin agreed to an income ratio of 5:3 when they decide to liquidate their partnership. After selling all of the partnership assets for cash, allocating gains or losses, and paying off all liabilities, Robert’s capital credit balance is $26,000 and Alvin’s is $22,000. How much of the remaining $48,000 will be distributed to Robert?
7. $18,000
8. $22,000
9. $26,000
10. $30,000
11. Noncash assets invested in a partnership are recorded at their
12. initial cost
13. fair market value
14. depreciable cost
15. incremental cost
16. If a new partner is admitted into a partnership by purchasing an existing partner's interest in whole or in part, then total partnership capital
17. increases
18. decreases
19. remains the same
20. none of the above
21. Partnership AB has an income sharing ratio of 5:5. In the current year, the partnership has a net loss of $15,000. Partner A receives a salary allowance of $18,000 and Partner B a salary allowance of $15,000. Partners A and B also receive an interest allowance of $2,000 each. Determine how to allocate the net loss among the two partners.
22. Partner A ($6,000) and Partner B ($9,000)
23. Partner A ($7,500) and Partner B ($7,500)
24. Partner A ($20,000) and Partner B ($17,000)
25. none of the above
26. Company A, Company B, and Company C join to form the ABC partnership. Company A’s equipment has a book value of $10,000. Its accumulated depreciation is $6,000, and its fair market value is $7,000. When entering this equipment on the books of the new partnership, it should be entered at
27. $4,000
28. $6,000
29. $7,000
30. $9,000
31. $11,000
32. Upon liquidation, any cash remaining after all liabilities have been paid should be distributed to the partners on the basis of their\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. Which of the following statements related to partnerships is correct*?*
2. Partnership assets are owned by the individual partners who initially contributed them.
3. Mutual agency is a disadvantage in a partnership.
4. A partnership cannot be formed with more than two sole proprietorships.
5. In the liquidation of a partnership, after all liabilities have been paid, individual partner capital accounts will always have credit balances.
6. Jones is investing in a partnership with James. Jones’ initial contribution consists of accounts receivable of $100,000; an allowance for doubtful accounts of $10,000; and $60,000 in cash. The entry that the partnership makes to record Jones’ initial contribution includes a
7. credit to “Jones, Capital” for $160,000
8. credit to “Jones, Capital” for $150,000
9. debit to “Accounts Receivable” for $90,000
10. credit to “Allowance for Doubtful Accounts” for $90,000
11. The name of the owners' equity statement for a partnership is the\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

###### Other Questions

1. Identify 3 advantages and 3 disadvantages of a partnership.

**Advantages:**

**Disadvantages:**

1. In forming a partnership, a partner contributes $200,000 of accounts receivable. All of the partners agree that 95 % of the A/R should be col­lectible. Journalize this transaction.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
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1. Mitt Romney contributed land, equipment, and $60,000 in cash to form a partnership with his buddy Barack Obama. The land had a book value of $40,000 and a market value of $68,000. The equipment had a book value of $30,000 and a market value of $35,000. The partnership also assumed a $10,000 note payable owed by Mitt that was associated with Mitt’s business. Show the journal entry that the partnership would make for Mitt’s contribution to the partnership.

|  |  |  |  |  |
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1. Gloria Sanchez and Pierre Mason have a partnership in which they share income equally. Their capital balances are $200,000 and $150,000, respectively. They agree that Mason will sell ¼ of his partnership interest to Michelle Rogers. Show the journal entry that must be made if the sales price is (a) $35,000 (b) $40,000

|  |  |  |  |  |
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1. Obama, Bush, and Clinton are forming a partnership. Obama is transferring $150,000 of personal cash and $50,000 of accounts receivable to the partnership. Bush is contributing land, a building, and equipment valued at $100,000, $300,000, and $50,000, respectively. Clinton is contributing $100,000 cash, accounts receivable of $80,000, and equipment worth $40,000. They all agree that the partnership will collect 90% of each contributing partner’s accounts receivable.

**Instructions**

1. Show the necessary journal entries to record each partner’s initial contribution to the partnership.
2. Instead of separate journal entries as in (a) above, show what a single compound journal entry would look like.
3. What is the total partnership capital after all the contributions have been made?

Answer (a)

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Answer (b)

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Answer (c) \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. On December 31, 2013, The Candy Company has $45,000 in cash, noncash assets of $120,000, and liabil­ities of $50,000. The two partners, Tootsie and Pops, are $70,000 and $45,000, respectively. The firm is liqui­dated, and $120,000 is received for the noncash assets. Tootsie’s and Pops’ income ratios are 70% and 30%, respectively.

**Instructions**

Develop a cash distribution schedule and show the journal entry for each step in the liquidation process.

Answer:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Ref** | **Debit** | **Credit** |
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1. George, Abraham, and John have a partnership. George’s capital balance is $40,000, Abraham’s is $50,000, and John’s is $60,000. George is leaving the partnership and is selling his interest equally to Abraham and John for $30,000 and $45,000 respectively. Show the journal entry made when George leaves the partnership.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Ref** | **Debit** | **Credit** |
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**Chapter 12**

**Corporations: Organization and Capital Stock Transactions**

**Learning Outcomes:**

1. Gain familiarization with the general concepts of a corporation.
2. Become familiar with the format and content of the shareholder equity section.
3. Develop the journal entries related to initial issuance of common and preferred stock.
4. Develop general journal entries related to treasury stock (T/S).

**(LO1)**

**Gain familiarization with the general concepts of a corporation**

Unlike a sole proprietorship or a partnership, which can be created by the owner or partners at will, a corporation is a business entity created under the laws of the state in which it is incorporated, and it is separate from its managers and shareholders (owners). A corporation may be private or public, depending on how the shares of stock are owned. The stocks (or shares) of a private corporation are held by one or a few investors. The shares of a private company are not publicly sold or traded. Examples of private corporations are PetSmart, Wawa (a convenience store with gas stations), and Wegman’s Food Market. Publicly held corporations have their shares traded on national stock exchanges, such as the New York Stock Exchange or Nasdaq. Examples of publicly held corporations are Microsoft, Amazon, Google, and Coca Cola.

Many of the characteristics of a corporation can be categorized as advantages or disadvantages, as follows:

Advantages:

* Unlike a sole proprietorship or partnership, which ends with the death or withdrawal of a partner, the life of the corporation is continuous.
* The stockholders (owners) of the corporation have limited liability. That is, they cannot lose more money than the amount they invested in the business.
* The stockholders can sell their investment in the corporation at any time, without any effect on the corporation.

Disadvantages:

* More government regulation
* Double taxation

**Forming a Corporation**

Authorization by the state of incorporation is required in order to form a corporation. Once established, the corporation may issue shares of stock. A stock (or share) is the term used to indicate ownership in a corporation. A public corporation (Microsoft, Pfizer, Macy’s, etc.) may issue stocks to raise funds. These stocks may be purchased by investors (institutional, individual, e.g.). The corporation’s articles of incorporation will specify the number of shares authorized. The following are definitions the student should become familiar with:

1. Authorized shares - The maximum number of shares a corporation may issue.
2. Issued shares - The number of authorized shares that have been sold. A company

may sell some or all of the authorized shares. Buyers may include institutions (pension funds, mutual funds), company insiders, or individual investors.

1. Outstanding shares - These are the number of shares owned by investors. Outstanding

shares may be as high as the number of shares issued. However, outstanding shares do not include treasury stock.

1. Treasury shares - A company can always buy back some of its own shares

previously issued and/or outstanding. When a

company repurchases its own stock, the repurchased shares are called treasury stock because they are held in the company’s treasury department. Treasury stock is not considered outstanding. However, it is considered issued.

**Example 1:**

A company is authorized to sell 500,000 shares of its own stock. It sells 300,000 shares. In this case, there are 300,000 shares issued and outstanding.

**Example 2:**

A company is authorized to sell 500,000 shares of its own stock. It sells 300,000 shares. Later, it repurchases 50,000 of the shares previously issued. In this case, we say there are 50,000 shares of treasury stock held in the treasury department, and only 450,000 shares are outstanding. The number of shares issued is still 300,000 because treasury shares are considered issued but not outstanding.

**Example 3:**

Assume all authorized shares have been sold and there are 75,000 treasury shares and 550,000 shares outstanding. How many shares were authorized? Recall that treasury stock is considered issued but not outstanding. Thus, there are 625,000 shares that were issued. In this case, this is also the number of shares authorized.

**Types of Stock**

In general, a corporation may issue two types of stock: common stock and preferred stock. While there may be subclasses of these types, we will concentrate on the generic types.

**Preferred Stock** Preferred stock is referred to as such because preferred stockholders

have certain advantages over common shareholders. Some of these include the right to receive a dividend before common stockholders, the right to cumulative dividends (for cumulative type preferred stock) and in receiving payments as a result of liquidation of the corporation. Before a company can issue preferred stock, it must have issued common stock.

**Common Stock** Denotes ownership in the corporation. Common stockholders may have voting

rights on matters important to the company and may receive dividends or

payouts from company earnings.

**(LO2)**

**Become familiar with the format and content of the shareholder equity section**

**The Shareholder Equity Section of a Balance Sheet**

The shareholder equity section on a balance sheet is more complicated than the shareholder equity section for a sole proprietorship or partnership.

Its most basic format is:

**Paid-in Capital**

**Capital Stock**

Preferred Stock

Common Stock

**Total capital Stock**

**Additional Paid-in Capital**

Preferred Stock – Excess over Par Value

Common Stock – Excess over Par or Stated Value

Excess from Treasury Stock

**Total additional Paid-in Capital**

**Total Paid-in Capital**

**Retained Earnings**

**Total Paid-in Capital and Retained Earnings**

**Less Treasury stocks**

**Total Stockholder Equity**

Note the terms *par value* and *stated value*.

Par valueis an arbitrary value assigned by a company on a per share basis. For example, the par value of Macy’s is $0.01. That’s correct: a penny. The par value for New Jersey Resources, an energy services company, is $2.50 per share.

For accounting purpose, par value per share is used to calculate the value for the preferred stock and common stock accounts. In some cases, a stock may not have a par value. In such a case, the board of directors assigns a stated value,which serves the same purpose as the par value.

The par or stated values have no relationship to the selling or market price of an individual stock. For any share(s) issued or sold at a price that exceeds the par or stated value, the excess dollar amount over that value is referred to as “excess over par (or stated) value for the preferred (or common) stock.”

**Example:** A company issues 1,000 shares of it $1.00 per share par value common stock for $5.00 per share.

Since the par value is $1.00, the common stock account is valued at $1,000 ($1.00 par value per share x 1,000 shares issued). The excess over par is $4.00 ($5.00 per share issue or market price minus the $1.00 per share par value). Thus, the total excess over par is $4,000 ($4.00 excess over par per share x 1,000 shares issued).

If a stock had a stated value, we would say “excess over stated value.” The math would be identical.

**Tiger Corporation**

**Account balances shown on**

Balance Sheet (partial) Normal Balance Side

December 31, 20xx

This is a representative shareholder equity section as may be found on a corporate Balance Sheet. **Preferred Stock**

Values indicated below come from the balances in the accounts shown on the right. 125,000

|  |  |
| --- | --- |
| **Shareholder Equity** | |
| **Paid-in Capital** | |
| **Capital Stock** | |
| **Preferred stock,** 8%, $25 par value, cumulative,  8,000 shares issued and outstanding | $125,000 |
| **Common stock,** $2 par value, 60,000 shares issued,  50,000 shares outstanding | 120,000 |
| **Total Capital Stock** | 245,000 |
|  |  |
| Paid-in capital in excess of P/V – P/S | 125,000 |
| Paid-in capital in excess of P/V – C/S | 480,000 |
| Paid-in capital from Treasury Stock | 0 |
| **Total additional Paid-in capital** | 605,000 |
| **Total Paid-in capital** | 850,000 |
|  |  |
| **Retained Earnings** | 1,050,000 |
| Total Paid-in capital and retained earnings | 1,900,000 |
|  |  |
| **Less:** Treasury Stock (10,000 shares) | (80,000) |
|  |  |
| **Total shareholder equity** | $2,285,000 |

**Common Stock**

120,000

**PIC in Excess of P/V-P/S**

125,000

**PIC in Excess of P/V-C/S**

480,000

**PIC from T/S**

See note below

**Retained Earnings**

**Assumptions:** 1,200,000

Preferred Stock issued at $60 per share

Common Stock issued at $10 per share

Treasury Stock S purchase at $8 per share  **Treasury Stock**

Paid-in capital from T/S is zero because none of the 10,000 shares of T/S have been reissued. 80,000

**(LO3)**

**Develop the Journal Entries Related to Initial Issuance of Common and Preferred Stock**

**Issuing Common Stock (C/S) For Cash**

**Case 1**: **Issuing Common Stock (C/S) for cash, above par value (p/v):**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares issued **x** sales price per share |
|  | Common Stock |  | C | = # of shares issued **x** par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | C | = # of shares issued **x** (sales price per share **–** par value per share) |
|  | To record issuance of C/S above par value |  |  |  |

**Example 1:**

On March 1, the ABC Company issued 1,000 shares of its $1.00 par value common stock for $10.00 per share. Show the journal entry that would be made.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | 10,000 |  | = 1,000 shares issued **x** $10.00 per share price |
|  | Common Stock |  | 1,000 | = 1,000 shares issued **x** $1.00 par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | 9,000 | = 1,000 shares issued **x** ($10.00 per share price **–** $1.00 per share par value) |
|  | To record issuance of C/S above par value |  |  |  |

**Case 2**: **Issuing Common Stock (C/S) for cash, above stated value (s/v):**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares issued **x** sales price per share |
|  | Common Stock |  | C | = # of shares issued **x** stated value per share |
|  | Paid-in Capital in excess of stated value – C/S |  | C | = # of shares issued **x** (sales price per share – stated value per share) |
|  | To record issuance of C/S above stated value |  |  |  |

**Example 2:**

On July 15, the ABC Company issued 1,000 shares of its $1.00 stated value common stock for $10.00 per share. Show the journal entry that would be made.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | 10,000 |  | = 1,000 shares issued **x** $10.00 per share price |
|  | Common Stock |  | 1,000 | = 1,000 shares issued **x** $1.00 stated value per share |
|  | Paid-in Capital in stated of Stated value – C/S |  | 9,000 | = 1,000 shares issued **x** ($10.00 per share price **–** $1.00 per share par value) |
|  | To record issuance of C/S above par value |  |  |  |

**Issuing Preferred Stock (P/S) For Cash**

**Case 1**: **Issuing Preferred Stock (P/S) for cash, at par value:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares issued **x** sales price per share |
|  | Preferred Stock |  | C | = # of shares issued x sales price per share |
|  | To record issuance of P/S at par value |  |  |  |

**Example 1:**

On August 1, the ABC Company issued 2,000 shares of its $5.00 par value stock for $5.00 per share. Show the journal entry that would be made. Note, in this case, that there is no excess over par. Thus, the par value and the selling price are equal.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | 10,000 |  | = 2,000 shares issued **x** $5.00 sales price per share |
|  | Preferred Stock |  | 10,000 | = 2,000 shares issued x $5.00 par value per share |
|  | To record issuance of P/S at par value |  |  |  |

**Case 2**: **Issuing Preferred Stock (P/S) for cash, above par value:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares issued x sales price per share |
|  | Preferred Stock |  | C | = # of shares issued x par value per share |
|  | Paid-in Capital in excess of par value – P/S |  | C | = # of shares issued x (sales price per share – par value per share) |
|  | To record issuance of P/S above par value |  |  |  |

**Example 2:**

On August 20, the ABC Company issued 5,000 shares of its $5.00 par value stock for $20.00 per share. Show the journal entry that would be made.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | 100,000 |  | = 5,000 shares issued x $20.00 per share sales price |
|  | Preferred Stock |  | 25,000 | = 5,000 shares issued x $5.00 par value per share |
|  | Paid-in Capital in excess of par value – P/S |  | 75,000 | = 5,000 shares issued x ($20.00 per share sales price – $5.00 par value per share) |
|  | To record issuance of P/S above par value |  |  |  |

**Issuing Common Stock (C/S) For NoncashAsset or Service**

**Note:**

To determine value for shares of stock issued for the noncash asset or service, use the fair market value of the *consideration* given up or received, whichever is the more clearly determinable. This value is usually evidenced by a bill for the service received in exchange for the stock, the fair value of an asset received in exchange for the stock, or the value of a stock that is freely traded on an organized stock exchange (e.g., New York Stock Exchange or NASDAQ).

**Case 1**: **Issuing Common Stock (C/S), for a service, above par value:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Account name - exp. | D |  | See note above on how to determine value |
|  | Common Stock |  | C | = # of shares issued x par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | C | = the difference between the two amounts above |
|  | To record issuance of C/S for ………. |  |  |  |

**Example 1:**

On February 15, the XYZ Company issued 5,000 shares of its $2.00 par value stock in exchange for professional services by a legal firm. The company’s stock is not publicly traded. The attorneys billed the company $25,000.

In this case, the consideration being exchanged is the company’s stock for the legal firm’s services. Since the stock is not publicly traded, we do not know its value. Therefore, we must value the transaction on the amount shown on the attorney’s bill. The total par value is $10,000 (5,000 shares x the $2.00 par value per share), and the excess over par is $15,000 ($25,000 – the $10,000 total par value). The journal entry thus becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Legal exp. | 25,000 |  | The amount of the legal bill, in this case |
|  | Common Stock |  | 10,000 | = 5,000 shares issued x $2.00 par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | 15,000 | = the difference between the two amounts |
|  | To record issuance of C/S for ………. |  |  |  |

**Case 2**: **Issuing Common Stock (C/S), for an asset, above par value:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Asset name | D |  | See note above on how to determine value |
|  | Common Stock |  | C | = # of shares issued x par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | C | = the difference between the two accounts above |
|  | To record issuance of C/S for ………. |  |  |  |

**Example 2 :**

On March 30, the XYZ Company issued 50,000 shares of its $2.00 par value in exchange for a building. The company’s stock is not publicly traded. The building’s book value is $90,000 and its fair market value is $225,000. Show the journal entry that would be made.

In this case, the consideration being exchanged is the company’s stock for a building. Since the stock is not publicly traded, we do not know its value. Therefore, we must value the transaction on the fair market value of the building. The total par value is $100,000 (50,000 shares x the $2.00 par value per share), and the excess over par is $125,000 ($225,000 – the $100,000 total par value). The journal entry thus becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Building | 225,000 |  | The amount of the building, in this case |
|  | Common Stock |  | 100,000 | = 50,000 shares issued x $2.00 par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | 125,000 | = the difference between the two amounts |
|  | To record issuance of C/S for ………. |  |  |  |

**Example 3:**

On July 15, the XYZ Company issued 100,000 shares of its $2.00 par value common stock in exchange for land on which it will erect a new office building. The stock is publicly traded on the New York Stock Exchange. On this day, the stock is trading for $6.00 per share. Show the journal entry that would be made.

In this case, the consideration being exchanged is the company’s stock for land. Since the stock is publicly traded, we know its share price at any given time. As such, we must value the transaction on the publicly traded value of the stock. The total par value is $200,000 (100,000 shares x the $2.00 par value per share), and the excess over par is $125,000 ($225,000 – the $100,000 total par value). The journal entry thus becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Land | 600,000 |  | The amount of the land, in this case |
|  | Common Stock |  | 200,000 | = 100,000 shares issued x $2.00 par value per share |
|  | Paid-in Capital in excess of par value – C/S |  | 400,000 | = the difference between the two amounts |
|  | To record issuance of C/S for ………. |  |  |  |

**(LO4)**

**Develop General Journal Entries Related to Treasury Stock (T/S)**

Treasury stock refers to a company’s own stock that had been previously issued and is later reacquired by the issuing company. It is also the name of the account used to record such transactions. The treasury stock account is a contra equity account. Any balance in the account reduces total shareholder equity or capital.

There are five cases we will consider regarding treasury stock. The first simply considers the transaction related to the initial (or subsequent) purchase by a company of its own previously issued and publicly traded stock. The remaining four cases deal with the disposal or resale of the previously purchased treasury stock.

Theory and examples will be shown for each of the following situations related to treasury stock:

1. the initial (or subsequent) purchase
2. reselling (disposal) of the stock at the original purchase price
3. reselling (disposal) of the stock at a price higher than the original purchase price
4. reselling (disposal) of the stock at a price lower than the original purchase price
5. reselling (disposal) of the stock at a price *significantly* lower than the original purchase price

**Case 1**: **Initial (or subsequent) Purchase of Treasury Stock**

When a company repurchases its own stock, it is effectively reducing the number of its outstanding shares, thus reducing its total shareholder equity. In the journal entry below, the treasury stock account is debited. Since the treasury stock account is a contra-equity account, the debit reduces equity. The cash account is credited (reduced).

In summary, the purchase of a company’s own stock reduces total shareholder equity as well as the asset cash.

The typical journal entry that would be made in this case is shown below.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Treasury Stock | D |  | = # of shares purchased x market price per share on **date of purchase** |
|  | Cash |  | C | = # of shares purchased x market price per share on **date of purchase** |
|  | To record purchase of (include #of shares of T/S purchased and market price per share) |  |  |  |

**Example 1:**

On May 12, the ABC Company purchased 5,000 of its own outstanding shares at a price of $25 per share.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 5/12 | Treasury Stock | 125,000 |  | = 5,000 shares purchased x $25.00 market price per share |
|  | Cash |  | 125,000 | = 5,000 shares purchased x $25.00 market price per share |
|  | To record purchase of (include #of shares of T/S purchased and market price per share) |  |  |  |

Once a company has repurchased its treasury stock, the question becomes what to do with it. One option is to cancel the treasury stock altogether. Another option might be to use the treasury stock internally for incentives, such as employee bonuses. These two options will not be considered herein. Instead, we will consider the option where a company resells the treasury stock at a later date, at the market price then in effect.

Assuming the company is going to resell the treasury stock, there are four scenarios that must be considered. The treasury stock may be resold at:

1. the original purchase price
2. - a market price higher than the original purchase price
3. a market price lower than the original purchase price
4. a market price *significantly* lower than the original purchase price

**Case 2 – Situation (a)**: **Disposal (resale) of Treasury Stock for cash, at a market price equal to its purchase price:**

**Note:**

Disposal (resale) of T/S means that the company that had originally purchased back its own stock is now reselling that same stock back into the market. Whenever T/S is disposed of, regardless of the selling price when they are resold, the T/S account must be credited at the original (initial) cost of the treasury stock on the date of its original (initial) purchase***.***

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares disposed of x market price per share on **date of sale** |
|  | Treasury Stock |  | C | = # of shares disposed of **x** price per share on **date of purchase** |
|  | To record disposal of T/S (include #of shares of T/S sold and sales price per share) |  |  |  |

**Example 2: Disposal (Resale) of Treasury Stock for Cash at a Market Price Equal to its Purchase Price**

Recall that on May 12, the ABC Company purchased 5,000 of its own outstanding shares at a price of $25 per share. For this and the following examples, let’s assume the company resells its treasury stock in increments of 1,000 over a period of several months. For this example, assume on June 30, the company resold 1,000 shares of its treasury stock for $25.00 per share.

Note, the selling price in this case equals the original purchase price. Thus, there is no increase or decrease over the purchase price. The company receives cash equal to the reduction in the value of the treasury stock it had previously issued.

The journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 6/30 | Cash | 25,000 |  | = 1,000 shares disposed of x $25.00 market price per share on **date of sale** |
|  | Treasury Stock |  | 25,000 | = 1,000 shares disposed of **x** $25.00 per share on **date of purchase** |
|  | To record disposal of 1,000 shares of T/S at $25.00 per share. |  |  |  |

The effect of this transaction is to increase the asset cash and increase the shareholder equity since the treasury stock account is being credited.

**Example 3:** **Disposal (Resale) of Treasury Stock for Cash at a Market Price Higher Than its Original Purchase Price**

Disposal of T/S above the original purchase price means that the company is receiving more cash than it spent to buy the shares being resold. If this were a personal transaction, we’d say we have a gain on the sale. However, a company does not recognize gains (or losses) on the sale of its own stock. The increase over the original purchase price is considered an increase in shareholder equity. The account used to show this increase is called “Paid-in Capital from Treasury Stock.” It is a capital account, and its normal balance side (the side the account increases on) is the credit side.

As stated in the previous case, whenever T/S is disposed of, regardless of the selling price when they are disposed, the T/S account must be credited at the original (initial) cost of the treasury stock on the date of its original (initial) purchase. The Paid-in Capital from Treasury Stock account is credited the difference (in total) between the cash received and the reduction in the treasury stock account. The format for the journal entry in this case is shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares disposed of x market price per share on **date of sale** |
|  | Treasury Stock |  | C | = # of shares disposed of **x** price per share on **date of purchase** |
|  | Paid-in Capital From T/S |  |  | = the difference between the two amounts above |
|  | To record disposal of T/S (include #of shares of T/S sold and sales price per share) |  |  |  |

Recall that on May 12, the ABC Company purchased 5,000 of its own outstanding shares at a price of $25 per share. Also, on June 30, the company resold 1,000 shares of its treasury stock for $25.00 per share. For this case, let’s assume the company, on July 31 resold another 1,000 shares of its treasury stock at a price of $30.00 per share. Prepare the journal entry for this transaction.

Note that the selling price per share in this case is higher than the original purchase price ($30.00 vs. $25.00). Therefore, there is a $5.00 increaseover the purchase price. The total cash the company receives is based on the market price it received for each share sold ($30.00 per share times the number of shares sold). As previously stated, whenever T/S is disposed of, regardless of the selling price at which they are disposed, the T/S account must be credited at the original (initial) cost of the treasury stock on the date of its original (initial) purchase ($25.00 per share times the number of shares sold). The Paid-in Capital from Treasury Stock account is credited the difference (in total) between the cash received and the reduction in the treasury stock account—in this case, $5,000 (the $5.00 increase per share over the original purchase price times the number of shares sold). The journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 7/31 | Cash | 30,000 |  | = 1,000 shares disposed of x $25.00 market price per share on **date of sale** |
|  | Treasury Stock |  | 25,000 | = 1,000 shares disposed of **x** $25.00 per share on **date of purchase** |
|  | Paid-in Capital from T/S |  | 5,000 | = 1,000 shares disposed x $5.00 excess over the original purchase price. |
|  | To record disposal of 1,000 shares of T/S at $30.00 per share. |  |  |  |

The effect of this transaction is to increase the asset cash and increase the two shareholder equity accounts; since the treasury stock account is being credited, it serves to increase shareholder equity, as does the excess cash received from reselling the treasury stock at a price higher than it was originally purchased for.

The three examples covered above are relatively straight forward. The next two are not. The student should study Examples 4 and 5 below very carefully.

**Case 4 – Situation (c)**: **Disposal (resale) of Treasury Stock for cash, at a market price below the original purchase price:**

This example differs from Example 3 above in that the T/S was resold at a sales price below its original purchase price.

Whenever this happens, the Paid-in Capital from T/S account will require a debit (if there is an existing balance on its credit side). Also, keep in mind that the balance in the Paid-in Capital from T/S account cannot go below zero, therefore limiting the amount that can be debited. If an additional debit amount is still needed to balance the transaction, it must come from the retained earnings account (see Example 5 below).

In this case, the format for the journal entry will look like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **Dt.** | Cash | D |  | = # of shares disposed of x market price on **date of sale** |
|  | Paid-in Capital From T/S | D |  | See notes above |
|  | Treasury Stock |  | C | = # of shares disposed of **x** price per share on **date of original purchase** |
|  | To record disposal of T/S below original cost |  |  |  |

Recall that on May 12, the ABC Company purchased 5,000 of its own outstanding shares at a price of $25 per share. Also, on June 30, the company resold 1,000 shares of its treasury stock for $25.00 per share. Then, on July 31, the company resold another 1,000 shares of its treasury stock at a price of $30.00 per share.

For this example, assume that on August 31 the company resold another 1,000 shares of its treasury stock for $22.00 per share.

Prepare the journal entry for the August 31 transaction.

Note that the selling price per share in this case is lower than the original purchase price ($22.00 vs. $25.00). Therefore, there is a $3.00 reductionfrom the purchase price. The total cash the company receives is based on the market price it received for each share sold ($22.00 per share times the number of shares sold). As previously stated, whenever T/S is disposed of, regardless of the selling price at which they are disposed, the T/S account must be credited at the original (initial) cost of the treasury stock on the date of its original (initial) purchase ($25.00 per share times the number of shares sold). The Paid-in Capital from Treasury Stock account is debited the difference (up to the credit balance in that account) because the balance in Paid-inthis account cannot go below zero as well.

At this point, the development of the journal entry looks like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **8/31** | Cash | 22,000 |  | = 1,000 shares sold of x $22.00 per share market price **on date of sale** |
|  | Paid-in Capital From T/S | D |  | See explanation below |
|  | Treasury Stock |  | 25,000 | = 1,000 shares sold **x** $25.00 per share on **date of original purchase** |
|  | To record disposal of T/S below original cost |  |  |  |

Note that we’re missing a debit amount for the Paid-inPaid-in Capital from T/S account. The amount needed is $3,000 (the difference between the price of the shares originally purchased and the selling price). We need to determine if there is there any balance in Paid-inthis account, and if it is at least $3,000.

In the previous transition, where the T/S was sold above the original purchase price, the Paid-in Capital account was credited $5,000. We can therefore reduce it by the $3,000 needed in this case. The completed journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **8/31** | Cash | 22,000 |  | = 1,000 shares sold of x $22.00 per share market price **on date of sale** |
|  | Paid-in Capital From T/S | 3,000 |  | See explanation below |
|  | Treasury Stock |  | 25,000 | = 1,000 shares sold **x** $25.00 per share on **date of original purchase** |
|  | To record disposal of T/S below original cost |  |  |  |

After completing this transaction, the remaining credit balance in the Paid-in Capital from Treasury Stock account is now $2,000.

**Case 5 – Situation (d)**: **Disposal (resale) of Treasury Stock for cash, at a market price significantly below the original purchase price:**

This example differs from Example 4 above in that the T/S was resold at a sales price *significantly below* its original purchase price. Recall that in the previous case, we had a sufficient credit balance in the Paid-in Capital from T/S account to cover the deficiency. In this case, we’ll look at what to do when the balance in Paid-inthis account is not enough by itself to cover any deficiency. (Hint: We use the Retained Earnings account to make up any shortfall once the Paid-in Capital from T/S account balance is zeroed out).

In this final example, assume the company sells its remaining shares at $20.00 per share on September 30.

Prepare the journal entry for the August 31 transaction.

First, note in this transaction the company is selling the 2,000 remaining shares. Also, the selling price per share is well below the original purchase price ($20.00 vs. $25.00). As such, **there is a $5.00 reduction** from the purchase price. The total cash the company receives is based on the market price it received for each share sold ($20.00 per share times the number of shares sold). As previously stated, **whenever** T/S is disposed of, regardless of the selling price at which they are disposed, the **T/S account must be credited at the original (initial) cost of the treasury stock on the date of its original (initial) purchase ($25.00 per share times the number of shares sold).**  The Paid-in Capital from Treasury Stock account is debited the difference (up to the credit balance in that account), because the balance in the Paid-in capital from treasury stock account **CANNOT** go below zero as well.

At this point, the development of the journal entry looks like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **8/31** | Cash | 40,000 |  | = 1,000 shares sold of x $22.00 per share market price **on date of sale** |
|  | Paid-in Capital From T/S | D |  | See explanation below |
|  | Retained Earnings | D |  |  |
|  | Treasury Stock |  | 50,000 | = 1,000 shares sold **x** $25.00 per share on **date of original purchase** |
|  | To record disposal of T/S below original cost |  |  |  |

Note that we’re missing a debit amount for the Paid-in capital account from T/S and the Retained Earnings account. The total amount needed to cover the deficiency is amount needed is $10,000 (the difference between the price of the shares originally purchased and the selling price). The question is, is there any balance in the Paid-in capital from T/S account, and is it at least $10,000.

There is only a $2,000 credit balance in the Paid-in capital from T/S account. We’ll debit the account the full amount since its balance cannot go below zero. We still need another $8,000. The only other account from which it can come from is Retained Earnings. As such, the completed journal entry becomes:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| **8/31** | Cash | 40,000 |  | = 2,000 shares sold of x $20.00 per share market price **on date of sale** |
|  | Paid-in Capital From T/S | 2,000 |  | See explanation above |
|  | Retained Earnings | 8,000 |  | = the total deficiency less the amount debited to the Paid-in capital from T/S account ($10,000 - $2,000) |
|  | Treasury Stock |  | 50,000 | = 1,000 shares sold **x** $25.00 per share on **date of original purchase** |
|  | To record disposal of T/S below original cost |  |  |  |

After completing this transaction, the remaining balance in the Paid-in capital from treasury stock account is zero.

**Exercises:**

**Exercise 12.1**

1. Prepare the journal entry to record Stony Company’s issuance of 100,000 shares of its $2 par value common stock, assuming the shares sell for:
2. $10 per share

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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1. $20 per share

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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1. Prepare the journal entry to record Falmer Company’s issuance of 60,000 shares of no-par value stock, assuming the shares sell for $30 per share.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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1. Prepare the journal entry to record Hamilton Inc’s issuance of 50,000 shares of $5 par value common stock, assuming the stock is given in exchange for a building valued at $420,000.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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**Exercise 12.2**

Make journal entries for each of the following situations for Hamilton Inc:

1. On April 6, Hamilton Inc. purchased 2,000 shares of its own shares of stock in the open market for a total amount of $20,000.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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1. On May 20 Hamilton Inc. sold 550 shares of its treasury stock for $12 per share.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
|  |  |  |  |  |
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1. On July 17, Hamilton Inc. sold 200 shares of its treasury stock for $8 per share.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
|  |  |  |  |  |
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1. On October 21, Hamilton Inc sold the remaining shares of its treasury stock for $7 per share.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Titles & Explanation** | **Ref.** | **Debits** | **Credits** |
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# Financial Accounting II

## Chapter 12 Test

### Corporations

#### True / False

1. T F Under Federal law, a corporation is considered a separate legal entity.
2. T F If a corporation issues its own stocks, it cannot repurchase them.
3. T F If a company buys back its own common stock, it debits the common stock account and

credits the cash account.

1. T F Purchasing treasury stock increases stockholder equity.
2. T F The retained earnings account represents cash collected by the company.
3. T F When a company issues common stock above the par value, a capital gain is realized.
4. T F On a balance sheet, treasury stock is shown as a reduction of shareholder equity.

##### Multiple Choice

1. Which of the following statements is correct?

a) A corporation is taxed in a manner similar to a partnership.

b) Corporate profits are taxed at the individual stockholder’s tax rate.

c) The board of directors are elected by the firm’s independent auditors.

d) Stockholders’ liability is limited to the value of the shares each owns.

1. The Sam Company is authorized to issue up to 2,000,000 shares of $2 par value common stock, and 400,000 of its 5%, $20 par value per share preferred stock.

During the year, Sam had the following transactions:

May 1 Issued 500,000 shares of common stock for $10 per share.

May 12 Issued 50,000 shares of common stock for an empty lot on which it plans to

construct a building. The lot was advertised for $1,000,000. Its fair value,

however, is $800,000.

May 12 The purchase of the empty lot was handled by attorneys, who accepted 20,000

of Sam’s common stock in exchange for their services. The attorney’s bill for the transaction was $10,000.

May 25 Purchased 15,000 shares of common stock for the treasury at $9 per share.

Dec. 6 Issued 50,000 shares of its preferred stock for $20 per share.

Journalize the transactions for the Sam Company.

|  |  |  |  |
| --- | --- | --- | --- |
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1. Corporations can issue

a) preferred stock if common stock had been previously issued

b) common stock

c) treasury stock if previously repurchased

d) all of the above

1. The Edsel Company provided the following balance sheet information (these are the only shares issued during a single initial public offering):

|  |  |
| --- | --- |
| 6%, $50.00 par value preferred stock | $ 150,000 |
| Common stock, $1.00 par value | 300,000 |
| Paid-in capital in excess of par value – P/S | 510,000 |
| Paid-in capital in excess of par value – C/S | 900,000 |
| Retained earnings | 90,000 |
| Treasury Stock (7,500 shares) | (22,500) |
| Total shareholder equity | **?** |

Determine the following:

1. Total shareholder equity \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
2. No. of preferred shares issued \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. Common shares issued \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. Price treasury shares were purchased at \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Preferred shares outstanding \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
6. Common shares outstanding \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
7. Preferred dividend per share \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
8. Total annual preferred dividend \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
9. The following information was obtained from the Mike Company’s balance sheet:

Common stock, $5 par value $300,000

Paid-in capital in excess of par value – common stock 200,000

Preferred stock, $50 par value 250,000

Paid-in capital in excess of par value – preferred stock 150,000

Retained earnings 400,000

Fill in the following:

1. Preferred stock issued: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ shares
2. Common stock issued: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ shares
3. Total paid-in capital: $ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. Total stockholder equity: $\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Given the following information, determine the total stockholder equity:

Common stock $120,000

Paid-in capital in excess of par 280,000

Retained earnings $475,000

Treasury stock 50,000

a) $400,000

b) $825,000

c) $875,000

d) $925,000

1. Define treasury stock and provide reasons a company may purchase it.

Answer:

1. Which of the following statements is incorrect?

a) Treasury stocks are not considered outstanding; however, they are considered issued.

b) Treasury stock purchases reduce stockholder equity.

c) Treasury stock reissued at a price higher than purchase price results in a capital gain.

d) Treasury stock reissued at a price higher than purchase price increases shareholder

equity.

1. Treasury stock is
2. not considered issued.
3. not considered authorized.
4. considered authorized, issued, and outstanding.
5. considered authorized and issued but not outstanding.
6. Treasury stock
7. is issued by the US government and is similar to savings bonds.
8. is held by the corporation’s treasury department and is considered issued but not outstanding.
9. is held by the corporation’s treasury department and is considered issued and outstanding.
10. is neither authorized, issued or outstanding.
11. On June 15, Penelope Corporation initially purchased 1,500 shares of its own common stock at $18 per share. The stated value of the stock is $0.60 per share. On July 15, it reissued 300 shares at $20 per share. The remaining shares were reissued on July 31, at $12 per share.

Journalize the above transactions.

|  |  |  |  |
| --- | --- | --- | --- |
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1. The Engle Company purchased 5,000 of its own shares at $12. Later, half the shares were sold for $12 per share. Afterwards, all remaining shares were sold for $15 per share.

Journalize the above transactions.

|  |  |  |  |
| --- | --- | --- | --- |
| Date | Account | Debit | Credit |
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1. The Rube Company had the following treasury stock transactions during August 2013:

August 1 Purchased 20,000 shares of its own stock for $20 per share.

August 3 Sold 5,000 shares of treasury stock for $25 per share.

August 11 Sold 3,000 shares of treasury stock for $30 per share.

August 18 Sold 5,000 shares of treasury stock for $20 per share.

August 22 Sold 4,000 shares of treasury stock for $15 per share.

August 31 Sold the remaining shares of treasury stock for $1per share.

Journalize the above transactions. You may omit reasons.

|  |  |  |  |
| --- | --- | --- | --- |
| **Date** | **Account** | **Debit** | **Credit** |
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**Chapter 13**

**Dividends, Stock Splits, and Prior Period Adjustments**

**Learning Outcomes:**

1. Understand the characteristics of dividends.
2. Develop the journal entries required for cash dividends
   1. for common stock
   2. for preferred stock
3. Develop the journal entries required for stock dividends.
4. Understand the characteristics of a stock split.
5. Develop the journal entries required for a prior period adjustment.
6. Become familiar with the statement of retained earnings.

**(LO1)**

**Understand the characteristics of dividends**

* A dividend is a payment, usually in the form of cash, to existing shareholders as of a certain date.
* Sometimes, instead of a cash dividend, a company may issue additional stock on a prorated basis.
* If the dividend is in the form of cash, it is referred to as a cash dividend.
* If it is in the form of additional shares of stock, it is referred to as a stock dividend.
* Most dividends are in the form of cash.
* Dividends are not guaranteed. That is, a company does not have to pay out or issue any type of dividend if it does not want to.
* A cash dividend may be construed as a sign of a financially healthy company.
* However, too high a dividend may portend trouble in the future.
* On the other hand, the lack of a dividend does not necessarily mean a company is in financial distress. The company can simply be reinvesting all of its cash back into the business as a way to expand or grow the business.

There are three important dates associated with dividends:

1. **Declaration Date**

On this date, the board of directors declares a dividend, and the company becomes liable for the payment or the issuance of stock. A journal entry is required.

1. **Record Date**

Owners of the shares on this date will receive the dividend. No journal entry is required.

1. **Payment Date (or issue date if a stock dividend)**

On this date, the cash payment is made, or the additional shares of stock are issued in the case of a stock dividend. A journal entry is required.

**(LO2a)**

**Develop the journal entries required for cash dividends**

**For Common Stock**

* When developing the journal entries for dividends, it is very important to determine the number of shares outstanding on the day the BOD declares the dividend.
* Cash dividends are usually declared and paid out on a quarterly basis to existing shareholders.
* On the declaration date, the company becomes liable for the dividend.
* Thecash dividend account is a contra capital account and reduces total shareholder equity.

The format of the journal entry to be made on the declaration date is shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Cash Dividend | D |  | = # of shares outstanding x dividend per share |
|  | Dividends Payable |  | C | = # of shares outstanding x dividend per share |
|  | To record declaration of a cash dividend. | | | |

The following example shows the journal entry required on a declaration date.

**Example 1:**

On March 3, the BOD of a company declares a $0.20 quarterly dividend on its common stock, payable on April 1 to shareholders of record on March 16. The company has 100,000 shares of common stock outstanding on the declaration date.

**Analysis:**

* On the declaration date (March 3), the company becomes liable for a cash dividend.
* The cash dividend will be paid at a later date (payment date).
* The company’s total liability is $20,000 (a cash dividend of $0.20 per share x 100,000 shares outstanding).
* In addition to the liability, cash dividends reduce total shareholder equity by the same $20,000.

The actual journal entry for the transaction is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 3/3 | Cash Dividend | 20,000 |  | = 100,000 shares outstanding x $0.20 dividend per share |
|  | Dividends Payable |  | 20,000 | = 100,000 shares outstanding x $0.20 dividend per share |
|  | To record declaration of a cash dividend. | | | |

The following note shows the journal entry required on a record date.

* The next date of importance is the record date.
* Stockholders shown on the company’s record book as owners of the stock will receive the dividend.
* Since this is an administrative activity in the company, **NO JOURNAL ENTRY IS REQUIRED.**

**On the Payment Date:**

* The company pays the cash dividend.
* Thus, it reduces its liability by the amount of the dividend, as well as its cash account.

The format of the journal entry to be made on the payment date is shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Dividends Payable | D |  | The amount of the cash dividend owed. |
|  | Cash |  | C | The amount of the cash dividend paid out. |
|  | To record payment of the cash dividend. | | | |

In Example 1 above, the cash dividend is payable on April 1 to shareholders of record on March 16. The company has 100,000 shares of common stock outstanding on the declaration date.

The journal entry on the payment date is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 4/1 | Dividends Payable | 20,000 |  | Reduction of the liability. |
|  | Cash |  | 20,000 | Reduction of cash when dividend is paid. |
|  | To record payment of the cash dividend. | | | |

**(LO2b)**

**Develop the journal entries required for cash dividends**

**For Preferred Stock**

* The accounts used with preferred stock cash dividends are identical to those covered above for common stock, with respect to the declaration, record, and payment dates.
* The main difference is with respect to the value of the dividend.
* When calculating the amount of the cash dividend on preferred stock, the following may have to be considered:

1. The dividend per share of preferred stock.
2. Whether the dividends are cumulative or noncumulative.
3. The total value of the dividend.

* It is the total value of the dividend, which is used in the journal entries.

**To calculate the cash dividend for a single share of preferred stock:**

The following is typical of the information provided for preferred stock on a shareholder equity statement (see sample statement in previous chapter):

|  |  |
| --- | --- |
| **Preferred stock,** 8%, $25 par value, cumulative, 8,000 shares issued and outstanding | $16,000 |

* Note that the value of the cash dividend per share is not given. This is typical for preferred stock.
* To calculate the cash dividend per share of preferred stock, simply multiply the % (percent) given times the par value:

**Cash dividend per share of preferred stock = % x P/V**

* In this case, the cash dividend per share of preferred stock is $2.00 per share (8% x $25.00).
* Thus, the owners of the preferred stock will receive an annual cash dividend of $2.00 for each share owned.

**To calculate the total cash dividend for the preferred stock**,

* Multiply the dividend per share times the number of preferred shares outstanding.

**Using the example above:**

Total cash dividend = dividend per share x number of preferred shares outstanding, or

$2.00 cash dividend per share x 8,000 shares preferred stock outstanding = $16,000

**The effect on a cash dividend on noncumulative and cumulative preferred stock:**

* Preferred stock may be issued as noncumulative or cumulative.

**Noncumulative Preferred Stock**

* Is a type of preferred stock which does not pay any previously unpaid cash dividends.
* If a company reinstates a cash dividend that it previously stopped paying, the company only pays the current year’s dividend and not any unpaid dividends (dividends in arrears).

**Cumulative Preferred Stock**

* A type of preferred stockrequiring that unpaid dividends (dividends in arrears) must be paid together with the current period’s dividend when the company resumes paying cash dividends.
* In other words, any previously unpaid dividends must be added to the current period’s dividend.
* Dividends on cumulative preferred stock is normally paid before noncumulative preferred shares and common shares receive their dividends.

**Journal Entries for preferred stock (Noncumulative and Cumulative).**

**Example 1 (noncumulative preferred stock):**

The ABC Company provided the following information, from the shareholder equity section of their balance sheet, related to their noncumulative preferred stock:

|  |
| --- |
| **Preferred stock,** 10%, $50 par value, **noncumulative**, 10,000 shares issued and outstanding |

The Board of Directors declared a cash dividend on June 1, payable on June 30, to shareholders of record on June 15. Journalize the transactions related to this dividend.

**Analysis:**

* Since the preferred stock is noncumulative, the journal entries will be the same as for common stock.
* However, unlike common stock, we need to calculate the total dividend.
* As previously stated, this consists of two steps:

1. Calculate the dividend per share. This is simply the % (percent) times the stock’s par value.
2. Calculate the total dividend. This is simply the dividend per share (calculated in step 1 above) times the total number of shares outstanding.

The dividend per share = 10% x $50.00 or $5.00 per share.

Since this type of preferred stock is noncumulative, the total dividend equals:

$5.00 per share x 10,000 shares outstanding = $50,000.

The journal entry on the declaration date is therefore:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 6/1 | Cash Dividend | 50,000 |  | = 10,000 shares outstanding x $5.00 dividend per share |
|  | Dividends Payable |  | 50,000 | Same as above |
|  | To record the declaration of a cash dividend on noncumulative preferred stock. | | | |

**The next date of importance is the record date**.

* Stockholders shown on the company’s record book as owners of the stock on the record date will receive the dividend.
* Since this is an administrative activity in the company, no journal entry is required**.**

**The next date of importance is the payment date**.

The journal entry on the payment date is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 6/30 | Dividends Payable | 50,000 |  | = 10,000 shares outstanding x $5.00 dividend per share |
|  | Cash |  | 50,000 | Same as above |
|  | To record the payment of the cash dividend on noncumulative preferred stock. | | | |

**Example 2 (Cumulative preferred stock):**

The XYZ Company provided the following information from the shareholder equity section of their balance sheet:

|  |
| --- |
| **Preferred stock,** 5%, $50 par value, **cumulative**, 6,000 shares issued and outstanding |

The company also declared on January 1 that it would reinstate its cash dividend on its cumulative preferred stock, payable on January 31 to shareholders of record on January 15. The dividend had been suspended for the past two years.

**Analysis:**

* Since this is cumulative preferred stock, the journal entries will be the same as for common stock.
* However, we must calculate the total dividend, which consists of two (2) parts:

1. the current year’s dividend **PLUS**,
2. any dividends owed for the two previous years.

**This consists of three (3) steps:**

1. Calculate the dividend per share.

This is simply the % (percent) times the stock’s par value.

1. Calculate the current year’s total dividend.

This is simply the dividend per share (step 1 above) times the total number of shares outstanding.

1. Add any dividends owed from previous years (assume the dividends owed for each year is the same as the current annual dividend).
   1. The dividend per share = 5 % x $50.00 or $2.50 per share.
   2. The current year dividend = $2.50 per share x 6,000 shares outstanding = $15,000.
   3. The dividends in arrears for two (2) years = 2 x $15,000 = $30,000.

Thus, the total dividend will be $45,000 ($15,000 in the current year + $30,000 owed).

The journal entry on the declaration date is therefore:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 1/1 | Cash Dividend | 45,000 |  | Current year’s dividend plus two years of dividends owed |
|  | Dividends Payable |  | 45,000 | Same as above |
|  | To record declaration of a cash dividend and dividends in arrears for cumulative preferred stocks. | | | |

**The next date of importance is the record date.**

* Stockholders shown on the company’s record book as owners of the stock will receive the dividend.
* Since this is an administrative activity in the company, no journal entry is required.

The journal entry on the payment date is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 1/31 | Dividends Payable | 45,000 |  | Current year’s dividend plus two years of dividends owed |
|  | Cash |  | 45,000 | Same as above |
|  | To record payment of cash dividend and dividends in arrears for cumulative preferred stocks. | | | |

**Now You Try It:**

1. On November 27, the board of directors of Beth Company declared a $.60 per share dividend. The dividend is payable on December 24 to shareholders of record on December 7. Beth has 25,500 shares of $1 par common stock outstanding at November 27. Journalize the entries needed on the declaration and payment dates.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Dt.** | **Account Name** | **Debit** | **Credit** |  |
|  |  |  |  |  |
| 11/27 | Cash Dividend |  |  |  |
|  | Dividend Payable |  |  |  |
|  |  |  |  |  |
| 12/7 | No Journal Entry |  |  |  |
|  |  |  |  |  |
| 12/24 | Dividend Payable |  |  |  |
|  | Cash |  |  |  |

1. Outstanding stock of the Larson Corporation includes 40,000 shares of $5 par common stock and

10,000 shares of 5%, $10 par noncumulative preferred stock. In 2019, Larson declared and paid dividends of $4,000. In 2020, Larson declared and paid dividends of $12,000. How much of the 2020 dividend was distributed to preferred shareholders?

a. $6,000

b. $7,000

c**.** $5,000

d. $12,000

1. Bodkin, Inc. has 5,000 shares of 5%, $100 par value, noncumulative preferred stock and 50,000 shares of $1 par value common stock outstanding at December 31, 2019, and December 31, 2020. The board of directors declared and paid a $25,000 dividend in 2019. In 2020, $55,000 of dividends were declared and paid. What were the dividends received by the preferred and common shareholders in 2020?

Preferred Common

a. $0 $55,000

b. $25,000 $30,000

c. $27,500 $27,500

d. $35,000 $20,000

1. Burnell, Inc. has 5,000 shares of 4%, $50 par value, cumulative preferred stock and 100,000 shares of $1 par value common stock outstanding at December 31, 2019, and December 31, 2018. The board of directors declared and paid a $8,000 dividend in 2019. In 2020, $30,000 of dividends were declared and paid. What were the dividends received by the preferred and common shareholders in 2020?

Preferred Common

a. $18,000 $12,000

b. $15,000 $15,000

c. $12,000 $18,000

d. $10,000 $20,000

1. The cumulative effect of the declaration and payment of a cash dividend on a company's financial statements is to

a. decrease total liabilities and stockholders' equity.

b. increase total expenses and total liabilities.

c. increase total assets and stockholders' equity.

d. decrease total assets and stockholders' equity.

**(LO3)**

**Develop the Journal Entries Required for Stock dividends**

* Sometimes a cash dividend paying company may need to conserve its cash.
* Instead of reducing or discontinuing its cash dividend, the company may substitute a stock dividend in the place of the cash dividend.
* The stock dividend enables each shareholder to receive additional shares proportional to the amount of shares currently owned, relative to other shareholders.
* As a result, the percent ownership that each shareholder has in the company remains unchanged, since each shareholder receives a proportionate number of new shares.

Journalizing stock dividends is a bit more complicated than journalizing cash dividends. It is important to familiarize yourself with the step-by-step process.

**Step 1**

Determine how many shares of stock are outstanding when the stock dividend is declared.

This is important because the total number of new shares to be issued will be a percent of the current shares outstanding.

**Step 2**

Determine how many new shares are going to be issued as a result of the stock dividend.

To calculate how many new shares will be issued, you multiply the number of shares outstanding (Step 1 above) by the percent (%) of the stock dividend. The % will be given in the problem statement.

**Step 3**

Determine the following:

1. market price of the stock on the declaration date (the price the stock is selling for in the market)
2. par value of the stock
3. paid-in capital in excess of par value – common stock (the difference between total market price and total par value)

**Step 4**

Prepare the following journal entries:

1. **On the declaration date:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Stock Dividend | D |  | = # of new shares x the market price per share |
|  | Common Stock Dividend Distributable (CSDD) |  | C | = # of new shares x the par value per share |
|  | Paid-in Capital in Excess of P/V – C/S |  | C | = the difference between the two accounts above. |
|  | To record declaration of a X% stock dividend. | | | |

* The Stock Dividend account is a contra equity account and, like the Cash Dividend account, reduces shareholder equity.
  + The other two accounts (CSDD and Paid-in Capital in Excess of P/V-C/S) are normal capital accounts and serve to increase shareholder equity.
  + Therefore, a stock dividend has no overall effect on shareholder equity since the debits must equal the credits.

1. **On the record date: no journal entry is required.**

Owners of existing shares on this date will receive their respective prorate shares on the issue date.

1. **On the distribution date:**

The owners of current shares on the record date will receive their new shares.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Common Stock Dividend Distributable (CSDD) | D |  | Same as on declaration date |
|  | Common Stock |  | C | Same as above. |
|  | To record issuance of new stock. | |  |  |

Since the CSDD and Common Stock accounts are normal capital accounts, and since one is debited and the other credited, there is no effect on total shareholder equity when the new shares are distributed to the existing shareholders.

**To summarize:**

* The declaration of a stock dividend does not affect total shareholder equity.
* The reduction of capital resulting from the debit to Stock Dividends is offset by the increase in capital from the credits to the CSDD and PIC in excess of P/V – C/S or S/V – C/S accounts.
* When the new shares are issued, there is also no effect on shareholder equity.

**Example 1 (Stock Dividend):**

On March 1, 2020, the ABC Company had 200,000 shares of its $5 par value common stock outstanding when its board of directors declared a 10% stock dividend. At the time of the declaration, the market price per share was $15.00. The stock dividend will be distributed on March 31 to shareholders of record on March 15.

Show all required journal entries.

**Solution:**

* On the declaration date, there were 200,000 shares outstanding.
* Since the stock dividend is 10%, an additional 20,000 new shares (10 % x 200,000 shares currently outstanding) must be issued on the issue date.
* Also note, the market price is $15.00 per share and the par value is $5.00 per share.
* You now have all of the information needed to create the journal entry on the declaration date, as shown below:

**Journal entry on the declaration date:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| 3/1 | Stock Dividend | 300,000 |  | = 20,000 new shares x the $15.00 market price per share |
|  | Common Stock Dividend Distributable (CSDD) |  | 100,000 | = 20,000 new shares x the $5.00 par value per share |
|  | Paid-in Capital in Excess of P/V – C/S |  | 200,000 | = the difference between the two accounts above. |
|  | To record declaration of a 10 % stock dividend. | | | |

**On the record date: no journal entry is required.**

**Journal entry on the issue date (issuance of new stock):**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Common Stock Dividend Distributable (CSDD) | 100,000 |  | Same as on declaration date |
|  | Common Stock |  | 100,000 | Same as above. |
|  | To record issuance of new stock. | | | |

**Now You Try It:**

1. On October 10, the board of directors of Pinto Corporation declared a 10% stock dividend. On October 10, the company had 10,000 shares of $1 par common stock issued and outstanding with a market price of $16 per share. The stock dividend will be distributed on October 31 to shareholders of record on October 25. Journalize the entries needed for the declaration and distribution of the stock dividend.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
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1. Nola, Inc. declared a 10% common stock dividend when it had 60,000 shares of $10 par value common stock outstanding.
   1. If the market value of $24 per share is used, what are the amounts debited to Stock Dividends and credited to Paid-in Capital in Excess of Par?
   2. Journalize the stock dividend transactions assuming the stock dividend was declared on March 1. The new stocks will be issued on March 31 to shareholders of record on March 15.

Paid-in Capital in

Stock Dividends Excess of Par

a. $60,000 $0

b. $144,000 $84,000

c. $144,000 $60,000

d. $60,000 $84,000

1. Solution (see journal entries, below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
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**(LO4)**

**Understand the characteristics of a stock split**

**Stock Splits – Basic Information**

* From an accounting perspective:
  + Must be approved by the company’s BOD.
  + Stock splits are an administrative task.
  + No journal entries are required.
  + Total shares outstanding **changes** after the split.
  + Par value per share **changes** after the split.
  + Market value per share **changes** after the split.
  + **Total shareholder equity** **DOES NOT CHANGE after the split.**
  + **Total par value DOES NOT CHANGE after the split.**
  + **Total Market Value DOES NOT CHANGE after the split.**
* Types of stock splits
  + **Forward splits (2 for 1; 3 for 2; etc.)**
    - Increase number of shares outstanding
    - **Decrease** market price and par value per share
    - Stock price appears more “affordable” to individual investors (this is the more important reason for a stock split).
    - However, the market value of the company at the time of the split has not changed.
  + **Reverse splits (1 for 10; 1 for 20; etc.)**
    - Decrease number of shares outstanding
    - **Increase** market price and par value per share
    - Stock price appears more “pricier” to individual investors (often done to avoid delisting from a stock exchange);
    - However, the market value of the company at the time of the split has not changed.

**Stock Splits - Examples**

**Example 1:**

A company has 100,000 shares of its $2.00 par value per share common stock outstanding when it declares a 2:1 stock split. The market price of the stock at the time of the split is $24 per share.

Determine:

1. shares outstanding before the split
2. PV per share and total PV before the split
3. MV per share and total MV before the split
4. shares outstanding after the split
5. PV per share and total PV after the split
6. MV per share and total MV after the split

**Solution** (See additional reasoning, below)**:**

1. shares outstanding before the split: 100,000
2. PV per share and total PV before the split: $2; 100,000 shares x $2 = $200,000
3. MV per share and total MV before the split: $24; 100,000 x $24 = $2,400,000
4. shares outstanding after the split: 100,000 x 2:1 = 200,000 shares
5. PV per share and total PV after the split: **½** x $2 = $1.00; 200,000 shares x $1.00 = $200,000
6. MV per share and total MV after the split: **½** x $24 = $12; 200,000 shares x $12 = $2,400,000

**Notes:**

1. Since this is a forward split, there will be more shares outstanding after the split.

Outstanding shares after the split = 200,000 (100,000 x 2/1)

1. Recall, total par value before and after the split does not change.

Total p/v before the split = $200,000 (100,000 shares outstanding x $2.00 per share p/v)

Therefore, after the split, the total p/v must also equal $200,000.

In order to achieve this, the new p/v per share must be equal to $1.00 ($2.00 per share p/v x the inverse of the forward split, which is ½)

Total p/v after the split = shares outstanding after the split x new p/v per share, or

200,000 shares x $1.00 p/v per share = $200,000.

1. Recall, the total market value just before and after the stock split does not change.

Total market price before the split = $2,400,000 (100,000 shares outstanding just before the split x $24.00 per share).

Therefore, after the split, the total market value must also equal $2,400,000.

In order to achieve this, the new market value per share must be equal to $12.00 ($24.00 per share market value before the split x the inverse of the forward split, which is ½).

Total market value just after the split = shares outstanding after the split x new market value per share just after the split, or

200,000 shares x $12.00 market value per share = $2,400,000.

From this point forward, the par value per share for any further stock transactions is the newly determined par value. That is, the $1.00 per share value.

**Example 2:**

A company has 100,000 shares of its $3.00 par value per share common stock outstanding when it declares a 3:2 stock split. The market price of the stock at the time of the split is $24 per share.

Determine:

1. the number of shares outstanding after the split
2. the new PV per share and total PV after the split
3. the new MV per share and total MV after the split

**Notes:**

1. Since this is also a forward split, there will be more shares outstanding after the split.

Outstanding shares after the split = 150,000 (100,000 x 3/2)

1. Recall, total par value before and after the split **does not change**.

Total p/v **before the split** = $300,000 (100,000 shares outstanding x $3.00 per share p/v)

Therefore, after the split, the total p/v must also equal $300,000.

In order to achieve this, the new p/v per share must be equal to $2.00 ($3.00 per share p/v x **the** **inverse** of the forward split, which is 2/3).

Total p/v after the split = shares outstanding after the split x new p/v per share, or

150,000 shares x $2.00 p/v per share = $300,000.

1. Recall, the total market value just before and after the stock split does not change.

Total market price before the split = $2,400,000 (100,000 shares outstanding just before the split x $24.00 per share).

Therefore, after the split, the total market value must also equal $2,400,000.

In order to achieve this, the new market value per share must be equal to $16.00 ($24.00 per share market value before the split x the inverse of the forward split, which is 2/3).

Total market value just after the split = shares outstanding after the split x new market value per share just after the split, or

150,000 shares x $16.00 market value per share = $2,400,000.

From this point forward, the par value per share for any further stock transactions is the newly determined par value. That is, the $2.00 per share value.

**Now You Try It:**

1. A company has 200,000 shares of its $4.00 par value per share common stock outstanding when it declares a 2:1stock split. The market price of the stock at the time of the split is $24 per share.

Determine:

1. thenumber of shares outstanding after the split
2. the new PV per share and total PV after the split
3. the new MV per share and total MV after the split
4. A company has 100,000 shares of its $3.00 par value per share common stock outstanding when it declares a 3:2 stock split. The market price of the stock at the time of the split is $24 per share.

Determine:

1. the number of shares outstanding after the split
2. the new PV per share and total PV after the split
3. the new MV per share and total MV after the split
4. A company has 100,000 shares of its $2.00 par value per share common stock outstanding when it declares a 1:2 stock split (hint: this is a reverse stock split). The market price of the stock at the time of the split is $24 per share.

Determine:

1. the number of shares outstanding after the split
2. the new PV per share and total PV after the split
3. the new MV per share and total MV after the split

**(LO5)**

**Develop the journal entries required for a prior period adjustment.**

**General Discussion:**

* There may come a time when an accounting error from a previously closed accounting period is discovered.
* The effect of the error would have been reflected in the financial statements for the period in which the error occurred.
* If the error is not discovered and corrected, it would continue to be carried over in the financial statements in future periods.

**Addressing Errors from Prior Periods:**

If the accounting period in which the error was made was closed, then you cannot fix the error in that period. You would have to address it in the current period.

To address such an error, the effect of the error on the affected accounts and the effect on net income or net loss (profits and losses) must be understood. The following situations will demonstrate this:

1. **An expense account was understated**

* If the error involved an expense account that was previously understated, then the effect of the error caused net income for that period to be overstated.
* As a result, retained earnings would have increased more than it should have, thus causing shareholder equity to be more than it should.
* To fix this error, the retained earnings account would have to be debited (reduced) by the amount of the error to reduce the increase due to the error.
* Develop the necessary journal entry to correct the effect of the error.

**Example 1:**

In 2021, a company understated the depreciation expense account by $15,000, after which the books were closed for the year. The error was discovered in 2022. How should the error be addressed in 2021?

**Discussion:**

* Since the books were closed for the year 2021, you cannot revise the financial statements for 2021.
* The effect of the error must be determined and incorporated onto the value in the Retained Earnings account in the year of discovery.
* This will help you to develop the necessary journal entry for 2022 (the year of discovery) to correct the effect of the error.

**Solution:**

* In 2021, the depreciation expense account was understated.
* Thus, total expenses were less than they should have been.
* Since total expenses were less than they should have been, net income for 2021 was greater than it should have been (total revenue minus total expenses = net income).
* In 2021, this greater profit went into the retained earnings account during the closing process.

To fix the error:

* The retained Earnings account **must be reduced**.
* This requires a debit to the retained earnings account.
* The other account would be the accumulated depreciation - equipment account to reflect the additional depreciation that should have been included.

The journal entry to fix this error in the current accounting period is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Retained Earnings | 15,000 |  | Amount of the error. |
|  | Accumulated Depreciation - Equipment |  | 15,000 | Same as above. |
|  | To correct a prior period error. | |  |  |

1. **An expense account was overstated**

If the error involved an expense account that was overstated, then the effect of the error caused net income for that period to be understated. As a result, retained earnings would have increased less than they should have, thus causing shareholder equity to be less than it should.

To fix this error, the retained earnings account would have to be credited by the amount of the error to reduce the increase it caused.

**Example 1:**

In 2021 a company purchased supplies for $25,000 and incorrectly debited the supplies expense account as shown below, after which the books were closed for the year. The error was discovered in 2022. How should the error be addressed in 2022?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Supplies Exp. | 25,000 |  |  |
|  | Cash |  | 25,000 |  |
|  | Purchased Supplies. | |  |  |

**Discussion:**

Since the books were closed for the year 2021, you cannot revise the financial statements for 2021. To address the error, you must determine the effect of the error on the 2021 financial statements. This will help you to develop the necessary journal entry for 2022 (the year of discovery) to correct the effect of the error.

In 2021, the supplies expense was debited, thus increasing total expenses unnecessarily. Since total expenses were greater than they should have been, net income for 2021 was less than it should have been (total revenue minus total expenses = net income). This lower profit went into the retained earnings account during the closing process.

To fix the error, we must increase the retained earnings account to reflect the higher net income that should have transferred into retained earnings in 2021. This requires a credit to the retained earnings account. The other account would be the supplies account since it was never used in the first place.

The journal entry to fix this error in the current accounting period is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
| Dt. | Supplies | 25,000 |  | Amount of the error. |
|  | Retained Earnings |  | 25,000 | Same as above. |
|  | To correct a prior period error. | |  |  |

**(LO6)**

**Become Familiar with the Statement of Retained Earnings**

The statement of retained earnings shows the cumulative profits and losses of the corporation over time, as well as the effect from dividends paid out and prior period adjustments.

The sample statements shown below are intended to enable the student to become familiar with some of the content found in such statements. All numbers contained therein are assumed values.

**Sample Retained Earnings Statements (No adjustments)**

|  |  |  |
| --- | --- | --- |
| **Woods Corporation**  Statement of Retained Earnings  Year Ended December 31, 2022 | | |
|  |  |  |
| Retained Earnings, Jan. 1, 2022 |  | $600,000 |
| Plus, Net Income |  | 170,000 |
| Retained Earnings, Dec. 31, 2022 |  | $770,000 |
|  |  |  |

**Sample Statement of Retained Earnings (with Dividends)**

|  |  |  |
| --- | --- | --- |
| **Woods Corporation**  Statement of Retained Earnings  Year Ended December 31, 2022 | | |
|  |  |  |
| Retained Earnings, Jan. 1, 2022 |  | $600,000 |
| Plus, Net Income |  | 170,000 |
|  |  | $770,000 |
|  |  |  |
| Less Dividends |  | (25,000) |
| Retained Earnings, Dec. 31, 2022 |  | $745,000 |

**Sample Statement of Retained Earnings (with Dividends and Prior Period Adjustment)**

|  |  |  |
| --- | --- | --- |
| **Woods Corporation**  Statement of Retained Earnings  Year Ended December 31, 2022 | | |
|  |  |  |
| Retained Earnings, Jan. 1, 2022 |  | $600,000 |
| Plus Effect from Understated Depreciation Expense from 2021 |  | 20,000 |
| Corrected Retained Earnings, January 1, 2022 |  | $620,000 |
|  |  |  |
| Plus, Net Income |  | 170,000 |
|  |  | $790,000 |
|  |  |  |
| Less Dividends |  | (25,000) |
| Retained Earnings, Dec. 31, 2022 |  | $765,000 |

**Let’s see what you’ve learned.**

**Try out the following comprehensive problem:**

On January 1, 2022, the Cordero Company had the following shares outstanding:

Preferred Stock: 30,000 shares, 8%, $50.00 par value

Common Stock: 60,000 shares, $6.00 par value

The following 3 transactions took place during the year and, where necessary, were appropriately recorded:

January 15: Issued an additional 20,000 common shares

February 28: Split its common shares 2:1.

June 30 : Issued an additional 40,000 shares of common stock

However, on August 1, the board of directors declared a 15% stock dividend. The stocks will be distributed on August 31 to shareholders of record on August 15. The market price of the common shares was $20.00 per share when the stock dividend was declared.

Instructions:

Show the analysis used to determine (a) the number of common shares currently outstanding on the declaration date and (b) the number of new common shares that will be issued. Then, show all necessary journal entries in the journal section below.

| **Date** | **Account Name** | **Debit** | **Credit** | **Comment** |
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**Exercises:**

**Ex 13.1**

On May 1st, Super company declared a cash dividend of $0.75 per common share to the shareholders of record on May 19th. The cash dividend will be paid on May 30th. The company has 500,000 shares authorized and 220,000 shares outstanding (par value of stock is $5 per share).

Prepare the required journal entries (if any) on May 1st, May 19th, and May 30th.

# Financial Accounting II

## Chapter 13 Test

### Cash Dividends, Stock Dividends, Stock Splits, Prior Period Adjustments

1. T F On the day the Board of Directors of a corporation declares a cash dividend, the

company debits the account dividends payable, which is a current liability account, and credits the cash account, which is a current asset account.

1. T F Dividends in arrears must be distributed to noncumulative preferred stockholders

before common stockholders can receive their dividends.

1. T F A stock dividend is a distribution of cash to the shareholders.
2. T F The declaration and issuance of a stock dividend affects assets and liabilities.
3. T F When a company declares a stock dividend, a journal entry is not required because a

stock dividend does not involve cash and cannot be expressed in monetary terms.

1. T F Neither a stock split nor a stock dividend requires a journal entry.
2. T F Since a stock dividend results in the issuance of more stocks, an individual stockholder’s

percentage ownership in the company increases as a result.

1. The journal entry for the declaration of a $0.60 per share dividend on 50,000 shares of outstanding common stock requires a

a) $30,000 credit to the cash account

b) $30,000 credit to the cash dividend account

c) $30,000 credit to the dividend payable account

d) none of the above

1. On the payment date, a cash dividend of $12,000 will require a

a) credit to cash for $12,000

b) credit to dividend payable for $12,000

c) credit to stock dividend for $12,000

d) none of the above

1. The declaration of a cash dividend
2. increases an asset
3. increases a liability
4. increases revenue
5. increases an expense
6. none of the above
7. The Goodbar company has 6,000 shares of 6%, $60 par value preferred stock outstanding. Determine the dividend for each individual share and in total.

a) $6.00 and $36,000

b) $0.06 and $360.00

c) $3.60 and $2,160

d) $3.60 and $21,600

e) cannot be determined with the information provided

1. Define the following terms:
   1. par value
   2. market value
   3. book value
   4. earnings per share
2. Show the typical journal entries for a cash dividend on the declaration, record, and issue dates.

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| Account | Debit | Credit | Comment |
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1. On March 30, Ambrite Corporation’s board of directors declared a $0.24 per share dividend on its 30,000 shares of outstanding common stock. The stock has a $2 per share par value. The dividend is payable on May 12 to shareholders of record on April 15. Show the journal entries the company would make on each of the pertinent dates.

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1. On March 30, Ambrite Corporation’s board of directors declared a 6% cash dividend on its 20,000 shares of outstanding preferred stock. The stock has a $5 per share par value. The dividend is payable on May 12 to shareholders of record on April 15. Show the journal entries the company would make on each of the pertinent dates.

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1. Show the typical journal entry for a stock dividend on the declaration, record, and issue dates.

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| Date | Account | Debit | Credit | Comment |
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1. When a stock dividend is declared, the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ account is valued at the market price and the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ is valued at the par value.
2. On July 1, a company had 150,000 shares of its $1.00 par value common stock outstanding. On July 15, the company declared a 4:3 stock split, with the shares issued on August 1. On November 1, the company declared a 10% stock dividend to shareholders of record on December 1. The shares from the stock dividend were issued on December 31. The stock had a market price of $20 on the declaration date.

Show all appropriate journal entries, including any that may not require a journal entry.

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1. What is a forward stock split and a reverse stock split? Discuss.

**Answer:**

1. The Baker Company had the following transactions during the current year:

April 1 Issued 6,000 shares of 8%, $50 preferred stock for $80 per share.

April 6 Issued 60,000 shares of $2 par value common stock for $12 per share.

June 1 Declared a 2-for-1 stock split to record holders on June 15

June 30 The shares for the stock split were issued.

August 1 Declared a 15% stock dividend on the common stock. The market price on this

day was $30

August 15 The record date for the stock dividend

August 31 The stock dividend was distributed

Prepare the appropriate journal entries. You may omit reasons.

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1. The Canuga Company has 76,000 of its $15 par value common stock issued and outstanding when it declares a 3:2 stock split. Determine the following:
2. shares outstanding after the split \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. par value after the split \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. The Yeltsin Corporation has 250,000 shares of $1.50 par value common stock outstanding. When the market price of the stock reaches $24.00 per share, the company splits the stock 1:2. Determine the following:
2. shares outstanding after the split \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. par value per share after the split \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. market value per share after the split \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Retained earnings represents
6. an accumulated contra cash account
7. conversion of net income to a cash basis
8. conversion of net income to an accrual basis
9. accumulated profits and losses
10. What is the formula for calculating earnings per share?

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. During the current year, the Biscuit Company generated net income of $700,000. The company has 25,000 shares of 6%, $60 preferred stock and 100,000 shares of $2 stated value common stock outstanding. Earnings per share for the current year is:

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. On May 1, the Illinois Company had 100,000 shares of its $1.50 par value common stock issued and outstanding. On May 15, the company declared a 15 % stock dividend when the market price was $20, to be distributed on June 15 to record holders on May 31. Show all applicable journal entries.

|  |  |  |  |  |
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1. If a corporation with a $1.50 par value common stock splits 3:1, the new par value per share is

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. In the following table, describe the effect of each of these transactions on the listed accounts by writing “I” (increase), “D” (decrease), or “NE” (no effect).

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Items | Capital  stock | Paid-in Capital | Retained Earnings | Total Stockholders' Equity |
| Sold treasury stock above the purchase price |  |  |  |  |
| Issued preferred stock above par |  |  |  |  |
| Declared a cash dividend |  |  |  |  |
| Declared a 10% stock dividend |  |  |  |  |
| Declared a stock split |  |  |  |  |
| Paid a cash dividend |  |  |  |  |
| Distributed the stock dividend |  |  |  |  |
| Distributed the stock split |  |  |  |  |
| Prior period adjustment for overstatement of net income |  |  |  |  |
| Prior period adjustment for understatement of net income |  |  |  |  |
| Sold treasury stock below the purchase price and any available PIC from T/S |  |  |  |  |

# Financial Accounting II

## Chapter 14

### Bonds, Mortgage Note Amortization, Leases

1. T F If a corporation issues bonds at a discount, the discount is considered an additional cost

of borrowing.

1. T F A capital lease is included on the balance sheet since the corporation is considered to

have purchased the asset.

1. T F The times interest earned ratio is calculated by dividing the interest expense by the income before income taxes.
2. T F If a lease term is equal to 70% of the economic life of the leased property, the lease is

considered to be an operating lease.

1. T F Serial bonds and callable bonds mature at the same time.
2. T F At maturity, a bond which originally sold at a premium will be redeemed at a value

higher than the face value.

1. T F A premium on bonds payable is shown as a deduction on the balance sheet.
2. T F Discount on bonds payable is a contra account and is deducted from bonds payable on

the balance sheet.

1. What is the semiannual interest on a $600,000, 8% bond issued on January 1?

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. A $12,000 face value bond selling at 104 sells for

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. On January 1, 2023, The Max Corporation issued $6,000,000, 10-year, 5% bonds at 100. Interest is payable semiannually on July 1 and January 1.

Show the journal entry to record the sale of the bonds, the interest accrued on June 30 and paid on July 1, and the interest accrued on December 31 and paid on January 1 of the following year.

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1. On January 1, 2023, The Max Corporation issued $6,000,000, 10-year, 5% bonds at 90. Interest is payable semiannually on July 1 and January 1.

Show the journal entry to record the sale of the bonds, the interest accrued on June 30 together with the amortization of the discount, and the payment of interest on July 1.

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1. On January 1, 2023, The Max Corporation issued $6,000,000, 10-year, 5% bonds at 105. Interest is payable semiannually on July 1 and January 1.

Show the journal entry to record the sale of the bonds, the interest accrued on June 30 together with the amortization of the premium, and the payment of interest on July 1.

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1. The JLO Bus Company has hired you to evaluate two alternative financing methods for construction of a new bus terminal facility in downtown Boston. JLO requires $5,000,000 in funding.

The alternatives are:

* issue a new $5,000,000 bond offering at 6%
* issue of 100,000 new shares of its common stock at a market price of $50 per share

Assuming income before interest and taxes under both alternatives is $2,200,000 and JLO’s federal tax rate 35%, evaluate each alternative through net income and earnings per share. The company currently has 500,000 shares of common stock outstanding. What advice would you provide JLO on choosing one or the other alternative?

**Answer:**

1. Which of the following is correct with respect to choosing between issuing bonds or stocks in order to raise funds?
2. Stock dividends will be deductible as an expense.
3. Issuing stocks will not create a liability on the balance sheet.
4. Issuing stocks will not affect earnings per share.
5. none of the above
6. The Jingle Company issues bonds at a discount. Amortization of the discount will
7. reduce bond interest expense
8. increase bond interest expense
9. reduce the amount paid at maturity
10. none of the above
11. On December 31, 2017, the Mylar Corporation bought land with a vacant office building for $1,000,000. The company made a $100,000 cash down payment and signed a 20 year, 5%, $900,000 mortgage note payable. The mortgage note requires semiannual payments of $36,110 payable on June 30 and December 31.
    1. Show the journal entry for the initial borrowing and the first two semiannual payments.
    2. Show the current and long-term liability amounts that would appear on the December 31, 2017 balance sheet.

**Answer a:**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account** | **Ref** | **Debit** | **Credit** |
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**Answer b:**

Current liability portion of the mortgage note payable on the December 31, 2017 Balance Sheet is $\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

Long-term liability portion of the mortgage note payable on December 31, 2017 Balance Sheet is $\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ .

**Chapter 15**

**Statement of Cash Flow**

**Learning Outcomes:**

1. Understand the purpose and use of the statement of cash flow.
2. Develop a statement of cash flow.
3. Perform analysis using the statement of cash flow.

**Learning Outcome #1**

**Understand the purpose and use of the statement of cash flow**

* The statement of cash flow (SCF) is the fourth financial statement prepared after the

1. income statement,
2. statement of retained earnings, and
3. balance sheet.

* The SCF provides information on the cash inflows, outflows, and net changes in cash during the accounting period.
* It also serves to prove the amount of the ending cash balance shown on the balance sheet in the current period.
* The main body of the SCF consists of three sections (and a Notes section at the bottom):

1. Operating Activities
2. Investing Activities
3. Financing Activities

**Operating Activities:**

* The operating activities section is the most important because it shows the cash inflows and outflows resulting from the main activities of the business.
* Operating activities are reflected in the current assets and current liabilities sections of the balance sheet as well as on the income statement (net income, depreciation expense, and any gains and losses on the sale of investments and/or long-term assets).

**Investing Activities:**

* The investing activities section shows the cash inflows and outflows from the company’s investing activities.
* Investing activities include but are not limited to the purchase and/or sale of long-term assets (land, buildings, equipment, etc.).
* This section also includes the purchase and sale of investments by the company in other institutions.

**Financing Activities:**

* The financing activities section shows the cash inflows and outflows from the company’s financing activities.
* Financing activities include but are not limited to the issuance of the company’s own stocks and bonds, the repurchase (treasury stock) of stocks or redemption of bonds, and the payment of dividends.

**Noncash Activities**

At the bottom of the SCF, notes may be added to denote significant noncash transactions, such as the conversion of convertible bonds into stock and other similar events. These events do not involve the outlay of cash.

**Learning Outcome #2**

**Develop a Statement of Cash Flow:**

Two methods may be used to develop the SCF:

1. The direct method
2. The Indirect methods

We will develop a SCF using the indirect method because it is the more popular method and it can be developed from readily available information.

In order to prepare a SCF, the following is needed:

* comparative balance sheet (at least two years)
* income statement
* other information

The comparative balance sheet will show the changes in assets, liabilities, and equity from one accounting period to the next. The income statement will provide the results of the operations of the business.

**To prepare the operating activities section:**

**Start with net income and adjust as follows:**

1. **Add back any depreciation expense.**

While depreciation is a legitimate expense and reduces revenue, it does not require a cash outlay.

1. **Add back any losses on the sale of any investment or long-term asset.**

* For the SCF, the complete sale must be separated into two parts:

1. the amount of the loss (proceeds – book value), and
2. the total cash received.

* The dollar amount of the loss on the sale of an investment or long-term asset is included as “Other Losses & Expenses” on the income statement.
* The amount of the loss shows by how much the book value of the item exceeded the proceeds received from its sale.
* While a loss offsets revenue, it is not a cash outlay.
* Since net income was reduced by the amount of the loss, and the loss is not a cash outlay, it must be added back into net income in the operating activities section.
* The total cash received from the sale is included in the investing activities section of the SCF. Thus, events resulting in a gain or loss are addressed in two separate sections of the SCF.

1. **Deduct any gain on the sale of any investment or long-term asset.**

* For the SCF, the complete sale must be separated into two parts:
  1. the amount of the gain (proceeds – book value), and
  2. the total cash received.
* The dollar amount of the gain on the sale of an investment or long-term asset is included as “Other Gains and Revenues” on the income statement.
* The amount of the gain shows by how much the proceeds received from its sale of the item exceeded its book value.
* While a gain increases revenue, it is not a cash receipt.
* Since net income was increased by the amount of the gain, and the gain is not a cash receipt, it must be deducted from net income in the operating activities section.
* The total cash received from the sale is included in the investing activities section of the SCF. Thus, events resulting in a gain or loss are addressed in two separate sections of the SCF.

After completing the above adjustments, go to the balance sheet and look at each current asset other than cash. For each noncash asset, determine the amount of the change from the prior period to the current period and whether the change was an increase or a decrease. One purpose of the SCF is to prove the cash at the end of the current period. Therefore, the cash account is never adjusted.

**In general, deduct from net income any increase in a current asset, and increase net income by any decrease in a current asset. For example:**

**For A/R:**

**Add back any decrease in A/R.**

An overall decrease in A/R indicates collection of amounts owed by customers.

**Deduct any increase in A/R.**

An overall increase in A/R indicates less (slower) collections from customers.

**For Inventory:**

**Add back any decrease in Inventory.**

An overall decrease in inventory indicates sales are being made and cash is coming in.

**Deduct any increase in Inventory.**

An overall increase in Inventory indicates cash is going out to buy more inventories.

**For Prepaid (P/P) Expenses** *(*these would be current assets such as supplies, P/P rent, insurance, advertising, etc.**):**

**Add back any decrease in P/P Expenses.**

**Deduct any increase in P/P Expenses.**

After completing the required adjustments for current assets, go to the balance sheet and look at each current liability. Determine the amount of the change from the prior period to the current period and whether the change was an increase or a decrease.

**In general, deduct from net income any reduction in a current liability, and increase net income by any increase in a current liability. For example:**

**For A/P:**

**Add back any increase in A/P.**

An overall increase in A/P indicates payables are increasing and cash is being conserved, which is equivalent to coming in.

**Deduct any decrease in A/P.**

An overall decrease in A/P indicates cash is going out to pay debts.

After making the required adjustments for current assets and current liabilities, net out their effects against net income and show a total amount along the line“Net increase or decrease in operating activities.”

If the sum of net income and all of the adjustments is positive, it means the operating activities provided cash (inflow).

If the sum of net income and all of the adjustments is negative, it means the operating activities used up cash (outflow).

**To prepare the investing activities section:**

* Review the long-term asset (fixed assets, property, plant and equipment) section of the balance sheet and any investments the company may have made.
* For each account, determine the amount of the change from the prior period to the current period, and the direction: increase or decrease.
* Any long-term asset or investment that increases from the prior period to the current period implies a purchase. Thus, cash flows into (positive) the company.
* Any long-term asset or investment that decreases from the prior period to the current period implies a sale. Thus, cash flows out (negative) from the company.
* The sale of any long-term asset or investment may result in a gain or loss (see above).
* The amount of the gain or loss is addressed in the operating activities section of the SCF as indicated in the discussion on preparing the operating activities section.
* The cash actually received from any sale is included in its entirety in this investing activity section as an inflow of cash.
* Thus, any sale of a long-term asset or investment may have to be addressed in two separate sections.

**To prepare the financing activities section:**

* Go to the balance sheet and look at the long-term liabilities and the shareholder equity sections.
* Look for any dividends the company paid out. This may be found on the income statement, or in an “Other (Additional) Information” section. If no dividend is indicated, look at the change in retained earnings to determine if there was a dividend. See below for information on how to determine if there is a dividend and how to determine the amount.
* In the long-term liabilities section of the balance sheet, you are looking for accounts such as long-term bonds and notes payable.
  + **If bonds payable or notes payable decrease in value:**
    - It means the company is paying down its debt and cash is flowing out of the company (negative).
    - The amount of the decrease will be deducted from the cash provided/used by financing activities.
  + **If bonds payable or notes payable increase in value:**
    - It means the company is borrowing and cash is flowing into the company (positive).
    - The amount of the increase will be added to the cash provided/used by financing activities.
* In the shareholder equity section of the balance sheet, you are looking at the various stock accounts (common, preferred, treasury).
  + Exclude retained earnings, except for possible dividends. Otherwise the retained earnings account is addressed indirectly thru the operating activities section and this section.
  + **If the common or preferred stock account increased in value:**

It means the company issued additional shares of stock and cash flowed into the company (positive).

The amount of the increase will be added to the cash provided/used by financing activities.

* + **If the common or preferred stock account decreases in value (also see treasury stock, below):**

It means the company is buying back some of its own stock and cash flowed out of the company (negative).

The amount of the decrease will be deducted from the cash provided/used by financing activities.

* + **If the treasury stock account increases in value:**

It means the company is buying back some of its own shares and cash flowed out of the company (negative).

* + The amount of the increase will be deducted from the cash provided/used by financing activities.
  + **If the treasury stock account decreases in value:**

It means the company re-issued some of its previously purchased treasury stock and cash flowed into the company (positive).

The amount of the decrease is added to the cash provided/used by operating activities.

* + **If a dividend is paid out:**

The amount of the dividend is deducted from the cash provided/used by financing activities as this is indicative of a cash outflow.

After completing the three sections, summarize the values calculated as follows:

Net cash provided/used by operating activities

+/- Net cash provided/used by investing activities

+/- Net cash provided/used by financing activities

= Net increase (+) or decrease (-) in cash (to this amount, add the beginning cash)

+ Beginning cash (the cash at the beginning of the current period or end of prior period)

= Cash at end of the current period (thus completing the SCF)

The cash at the end of the current period should be the same as the value shown on the balance sheet for the end of the current period, thus proving the cash amount after determining all of the above cash inflows and outflows.

The ‘Noncash Activities’ area appears below the cash at the end of the current period. This section identifies significant operating, investing, and financing activities deemed necessary, such as the conversion of convertible bonds into common stocks, issuance of stocks or bonds for the acquisition of a building, and other similar activities.

**Learning Outcome #3**

**Perform analysis using the statement of cash flow:**

**Determining the dividend:**

* Reference to a dividend may not be provided.
* When developing the SCF, therefore, it is important to determine whether there was a cash dividend payment (and its value, if so).
* This is necessary because the payment of a cash dividend is a cash outflow (negative) in the company’s financing activities.
* To determine if there is a dividend when none is shown, look for net income on the current period income statement and the change in retained earnings on the balance sheet from the prior period to the current period.
  + If the retained earnings account changed by the same amount as the net income, then there were no dividend payments.
  + If the change in retained earnings is less than the net income, then subtract the change in the retained earnings account from the net income and that will give you the amount of the dividend.
  + While there may be other reasons for the change in retained earnings, such as a correction to a prior period error, these discussions are beyond the scope of this topical report.

**Example:**

Assume net income was $55,000 for the year 2020, and the balances in the retained earnings account were as shown below:

2020 2019

Retained Earnings Retained Earnings

$100,000 $75,000

For a corporation, profits flow into the retained earnings account. As you can see, the balance in the 2020 retained earnings account increased by $25,000 from the prior year, but the net income for the same year was $55,000. Thus $30,000 ($55,000 - $25,000) must have been siphoned off as a dividend payment.

The following is an example of a statement of cash flow:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **The ABC Company**  Statement of Cash Flow  Quarter Ending June 30, XXXX | | | | |
| **Cash Flow from Operating Activities:** | | | | |
| Net Income | |  |  | $300,000 |
| Adjustments: | |  |  |  |
| Depreciation Expense | |  | $3,000 |  |
| Gain on sale | |  | (1,000) |  |
| Increase in A/R | |  | (15,000) |  |
| Increase in inventory | |  | (20,000) |  |
| Decrease in supplies | |  | + 6,000 |  |
| Decrease in A/P | |  | (12,000) | $39,000 |
| Net Cash **Provided** by Operating Activities | | | | +$339,000 |
|  |  | |  |  |
| **Cash Flow from Investing Activities:** | | | | |
| Purchase of land | |  | ($100,000) |  |
| Purchase of Equipment | |  | (50,000) |  |
| Purchase of investment | |  | (30,000) |  |
| Net Cash **Used** by Investing Activities | | | | ($180,000) |
|  | | | | |
| **Cash Flow from Financing Activities:** | | | | |
| Payment of dividend | |  | ($15,000) |  |
| Repurchase of common stock | |  | (10,000) |  |
| Issuance of bonds | |  | 30,000 |  |
| Net Cash **Provided** by Financing Activities | | | | +$5,000 |
|  | | | |  |
| Net Increase or Decrease in Cash | | | | $164,000 |
| + Cash at Beginning of Period | | | | XXXXX |
|  | | | |  |
| = Cash at End of Period | | | | **YYYYY** |
|  | | | |  |
|  | | | |  |
| **Notes:** | | | | |

* A review of the above SCF shows that most of the cash flow was provided by the operating activities ($339,000); there wasan outflow of $180,000 from investing activities and an inflow of $5,000 from financing activities. This means the business is generating most of its cash from its main business activities, which is desirable.
* The business also seems to have sufficient cash to make the purchases shown on the investing activities section. It did not have to raise sufficient funds thru financing, and its dividend appears safe.
* It merits noting that while everything appears fine in the example above, things don’t always fall so neatly into place.
  + Worse results do not necessarily mean a company is in financial distress.
  + For example, a company may have purchased another company with the expectation of significant sales later on.
  + This might affect significantly the investing and financing activities at the expense of cash flow from operations.
  + Thus, each quarter’s SCF should be scrutinized carefully to develop a strong sense of the company’s direction.

**Free Cash Flow:**

* Another form of analysis is free cash flow, or FCF.
* FCF refers to the cash used/provided by operating activities after subtracting invested capital and any dividend payment, or

**FCF = cash used/provided by operating activities – capital expenditures – cash dividends**

* Invested capital or capital expenditures refers to cash outlays the company uses to purchase physical assets, such as land, buildings, and equipment, in order to improve operations.
* Although a positive FCF is desired, it could also be negative, assuming overextension of capital expenditures or weak cash flow from operating activities.
* A positive FCF indicates the company has excess cash, which it can put back into the business to further growth, increase dividend payouts, or reduce the number of shares outstanding. All of these are looked upon favorably.

**Appendix:**

How to prepare each activity?

|  |
| --- |
| * **Cash flows from operating activities** |
| Net income $## |
| Add: Depreciation expense (Noncash Expenses) + |
| Add: Loss on disposal of plant assets +  Less: Gain on disposal of plant assets -  Add: Decrease in Current Assets (Exclude Cash) +  Dec. in AR +  Less: Increase in Current Assets (Exclude Cash) -  Inc. in Inventory -  Add: Increase in Current Liability +  Less: Decrease in Current Liability -  Add: Receive Interest +  Add: Receive Dividends +  Less: Pay Interest - |

**Net cash provided or (used) by operating activities XX**

* **Cash flows from investing activities**

Sale of any Prorerty Plant & Equipment +

Purchase of any Prorerty Plant & Equipment -

Sale of long term investment +

Purchase a stocks in another company -

Lend on a LT note receivable -

Received a principle on LT note receivable +

**Net cash provided or (used) by investing activities XX**

* **Cash flows from financing activities**

Issue Bonds +

Issue Stocks +

Borrowed on LT Note Payable +

Pay back a LT Note Payable -

Issue Mortgage +

Purchase TS -

Bonds Redeemed -

Pay dividends -

Increase in paid-in capital in excess of par +

**Net cash provided or (used) by financing activities XX**

**Exercises:**

**Exercise 15.1**

Lopez Company reports net income of $80,000 for the year ended December 31, 2022. It also reports a $10,200 depreciation expense and a $7,500 gain on sale of equipment. Its comparative balance sheet reveals a $30,500 decrease in account receivable, a $3,300 decrease in inventory, a $600 increase in office supplies, a $12,700 increase in account payable, and a $980 increase in income tax payable.

Prepare the operating activity section of the statement of cash flow for 2022. Use the indirect method.

**Exercise 15.2**

Robert’s Inc. provided the following information for the year 2022.

Net Income $825,000

Sale of a parcel of Building $980,000

Sale of other long-term assets $525,000

Issuance of Bonds $800,000

Purchase of equipment for cash $180,000

Paid a cash dividend $230,000

Received a cash dividend from an investment $25,000

Prepare the investing activity section of the statement of cash flow for 2022.

**Exercise 15.3**

Lee Company provided the following information for the year 2022:

Decrease in account receivable $80,000

Payment of cash dividends $100,000

Increase in accounts payable $120,000

Depreciation expense $40,000

Increase in bonds payable $650,000

Sale of investments $200,000

Issuance of common stock $290,000

Prepare the financing activity section of the statement of cash flow for 2022.

**Exercise 15.4**

The Brown Corporation’s financial statements are presented below:

**Brown Corp.**

**Income Statement**

**For the year ended December 31, 2022**

|  |  |  |
| --- | --- | --- |
| Sales |  | $ 2,988,000 |
| Cost of Goods Sold |  | (1,791,000) |
| Gross Profit |  | 1,197,000 |
| Operating Expenses: |  |  |
| Depreciation Expense | $ 81,000 |  |
| Other Expenses | 751,500 | (832,500) |
| Net Income before taxes |  | 364,500 |
| Income Taxes |  | (63,000) |
| Net Income after taxes |  | $ 301,500 |

**Brown Corp.**

**Balance Sheet**

**As of December 31, 2022**

**2022 2021**

Cash $ 261,000 $ 175,500

Accounts Receivable 139,500 121,500

Merchandise Inventory 913,500 801,000

Equipment 499,500 445,500

Accum. Depr. -- Equip ( 234,000) (153,000)

Total Assets $1,579,500 $ 1,390,500

|  |  |  |  |
| --- | --- | --- | --- |
| Accounts Payable | $ 103,500 |  | $ 144,000 |
| Income Taxes Payable | 40,500 |  | 36,000 |
| Common Stock, $1 par | 873,000 |  | 837,000 |
| Additional paid-in capital | 297,000 |  | 243,000 |
| Retained Earnings | 265,500 |  | 130,500 |
| Total Liab + Equity | $1,579,500 |  | $ 1,390,500 |

**Additional Information**

* 1. Purchased equipment for $54,000 cash. No equipment was sold during 2022.
  2. Issued 30,000 shares of common stock for $3 per share.
  3. Declared and paid $166,500 of cash dividends.

Prepare a statement of cash flows using the indirect method.

# Financial Accounting II

## Chapter 15 Test

### Statement of Cash Flow

1. Identify which of the three sections (operating, investing, financing) in the body of the statement of cash flow is affected by each of the items below. If an item is a noncash item, indicate it with “NC.” Mark each with a “+” if it is a cash inflow, a “-” if it is a cash outflow, or “N/A” if it is neither.

|  |  |  |
| --- | --- | --- |
| **Item** | **Statement Section** | **Inflow or Outflow** |
| Purchased land |  |  |
| Sold merchandise for cash |  |  |
| Paid employee salaries |  |  |
| Stock dividend was distributed |  |  |
| Payment made on account |  |  |
| Paid a cash dividend |  |  |
| Received a cash dividend |  |  |
| Sold treasury stock above cost |  |  |
| Stocks were issued to replace a convertible bond |  |  |
| Paid interest owed |  |  |
| Issued common stock for land |  |  |

1. T F If a company is using the indirect method to prepare a statement of cash flow, the

depreciation expense would be added when reconciling net income to cash provided by

operating activities.

1. T F If a company is using the indirect method to prepare a statement of cash flow, any gain

on the sale of a long-term asset is subtracted when reconciling net income to cash

provided by operating activities.

1. A company purchased equipment seven years ago at a cost of $60,000. In the current year, the company sold the equipment at a loss of $6,000. The equipment had accumulated depreciation of $48,000 at the time of sale. If the company uses the indirect method to prepare a statement of cash flow, what amounts would be reported on the following sections, if any:

Operating section \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inflow or outflow (circle the correct answer)

Investing section \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inflow or outflow (circle the correct answer)

Financing section \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inflow or outflow (circle the correct answer)

1. By what amount does cash increase or decrease if the statement of cash flow shows the following:

Cash provided by operating activities $17,500

Cash used by investing activities $12,250

Cash used by financing $4,300

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ increase or decrease (circle the correct answer)

1. The Perseus Corporation generated $52,000 in net income during 2013. The following income statement and balance sheet information was also provided:

|  |  |
| --- | --- |
| Depreciation expense | $18,000 |
| Loss on sale of a long term asset | 3,500 |
| Decrease in A/R | 14,000 |
| Decrease in inventory | 21,000 |
| Decrease in A/P | 12,000 |
| Decrease in salaries and wages payable | 8,500 |
| Increase in taxes payable | 11,000 |
| Purchased equipment for cash | 125,000 |

Using the indirect method, develop the operating activities section of the statement of cash flow.

1. The Athena Corporation experienced a net loss of $43,000 during 2023. In addition, the company’s accounts receivable increased by $22,000, inventory decreased by $1,500, accounts payable increased by $34,000, taxes payable decreased by $9,500 and the depreciation expense was $17,000. Determine the amount of cash provided or used by operating activities during the year.

Amount: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ provided or used (circle the correct answer)

Answer the following true/false questions with respect to adjustments that must be made in the operating activities section when developing the statement of cash flow:

1. T F Increases in A/R are added to net income.
2. T F Increases to A/P are added to net income.
3. T F Increases to Income Tax Payable id deducted from net income.
4. T F Purchase of equipment for cash is deducted from net income.
5. T F Gains on sale of long-term assets are added to net income.
6. T F Depreciation expense is deducted from net income.
7. T F Losses on sale of a long-term asset are deducted from net income.
8. T F An increase in prepaid expenses is added to net income.
9. During 2023, the Grande Corporation generated $460,000, in net income $210,000. During the same year, the depreciation expense totaled $42,000, A/R increased by $22,000, Inventory decreased by $36,000, prepaid expenses increased by $6,000, A/P decreased by $18,000. The Grande corporation also experienced a loss of $6,000 on the sale of a long-term asset. The asset was sold for $15,000. Determine how much cash was provided or used by operating activities.

Answer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_provided or used (circle the correct answer)

1. Assume a company uses the indirect method to prepare a statement of cash flow. Amortization of a long-term intangible asset

a) is subtracted from net income in the operating activities section

b) is added as a cash inflow in the investing activities section

c) is added to net income in the operating activities section

d) does not appear on the statement of cash flow because it is not an outlay of cash

1. King Coal provided the following information:

Proceeds from the sale of a parcel of land $250,000

Proceeds from the sale of other long-term assets $125,000

Proceeds from the issuance of additional common stock $140,000

Purchase long term assets for cash $60,000

Paid a cash dividend $120,000

Received a cash dividend from an investment $12,000

Determine how much cash was provided or used by investment activities.

Answer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ provided or used (circle the correct answer)

1. Queen Coal provided the following information:

Increase in accounts payable $120,000

Increase in bonds payable 400,000

Sale of investments 150,000

Issuance of common stock 180,000

Payment of cash dividends 90,000

Net cash provided by financing activities is:

a) $280,000

b) $490,000

c) $460,000

d) $520,000

1. The Solar Power Company provided the following information for its 2023 fiscal year:

Total Sales 105,000

Net Income $60,000

Cash Provided by Operating Activities 31,000

Capital Expenditures 15,000

Dividends Paid 4,000

Determine the free cash flow for 2023.

1. The 2023 and 2022 balance sheets for the Woods Corporation are shown below:

The Woods Corporation

Balance Sheet

End of Year

**2023 2022**

**Assets**

Cash $ 60,000 $30,000

Accounts receivable 20,000 12,000

Merchandise Inventory 30,000 16,000

Prepaid expenses 7,000 10,000

Investments (*long term*) -0- 22,000

Equipment 58,000 28,000

Accumulated depreciation—equipment (21,000) (13,000)

**Total assets $154,000 $105,000**

**Liabilities and Shareholder Equity**

Accounts payable $ 25,000 $ 9,000

Bonds payable 45,000 54,000

Common stock 52,000 30,000

Retained earnings 32,000 12,000

**Total liabilities and shareholder equity $154,000 $105,000**

**Additional information for the year 2023:**

1. Total sales were $230,000.
2. Total net income was $40,000.
3. A long term investment that cost $22,000 was sold for $16,000.
4. Paid total cash dividends of $20,000.

**Instructions**

Using the indirect method, prepare a complete statement of cash flow for the year ended December 2023.

##### Answer:

**Chapter 16**

**Financial Analysis**

**(Horizontal, Vertical, and Ratios)**

**Learning Outcomes:**

1. Understand the meaning of financial analysis.
2. Perform horizontal analysis.
3. Perform vertical analysis.
4. Perform ratio analysis.

**(LO1)**

**Understand the meaning of financial analysis.**

**Financial analysis is the study of a company’s current and historical financial statements in order to**

* evaluate a company’s liquidity (ability to meet its short-term debt)
* evaluate a company’s ability to generate profits (profitability)
* assess a company’s ability to successfully continue as a going concern and meet long term debt obligations (solvency)
* help a company’s management and other interested parties determine how well the company is performing
* identify problems areas
* help investors choose between different investments

**Financial analysis is used by many organizations and professions, such as:**

* accountants
* financial advisors
* investment advisors
* investment banks

**Tools used in financial analysis may consist of, but not be limited to:**

* horizontal analysis
* vertical analysis (common sizing)
* ratio analysis

**Financial analysis can be performed on an intracompany basis, an intercompany basis, or an industry basis.**

* An intracompany analysis compares a single company’s financial numbers over several years.
* An intercompany analysis compares the financial numbers of one company with those of its competitor(s).
* Industry analysis compares the financial numbers of a company to those of industry averages.

**To perform financial analysis:**

* A company’s most recent financial statements are needed.
* Ideally the statements should have been audited by an independent CPA firm.
* Regardless of the type of analysis performed (ratio, horizontal, or vertical), the analyst should keep in mind that each type supplements the other.
* Therefore, the analyst should not depend on or prefer any one type, but rather use the three together.

**(LO2)**

**Perform Horizontal Analysis**

Horizontal analysis (HA) is an analytical tool that can be used to analyze historical financial information across multiple accounting periods.

* It may be applied to a company’s accounts, as well as ratios.
* It is sometimes referred to as trend analysis, and it can also be used for forecasting or to detect trends or patterns.
* Results from HA can be expressed in nominal (dollars) terms and/or as a percentage.
* Because it requires selecting a base year and a future year, the analyst needs to be aware that results can be manipulated by the choice of years. For examples, a poor year can be deliberately selected as the base year in order to show significant improvement from one year to the next.

The use of horizontal analysis is best shown by example:

**Example 1:** **Horizontal Analysis of an Income Statement**

The table below shows a comparative income statement for the years ending 2018 and 2019. The results of HA are shown in the “Nominal” and “% Change” columns:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **W. Faulkner Company**  **Income Statement**  **Years Ending December 31, 2019 and 2018** | | | | | |
|  | **2019** | **2018** |  | **Nominal Change** | **% Change** |
|  | $ | $ |  | $ |  |
| Sales | 959,000 | 820,000 |  | 139,000 | +16.95 |
| Less: |  |  |  |  |  |
| Cost of Goods Sold | 440,000 | 360,000 |  | 80,000 | +22.22 |
| Gross Profit | 519,000 | 460,000 |  | 59,000 | +12.83 |
| Less: |  |  |  |  |  |
| Selling Expenses | 76,000 | 64,000 |  | 12,000 | +18.75 |
| Administrative Expenses | 63,000 | 51,000 |  | 12,000 | +23.53 |
| Income from Operations | 380,000 | 345,000 |  | 35,000 | +10.14 |
| Less: |  |  |  |  |  |
| Interest Expense | 4,000 | 4,000 |  | 0 | 0 |
| Income Before Income Taxes | 376,000 | 341,000 |  | 35,000 | +10.26 |
| Less: |  |  |  |  |  |
| Income Taxes @30% | 112,800 | 102,300 |  | 10,500 | +10.26 |
| Net Income | 263,200 | 238,700 |  | 24,500 | +10.26 |

**Discussion:**

Any year can be designated as the base year. In this example, the earlier year (2018) is considered the base year.

**Looking at Sales:**

* Notice the change is positive: + $139,000. This is the nominal (in dollars) change.
* To calculate the % change, divide the nominal change by the base year amount:
  + % Change = Nominal Change ÷ Base Year Amount X 100%
  + % Change = +$139,000 ÷ $820,000 x 100% = + 16.95 %
* The analysis shows that sales increased by 16.95 % between 2018 and 2019.

**Is this a good thing or not?**

* As is true in many cases, the answer is, it depends.
* What do you think?

**(LO3)**

**Vertical Analysis**

In vertical analysis (also referred to as common sizing):

* Each account on the income statement and balance sheet is expressed as a percentage of a “common” account on the specific statement.
* To calculate the percentage, divide each account’s nominal (dollar) value by the “common” account’s nominal (dollar) value.
  + For the income statement, the common account is gross or net sales;
  + For the balance sheet, it is total assets.
* Hence, each account in the income statement is expressed as a percentage of gross or net sales, along with its nominal (dollar) value, while
* For the balance sheet each account is expressed as a percentage of total assets, along with its nominal dollar value.

Vertical analysis can be used for intracompany analysis, intercompany analysis, and industry analysis, and it is not limited to the size of the companies.

A company’s management will look at a common sized financial statement for signs of changes in the various accounts. Keep in mind that just because the value of an account changes from one accounting period to the next, it doesn’t necessarily mean the change is good or bad.

For example, say administrative and selling expenses were 5% of revenue in 2016 and 7% in 2017. This merits looking into. Why did these expenses increase?

The change may be reasonable if sales also increased. However, if sales decreased during this time, then management must look elsewhere to explain the increase in expenses.

The company’s management may also establish standardsfor the various accounts and use vertical analysis to determine if the standard amounts are being met. For example, say the management establishes that sales return and allowances should not exceed 1% of revenue. In any period when the percent is exceeded, management will have to determine why.

As you can see, the use of percentages instead of dollar amounts in the different accounts facilitates analysis.

The example below shows how to do vertical analysis for an income statement and a balance sheet and how to interpret the results.

**Example 2:** Vertical Analysis of an Income Statement

|  |  |  |  |
| --- | --- | --- | --- |
| **W. Faulkner Company**  **Income Statement**  **Year Ending December 31, 2019 and 2018** | | | |
|  | **2019** |  | **2018** |
|  | $ |  | $ |
| Sales | 959,000 |  | 820,000 |
| Less: |  |  |  |
| Cost of Goods Sold | 440,000 |  | 360,000 |
| Gross Profit | 519,000 |  | 460,000 |
| Less: |  |  |  |
| Selling Expenses | 76,000 |  | 64,000 |
| Administrative Expenses | 63,000 |  | 51,000 |
| Income from Operations | 380,000 |  | 345,000 |
| Less: |  |  |  |
| Interest Expense | 4,000 |  | 4,000 |
| Income Before Income Taxes | 376,000 |  | 341,000 |
| Less: |  |  |  |
| Income Taxes @30% | 112,800 |  | 102,300 |
| Net Income | 263,200 |  | 238,700 |

Solution:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **W. Faulkner Company**  **Income Statement**  **Year Ending December 31, 2018** | | | | | |
|  | **2018** | |  | **2017** | |
|  | $ | **%** |  | $ | **%** |
| Sales | 959,000 | **100.0%** |  | 820,000 | **100.0%** |
| Less: |  |  |  |  |  |
| Cost of Goods Sold | 440,000 | **45.9%** |  | 360,000 | **43.9%** |
| Gross Profit | 519,000 | **54.1%** |  | 460,000 | **56.1%** |
| Less: |  |  |  |  |  |
| Selling Expenses | 76,000 | **7.9%** |  | 64,000 | **7.8%** |
| Administrative Expenses | 63,000 | **6.6%** |  | 51,000 | **6.2%** |
| Income from Operations | 380,000 | **39.6%** |  | 345,000 | **42.1%** |
| Less: |  |  |  |  |  |
| Interest Expense | 4,000 | **0.4%** |  | 4,000 | **0.5%** |
| Income Before Income Taxes | 376,000 | **39.2%** |  | 341,000 | **41.6%** |
| Less: |  |  |  |  |  |
| Income Taxes @30% | 112,800 | **11.8%** |  | 102,300 | **12.5%** |
| Net Income | 263,200 | **27.4%** |  | 238,700 | **29.1%** |

Note that the common sized income statement shows nominal (dollar) values and percentages. Also note how each percentage is calculated. The nominal value of each account is divided by the sales account and multiplied by 100%.

**(LO4)**

**Perform Ratio Analysis**

Ratios are numerical values derived from the specific balances in a company's financial statements for the purpose of determining a company’s financial and operating performance over a certain time period. Ratios are grouped by categories: liquidity, operability, profitability, and solvency.

In general, liquidity ratios are used to determine a company’s ability to meet its short-term debt obligations, such as payroll, taxes, suppliers, lenders, etc. Solvency ratios measure a company’s ability to its long-term debt obligations, while profitability ratios measure the profitability of a company.

**Table 18 – 1 List of Ratios, Purpose, and Formulas**

|  |  |  |  |
| --- | --- | --- | --- |
| **Ratios** | **Purpose** | **Formula** | **Comment\*** |
|  | | | |
| **Liquidity** | | | |
| Current Ratio | Measures a company’s ability to meet its short-term debt obligations | Current Assets ÷ Current Liabilities | A reasonable value is industry specific. A value > 1 is reasonable (higher is better). E.g., A ratio of 1.25 means a company has $1.25 for every $1.00 of current liabilities. |
|  | | | |
| Acid Test or Quick  Ratio | A stricter measure of a company’s ability to meet its short-term debt obligations | (Current Assets – Inventory) ÷ Current Liabilities | A reasonable value is industry specific. Will be less than the current ratio. Look for a value close to 1 (higher is better). A ratio of 0.5, for example, means a company has $0.50 for every $1.00 of current liabilities. |
|  | | | |
| Receivables Turnover | A measure of how often during the year a company collects or turns over its accounts receivable | Net credit sales ÷ Average accounts Receivables | A reasonable value is industry specific. Generally, higher and/or increasing values are better. Calculated value should be used together with days in receivable and company credit policies. |
|  |  |  |  |
| Days in Receivable  (DIR) | The averages number of days it takes a company to collect its accounts receivable | 365 Days ÷ Receivables Turnover | A reasonable value is industry specific. Compare calculated value to company’s credit terms. E.g., if a company’s terms are 2/10, net 30, a value of less than 30 days is good. Generally, look for a low or decreasing number of days |
|  |  |  |  |
| Inventory Turnover | A measure of how often a company sells and replaces its inventory | Cost of Goods Sold ÷ Average Inventory | A reasonable value is industry specific. Generally, a higher and/or increasing value is better. Calculated value should be used together with days in inventory. |
|  |  |  |  |
| Days in Inventory (DII) | The average number of days it takes a company to sell its inventory | 365 Days ÷ Inventory Turnover | A reasonable value is industry specific. Generally, look for a low or decreasing number. |
|  |  |  |  |
| Asset Turnover | A measure of how well the company’s management uses its total assets to generate revenue | Net Sales ÷ Average Total Assets | A reasonable value is industry specific. Generally, a higher and/or increasing value is better. E.g., a value of 0.75 means the company is generating $0.75 for every $1.00 of assets. Generally, look for a value near 1.0. |

|  |  |  |  |
| --- | --- | --- | --- |
| **Solvency** | | | |
| Debt Ratio | A measure of a company’s total debt to total assets as a percent | (Total Liabilities ÷ Total Assets) x 100% | A reasonable value is industry specific. A lower percentage (less debt, < 50%) is generally better. A decreasing value is also a positive sign. |
|  |  |  |  |
| Times Interest  Earned | A measure of how many times a company can meet its interest obligations on its debts | (Earnings Before Interest expense and Taxes) ÷ Interest Expense | A reasonable value is industry specific. The higher the better. Look for values >>1.0. |

|  |  |  |  |
| --- | --- | --- | --- |
| **Profitability** | | | |
| Gross Profit Margin | A top-line measure of profitability after subtracting COGS | (Gross Profit ÷ Net Revenue) x 100% | A percentage. The higher the better. Also referred to as Gross Margin. |
|  |  |  |  |
| Profit Margin | A bottom-line measure of overall profitability | (Net Income ÷ Net Revenue) x 100% | A percentage. The higher the better. |
|  |  |  |  |
| Return on Assets | A measure of a company’s profits on its investment in total assets | Net Income ÷ Average Total Assets | A percentage. The higher the better. |
|  |  |  |  |
| Return on Equity | A measure of a company’s profits based on investments by shareholders | {Net Income – Preferred Stock Dividends) ÷ Average Shareholder Equity | A percentage. The higher the better. |
|  |  |  |  |
| Earnings Per Share (EPS) | A company’s net income expressed on a per share basis | (Net Income – Preferred Stock Dividends) ÷ (Average Number of Shares Outstanding | The units are dollars per share. The higher the better. |
|  |  |  |  |
| Price to Earnings (P/E) | Mostly used for valuing the price of a stock | Market Price of Common Stock Per Share ÷ EPS | A unit less number. |
|  |  |  |  |
| Payout Ratio | Percent of net income a company pays out in dividends | Cash dividends paid to common shareholders ÷ (Net Income – Preferred Stock Dividends, if any) | A percentage. |

**Example 3:**

The Balance Sheet and Income Statement for the Mary Shelley Company is shown below. Perform a complete ratio analysis for 2018 and 2017, using all of the ratios shown in table 18 – 1 above, and indicate whether the ratio has improved (I) or deteriorated (D) from one year to the next.

|  |  |  |  |
| --- | --- | --- | --- |
| **Mary Shelley Company** | | | |
| **Comparative Balance Sheet** | | | |
| **December 31, 2018** | | | |
|  |  |  |  |
|  | **2018** | **2017** | **2016** |
| **Assets** |  |  |  |
| **Current Assets** |  |  |  |
| Cash | $30,000 | $40,000 | $46,000 |
| Marketable Securities | 5,000 | 6,000 | 1,000 |
| Accounts Receivables, Net | 40,000 | 45,000 | 35,000 |
| Merchandise Inventory | 50,000 | 55,000 | 60,000 |
| Prepaid Expenses | 5,000 | 6,000 | 4,000 |
| **Total Current Assets** | **$130,000** | **$152,000** | **$146,000** |
| Land | $75,000 | $75,000 | $75,000 |
| Plant & Equipment, net | 105,000 | 70,000 | 70,000 |
| **Total Assets** | **$310,000** | **$297,000** | **$291,000** |
|  |  |  |  |
| **Liabilities & Shareholder Equity** |  |  |  |
| **Liabilities** |  |  |  |
| **Current Liabilities** |  |  |  |
| Accounts Payable | $90,000 | $95,000 | $84,000 |
| Deferred Liabilities | 15,000 | 12,000 | 22,000 |
| **Total Current Liabilities** | **$105,000** | **$107,000** | **$106,000** |
| Bonds Payable | 75,000 | 80,000 | 90,000 |
| **Total Liabilities** | **$180,000** | **$187,000** | **$196,000** |
|  |  |  |  |
| **Shareholder Equity** |  |  |  |
| Common Stock ($1.00 par value) | $25,000 | $25,000 | $25,000 |
| Additional Paid-in Capital | 30,000 | 30,000 | 30,000 |
| Retained Earnings | 75,000 | 55,000 | 40,000 |
| **Total Shareholder Equity** | **$130,000** | **$110,000** | **$95,000** |
| **Total Liabilities & Shareholder Equity** | **$310,000** | **$297,000** | **$291,000** |
|  |  |  |  |
|  |  |  |  |
| **Notes:** | | | |
| Assume 25,000 shares are outstanding. | |  |  |
| Assume the shares were trading at $7.00 per share in 2018. | | |  |
| Assume the shares traded at $5.00 per share in 2017. | | |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Mary Shelley Company** | | | |
| **Income Statement** | | | |
| **December 31, 2018** | | | |
|  |  | **2018** | **2017** |
|  |  |  |  |
| Sales |  | $900,000 | $825,000 |
| Less: Cost of Sales |  | 650,000 | 600,000 |
| Gross Profit |  | $250,000 | $225,000 |
| Less: Selling & Administrative Expenses |  | 180,000 | 165,000 |
| Income from Operations |  | $70,000 | $60,000 |
| Less: Interest Expense |  | 15,000 | 13,000 |
| Income Before Income Taxes |  | $55,000 | $47,000 |
| Less: Income Taxes |  | 19,250 | 16,450 |
| Net Income |  | $35,750 | $30,550 |
|  |  |  |  |
| **Notes:** |  |  |  |
| In 2018, dividends of $15,750 were paid to common stockholders. | | | |
| In 2017, dividends of $15,550 were paid to common stockholders. | | | |

**Solution:**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Liquidity Ratios** | **Formula** | **2018** | **2017** | **I / D** | **Comments** |
|  | | | | | |
| **Liquidity** |  |  |  |  |  |
| Current Ratio | Current Assets **÷** Current Liabilities | 1.24 | 1.42 | D | While both values are greater than 1, there was a slight reduction, but OK. |
|  | | | | | |
| Acid Test (Quick Ratio) | (Cash + Marketable Securities + Net Receivables) **÷** Current Liabilities | 0.71 | 0.89 | D | In both cases the values were less than 1 and decreased further. May need further review. |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Receivables Turnover | Net credit sales ÷Average accounts Receivables | 21.2 | 20.67 | I | In this case, there was a slight improvement. |
|  | | | | | |
| Days in Receivable | 365 Days ÷Receivables Turnover | 17.2 days | 17.7 days | I | OK if under normal credit terms. |
|  | | | | | |
| Inventory Turnover | Cost of Goods Sold ÷Average Inventory | 12.38 | 10.43 | I | In this case, value increased. May be OK depending on the type of inventory. |
|  | | | | | |
| Days in Inventory | 365 Days ÷Inventory Turnover | 29.5 days | 35 days | I | In this case, days in inventory decreased. Seems high. Depends on type of inventory. |
|  | | | | | |
| Asset Turnover | Net Sales ÷Average Total Assets | 2.97 | 2.81 | I | Over 1 is good, considering total assets turnover. |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Solvency** |  | **2018** | **2017** | **I / D** | **Comments** |
| Debt Ratio | (Total Liabilities ÷Total Assets) x 100% | 58 % | 63 % | I | Going down, but still high. |
|  | | | | | |
| Times Interest Earned | (**E**arnings **B**efore **I**nterest expense and **T**axes) ÷Interest Expense | 4.67 | 4.62 | I | While it did improve, it could be higher. |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Profitability Ratios** | **Formula** | **2018** | **2017** | **I / D** | **Comments** |
|  |  |  |  |  |  |
| Gross Profit Margin | (Gross Profit ÷Net Revenue) x 100% | 27.8 % | 27.3 % | I |  |
|  | | | | | |
| Profit Margin | (Net Income ÷Net Revenue) x 100% | 3.97 % | 3.7 % | I |  |
|  | | | | | |
| Return on Assets | Net Income ÷Average Total Assets | 11.79 % | 10.07 % | I |  |
|  | | | | | |
| Return on Equity | Net Income – Preferred Stock Dividends} ÷Average Shareholder Equity | 29.8 % | 29.9 % | D |  |
|  | | | | | |
| Earnings Per Share (EPS) | (Net Income – Preferred Stock Dividends) ÷ **(**Average Number of Shares Outstanding | $1.43 | $1.22 | I |  |
|  | | | | | |
| Price to Earnings (P/E) | Market Price of Common Stock Per Share **÷ EPS** | 4.9 | 4.1 | I |  |
|  | | | | | |
| Payout Ratio | Cash dividends paid to common shareholders **÷ (**Net Income – Preferred Stock Dividends, if any) | 44 % | 50.1 % | I | Normally should be lower than 50%. |

**Exercises:**

1. The Elias Corporation reported net income for its three most recent years:

|  |  |
| --- | --- |
| 2019 | $22,000 |
| 2018 | $21,000 |
| 2017 | $28,000 |

Determine the following:

Nominal change from 2017 to 2018

Percent change from 2018 to 2019

1. Circle the type of ratio (L = Liquidity; S = Solvency; P = Profitability) and calculate the ratios for 2019.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| a. | L, S, or P Ratio | Current Ratio \_\_\_\_\_\_\_\_\_\_\_\_ | i. | L, S, or P Ratio | Times Interest Earned \_\_\_\_\_\_\_\_\_ |
| b. | L, S, or P Ratio | Acid Test \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ | j. | L, S, or P Ratio | Gross Margin \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| c. | L, S, or P Ratio | Quick Ratio \_\_\_\_\_\_\_\_\_\_\_\_\_ | k. | L, S, or P Ratio | Profit Margin \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| d. | L, S, or P Ratio | Receivables T/O \_\_\_\_\_\_\_\_\_ | l. | L, S, or P Ratio | Return on Assets \_\_\_\_\_\_\_\_\_\_\_\_\_ |
| e. | L, S, or P Ratio | Days in Receivables \_\_\_\_\_\_ | m. | L, S, or P Ratio | Return on Equity \_\_\_\_\_\_\_\_\_\_\_\_\_ |
| f. | L, S, or P Ratio | Inventory T/O \_\_\_\_\_\_\_\_\_\_\_ | n. | L, S, or P Ratio | Price to Earnings Ratio \_\_\_\_\_\_\_\_ |
| g. | L, S, or P Ratio | Days in Inventory \_\_\_\_\_\_\_\_ | o. | L, S, or P Ratio | Earnings per Share \_\_\_\_\_\_\_\_\_\_\_ |
| h. | L, S, or P Ratio | Debt Ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_ | p. | L, S, or P Ratio | Payout Ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |

1. **Define the following terms:**

Liquidity

Profitability

Solvency

# Financial Accounting II

## Chapter 16 Test

### Analyzing Companies

1. T F Vertical analysis of the income statement requires that only expense accounts are shown

as a percentage of the base amount net sales.

1. T F Analysis of financial information within the same company for different accounting

periods is referred to as intercompany analysis.

1. T F Analysis of one company’s financials with a different company’s financials is referred to

as intracompany analysis.

1. T F There is no such thing as industry analysis.
2. T F Another name for vertical analysis is common size analysis.
3. T F Days in receivables shows how long, on average, it takes a company to sell its

inventory.

1. T F The current ratio, the acid test, and the quick ratio are all used to measure a company’s

ability to meet its short-term debt obligations.

1. T F The inventory turnover ratio is a measure of the average number of days an item is in

inventory before it is sold.

1. Evaluating an increase or decrease in sales, either nominally or as a percent, would most likely be a form of

what type of analysis?

Answer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. In performing a vertical analysis, the base for a current asset is

a) total current assets

b) total assets

c) total liabilities and stockholders' equity

d) prepaid expenses

1. In performing a vertical analysis for a service company, the base amount for service revenue is

a) service revenue

b) net income

c) a and b

d) none of the above

1. Which of the following is true of vertical analysis?

a) A base amount is required for the balance sheet and the income statement.

b) A base amount is required for the income statement but not the balance sheet.

c) The same base amount is used for the balance sheet and the income statement.

d) none of the above

1. Bella, Inc. shows the following on its income statement (in millions of dollars):

Bella, INC.

Income Statement

For the Year Ended December 31, 2023

Net Sales $300

Cost of Goods Sold 120

Gross Profit 180

Operating Expenses 44

Net Income $136

Using vertical analysis, what percentage is assigned to gross profit?

a) 30%

b) 40%

c) 60%

d) none of the above

1. Bella, Inc. shows the following on its income statement (in millions of dollars):

Bella, INC.

Income Statement

For the Year Ended December 31, 2023

Net Sales $300

Cost of Goods Sold 120

Gross Profit 180

Operating Expenses 44

Net Income $136

Using vertical analysis, what percentage is assigned to operating expenses?

a) 14.7%

b) 24.4%

c) 32.4%

d) 36.7%

1. The Steele Corporation reported net income for its three most recent years:

|  |  |
| --- | --- |
| 2019 | $22,000 |
| 2018 | $21,000 |
| 2017 | $28,000 |

Determine the following:

1. nominal change from 2017 to 2018 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
2. nominal change from 2018 to 2019 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. percent change from 2017 to 2018 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. percent change from 2018 to 2019 \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Define and give the formulae for the following terms:
6. inventory turnover:
7. days in inventory:
8. Define and give the formulae for the following terms:
9. receivables turnover:
10. days in receivables:
11. The Florence Company’s cost of goods sold for the year 2023 was $2,400,000. Its inventory at the

beginning and end of the year were $172,000 and $128,000, respectively. Determine the following:

1. average inventory turnover \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. days in inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
2. The Bellaire Company had net credit sales of $1,825,000 during 2023. Its average net receivables for the

year were $180,000. The receivables turnover for 2023 was\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. What does the times interest earned ratio show?
2. What is the formula for the times interest earned ratio?
3. The Credence Corporation generated $420,000 of net income for the year. At the beginning and end of the year, the common stockholder equity was $620,000 and $640,000, respectively. The company also had 3,000 shares of 6%, $50 par value preferred stock.

Determine the Credence Company’s return on equity.

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. Determine a company’s times interest earned ratio, given the following:

Credit sales $1,250,000

Cost of Goods Sold $725,000

Interest expense $28,000

Net income $148,000

Income tax expense $69,000

Answer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. If net income is $605,000, income tax expense is $104,000, and interest expense is $150,000, the times interest earned would be:

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. The Quick Corporation has 4,000 shares of 8%, 100 par value preferred stock and 100,000 shares of common stock outstanding. If net income at the end of the year is determined to be $375,000, what were the Quick Corporation’s earnings per share for the year?

Answer: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. The Gemini Company has 10,000 shares of 12%, $50 par value preferred stock and 300,000 shares of common stock outstanding. Net income for the year is $1,500,000. The earnings per share of common stock is:

Answer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. The following information was provided by the Noor Corporation for the 2023 and 2022 tax years:

**2023 2022**

Cash $900,000 $700,000

Accounts Receivable 240,000 290,000

Allowance for doubtful accounts 12,000 14,000

Merchandise Inventory 220,000 190,000

Accounts Payable 205,000 165,000

Salaries and wages payable 22,000 18,000

Long-term debt 350,000 280,000

Net sales (all sales on account) 1,050,000 840,000

Cost of goods sold 725,000 640,000

Salaries and wages expense

Interest expense 60,000 55,000

Income tax expense 75,000 60,000

Net income 150,000 85,000

**Instructions**

Using the information above, determine the following ratios for the most recent year:

1. Current ratio: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
2. Acid test: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. Inventory turnover: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. Days in Inventory: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Receivables turnover: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
6. Days in receivables: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
7. Times interest earned: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
8. The following information was provided by the Clarise Corporation:

Clarise Corporation

Comparative Balance Sheet

End of Year

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**Assets 2023 2022**

Cash $ 30,000 $ 45,000

Short-term investments 10,000 40,000

Accounts receivable (net) 60,000 50,000

Merchandise Inventory 60,000 80,000

Property, plant and equipment (net) 200,000 325,000

**Total assets $360,000 $540,000**

**Liabilities and shareholder equity**

Accounts payable $ 15,000 $ 35,000

Short-term notes payable 25,000 100,000

Bonds payable 75,000 200,000

Common stock 140,000 140,000

Retained earnings 105,000 65,000

**Total liabilities and shareholder equity $360,000 $540,000**

Clarise Corporation

Income Statement

End of Year 2023

Net sales $600,000

Cost of goods sold 250,000

Gross profit 350,000

Expenses

Operating expenses $160,000

Interest expense 40,000

Total expenses 200,000

Income before income taxes 150,000

Income tax expense 52,500

Net income $97,500

Additional information:

1. The value of the common stock at year end 2023 was $20.00 per share.
2. Common stock outstanding was 50,000 shares during each year.
3. Cash dividends of $57,500 were paid in 2023.
4. There are no preferred shares outstanding.

**Instructions**

Determine the following ratios for the most recent year:

1. Current ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
2. Acid test \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
3. Quick ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
4. Receivables turnover \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
5. Days in receivables \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
6. Inventory turnover \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
7. Days in inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
8. Times interest earned \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
9. Debt ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
10. Gross margin \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
11. Profit margin \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
12. Return on assets \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
13. Return on equity \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
14. Price-earnings ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
15. Earnings per share \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
16. Payout ratio \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_