

TEST #4 REVIEW SESSION, DECEMBER 20, 2008, 12:30 - 3:30 p.m.

CH. 11 – REPORTING AND ANALYZING EQUITY

→ This chapter focuses on details of the corporate form of organization, including recording transactions involving issuing stock, paying cash and stock dividends, stock splits, re-purchasing outstanding shares (Treasury stock), and calculating EPS.

[1] – Identify characteristics of corporations and their organization.

- A corporation is a separate legal entity. Owners are called stockholders. May be privately (closely) held or publicly held.

ADVANTAGES –

- Separate legal entity. Agents are its officers and managers.
- Limited liability of stockholders.
- Ease of transfer of ownership.
- Continuous life.
- Ease of capital accumulation

DISADVANTAGES –

- Double taxation of income
- More complex to form and operate, government regulations.

ORGANIZATION: Stockholders → Directors → CEO → Officers, managers, employees

BASICS OF CAPITAL STOCK:

Authorized shares

Issued shares

Outstanding shares

Par value – minimum legal capital. No-par, stated value

QS11-1

[2] – Describe the components of stockholders' equity.

[1]. Contributed capital (Paid-in): Preferred stock – par, Common stock – par, PIC in excess of par

[2]. Retained earnings.

[3] – Record the issuance of corporate stock.

At par: DR Cash, CR Common Stock

Premium: DR Cash, CR Common Stock – par, CR PIC in excess of par.

No-par: DR Cash, CR Common Stock – no-par

QS11-5, QS11-6

[4] – Record transactions involving cash dividends.

Date of declaration: DR Retained Earnings, CR Dividends Payable

Date of record: (no entry)

Date of payment: DR Dividends Payable, CR Cash

QS11-7

[5] – Account for stock dividends and stock splits.

STOCK DIVIDEND: Issue additional shares of stock to existing stockholders. (to keep market price affordable, conserve cash)

- Small stock dividend (25% of outstanding shares or less) – use market price.
- Large stock dividend (more than 25% of outstanding shares) – use par value

STOCK SPLIT: Not a dividend. Does not reduce retained earnings. No accounting entry required.

Increases number of outstanding shares, decreases par value per share. No change in capitalization or any totals in Stockholders' Equity.

[6] – Explain characteristics of common and preferred stock.

PREFERRED – hybrid between stock and bond. Preference as to dividends, liquidation. Specified dividend rate. Preferred shareholders do not vote.

Cumulative preferred: missed dividends must be made up before any dividends are paid on common.

Convertible: preferred shares may be exchanged for shares of common stock, at shareholder's option.

Callable: corporation has the right to purchase and retire shares at a specified price.

COMMON – basic ownership of the corporation. Last in line for dividends, but may share in extra dividends. Vote at annual and special meetings of shareholders. Elect board of directors.

([7] – Distribute dividends between common stock and preferred stock.)

[8] – Record purchases and sales of treasury stock and the retirement of stock.

Treasury stock is issued shares which have been re-purchased by the corporation. They remain issued but are no longer outstanding.

Purchase: DR Treasury Stock (cost), CR Cash

Re-issue for more DR Cash, CR Treasury Stock, CR PIC

Retired stock is no longer issued.

[9] – Explain the items reported in the statement of retained earnings.

Statement of Retained Earnings – pg. 459

Statement of Stockholders' Equity – pg. 460

[10] – Compute earnings per share (EPS) and explain its use.

EPS = (Net income – preferred dividends) / Weighted average common shares outstanding

QS11-13

[11] – Compute price-earnings (P/E) ratio and describe its use in analysis.

P/E Ratio = market price per share / EPS

[12] – Compute dividend yield and explain its use in analysis.

Dividend yield = annual cash dividends per share / market price per share

QS11-15

[13] – Compute book value and explain its use in analysis.

Book value per share (common) =
stockholders equity for common / number of outstanding common shares

End-of-Chapter Discussion Questions, pg. 469: 5, 6, 7, 8, 10, 12, 13, 15.

QS11-5. Issue common stock.

	ACCOUNT	DEBIT	CREDIT
[a].	_____	_____	_____
	_____		_____
	_____		_____
[b].	_____	_____	_____
	_____		_____
[c].	_____	_____	_____
	_____		_____
	_____		_____
	_____		_____

QS11-6. Issue preferred stock.

	ACCOUNT	DEBIT	CREDIT
[a].	_____	_____	_____
	_____		_____
	_____		_____
[b].	Dividend paid to preferred shareholders:	\$_____	

QS11-7. Accounting for cash dividends.

	ACCOUNT	DEBIT	CREDIT
5-15	_____	_____	_____
	_____		_____
6-30	_____	_____	_____
	_____		_____

Calculate preferred dividends, given the following information:

Net income	\$ 750,000
Average common stockholders' equity	\$2,250,000
Return on common stockholders equity	25%
 Total preferred dividends:	 \$_____

QS11-13. Basic earnings per share (EPS).

EPS = Net income (common) / Avg. number of common shares outstanding.

$$= \$ \underline{\hspace{2cm}} / \underline{\hspace{2cm}} = \$ \underline{\hspace{2cm}} \text{ per share}$$

QS11-15. Dividend yield.

Dividend yield = Annual dividends per share / Market price per share

$$= \$ \underline{\hspace{2cm}} / \$ \underline{\hspace{2cm}} = \underline{\hspace{2cm}} \%$$

CH. 12 – REPORTING AND ANALYZING CASH FLOWS

→ Cash flows have become more important in recent years. The statement of cash flows was developed in the 1970s to provide important additional information to statement users who wanted a better understanding of the sources of cash (inflows) and the uses the company made of its cash (outflows).

[1] – Explain the purpose and importance of cash flow information..

The purpose of the statement of cash flows is to report all major cash receipts (inflows) and cash payments (outflows) during a period, grouped by the three major business activities: OPERATING, INVESTING, AND FINANCING. The statement helps users evaluate a company by answering some important questions:

1. How did the company obtain its cash?
2. Where did the company spend its cash?
3. What explains the change in cash balance?

[2] – Distinguish between operating, investing, and financing activities.

OPERATING – transactions and events that determine net income.

INVESTING – acquisitions and disposals of non-current assets.

FINANCING – activities that affect long-term liabilities and equity.

QS12-2

[3] – Identify and disclose non-cash investing and financing activities.

Important non-cash items are disclosed at the bottom of the statement (full disclosure principle). For example, purchasing long-term assets with a long-term note.

[4] – Describe the format of the statement of cash flows.

Cash flows from operating activities, plus cash flows from investing activities, plus cash flows from financing activities equals net increase (decrease) in cash, plus cash balance at end of last period equals cash balance at end of this period. Should be the same as ending cash on the balance sheet.

[5] – Prepare a statement of cash flows.

DIRECT METHOD – preferred by GAAP, but not used much in practice.

INDIRECT METHOD – used by most companies:

[6] – Compute cash flows from operating activities using the indirect method.

Operating activities – start with net income from the income statement, add depreciation expense for the period, determine changes in current assets and current liabilities, add non-cash losses and deduct non-cash gains on income statement, to get cash income. Operating activities are shown on a NET BASIS.

QS12-3

[7] – Determine cash flows from both investing and financial activities.

Investing and **financing** activities are shown on a GROSS BASIS

E12-10

[8] – Analyze the statement of cash flows.

How much cash was generated by operating activities?

How were acquisitions of L-T assets financed?

Ability to generate future cash flows?

[9] – Compute and apply the cash flow to total assets ratio.

$$\text{Cash flow to total assets} = \text{Cash flow from operations} / \text{average total assets}$$

Indicates earnings quality. Compare to ROTA.

End-of-Chapter Discussion Questions, pg. 517: 1, 4, 5, 6, 10, and 11.

QS12-3. Cash Flows from Operations (Indirect).

KATAHN COMPANY
Statement of Cash Flows – Operating Activities
For the Year Ending December 31, 2008

Net income	\$ _____
Depreciation expense	_____
(Increase) Decrease in current assets:	
Accounts Receivable	_____
Inventory	_____
Increase (Decrease) in current liabilities:	
Accounts Payable	_____
Income Tax Payable	_____

Net cash provided by operating activities	\$ _____ =====

(Bonus question). Calculate cash paid for merchandise, given the following information. Cost of Goods sold during the period was \$312,000:

	<i>Beginning bal.</i>	<i>Ending bal.</i>
Merchandise Inventory	\$68,000	\$82,000
Accounts Payable	\$38,000	\$35,800

E12-10. Statement of Cash Flows (Indirect).

IKIBAN, INC.
Statement of Cash Flows
For the Year Ending June 30, 2008

<i>Operating activities:</i>	
Net Income	\$ _____
Depreciation expense	_____
(Increase) Decrease in current assets:	
Accounts Receivable	_____
Inventories	_____
Prepaid Expenses	_____
Increase (Decrease) in current liabilities:	
Accounts Payable	_____
Wages Payable	_____
Income Tax Payable	_____
Gain on sale of equipment	_____

Net cash provided by operating activities	_____
<i>Investing activities:</i>	
Purchase new equipment	_____
Sold old equipment	_____

Net cash (used) by investing activities	_____
<i>Financing activities:</i>	
Retired note payable	_____
Issued common stock	_____
Paid cash dividends	_____

Net cash (used) by financing activities	_____

Net change in cash during the year	_____
Add: beginning cash balance, July 1, 2007	_____

Ending cash balance, June 30, 2008	\$ _____ *
	=====

(*) Check figure: Ending cash balance should be the same amount as cash on the balance sheet for the year end 2008.

CH. 13 – ANALYZING AND INTERPRETING FINANCIAL STATEMENTS

→ This chapter summarizes the various measures for analyzing financial information which were presented in earlier chapters, and it discusses some overall techniques for interpreting financial statements.

[1] – Explain the purpose of analysis.

Strategic information for inside users.

External users: information for investment decisions, tax matters, lending decisions, credit terms.

[2] – Identify the building blocks of analysis.

1. LIQUIDITY AND EFFICIENCY (short-term creditors, managers)
2. SLOVENCY (long-term creditors, investors)
3. PROFITABILITY (investors, managers)
4. MARKET PROSPECTS (investors)

QS 13-5

[3] – Describe standards for comparisons in analysis.

- Within the company – compare with plans, prior periods (*Intra-company*)
- Competitor (*Inter-company*)
- Industry averages
- Guidelines (rules of thumb)

[4] – Identify the tools of analysis.

1. HORIZONTAL ANALYSIS – Trend
2. VERTICAL ANALYSIS – Common size
3. RATIO ANALYSIS

QS 13-7

[5] – Explain and apply methods of horizontal analysis.

Dollar and percent changes in a single line-item. Comparative balance sheets and income statements.

QS13-4

[6] – Describe and apply methods of vertical analysis.

Each item in a column is expressed as a percent of a total:

Balance Sheet – Total assets

Income statement – total revenues

[7] – Define and apply ratio analysis.

1. LIQUIDITY AND EFFICIENCY

- a. Net Working Capital = CA – CL
- b. Current Ratio = CA / CL
- c. Acid-Test Ratio = (Cash + Receivables) / CL
- d. AR Turnover = Credit Sales / Avg. Accounts Receivable
- e. Inventory Turnover = COGS / Avg. Inventory
- f. Days' Sales Uncollected = (Ending AR / Credit Sales) x 365
- g. Days' Sales in Inventory = (Ending Inventory / COGS) x 365
- h. Total Asset Turnover (TATO) = Sales / Avg. Total Assets

2. SOLVENCY

- a. Debt Ratio = Total Liabilities / Total Assets
- b. Equity Ratio = Total Equities / Total Assets
- c. Debt-to-Equity (D/E) Ratio = Total Liabilities / Total Equities
- d. Times Interest Earned (TIE) = EBIT / I

3. PROFITABILITY

- a. Profit Margin = Net Income / Total Sales
- b. Gross Margin Ratio = Gross Profit / Total Sales
- c. Return on Total Assets (ROTA) = Net Income / Avg. Total Assets
- d. Return on Common Equity (ROCE) = (Net Income – Pfd. dividends) / Avg. Stkhldrs' Eq.
- e. Book Value per Share = Common Equity / Avg. No. of common shares outstanding
- f. Basic Earnings per Share (EPS) = (Net income – Pfd. Dividends) / Wtd. Avg. Outs. Shrs.

4. MARKET PROSPECTS

- a. Price-Earnings (P/E) Ratio = Market price per share / EPS
- b. Dividend Yield = Annual cash dividends per share / market price per share

[See summary of ratios: Exhibit 13.16, page 557]

[8]. Components of a Multiple-step Income Statement –

Normal, continuing operations:

Net sales – COGS = GM – Operating expenses – Operating Income (EBIT)

EBIT – Interest expense = income before tax – federal income tax = Net income (continuing oper.)

Discontinued segments

Extraordinary income: gains & losses (unusual, infrequent)

Net income

Changes in accounting principle

Comprehensive income

Discussion Questions, pgs. 565, 566: 2, 7, 8, 9, 10, and 11.

E13-3. Common-size analysis, income statement.

MACHIKO CORPORATION
Comparative Income Statements
For Years Ended December 31, 2008 and 2007

	2008	%	2007	%
Sales	\$740,000	100.0%	\$625,000	100%
Cost of Goods Sold	<u>560,300</u>	_____	<u>290,800</u>	_____
Gross Profit	179,700	_____	334,200	_____
Operating Expenses	<u>128,200</u>	_____	<u>218,500</u>	_____
Net Income	<u>\$ 51,500</u>	=====	<u>\$115,700</u>	=====

E13-6. Common-size analysis, balance sheet.

(a).

SIMEON COMPANY
Comparative Balance Sheets
For Years Ended December 31, 2009, 2008, and 2007

	2009	2008	2007	2009 %	2008 %	2007 %
Assets						
Cash	\$31,800	\$35,625	\$37,800	_____%	_____%	_____%
Accounts receivable	89,500	62,500	50,200	_____	_____	_____
Merchandise inventory	112,500	82,500	54,000	_____	_____	_____
Prepaid expenses	10,700	9,375	5,000	_____	_____	_____
Plant assets, net	<u>278,500</u>	<u>255,000</u>	<u>230,500</u>	_____	_____	_____
Total assets	<u>\$523,000</u>	<u>\$445,000</u>	<u>\$377,500</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Liabilities & Equity						
Accounts payable	\$129,900	\$75,250	\$51,250	_____%	_____%	_____%
LT Notes payable	98,500	101,500	83,500	_____	_____	_____
Common stock	163,500	163,500	163,500	_____	_____	_____
Retained earnings	<u>131,100</u>	<u>104,750</u>	<u>79,250</u>	_____	_____	_____
Total liabil. & equity	<u>\$523,000</u>	<u>\$445,000</u>	<u>\$377,500</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

(b). Calculate Simeon Company's working capital:

	2009	2008	2007
_____	_____	_____	_____

(c). Calculate Simeon Company's dividend yield:

[1]. Cash dividends paid per share	\$2.65	\$2.40	\$1.95
[2]. Market price per share	\$66.25	\$56.47	\$52.00
[3]. Dividend yield:	_____%	_____%	_____%