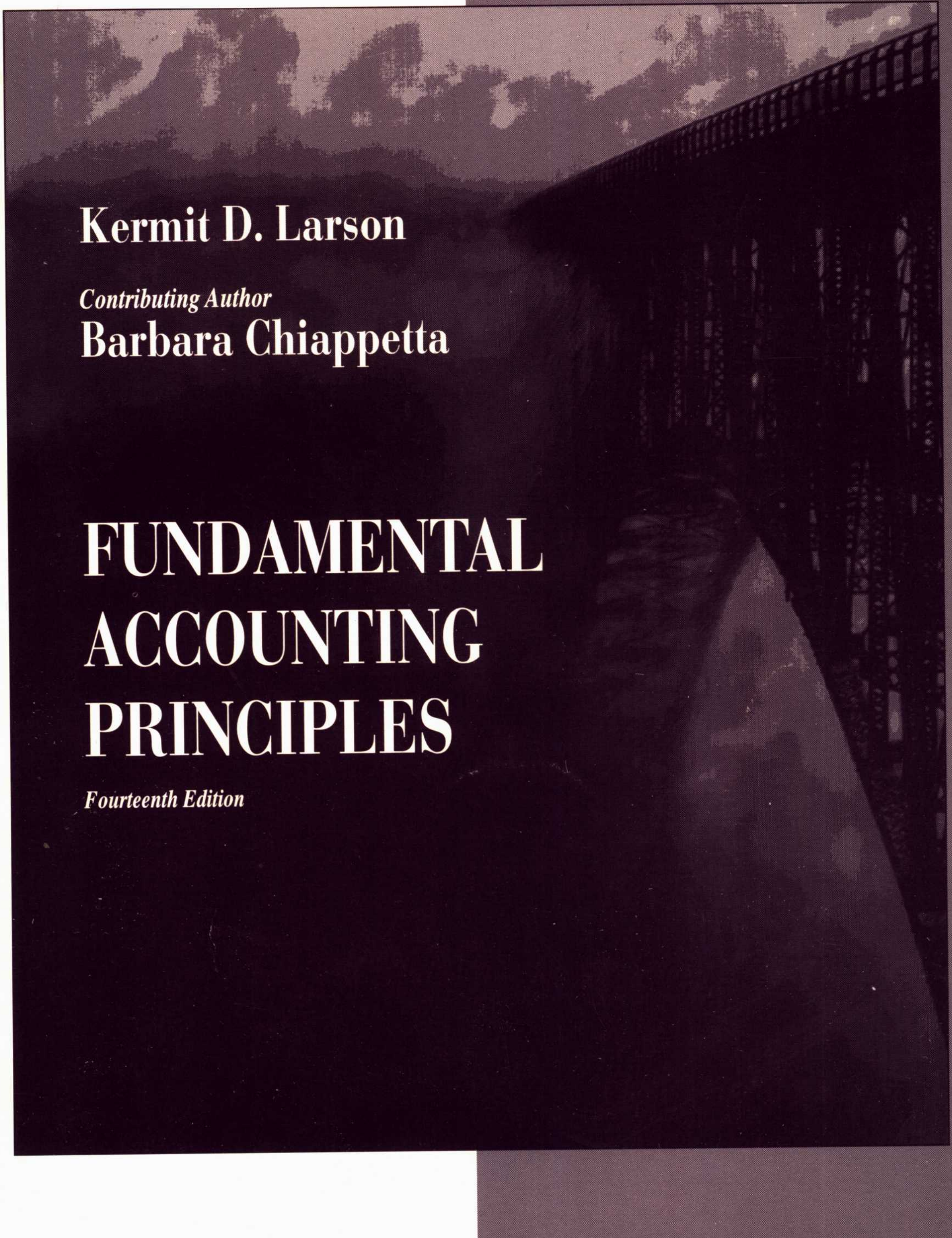
Study Guide

Volume II, Chapters 13-25

for use with



Kermit D. Larson

Contributing Author

Barbara Chiappetta

FUNDAMENTAL ACCOUNTING PRINCIPLES

Fourteenth Edition

STUDY GUIDE

Volume II, Chapters 13-25

for use with

FUNDAMENTAL ACCOUNTING PRINCIPLES

Fourteenth Edition

Kermit D. Larson
University of Texas-Austin

Chicago • Bogotá • Boston • Buenos Aires • Caracas
London • Madrid • Mexico City • Sydney • Toronto

Table of Contents

Chapter 13	Corporations and Partnerships	1
Chapter 14	Additional Corporate Transactions; Reporting Income and Retained Earnings; Earnings per Share	19
Chapter 15	Installment Notes Payable and Bonds	33
Chapter 16	Reporting and Using Cash Flows in Decision Making	49
Chapter 17	Analyzing Financial Statements	63
Chapter 18	An Introduction to Managerial Accounting and Cost Accounting Concepts	75
Chapter 19	New Production Management Concepts and Job Order Cost Accounting Systems	91
Chapter 20	Process Cost Accounting	103
Chapter 21	Cost Allocation and Activity-Based Costing	117
Chapter 22	Cost-Volume-Profit Analysis	129
Chapter 23	The Master Budget: A Formal Plan for the Business	141
Chapter 24	Flexible Budgets and Standard Costs	153
Chapter 25	Capital Budgeting and Other Managerial Decisions	167
Appendix C	Payroll Reports, Records, and Procedures	179
Appendix D	Accounting Principles, the FASB's Conceptual Framework, and Alternative Valuation Methods	189
Appendix E	Present and Future Values: An Expansion	201

13 Corporations and Partnerships

Learning Objective 1:

Explain the unique characteristics of the corporate form of business.

Summary

Corporations are separate legal entities. As such, their stockholders are not liable for the corporate debts. Stocks issued by corporations are easily transferred between stockholders, and the life of corporations does not end with the incapacity or death of a stockholder. A corporation acts through its agents, who are its officers and managers, not its stockholders. Corporations tend to be closely regulated by government and are subject to income taxes.

Learning Objective 2:

Record the issuance of par value stock and no-par stock with or without a stated value, and explain the concept of minimum legal capital.

Summary

When stock is issued, the par or stated value is credited to the stock account and any excess is credited to a separate contributed capital account. If the stock has no par or stated value, the entire proceeds are credited to the stock account. Stockholders must contribute assets equal to the minimum legal capital of a corporation or be potentially liable for the deficiency. And, as long as any liabilities remain unpaid, the minimum legal capital cannot be paid to stockholders.

Learning Objective 3:

Record transactions that involve dividends and stock subscriptions and explain the effects of stock subscriptions on the balance sheet.

Summary

If a corporation sells stock through subscriptions, the unpaid portion is recorded as a receivable and the subscribers' equity is recorded in contributed capital accounts. The balance of the Common Stock Subscribed account is transferred to the Common Stock account when the shares are issued, which normally occurs after all payments are received. Three dates are involved when cash dividends are distributed to stockholders. The board of directors binds the company to pay the dividend on the date of declaration. The recipients of the dividend are identified on the date of record. The cash is paid to the stockholders on the date of payment.

Learning Objective 4:

State the differences between common and preferred stock, and allocate dividends between the common and preferred stock of a corporation.

Summary

Preferred stock has a priority (or senior status) relative to common stock in one or more ways. Usually, common stockholders cannot be paid dividends unless a specified amount of dividends also is paid to preferred shareholders. Preferred stock also may have a priority status if the corporation is liquidated. The dividend preference for many preferred stocks is cumulative. Many companies are authorized to issue participating preferred stocks as a poison pill against hostile takeovers.

Learning Objective 5:

Describe convertible preferred stock and explain the meaning of the par value, call price, market value and book value of corporate stock.

Summary

Convertible preferred stock can be exchanged by its holders for common stock. If preferred stock is callable, the amount that must be paid to retire the stock is its call price plus any dividends in arrears. Market value is the price that a stock commands when it is bought or sold. The book value of preferred stock is any dividends in arrears plus its par value or, if it is callable, its call price. The remaining stockholders' equity is divided by the number of outstanding common shares to determine the book value per share of the common stock.

Learning Objective 6:

Explain the concepts of mutual agency and unlimited liability for a partnership, record the investments and withdrawals of partners, and allocate the net incomes or losses of a partnership among the partners.

Summary

Mutual agency means that every partner can bind a partnership to contracts that are within the normal scope of the business. In a general partnership, each partner has unlimited liability for the debts of the partnership. A partnership agreement should specify the method for allocating the partnership's net income or loss among the partners. This allocation may be done on a fractional basis, or it may use salary and interest allowances to compensate partners for differences in their service and capital contributions.

Learning Objective 7:

Calculate dividend yield and describe its meaning.

Summary

The dividend yield is the ratio between a stock's annual dividends per share and its market value per share. It describes the rate of return provided to the stockholders from the company's dividends. The yield can be compared with the rates of return offered by other kinds of investments to determine whether the stock should be viewed as an income or growth stock.

Learning Objective 8:

Define or explain the words and phrases listed in the chapter glossary.

Summary

See Problem III.

Topical Outline

I. Characteristics of corporations

A. Separate legal entity—a corporation, through its agents, may conduct business affairs with the same rights, duties, and responsibilities as a person.

B. Lack of stockholders' liability.

C. Ease of transferring ownership rights.

D. Continuity of life—a perpetual life is possible for a successful corporation.

E. Stockholders are not agents of the corporation.

F. Ease of capital accumulation—the advantages of the corporate form make it easier for a corporation to raise large amounts of capital.

G. Increased governmental regulation.

H. Taxation—corporate income is taxed; and when income is distributed to shareholders as dividends, it is taxed a second time.

II. Organizing and managing a corporation

A. Organization costs—normally debited to an asset account and amortized over a period not to exceed 40 years.

B. Management—stockholders, board of directors and administrative officers.

III. Common stock

A. A corporation may issue no more stock than is authorized by its charter.

B. Stock may be issued in exchange for cash or other assets.

C. Par value—an arbitrary value assigned to a share of stock when the stock is authorized. In many states, the par value of a corporation's stock also establishes the minimum legal capital.

D. Premium on stock—the difference between the par value of stock and its issue price when it is issued at a price above par value.

E. Discount on stock—the difference between the par value of stock and its issue price when it is issued at a price below par value. Stock is seldom issued at a discount, since the discount could create a contingent liability for the shareholders.

F. No-par stock—a class of stock that does not have a par value.

1. Advantage is that it may be issued at any price without having a discount liability attached.

2. A stated value may be placed on no-par stock; the stated value then becomes minimum legal capital and is credited to the no-par stock account at the time the stock is issued.

G. Subscriptions—in some instances, stock can be purchased on an installment basis.

1. Subscriptions receivable are reported as assets.

2. Common stock subscribed is reported in stockholders' equity.

H. Rights of common stockholders

1. The right to vote at stockholders' meetings.
2. The right to sell or otherwise dispose of their stock.
3. The right (known as the preemptive right) of first opportunity to purchase any additional shares of common stock issued by the corporation.
4. The right to share equally with other common stockholders in any dividends, with the result that each common share receives the same amount.
5. The right to share equally in any assets that remain after creditors are paid when the corporation is liquidated, with the result that each common share receives the same amount.

IV. Corporate dividends

A. Date of declaration—the day the directors vote to pay a dividend.

B. Date of record—the date on which a corporation's records are examined to identify the stockholders who will receive a dividend.

C. Date of payment—the date on which a corporation disburses a cash dividend to the stockholders.

D. Accounting for dividends

1. On declaration date, debit Cash Dividends Declared and credit Common Dividend Payable.
2. On payment date, debit Common Dividend Payable and credit Cash.
3. At the end of the period, close Cash Dividends Declared to Retained Earnings.

V. Preferred stock

A. Preferred stock—so called because of preferences granted to its owners

1. Preference as to payment of dividends.
2. Preference in distribution of assets upon liquidation.

B. Cumulative or noncumulative preferred stock

1. Cumulative—any undeclared dividends accumulate each year until they are received.
2. Noncumulative—the right to receive dividends is forfeited in any year that dividends are not declared.
3. Full-disclosure principle requires that the amount of preferred dividends in arrears be reported as of the balance sheet date, normally in a footnote to the financial statements.

C. Participating or nonparticipating preferred stock

1. Nonparticipating preferred stock—dividends are limited each year to a maximum amount determined by applying the preferred percentage to the par value.
2. Participating preferred stock—gives its owners the right to share in dividends in excess of the stated percentage or amount. This stock is used as a poison pill against hostile takeovers.

VI. Convertible preferred stock

A. Convertible preferred stock offers investors a higher potential return.

B. The carrying amount of the converted preferred stock becomes the book value of the capital contributed for the new shares of common stock.

VII. Stock values

A. Call price of callable preferred stock—the amount that must be paid to call and retire a preferred share.

B. Market value—the amount at which a share of stock may be bought or sold.

C. Book value—one share's portion of the issuing corporation's net assets as recorded in its accounts

1. Common stock—total stockholders' equity (less the book value of preferred stock, if any) divided by number of common shares outstanding.

2. Preferred stock—redemption value (or par value if there is no redemption value) plus any cumulative dividends in arrears divided by number of preferred shares outstanding.

3. Generally has little bearing upon liquidation value or market value.

VIII. Characteristics of partnerships

A. A voluntary association.

B. Based on a contract, which should be in writing but may be expressed orally.

C. Limited life-death, bankruptcy, or expiration of the contract period automatically ends a partnership.

D. Mutual agency—every partner is an agent of the partnership and can enter into and bind it to any contract within the normal scope of its business.

E. Unlimited liability—each general partner is responsible for payment of all the debts of the partnership if the other partners are unable to pay a share.

F. May be general or limited

1. General partnerships—all partners have unlimited liability.

2. Limited partnerships—have two classes of partners, general and limited. The general partners assume unlimited liability for the debts of the partnership. The limited partners assume no personal liability beyond their invested amounts.

IX. Partnership accounting

A. Capital and withdrawals accounts for each partner.

B. Measurement and division of earnings

1. Salaries to partners and interest on partners' investments are not partnership expenses; they are allocations of net income.

2. In the absence of an agreement, partnership earnings and losses are shared equally among the partners.

3. Methods of dividing partnership earnings

a. Fractional basis.

b. Ratio of capital investments.

c. Salary and interest allowances with the remainder in a fixed ratio.

4. Partners may agree to salary and interest allowances to reward unequal contributions of services or capital.

X. Dividend yield

A. Used to determine whether a company's stock is a growth stock or an income stock.

B. Calculated as: $\frac{\text{Annual cash dividends per share}}{\text{Market value per share}}$

Problem I

The following statements are either true or false. Place a (T) in the parentheses before each true statement and an (F) before each false statement.

1. ( ) Par value has nothing to do with a stock's worth.
2. ( ) Final authority in the management of corporation affairs rests with its board of directors.
3. ( ) The life of a corporation may be unlimited.
4. ( ) To transfer and sell his or her interest in a corporation, a stockholder must secure permission from the corporation's secretary.
5. ( ) The chief executive officer of a corporation is usually elected by the stockholders at one of their annual meetings.
6. ( ) The president of a corporation is responsible to its board of directors for management of the corporation's affairs.
7. ( ) A discount on stock is the difference between market value and the amount at which stock is issued when the stock is issued at a price below its par value.
8. ( ) Jay and Faye are partners in the operation of an insurance agency. Business has been slow, and without consulting Faye, Jay entered into a contract with Rays Limited to purchase three satellite dishes to be sold by the partnership. Faye repudiated the contract. Rays Limited should be able to hold the partnership liable on the contract.
9. ( ) Partnership accounting is exactly like that of a single proprietorship except for transactions affecting the partners' equities.
10. ( ) Although a partner does not work for either a salary or interest, to be fair in the distribution of partnership earnings, it is often necessary to provide allowances for services and investments.
11. ( ) Hadley Corporation stock has a current market value of $16 and is expected to pay cash dividends of $1.20 during the next year. The expected dividend yield of Hadley stock is 7.5%.

Problem II

You are given several words, phrases, or numbers to choose from in completing each of the following statements or in answering the following questions. In each case select the one that best completes the statement or answers the question and place its letter in the answer space provided.

_______ 1. The difference between the par value of stock and its issue price when it is issued at a price above par value is the:

a. Contributed capital.
b. Stock dividend.
c. Minimum legal capital.
d. Premium on stock.
e. Discount on stock.

_______ 2. Vector Corporation has outstanding 3,000 shares of $100 par value, 7% cumulative and nonparticipating preferred stock and 10,000 shares of $10 par value common stock. Dividends have not been paid on the preferred stock for the current and one prior year. The corporation has recently prospered, and the board of directors has voted to pay out $49,000 of the corporation's retained earnings in dividends. If the $49,000 is paid out, how much should the preferred and common stockholders receive per share?

a. $14.00 per share preferred, $0.70 per share common.
b. $ 7.00 per share preferred, $2.80 per share common.
c. $12.25 per share preferred, $1.23 per share common.
d. $ 1.14 per share preferred, $4.56 per share common.
e. $16.33 per share preferred, $ -0- per share common.

_______ 3. Vector Corporation has outstanding 3,000 shares of $100 par value, 7% noncumulative and nonparticipating preferred stock and 10,000 shares of $10 par value common stock. Dividends have not been paid on the preferred stock for the current and one prior year. The corporation has recently prospered, and the board of directors has voted to pay out $49,000 of the corporation's retained earnings in dividends. If the $49,000 is paid out, how much should the preferred and common stockholders receive per share?

a. $ 1.14 per share preferred, $4.56 per share common.
b. $ 9.33 per share preferred, $2.10 per share common.
c. $ 7.00 per share preferred, $2.80 per share common.
d. $14.00 per share preferred, $0.70 per share common.
e. $12.25 per share preferred, $1.23 per share common.

_______ 4. Participating preferred stock is:

a. Preferred stock that can be exchanged for shares of the issuing corporation's common stock at the option of the preferred stockholder.
b. Preferred stock on which undeclared dividends accumulate annually until they are paid.
c. Preferred stock on which the right to receive dividends is forfeited for any year that the dividends are not declared.
d. Preferred stock that the issuing corporation, at its option, may retire by paying a specified amount to the preferred stockholders plus any dividends in arrears.
e. Preferred stock that gives its owners the right to share in dividends in excess of the stated percentage or amount.

_______ 5. Stated value of no-par stock is:

a. One share's portion of the issuing corporation's net assets as recorded in the corporation's accounts.
b. An arbitrary amount assigned to no-par stock by the corporation's board of directors which is credited to the no-par stock account when the stock is issued.
c. The difference between the par value of stock and its issue price when it is issued at a price below or above par value.
d. The market value of the stock on the date of issuance.
e. The price at which a share of stock can be bought or sold.

________ 6. Reggie and Veronica began a partnership by investing $28,000 and $20,000, respectively, and during its first year the partnership earned a $42,000 net income. What would be the share of each partner in the net income if the partners had agreed to share by giving a $16,400 per year salary allowance to Reggie and an $18,000 per year salary allowance to Veronica, plus 10% interest on their beginning-of-year investments, and the remainder equally?

a. Reggies' share, $20,600; Veronica's share, $21,400.
b. Reggies' share, $22,200; Veronica's share, $19,800.
c. Reggies' share, $21,400; Veronica's share, $20,600.
d. Reggies' share, $24,500; Veronica's share, $17,500.
e. Reggies' share, $21,000; Veronica's share, $21,000.

________ 7. On December 15, RTA Corporation declares a $.75 per share cash dividend on its 4,000 outstanding shares. Payment date is January 15. On December 31, RTA should make the following entry related to the cash dividend:

a.	Cash Dividends Declared	3,000	
	Retained Earnings		3,000
b.	Cash Dividends Declared	3,000	
	Common Dividend Payable		3,000
c.	Retained Earnings	3,000	
	Cash Dividends Declared		3,000
d.	Retained Earnings	3,000	
	Common Dividend Payable		3,000

e. No entry should be made on December 31 related to the cash dividend.

Problem III

Many of the important ideas and concepts discussed in Chapter 13 are reflected in the following list of key terms. Test your understanding of these terms by matching the appropriate definitions with the terms. Record the number identifying the most appropriate definition in the blank space next to each term.

_______ Book value of a share of stock
_______ Call price of preferred stock
_______ Callable preferred stock
_______ Convertible preferred stock
_______ Cumulative preferred stock
_______ Date of declaration
_______ Date of payment
_______ Date of record
_______ Deficit
_______ Discount on stock
_______ Dividend in arrears
_______ Dividend yield
_______ Financial leverage
_______ General partner
_______ General partnership
_______ Limited liability partnership
_______ Limited partners
_______ Limited partnership
_______ Minimum legal capital
_______ Mutual agency
_______ Noncumulative preferred stock
_______ No-par stock
_______ Organization costs
_______ Par value
_______ Participating preferred stock
_______ Partnership
_______ Partnership contract
_______ Preemptive right
_______ Preferred stock
_______ Premium on stock
_______ Proxy
_______ Stated value of no-par stock
_______ Stock subscription
_______ Unlimited liability of partners

1. An arbitrary amount assigned to no-par stock by the corporation's board of directors; this amount is credited to the no-par stock account when the stock is issued.
2. Preferred stock that the issuing corporation, at its option, may retire by paying a specified amount (the call price) to the preferred stockholders plus any dividends in arrears.
3. An amount of assets defined by state law that stockholders must invest and leave invested in a corporation; this provision is intended to protect the creditors of the corporation.
4. The right of common stockholders to protect their proportionate interest in a corporation by having the first opportunity to buy additional shares of common stock issued by the corporation.
5. The amount that must be paid to call and retire a preferred share.
6. Partners who have no personal liability for debts of the partnership beyond the amounts they have invested in the partnership.
7. The difference between the par value of stock and its issue price when it is issued at a price below par value.
8. A legal document that gives an agent of a stockholder the power to exercise the voting rights of that stockholder's shares.
9. The date on which a corporation actually disburses a cash dividend directly to the stockholders.
10. The costs of bringing a corporation into existence, including legal fees, promoters' fees, and amounts paid to the state to secure the charter.

11. A preferred stock that can be exchanged for shares of the issuing corporation's common stock at the option of the preferred stockholder.

12. Preferred stock on which undeclared dividends accumulate until they are paid; common stockholders cannot receive a dividend until all cumulative dividends have been paid.

13. A partnership in which all partners have unlimited liability for partnership debts.

14. Stock that gives its owners a priority status over common stockholders in one or more ways, such as the payment of dividends or the distribution of assets upon liquidation.

15. An arbitrary value assigned to a share of stock when the stock is authorized.

16. The difference between the par value of stock and its issue price when it is issued at a price above par value.

17. An unpaid dividend on cumulative preferred stock; it must be paid before any regular dividends on the preferred stock and before any dividends on the common stock.

18. Preferred stock that gives its owners the right to share in dividends in excess of the stated percentage or amount.

19. A contractual commitment by an investor to purchase unissued shares of stock and become a stockholder.

20. A partnership that has two classes of partners, limited partners and one or more general partners.

21. A preferred stock on which the right to receive dividends is forfeited for any year that the dividends are not declared.

22. The achievement of an increased return on common stock by paying dividends on preferred stock or interest at a rate that is less than the rate of return earned with the assets invested in the corporation by the preferred stockholders or creditors.

23. A partner who assumes unlimited liability for the debts of the partnership; in a limited partnership, the partner who is usually responsible for its management.

24. The legal relationship among the partners whereby each partner is an agent of the partnership and is able to bind the partnership to contracts within the apparent scope of the partnership's business.

25. One share's portion of the stockholders' equity recorded in the accounts.

26. The agreement between partners that sets forth the terms under which the affairs of the partnership will be conducted.

27. The legal relationship among general partners that makes each of them responsible for paying all the debts of the partnership if the other partners are unable to pay their shares.

28. A class of stock that does not have a par value; it can be issued at any price without creating a discount liability.

29. An unincorporated association of two or more persons to carry on a business for profit as co-owners.

30. The date on which a corporation's board of directors votes to pay a dividend; the dividend becomes a liability on this date.

31. A company's annual cash dividends per share divided by the market value per share.

32. A debit balance in the Retained Earnings account; this situation arises when a company's cumulative losses and dividends are greater than the cumulative profits earned in other years.

33. The date on which a corporation's records are examined to identify the stockholders who will receive a dividend.

34. A partnership in which each partner is not personally liable for malpractice claims unless the partner was responsible for providing the service that resulted in the claim.

Problem IV

Complete the following by filling in the blanks.

1. Organization costs are classified on the balance sheet as an ______________________________ asset. However, due to income tax rules organization costs are commonly written off over the first ______________________ years of a corporation's life.

2. Laws establishing minimum legal capital requirements were written to protect ________________ ____________________________, with the protection resulting from making illegal the payment of any dividends that reduce stockholders' equity below ______________________________________ .

3. When stock is issued at a price above its par value, the difference between par and the price at which the stock is issued is called a ____________________________________ .

4. Advantages claimed for no-par stock are: (a) It may be issued at any price without ________________________________ . (b) Uninformed persons buying such stock are not misled as to the stock's worth by a ___________________________ printed on the certificates.

5. Laws setting minimum legal capital requirements normally require stockholders to invest, in a corporation, assets equal in value to minimum legal capital or be contingently liable to ____ for the deficiency.

6. A preferred stock is so called because of the preferences granted its owners. The two most common preferences are a preference as to ____ ____ and a preference ____ ____ .

7. In many jurisdictions when a corporation issues par value stock, it establishes for itself a ____ equal to the par value of the issued stock.

8. In addition to its separate legal existence, other characteristics of a corporation as a form of business organization are ____ ____ ____ ____ ____ ____ .

9. A corporation is said to be a separate legal entity; this phrase means that in a legal sense a corporation is ____ ____ .

10. A ______________________ (limited, general) partnership has two classes of partners.

11. Blake and Dillon are partners who have always shared incomes and losses equally. Hester has sued the partners on a partnership debt and obtained a $12,000 judgment. The partnership and Dillon have no assets; consequently, Hester is attempting to collect the entire $12,000 from Blake. Blake has sufficient assets to pay the judgment but refuses, claiming she is liable for only one half the $12,000.

    Hester ______________________ (can, cannot) collect the entire $12,000 from Blake because ____.

12. Since a partnership is a voluntary association, an individual ______________________ (can, cannot) be forced against his will to become a partner; and since a partnership is based on a contract, its life is ______________________.

13. The fact that partners cannot enter into an employer-employee contractual relation with themselves supports the contention held in law and custom that partners work for partnership ______________________ and not for a salary. Furthermore, partners invest in a partnership for ______________________ and not for interest.

14. The phrase mutual agency, when applied to a partnership, means ____.

Problem V

The stockholders' equity section from Sonar Corporation's balance sheet shows the following:

CAPITAL STOCK AND RETAINED EARNINGS

Preferred stock, $100 par value, 8% cumulative and nonparticipating, issued and outstanding 2,000 shares	$200,000	
Common stock, $10 par value, issued and outstanding 25,000 shares	250,000	
Total contributed capital		$450,000
Retained earnings		230,000
Total stockholders' equity		$680,000

1. If there are no dividends in arrears, the book value per share of the corporation's preferred stock is $ ______________________, and the book value per share of its common stock is $ ______________________.

2. If a total of two years' dividends are in arrears on the preferred stock, the book value per share of the preferred stock is $ ______________________, and the book value per share of the common stock is $ ______________________.

Problem VI

A corporation accepted subscriptions to 25,000 shares of its $5 par value common stock at $5.50 per share. The subscription contracts called for 20% down payments with the balance in 30 days. The explanations for several entries involving this stock follow. Complete the entries.

DATE	ACCOUNT TITLES AND EXPLANATION	P.R.	DEBIT	CREDIT
Sept. 5				
	Accepted subscriptions to 25,000 shares of			
	common stock at $5.50 per share.			
5				
	Received $27,500 from the common stock sub-			
	scribers as down payments on their shares.			
Oct. 5				
	Received payment in full of the balance due on			
	the September 5 common stock subscriptions.			
5				
	Issued the common stock of the fully paid sub-			
	scribers.			