

# Notes Payable

## Debt and Equity Financing

Balance Sheet		
<b>Assets:</b>		<b>Liabilities and Stockholders' Equity:</b>
<b>Current Assets:</b>		<b>Current Liabilities:</b>
Cash	\$ xxx	Accounts Payable \$ xxx
Accounts receivable	xxx	Wages Payable xxx
Less: Allowance for Uncollectible A/R	(xxx)	Payroll Taxes Payable xxx
Inventories	xxx	
Prepaid Expenses	xxx	
	xxx	
<b>Long-Term Assets:</b>		<b>Long-Term Liabilities:</b>
Property and Equipment	xxx	?
Less: Accum. Dep'n.	(xxx)	
Intangibles	xxx	
	xxx	
<b>Total Assets:</b>	\$ xxx	<b>Stockholders' Equity:</b>
		?

## Long-Term Liabilities

### Long-Term Notes Payable

### Mortgage Notes Payable

### Bonds Payable

### Lease Liabilities

### Deferred Income Taxes Payable

### Pension Liabilities

## Long-Term Liabilities

### Long-Term Note Payable:

**Example:** \$100,000 is borrowed from the bank on **9/1/X5**. The note bears 8% annual interest payable every six months and matures in three years.

Entry at **9/1/X5**:

Cash	100,000	
Note Payable		100,000

Adjusting entry at **12/31/X5**: (Interest:  $100,000 \times .08 \times 4/12 = 2,666.66$ )

Interest Expense	2,667	
Interest Payable		2,667

**Entry at 3/1/X6:** (Interest:  $100,000 \times .08 \times 6/12 = 4,000.00$ )  
 (Interest:  $100,000 \times .08 \times 2/12 = 1,333.33$ )

Interest Payable	2,667	
Interest Expense	1,333	
Cash	4,000	

**Entry at 9/1/X6:** (Interest:  $100,000 \times .08 \times 6/12 = 4,000.00$ )

Interest Expense	4,000	
Cash		4,000

**Adjusting entry at 12/31/X6:** (Interest:  $100,000 \times .08 \times 4/12 = 2,666.66$ )

Interest Expense	2,667	
Interest Payable		2,667

**Interest recorded for the entire year 'X6:**

3/1/X6:	\$ 1,333
9/1/X6:	4,000
12/31/X6:	2,667
	\$ 8,000 (100,000 x .08 x 1 = \$8,000)

**Entry at maturity 9/1/X8:**

Interest Expense	4,000	
Cash		4,000

Note Payable	100,000	
Cash		100,000

# Notes Payable

**Problem: Note Payable**

On **5/1/X4**, \$15,000 cash is borrowed from a local bank under a note bearing interest at 12% payable annually on **5/1/X5** and **5/1/X6**. The principal amount is due at maturity, **5/1/X6**.

- Prepare all the journal entries required throughout the life of the note assuming all principal and interest payments are made on a timely basis. (Do not forget the adjusting entries required for interest expense at **12/31/X4** and **12/31/X5** in order to properly prepare financial statements on those dates.)
- Determine the amount of interest expense recognized under the note in each year **20X4**, **'X5**, and **'X6** along with the total interest expense recognized over the entire term of the note.

**Solution: Note Payable**

**A. 5/1/X4:**

Cash	15,000	
Note Payable		15,000

**12/31/X4 Adjusting Entry:** (May 1st - Dec. 31st)

Interest Expense	1,200	
Interest Payable		1,200

$$(\$15,000 \times .12 \times 8/12 = \$1,200)$$

**5/1/X5:** (Date first interest payment due)

Interest Payable	1,200	
Interest Expense	600	
Cash		1,800

$$(\$15,000 \times .12 \times 12/12 = \$1,800)$$

$$(\$15,000 \times .12 \times 4/12 = \$600)$$

**Solution: Note Payable**

**12/31/X5 Adjusting Entry:**

Interest Expense	1,200	
Interest Payable		1,200

$$(\$15,000 \times .12 \times 8/12 = 1,200)$$

**5/1/X6:** (Maturity)

Interest Payable	1,200	
Interest Expense	600	
Cash		1,800

$$(\$15,000 \times .12 \times 12/12 = 1,800)$$

Note Payable	15,000	
Cash		15,000

**Solution: Note Payable**

**B. Interest Expense:**

<u>Year</u>	<u>Interest Expense</u>
<b>20X4</b>	(8 mos. <b>5/1 - 12/31</b> ) <b>\$1,200</b>
<b>20X5</b>	(12 mos. <b>1/1 - 12/31</b> ) <b>1,800</b>
<b>20X6</b>	(4 mos. <b>1/1 - 5/1</b> ) <b>600</b>
	<b><u>\$3,600</u></b>

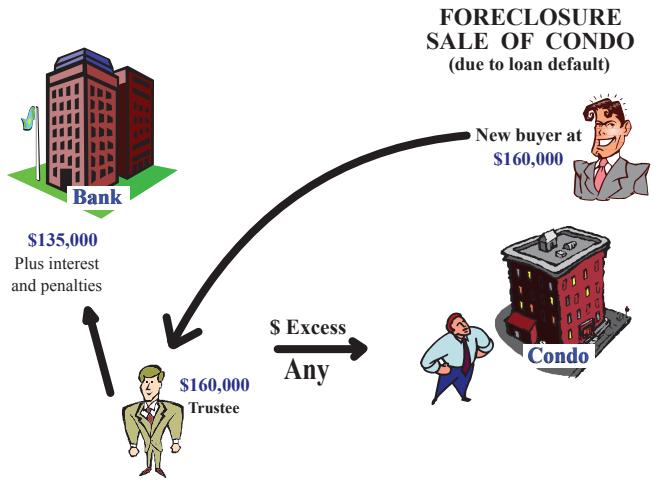
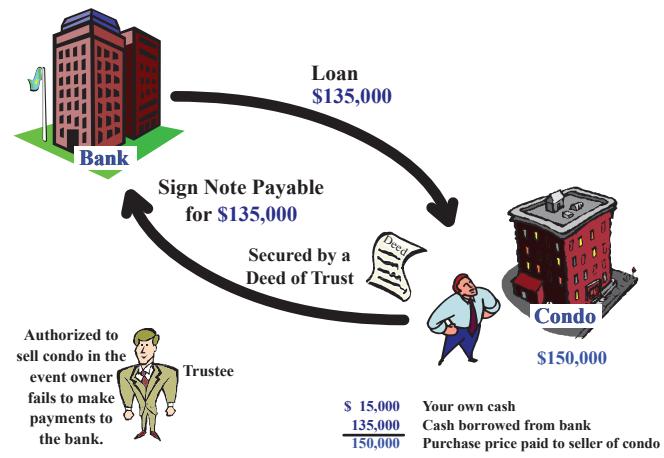
$$(\$15,000 \times .12 \times 24/12 = \$3,600)$$

# Mortgage Notes Payable

## Mortgage Note Payable:

A mortgage note payable is a loan or note payable for which real estate (land and/or building) has been pledged as collateral or security through a legal document referred to as a trust deed. A trust deed authorizes a third party to sell the property, in the event of default on the note payable, and disburse the proceeds from the sale to the lender.

Mortgage Notes Payable are usually created in conjunction with the purchase of real estate.



## Common Characteristics of Mortgage Notes Payable:

1. Typically long-term (15, 25 or 30 years)
2. Typically bears a fixed or adjustable rate of interest.
3. Typically requires a monthly payment (fixed in amount or adjustable) which includes not only the monthly interest due, but a portion of the principal such that by maturity, the entire amount of principal will have been repaid in full (fully amortizing note).
4. Most mortgage notes provide that monthly payments be applied first to any interest due at the time of payment with any excess paid to be applied to principal.

**Example:** On **4/1/X7**, real estate is purchased for **\$300,000** (land and building valued at **\$50,000** and **\$250,000**, respectively) with the price paid in cash (**\$30,000**) and the execution of a mortgage note payable (**\$270,000**). Record the transaction:

**4/1/X7:**

Land	50,000	
Building	250,000	
Cash		30,000
Mortgage Note Payable		270,000

Assume that the **\$270,000** mortgage note payable is a fully amortizing mortgage over 30 years and bears **9%** annual interest compounded monthly, with monthly payments of **\$2,172.48** payable on the 1st of each month beginning **5/1/X7** for the next 30 years.

### Entry for 1st payment at 5/1/X7:

(Interest:  $270,000 \times .09 \times 1/12 = 2025.00$ )

Interest Expense	2,025.00
Mortgage Note Payable	147.48
Cash	2,172.48
Mortgage Note Payable	270,000
147.48	
<hr/>	
	269,852.52

# Mortgage Notes Payable

## Entry for second payment on 6/1/X7:

(Interest:  $269,852.52 \times .09 \times 1/12 = 2,023.89$ )

Interest Expense	<b>2,023.89</b>	
Mortgage Note Payable	<b>148.59</b>	
Cash		<b>2,172.48</b>

<b>Mortgage Note Payable</b>	
	<b>270,000</b>
<b>147.48</b>	
<b>148.59</b>	
	<b>269,703.93</b>

## Mortgage Amortization Schedule

<b>Month</b>	<b>Monthly Payment</b>	<b>Beginning Principal Balance</b>	<b>Interest Portion</b>	<b>Principal Portion</b>
1	2,172.48	270,000.00	2,025.00	147.48
2	2,172.48	269,852.52	2,023.89	148.59
3	2,172.48	269,703.93	2,022.78	149.70
4	2,172.48	269,554.23	2,021.66	150.82
5	2,172.48	269,403.41	2,020.53	151.95
6	2,172.48	269,251.46	2,019.39	153.09
7	2,172.48	269,098.37	2,018.24	154.24
8	2,172.48	268,944.13	2,017.08	155.40
358	2,172.48	6,420.86	48.16	2,124.32
359	2,172.48	4,296.54	32.22	2,140.13
360	2,172.48	2,156.28	16.17	2,156.28
<b>Totals</b>			<b>512,093</b>	<b>270,000</b>

## How do you build equity in real estate?

(In this context, equity means the amount of cash left to the owner in the event of sale of property.)

### Purchase of property:

Cash down (equity)	<b>\$ 30,000</b>
Mortgage note payable	<b>270,000</b>
<b>Total purchase price</b>	<b>\$ 300,000</b>

### Cash proceeds upon sale after two months (assume no selling costs):

Sales price	<b>\$ 300,000</b>
Payoff of mortgage note payable	<b>(269,704)</b>
<b>Net cash upon sale</b>	<b>\$ 30,296</b>

### Build up in equity over two months:

Cash proceeds upon sale	<b>\$ 30,296</b>
Cash invested upon purchase	<b>(30,000)</b>
<b>Build up in equity (cash)</b>	<b>\$ 296</b>

**\$ 296** = Principal portion of monthly mortgage payments for two months.

Most build up in equity on real estate comes from appreciation in property value over time.

### Assume the property is sold after one year.

Sales price	<b>\$ 330,000</b>
Less: Selling costs (7%)	<b>(23,100)</b>
Net sales price	<b>306,900</b>
Payoff of note payable	<b>(268,155)</b>
<b>Net cash upon sale</b>	<b>\$ 38,745</b>

### Build up in Equity for the year:

Cash received upon sale	<b>\$ 38,745</b>
Cash invested at purchase	<b>(30,000)</b>
<b>Build up in equity</b>	<b>\$ 8,745</b>

### What caused this \$8,745 build up in equity?

#### Appreciation in value:

Net sales price	<b>\$ 306,900</b>
Less: Original cost	<b>300,000</b>
<b>Net appreciation</b>	<b>\$ 6,900</b>

#### Plus: Payments of principal on the note during the year:

<b>(270,000 - 268,155)</b>	<b>\$ 1,845</b>
<b>Build up in equity</b>	<b>\$ 8,745</b>

# Mortgage Notes Payable

## Problem: Mortgage Note Payable

A building, including the land upon which it sits, is purchased on **7/1/X2** for **\$400,000** with **10%** of the price paid for in cash and the remainder through the execution of a Mortgage Note Payable. The mortgage note bears an **8%** fixed interest rate compounding monthly for **30** years and is fully amortizing with monthly payments of **\$2,641.55** due on the 1st of each month beginning on **8/1/X2**.

- A. Prepare the journal entry to record the purchase of the land and building on **7/1/X2**. (Assume that the land is valued at **20%** of the total price.)
- B. Why would allocation of the purchase price between land and building be important for financial reporting and income tax purposes?
- C. Prepare the **8/1/X2** and **9/1/X2** entries to record the monthly mortgage payments on those dates.

## Problem: Mortgage Note Payable

D. Determine the balance of the Mortgage Note Payable on **9/1/X2** following the monthly payment on that date.

E. What would be the effect if monthly payments in excess of **\$2,641.55** were periodically made?

## Solution: Mortgage Note Payable

A building, including the land upon which it sits, is purchased on **7/1/X2** for **\$400,000** with **10%** of the price paid for in cash and the remainder through the execution of a Mortgage Note Payable. The mortgage note bears an **8%** fixed interest rate compounding monthly for **30** years and is fully amortizing with monthly payments of **\$2,641.55** due on the 1st of each month beginning on **8/1/X2**.

- A. Prepare the journal entry to record the purchase of the land and building on **7/1/X2**. (Assume that the land is valued at **20%** of the total price.)

Land	80,000	
Building	320,000	
Mortgage Note Payable	360,000	
Cash	40,000	

## Solution: Mortgage Note Payable

B. Why would allocation of the purchase price between land and building be important for financial reporting and income tax purposes?

Land is not depreciable. The greater the allocation to the building, which is depreciable, the higher the depreciation expense and lower resulting net income for financial reporting purposes. This would also result in lower income taxes.

## Solution: Mortgage Note Payable

- C. Prepare the **8/1/X2** and **9/1/X2** entries to record the monthly mortgage payments on those dates.

**8/1/X2:**

Interest Expense	2,400.00	
Mortgage Note Payable	241.55	
Cash	2,641.55	

**9/1/X2:**

Interest Expense	2,398.39	
Mortgage Note Payable	243.16	
Cash	2,641.55	

## Solution: Mortgage Note Payable

D. Determine the balance of the Mortgage Note Payable on **9/1/X2** following the monthly payment on that date.

Mortgage Note Payable		
		360,000 7/1/X2
8/1/X2	241.55	
9/1/X2	243.16	
<hr/>		
359,515.29		

## Mortgage Notes Payable

### Solution: Mortgage Note Payable

E. What would be the effect if monthly payments in excess of \$2,641.55 were periodically made?

The term of the note would be shortened. The note would be paid off in less than 30 years.

# Bonds Payable

## Bonds

Bonds are Notes Payable arising from the borrowing of cash from the public.

**Example:** On **11/1/X3**, XYZ Corporation issued **\$1,000,000** of cash through bonds issued at face value, bearing interest at an annual rate of 7% payable semi-annually on **5/1** and **11/1** of each year through maturity at **11/1/X6**.

### Entry at 11/1/X3:

Cash	<b>1,000,000</b>	
Bonds Payable		<b>1,000,000</b>

### Adjusting Entry at 12/31/X3:

(Interest:  $1,000,000 \times .07 \times 2/12 = 11,667$ )

Interest Expense	<b>11,667</b>	
Interest Payable		<b>11,667</b>

**Entry at 5/1/X4:** (Interest:  $1,000,000 \times .07 \times 6/12 = 35,000$ )  
 (Interest:  $1,000,000 \times .07 \times 4/12 = 23,333$ )

Interest Payable	<b>11,667</b>	
Interest Expense		<b>23,333</b>
Cash		<b>35,000</b>

### Entry at 11/1/X4:

Interest Expense	<b>35,000</b>	
Cash		<b>35,000</b>

### Entry at Maturity, 11/1/X6:

Bonds Payable	<b>1,000,000</b>	
Cash		<b>1,000,000</b>
Interest Expense		<b>35,000</b>
Cash		<b>35,000</b>

## Common Terms Associated with Bonds

**Bond Indenture:** The written contract that spells out the legal terms and conditions of the obligations of the bond issuer and the rights of the bondholders.

**Debentures:** Unsecured bonds.

**Secured or Mortgage-Backed Bonds:** Bonds for which property or real estate are specified as collateral.

**Junk Bonds:** Unsecured bonds issued by companies with low credit ratings.

**Senior or Subordinated Bonds:** Typically unsecured bonds that are designated as having priority or subordinated rights to other unsecured creditors.

**Term Bonds:** Bonds that require principal repayment in full at maturity.

**Serial Bonds:** Bonds that require principal repayment periodically throughout the term of the bond.

**Convertible Bonds:** Bonds which may be converted to other securities, such as stock, after a specified period of time, at the option of the bondholder.

**Callable Bonds:** Bonds which can be paid off prior to maturity at the option of the company issuing the bonds.

**Bonds issued at a premium or a discount:** Bonds which are issued for cash in an amount greater or less than the face amount or principal of the note.

**Bond Exchange:** A market where bondholders may sell their bonds to other investors.

### Problem: Bonds Payable

On **8/1/X3**, a company borrows **\$10,000,000** cash from the public through the issuance of bonds that mature in three years and bear interest at a rate of **9%**. The interest is payable quarterly.

a. Prepare the journal or adjusting entries required to record:

**8/1/X3:** The issuance of the bonds at their face value of **\$10,000,000**

**11/1/X3:** The quarterly interest payment

**12/31/X3:** The adjusting entry for interest expense

**2/1/X4:** The quarterly interest payment

**8/1/X6:** The final quarterly interest payment and payoff of the principle amount of the bonds

### Problem: Bonds Payable

- b. What entry would the company make on their books if a bondholder owning **\$10,000** of the bond sold that bond to an investor through the New York Bond Exchange at a price of **\$10,500**?

# Bonds Payable

Solution: Bonds Payable

- a. **8/1/X3:** The issuance of the bonds at their face value of \$10,000,000

Cash	10,000,000	
Bonds Payable		10,000,000

**11/1/X3:** The quarterly interest payment

Interest Expense	225,000	
Cash		225,000

(Interest:  $10,000,000 \times .09 \times 3/12 = 225,000$ )

**12/31/X3:** The adjusting entry for interest expense

Interest Expense	150,000	
Interest Payable		150,000

(Interest:  $10,000,000 \times .09 \times 2/12 = 150,000$ )

Solution: Bonds Payable

- a. (continued)

- 2/1/X4:** The quarterly interest payment

Interest Payable	150,000	
Interest Expense	75,000	
Cash		225,000

(Interest:  $10,000,000 \times .09 \times 1/12 = 75,000$ )

- 8/1/X6:** The final quarterly interest payment and payoff of the principle amount of the bonds

Interest Expense	225,000	
Bond Payable	10,000,000	
Cash		10,225,000

Solution: Bonds Payable

- b. No entry on the company's books.

# Common Stock

## Financing of a Business

(Obtaining resources necessary to operate a business)

### 1. Debt Financing (Borrowing):

- Accounts Payable
- Notes Payable
- Bonds Payable
- Other Payables

### 2. Equity Financing (Investor/Owners):

- Capital Contributions
- (Capital Stock)
- Retained Earnings

## Two Basic Forms of Corporate Ownership or Capital Stock

**Common Stock:** The basic form of ownership for all corporations. Common stockholders have the right to vote in corporate matters (ie. election of a board of directors), the right to share equally per share in corporate profits paid out as dividends and any distributions to owners in the event of business termination. All companies issue common stock and are controlled or owned by the common stockholders or owners.

**Preferred Stock:** A supplemental form of ownership which provides certain preferential but limited rights to those of common shareholders. Preferred shareholder's typically have no voting rights but have a limited priority right over common shareholders to dividends and distributions in the event of termination. Many companies do not issue preferred stock, but it is an option available in the financing of a business.

## Common Stock

**Example:** A company issues **10,000** shares of **\$ .01** par value common stock for **\$50** per share.

Cash	<b>500,000</b>	
Common Stock, at par ( <b>.01</b> ) per share		<b>100</b>
Paid in Capital in Excess of Par, Common Stock		<b>499,900</b>

### Balance Sheet

#### Stockholders' Equity:

Contributed Capital:	
Common Stock, <b>.01</b> Par Value	<b>\$100</b>
Paid in Capital in Excess of Par, Common Stock	<b>499,900</b>
	<b>\$500,000</b>
Retained Earnings	<b>250,000</b>
Total Stockholders' Equity	<b>\$750,000</b>

**Example:** A company issues **10,000** shares of **\$ .01** stated value common stock for **\$50** per share.

Cash	<b>500,000</b>	
Common Stock, at Stated Value ( <b>.01</b> ) per share		<b>100</b>
Paid in Capital in Excess of Stated Value, Common Stock		<b>499,900</b>

### Balance Sheet

#### Stockholders' Equity:

Contributed Capital:	
Common Stock, <b>.01</b> Stated Value	<b>\$100</b>
Paid in Capital in Excess of Stated Value, Common Stock	<b>499,900</b>
	<b>\$500,000</b>
Retained Earnings	<b>250,000</b>
Total Stockholders' Equity	<b>\$750,000</b>

**Example:** A company issues **10,000** shares of no par value common stock for **\$50** each in cash.

Cash	<b>500,000</b>	
Common Stock (no Par Value)		<b>500,000</b>

### Balance Sheet

#### Stockholders' Equity:

Contributed Capital:	
Common Stock	<b>\$500,000</b>
Retained Earnings	<b>250,000</b>
Total Stockholders' Equity	<b>\$750,000</b>

# Preferred Stock

## Disadvantages in raising capital through the issuance of common stock:

1. Others are given a vote and say in the business.
2. Others are given rights to participate in the monetary benefits of ownership (dividends, increased stock values, and proceeds in the event of liquidation).

## Disadvantages of raising capital through debt:

1. Capital borrowed (principal) must be paid back plus interest at scheduled times regardless of operating performance and ability to pay.
2. Potential forced liquidation of assets in the event of default.

## Preferred Stock

**Preferred Stock** is a form of equity ownership that is designed to avoid the disadvantages of common stock without becoming debt that has to be repaid in the future.

### Preferred Stock is:

1. typically non-voting,
2. limited in the sharing of dividend distributions,
3. reflected as "owners equity" on the balance sheet because the company is not required to repay the amount of capital contributed by preferred shareholders except in the event of business termination.

## Why would anyone ever make capital contributions to a company in exchange for preferred stock?

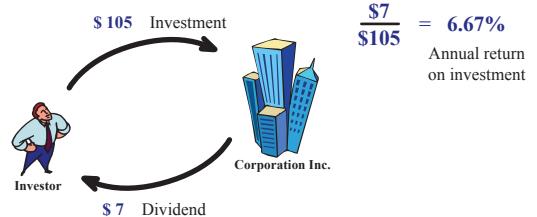
1. Preferred shareholders have dividend limitations but they also have dividend preferences over common shareholders.
2. Preferred shareholders have preferences in the distribution of assets in the event of business termination.
3. Some tax benefits to corporate investors.

## How is the dividend preference determined?

**Example:** In addition to **10,000** shares of no par value common stock issued at **\$50** per share, the company issues **5,000** shares of **7%, \$100** par value preferred stock for **\$105** per share.

Cash		525,000
Preferred Stock		525,000

$$.07 \times \$100 = \$7 \text{ per share, per year}$$



## How does a preferred shareholder ever get their money (investment) back?

1. Wait until the business terminates.
2. Sell to other investors.

### Problem: Issuing Stock

The Asay Co. wishes to raise **\$100,000** of cash from investors (equity financing). Prepare the journal entry that would be appropriate for each of the following independent scenarios:

- a. Issue **10,000** shares of **.01** par value common stock for **\$100,000** cash.
- b. Issue **10,000** shares of **.01** stated value common stock for **\$100,000** cash.
- c. Issue **10,000** shares of no par common stock for **\$100,000** cash.
- d. Issue **5,000** shares of **6% \$15** par value preferred stock for **\$100,000** cash.

Calculate the annual dividend preference for the **5,000** shares of preferred stock under D above.

## Preferred Stock

### Solution: Issuing Stock

a.	Cash Common Stock, Par Value Paid-In Capital in Excess of Par, Common Stock	100,000	100	99,900
b.	Cash Common Stock Stated Value Paid-In Capital in Excess of Stated Values, Common Stock	100,000	100	99,900
c.	Cash Common Stock	100,000	100,000	
d.	Cash Preferred Stock, Par Value Paid-In Capital in Excess of Par, Preferred Stock	100,000	75,000	25,000

Dividend preference for Preferred Stock:  $75,000 \times .06 = \$4,500$  annually

# Dividend Payments

## The Process of Dividend Declaration and Payment

**Example:** On **11/1/X5** the company's Board of Directors meet and declare a total dividend of **\$100,000** to be paid to shareholders of record as of **12/1/X5** with actual payment to be made on **1/1/X6**.

### Entry at **11/1/X5** (Date of Declaration):

Dividends, Preferred Stock	<b>35,000</b>	
Dividends, Common Stock	<b>65,000</b>	
Dividends Payable	<b>100,000</b>	

**Note:** Preferred shareholders will receive **\$7** for every share of stock held and the common shareholders will receive **\$6.50** ( $\$65,000 \div 10,000$  shares) for every share held.

### Entry at **12/1/X5** (Date of Record):

No Entry

### Entry at **11/1/X5** (Date of Declaration):

Dividends, Preferred Stock	<b>35,000</b>	
Dividends, Common Stock	<b>65,000</b>	
Dividends Payable	<b>100,000</b>	

### Entry at **12/1/X5** (Date of Record):

No Entry

### Closing Entry at **12/31/X5**:

Retained Earnings	<b>100,000</b>	
Dividends, Preferred Stock		<b>35,000</b>
Dividends, Common Stock		<b>65,000</b>

### Entry at **11/1/X6** (Date of Payment):

Dividends Payable	<b>100,000</b>	
Cash		<b>100,000</b>

Assume only **\$20,000** of dividends had been declared on **11/1/X5**

### Entry at **11/1/X5** (Date of Declaration):

Dividends, Preferred Stock	<b>20,000</b>	
Dividends Payable		<b>20,000</b>

Dividend Preference:  $7\% \times \$100 \times 5,000$  shares = **\$35,000**

Do the preferred shareholders have any ongoing future rights to the **\$15,000** deficiency in current year dividends?

- If preferred stock is designated as "cumulative," shareholders have an ongoing carryover preference for any prior year dividend shortfalls referred to as "dividends in arrears."
- "Non-cumulative" preferred stock has no carryover rights on dividend shortages in any year.

How are the rights of preferred shareholders to dividends in arrears disclosed in the financial statements?

- Are they a liability? **NO!**
- Dividends in arrears are disclosed in the footnotes to the financial statements.

**Example:** If dividends in arrears on the cumulative preferred stock in the prior example amount to **\$15,000** in **20X5**, and declared dividends for **20X6** amount to **\$75,000**, how much would go to the preferred versus common shareholders?

#### Preferred Dividend:

20X5 arrears of	<b>\$ 15,000</b>
20X6 preference	<b>35,000</b>
<b>Total Dividend</b>	<b>\$ 50,000</b>

#### Common Dividend: **\$ 25,000**

How much goes to the Preferred vs. Common Shareholders if a **\$10,000,000** dividend was declared?

Preferred - \$50,000      Common - \$9,950,000

What kind of stock (Preferred vs. Common) would an aggressive investor looking to maximize profits prefer to own?

- Common Stock

### Problem: Dividend Dates

Prepare the journal entries for Smith Co. for the following events:

- 11/1/X7** - The board of directors declares a **\$100,000** cash dividend payable to common shareholders with a date of record of **12/1/X7** and date of payment scheduled for **1/1/X8**.
- 12/1/X7** - Date of record noted.
- 12/31/X7** - Closing entry made.
- 1/1/X8** - payment of **\$100,000** cash dividend made prorata to all common shareholders.

### Solution: Dividend Dates

- Dividends, Common Stock      **100,000**  
Dividends Payable                  **100,000**
- No entry.
- Retained Earnings      **100,000**  
Dividends, Common Stock                  **100,000**
- Dividends, Payable      **100,000**  
Cash                          **100,000**

# Dividend Payments

## Problem: Dividend Calculations

Given the following capital structure for the years **20X3**, **20X4**, and **20X5**:

Preferred Stock, <b>7% \$20</b>	
par value, <b>50,000</b> shares	<b>\$1,000,000</b>
Common Stock, <b>\$.50</b>	
par value, <b>100,000</b> shares	<b>50,000</b>
Paid in Capital in Excess of Par,	
Preferred Stock	<b>100,000</b>
Paid in Capital in Excess of Par,	
Common Stock	<b>2,000,000</b>

Calculate the total amount of dividends to be distributed to the preferred vs. common stockholders in each year if the total dividend amounts to **\$100,000** in **20X3**, **\$50,000** in **20X4** and **\$500,000** in **20X5** under the following two assumptions:

- A. The preferred stock is non-cumulative.
- B. The preferred stock is cumulative and dividends in arrears at **12/31/X2** amount to **\$100,000**.

**Question:** Should preferred dividends in arrears at the end of an accounting period be reflected as a liability on the balance sheet? Why?

## Solution: Dividend Calculations

Calculate the total amount of dividends to be distributed to the preferred vs. common stockholders in each year if the total dividend amounts to **\$100,000** in **20X3**, **\$50,000** in **20X4** and **\$500,000** in **20X5** under the following two assumptions:

- A. The preferred stock is non-cumulative.

	<b>20X3</b>	<b>20X4</b>	<b>20X5</b>
Preferred stock:	<b>\$70,000</b>	<b>\$50,000</b>	<b>\$70,000</b>
Common stock:	<b>\$30,000</b>	<b>0</b>	<b>\$430,000</b>

## Solution: Dividend Calculations

Calculate the total amount of dividends to be distributed to the preferred vs. common stockholders in each year if the total dividend amounts to **\$100,000** in **20X3**, **\$50,000** in **20X4** and **\$500,000** in **20X5** under the following two assumptions:

- B. The preferred stock is cumulative and dividends in arrears at **12/31/X2** amount to **\$100,000**.

	<b>20X3</b>	<b>20X4</b>	<b>20X5</b>
Preferred Stock: Arrears	<b>\$ 100,000</b>	<b>\$ 50,000</b>	<b>\$ 90,000</b>
Current Preference	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 70,000</b>
Common Stock	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 340,000</b>

Preferred Dividends in Arrears @ Year End **\$ 70,000**    **\$ 90,000**    **\$ 0**

**Answer:** Preferred dividends in arrears are not to be reflected as a liability on the balance sheet because a company has no legal obligation to ever pay dividends unless the board of directors officially declares a dividend distribution. The amount of dividends in arrears is typically disclosed in the footnotes to the financial statements.