FINANCIAL ACCOUNTING

LO1: IDENTIFY THE ACTIVITIES AND USERS ASSOCIATED WITH ACCOUNTING

Accounting: The information system that **identifies**, **records**, and **communicates** the economic events of an organization to interested users.

Two Main Types of Users:

1. **Internal Users**: Managers who plan, organize, and run a business.

Examples: Marketing managers, production supervisors, finance directors, and company officers.

2. **External Users**: Includes **investors** who use accounting information to make decisions to buy, hold, or sell stock and **creditors** who use the accounting information to evaluate the risks of selling on credit or lending money.

Other Examples: Taxing Authorities (Ex: IRS), customers, labor unions, and regulatory agencies (Ex: Securities and Exchange Commission (SEC)).

LO2: EXPLAIN THE BULDING BLOCKS OF ACCOUNTING: ETHICS, PRINCIPLES, AND ASSUMPTIONS

Ethics In Financial Reporting

Sarbanes-Oxley Act (SOX): Passed by congress to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX….

1. Top management must now certify the accuracy of financial information.
2. Penalties for fraudulent financial activity are much more severe.
3. The independence of the outside auditors who review the accuracy of corporate financial statements and the oversight role of the board of directors has increased.

Standard-Setting Environment

1. GAAP: (Generally Accepted Accounting Principles) rules and concepts that govern financial accounting. It attempts to make information RELEVANT, RELIABLE, and COMPARABLE.

Standard-setting bodies that determine these guidelines:

- **SEC (Securities and Exchange Commission):** oversees the U.S. financial markets and accounting standard-setting bodies.
- **FASB (Financial Accounting Standards Board):** The primary accounting standard-setting body in the United States.
- **IASB (International Accounting Standards Board):** The primary accounting standard-setting body for countries outside the united States that use International Financial Reporting Standards (IFRS).

- **PCAOB (Public Company Accounting Oversight Board)**: Determine the auditing standards and review performance of auditing firms.

2. **Characteristics of Financial Information**: Financial information needs to be **USEFUL** to investors and creditors for making decisions about providing capital. **Useful information possesses two important qualities…**

   1. **RELEVANCE:** Has the potential to impact decision making. Information is relevant if it has…
      - **Predictive Value:** helps provide accurate expectations about the future.
      - **Confirmatory Value:** confirms or corrects prior expectations.
      - **Materiality:** when its size makes it likely to influence the decision of an investor or creditor.

   2. **FAITHFUL REPRESENTATION**: The information accurately reflects an entity's economic activity or condition. To provide a faithful representation, information must be…
      - **Complete:** nothing important has been omitted.
      - **Neutral:** is not biased toward one position or another.
      - **Free from Error:** no errors or omissions in amounts and process used to report amounts.

3. **Accounting Principles:** ***MEASUREMENT PRINCIPALS***
   - ***Historical Cost Principle****:* *A*ccounting information is based on actual cost. Cost is measured on a cash or equal to cash basis. (Ex: Bob bought equipment for $15,000 so the equipment should be valued at $15,000). **In generally, most assets have to be valued using the historical cost principle.**

   - ***Fair Value Principle****:* Indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). **Only in situations where assets are actively traded, such as investment securities, is the fair value principle applied.**

4. **2 Main Assumptions in the Accounting Process**
   - ***MONETARY UNIT ASSUMPTION:*** stable monetary unit of measure used in U.S. financial statements such as the U.S. dollar.
   - ***ECONOMIC ENTITY ASSUMPTION:*** business is accounted for separately from other business entities, including its owner.

TYPES OF BUSINESS ENTITIES

1. **Sole Proprietorship**: business owned by ONE PERSON and that person and company are viewed as ONE entity for tax and liability purposes. For example, if a customer sues Bill who owns the proprietorship, the court can order Bill to sell his personal belongings including his house to settle the debt.
   - Simple to establish
   - Owner controlled
   - Tax advantages

2. **Partnership**: owned by TWO OR MORE PEOPLE who are JOINTLY liable for tax and other obligations. Like a proprietorship, partnerships are NOT LEGALLY SEPARTE from owners. Each partner's share of profits is reported and taxed on that partner's tax return.
   - Simple to establish
   - Shared control
   - Broader skills and resources
   - Tax advantages

3. **Corporation**: a business legally separate from its owner or owners, meaning it is responsible for its own acts and its own debts. A corporation is owned by shareholders who are NOT personally liable for corporate acts and debts. A corporation acts through its managers.
   - Easier to transfer ownership
   - Easier to raise funds
   - No personal liability
   - A major disadvantage is that corporations face **double taxation** (The corporation is taxed as a separate entity and the owner's (stockholders) are taxed on any earnings distributed to them from the corporation.

Attribute Present	Proprietorship	Partnership	Corporation
One owner allowed	YES	NO	YES
Business taxed	NO	NO	YES
Limited liability	NO*	NO*	YES
Business entity	YES	YES	YES
Legal entity	NO	NO	YES
Unlimited life	NO	NO	YES

*A proprietorship or partnership that is set up as an LLC (Limited Liability Corporation) has limited liability. **(LLCs are talked about more in business law courses)**

LO 3: STATE THE ACCOUNTING EQUATION, AND DEFINE IT COMPONENTS

The two basic elements of a business are what it **owns** and what it **owes**. Assets are the resources a business owns.

Liabilities and stockholders' equity are the rights or claims against these resources.

The Basic Accounting Equation: Assets = Liabilities + Stockholders' Equity

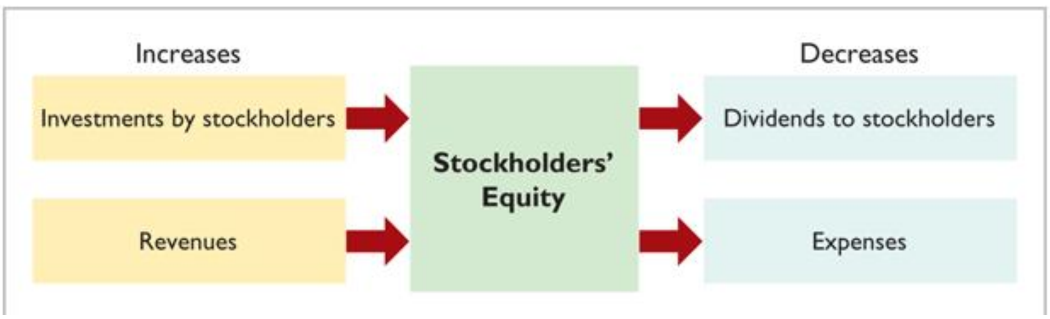
This relationship is the basic accounting equation. Assets must equal the sum of liabilities and stockholders' equity. The equation provides the underlying framework for recording and summarizing economic events

Assets - resources a business **owns**. The business uses its assets in carrying out such activities as production and sales.

Liabilities -claims against assets—existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts.

Stockholders' Equity The ownership claim on a corporation's total assets is stockholders' equity

- **Common Stock** A corporation may obtain funds by selling shares of stock to investors. Common stock is the term used to describe the total amount paid in by stockholders for the shares they purchase.
- **Retained Earnings** determined by three items: revenues, expenses, and dividends.
  - **Revenues** are the increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business.
  - **Expenses** are the cost of assets consumed or services used in the process of generating revenue.
  - **Dividends** Net income represents an increase in net assets which are then available to distribute to stockholders.



LO 4: ANALYZE THE EFFECT OF BUSINESS TRANSACTIONS ON THE BASIC ACCOUNTING EQUATION

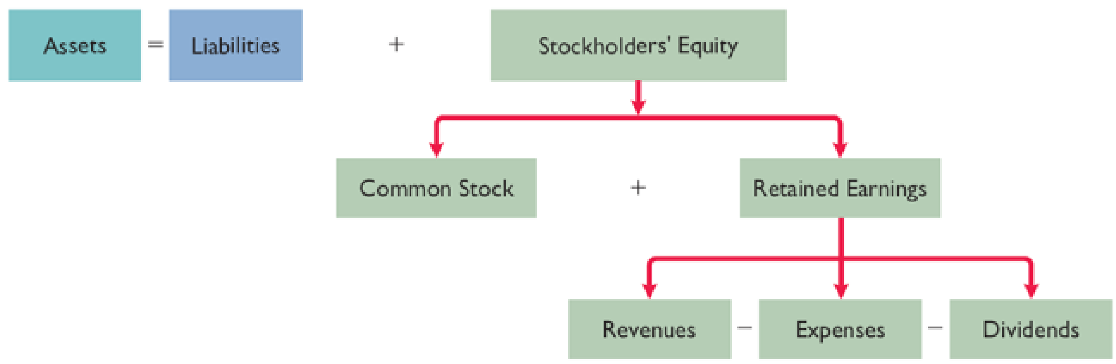
THE ACCOUNTING INFORMATION SYSTEM

- **Accounting Information System:** system of **collecting**, **processing** transaction data, and **communicating** financial information to decision makers.
  - Rely on the **accounting process.**
    1. Analyze business transactions
    2. Journalize
    3. Post
    4. Trial Balance
    5. Adjusting Entries
    6. Adjusted Trial Balance
    7. Financial Statements
    8. Closing Entries

9. Post-Closing Trial Balance

- **Transactions:** economic events that require recording in the financial statements.
  - Assets, liabilities, or stockholders' equity items change as a result of some economic event.
  - **Dual effect** on the accounting equation **(Assets = Liabilities + Stockholders' Equity)**
  - Not all activities represent transactions.
  - Ex: The payment of rent, purchase of a building, and sale of goods all represented transactions that need to be recorded.

ANALYZING TRANSACTIONS



When analyzing transactions keep in mind........

- **The accounting equation MUST ALWAYS <u>BALANCE</u>.**
- **The cause of each change in stockholders' equity must be indicated.**

Example Business Transactions (From Smith Inc.): Keep A = L + SE in Balance

1. **Smith Inc. receives $30,000 cash from investors in exchange for common stock.**

Assets go UP **(Cash goes UP)**
Stockholders' Equity goes UP **(Common Stock goes UP)**

	Assets =				Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		

2. **Smith Inc. pays $4,000 for supplies.**

Assets go UP **(Supplies goes UP)**
Assets go DOWN **(Cash goes DOWN)**

	Assets =				Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		
2	($4,000)	$4,000						

3. **Smith Inc. provides consulting services and immediately collects $4,200 cash.**

Assets go UP **(Cash goes UP)**
Stockholders' Equity goes UP **(Revenue goes UP)**

	Assets =				Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		
2	($4,000)	$4,000						
3	$4,200						$4,200	

4. **Smith Inc. pays $1,000 cash for employee salary.**

Stockholders' Equity goes DOWN **(Expenses go UP)**

	Assets =				Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		
2	($4,000)	$4,000						
3	$4,200						$4,200	
4	($1,000)							$1,000

Assets go DOWN **(Cash goes DOWN)**

5. **Smith Inc. provides services of $2,000 and rents its test facilities for $500 to Joe's Raviolis. Joe is billed $2,500 for these services and has not paid yet.**

Assets go UP **(Accounts Receivable goes UP)**
Stockholders' Equity goes UP **(Revenue goes UP)**

				Assets =	Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		
2	($4,000)	$4,000						
3	$4,200						$4,200	
4	($1,000)							$1,000
5			$2,500				$2,500	

6. **Smith Inc. bought $8,000 of equipment on credit from Big Al's Machine World.**

Assets go UP **(Equipment goes UP)**
Liabilities go UP **(Accounts Payable goes UP)**

				Assets =	Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000		
2	($4,000)	$4,000						
3	$4,200						$4,200	
4	($1,000)							$1,000
5			$2,500				$2,500	
6				$8,000	$8,000			

7. **Smith Inc. pays BIG Al's Machine World $3,000 cash towards the payable from transaction 6.**

Liabilities go DOWN **(Accounts Payable goes DOWN)**

				Assets =	Liabilities +	Stockholders' Equity		
Transaction	**Cash**	**Supplies**	**Accounts Recievable**	**Equipment**	Accounts Payable +	Common Stock	Revenues -	Expenses
1	$30,000					$30,000	Assets go	
2	($4,000)	$4,000						
3	$4,200						$4,200	
4	($1,000)							$1,000
5			$2,500				$2,500	
6				$8,000	$8,000		DOWN	
7	($3,000)				($3,000)			
	$26,200	$4,000	$2,500	$8,000	$5,000	$30,000	$6,700	($1,000)
			$40,700			**$40,700**		

(Cash goes DOWN)

LO 5: DESCRIBE THE FOUR FINANCIAL STATEMENTS AND HOW THEY ARE PREPARED

1. Income Statement
2. Retained Earnings Statement
3. Balance Sheet
4. Statement of Cash Flows

Income Statement

- Describes a company's revenues and expenses which result in **net income** (revenues exceed expenses) or a **net loss** (expenses exceed revenues) over a **specific period of time** due to earnings activities.
- Example: An income statement would be prepared for January 1, 20XX to December 31, 20XX.

SIERRA CORPORATION
Income Statement
For the Month Ended October 31, 2017

Revenues		
Service revenue		$10,600
Expenses		
Salaries and wages expense	$5,200	
Rent expense	900	
Supplies expense	1,500	
Depreciation expense	40	
Interest expense	50	
Insurance expense	50	
Total expenses		7,740
Net income		$ 2,860

Statement of Retained Earnings

- Explains changes in retained earnings from net income, net loss, and dividends over **a specific period of time**. (same time period as covered by the income statement)
- Helps users evaluate dividend payment practices.
- **Uses NET INCOME from the income statement to calculate the ending balance retained earnings**

SIERRA CORPORATION
Retained Earnings Statement
For the Month Ended October 31, 2017

Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$2,360

- ***Balance Sheet***
- Describes a company's financial position (types and amounts of assets, liabilities, and equity) at a **point in time**.
- Example: A balance sheet would be prepared "As of December 31, 20XX" because it gives a snapshot of the company's financial position as of that date.
- **Basic Accounting Equation**:
  ASSETS = LIABILITIES + STOCKHOLDERS'EQUITY
- **Assets**: resources OWNED by the company.
- **Liabilities**: claims of creditors. (amounts OWED by the company.)
- **Stockholders' Equity**: The owners' claim to assets.
- **Uses ENDING BALANCE in RETAINED EARNINGS from Statement of Retained Earnings.**

SIERRA CORPORATION
Balance Sheet
October 31, 2017

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

Statement of Cash Flows

- Identifies cash inflows (receipts) and cash outflows (payments) over a **specific period of time**.
- Helps to explain the change in the cash balance from the beginning of the period to the end of the period.
- **Uses the CASH balance on the balance sheet to compute "Cash at end of period."**
- The Statement of Cash Flows is divided up into 3 sections: Operating, Investing, and Financing Activities.

SIERRA CORPORATION
Statement of Cash Flows
For the Month Ended October 31, 2017

Cash flows from operating activities		
Cash receipts from operating activities	$11,200	
Cash payments for operating activities	(5,500)	
Net cash provided by operating activities		$ 5,700
Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issuance of note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		$15,200

Summary of Accounts

Name	Category/ Financial Statement	Quick Definition
Cash	Asset/Balance Sheet	Includes money and any medium of exchange that bank has for deposit (coins, checks, money orders, checking account balances.)
Accounts Receivable	Asset/Balance Sheet	Held by the SELLER. Promises of future payment to seller from buyer. (RECEIVE money later)
Notes Receivable	Asset/Balance Sheet	A written promissory note that gives a business the right to receive cash in the future. The receipt of cash includes the original amount (principal) and interest.
Inventory	Asset/Balance Sheet	Goods a company owns and expects to sell in its normal operations.
Prepaid Accounts	Asset/Balance Sheet	Assets that represent payments of FUTURE expenses such as Prepaid Insurance (pay for it ahead of the time you are going to use the insurance.)
Supplies Accounts	Asset/Balance Sheet	Assets such as paper, toner, and pens that become expenses when they are used up.
Property, Plant, and Equipment Accounts	Asset/Balance Sheet	Incudes land, buildings, and equipment. Equipment and building accounts get expensed by allocating their cost over the periods benefited by them. Land accounts DO NOT get expensed over their life.
Accounts Payable	Liability/Balance Sheet	Promise by the BUYER to pay the seller at a later date.
Notes Payable	Liability/Balance Sheet	A formal promise that includes signing a promissory note to pay a future amount.
Unearned Revenue Accounts	Liability/Balance Sheet	Liability that is going to be settled in the future when a company delivers its products or services. (Ex: Jim's neighbor gave him $50 now to mow their lawn while they are on vacation. Jim has an obligation to mow his neighbor's lawn in the future.)
Accrued Liabilities	Liability/Balance Sheet	Amounts owed that are not yet paid.
Common Stock	Stockholders' Equity/Balance Sheet	Amount that shareholders (owners) invest in the company.
Dividends	Stockholders' Equity /Retained Earnings	Distribution of assets such as cash to the shareholders of the company. It REDUCES retained earnings. (NOT AN EXPENSE)
Revenue (Ex: Sales, Professional Service, and Rent Revenue.)	Revenue/Income Statement	INCREASE retained earnings and are resources generating by a company's earning activities.
Expenses (Ex: Advertising, Store Supplies, Rent, and Utilities Expense)	Expenses/Income Statement	DECREASE retained earnings and are the cost of assets or services used to earn revenues.