FINANCIAL ACCOUNTING

LO 1: Identify the forms of business organization and the uses of accounting information.

TYPES OF BUSINESS ENTITITES

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)**

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.

USERS AND USES OF FINANCIAL INFORMATION

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)).

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.

LO 2: Explain the three principle types of business activity.

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

Financing Activities

2 primary sources of outside funds for corporations are:

1. **Borrowing money (debt financing**)
   - **Liabilities:** amounts OWED.
   - **Creditors:** party to whom amounts are owed.
   - Payables ("Pay Later") such as **notes payable** and **bonds payable** are types of liabilities.

2. **Issuing (selling) shares of stock.**
   - **Common Stock:** describe the amount paid by stockholders for shares (ownership in a company) they purchase.
   - **Dividends:** payments to stockholders (owners of a company).

Investing Activities

"Purchase of resources a company needs to operate."

- **Assets:** Resources OWNED by a business.
  - This includes the cash received/paid for the sale/purchase of computers, delivery trucks, furniture, buildings, and investments.

Operating Activities

Activities that are involved in running the day to day operations of a company.

- **Revenues**: Amounts earned from the sale of products and other sources.
  - Examples: sales revenue, service revenue, and interest revenue
- **Inventory:** Goods available for sale to customers.
- **Accounts Receivable:** Right to receive money from a customer as a result of a sale.
  - **Receivables = "Receive Later"**
- **Expenses**: cost of assets consumed or services used.
  - Examples: Cost of goods sold, selling, marketing, administrative, interest, and income taxes expenses.
- **Liabilities:** amounts OWED and arise from expenses.
  - Examples: Accounts payable, interest payable, wages payable, sales taxes payable, and income taxes payable.
  - **Payables = "Pay Later"**

LO 3: 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 **<u>net income</u>** (revenues exceed expenses) or a **<u>net loss</u>** (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.

OTHER ELEMENTS OF AN ANNUAL REPORT

- U.S. companies that are publicly traded must provide shareholders with an annual report.
- The annual report always includes:
  1. **Financial statements**
     - Income Statement, Statement of Retained Earnings, Balance Sheet, and Statement of Cash Flows.
  2. **Management discussion and analysis**
     - "Management's views on the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations."
  3. **Notes to the financial statements**
     - Clarify the financial statements and provide additional detail such as significant accounting policies and methods used in preparing financial statements.
  4. **Auditor's report**
     - Prepared by an independent outside **auditor**. **(An accounting professional that examines a company's financial statements, a Certified Public Accountant)**
     - States the auditor's opinion on the fairness of the presentation of the financial position and results of operations and their conformance with GAAP (Generally Accepted Accounting Principles.)