

# INTRODUCTION TO FINANCIAL ACCOUNTING

## Key Topics to Know

### Forms of Business Ownership:

- Sole proprietorship
- Partnership
- Corporation

### Types of Business Activities:

- Financing – sources of outside funds used to operate the business
- Investing – purchase of resources (assets) the business needs to operate
- Operating – the daily activities of the business

### Basic Financial Statements:

- Income Statement – revenue accounts and expense accounts, net income
- Statement of Retained Earnings – retained earnings account, net income and the dividends account
- Balance Sheet – asset accounts, liability accounts and owners' equity accounts – capital stock and retained earnings
- Statement of Cash Flows – explains how the changes in account balances during an accounting period affect the balance in the cash account
- Interrelationship among the financial statements

### Accounting Equation and Components:

- Three basic elements: Assets, Liabilities, Stockholders Equity
- Stockholders' Equity = Retained Earnings + Common Stock
- The accounting equation must always balance

### Income Statement:

- Revenues – Expenses = Net Income
- Net Income vs. Net Loss
- Prepare an Income Statement

**Retained Earnings Statement:**

- Beginning balance in Retained Earnings + Net Income – Dividends = ending balance in Retained Earnings
- Retained Earnings Statement links the income statement and dividends to the Balance Sheet
- Prepare a retained earnings statement

**Balance Sheet**

- Assets = Liabilities + Owners' Equity
- Owners' Equity = Common Stock + Retained Earnings
- Prepare a balance sheet

## Practice Problems

### **Problem #1 – Accounting Equation**

J Company had assets of \$100,000 and liabilities of \$75,000 at the end of the fiscal year, December 31.

- Required:
- a) Determine the owners' equity at December 31.
  - b) Assets increased by \$25,000 and liabilities increased by \$15,000 during the next year. Determine owners' equity at the end of the next year.
  - c) What is the increase or (decrease) in owner's equity for the year?

### **Problem #2 – Financial Statements**

A list of accounts and their balances for the L Company for the month ended October 31 is shown below.

Cash	\$9,000
Accounts receivable	11,000
Supplies	5,500
Equipment	22,000
Notes payable	2,000
Accounts Payable	9,000
Dividends	2,000
Common Stock	12,000
Retained Earnings	18,000
Fees Earned	23,300
Salaries Expense	12,200
Rent Expense	1,000
Supplies Expense	600
Depreciation Expense	1,000

- Required: Prepare an income statement, a statement of retained earnings, and a balance sheet

**Problem #3 – Characteristics of Ownership**

The characteristics below apply to at least one of the forms of business organization.

- a) Is a separate legal entity.
- b) Is allowed to be owned by one person only.
- c) Owner or owners are personally liable for debts of the business.
- d) Is a separately taxable entity.
- e) Is a business entity.
- f) May have a contract specifying the division of profits among the owners.
- g) Has an unlimited life

**Proprietorship      Partnership      Corporation**

- a)
- b)
- c)
- d)
- e)
- f)
- g)

Required: Complete the chart to indicate (with a "yes" or "no") whether or not a characteristic applies to each type of business organization.

**Problem #4 – Using the Accounting Equation**

C Company has the following account balances for the dates given:

	<u>October 1</u>	<u>October 31</u>
Cash	\$40,000	\$60,000
Accounts receivable	40,000	38,000
Accounts payable	6,000	?

Net income, for October was \$20,000 and there were no investments in company stock or dividends paid to the owners.

- Required:
- Determine the equity at October 1
  - Determine the equity at October 31.
  - Determine accounts payable at October 31

## Multiple Choice Questions

1. The costs of providing goods and services to customers are referred to as:
  - a) Assets.
  - b) Expenses.
  - c) Liabilities.
  - d) Revenues.
  
2. An alternative form of the accounting equation is:
  - a)  $\text{Net Income} = \text{Revenues} - \text{Expenses}$ .
  - b)  $\text{Stockholders' Equity} = \text{Assets} + \text{Liabilities}$ .
  - c)  $\text{Assets} = \text{Liabilities} - \text{Stockholders' Equity}$ .
  - d)  $\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$ .
  
3. The owners' interest in a corporation is called:
  - a) Dividends.
  - b) Assets.
  - c) Liabilities.
  - d) Stockholders' equity.
  
4. The equation best describing the balance sheet is:
  - a)  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .
  - b)  $\text{Revenues} - \text{Expenses} = \text{Net Income}$ .
  - c)  $\text{Ending Retained Earnings} + \text{Dividends} = \text{Net Income}$ .
  - d)  $\text{Revenues} + \text{Expenses} = \text{Net Income}$ .
  
5. Liabilities are shown in which of the following statements?
  - a) Income statement.
  - b) Statement of cash flows.
  - c) Balance sheet.
  - d) Statement of retained earnings.
  
6. Identify which of the following are considered external users of financial accounting information.
  - a) Employees
  - b) Managers
  - c) Owners
  - d) Banks

7. Which of the following is NOT a type of information communicated by the financial statements?
- a) whether or not the business is profitable
  - b) what types of assets business owns
  - c) how long the business has been in operation
  - d) how much the business owes others
8. Which of the following statements about liabilities is false?
- a) A net loss on the income statement decreases liabilities.
  - b) The acquisition of a bank loan increases both assets and liabilities.
  - c) The amount of a company's liabilities is equal to (assets - equity).
  - d) Liabilities are reported on the balance sheet
9. Which of the following statements about assets is true?
- a) The issuance of stock to owners for cash would increase assets and decrease owners' equity
  - b) Purchasing equipment for cash would increase one type of asset and decrease another type of asset
  - c) Paying a dividend to stockholders would decrease assets and increase stockholders' equity
  - d) Making a payment on a bank loan would decrease assets and stockholders' equity
10. Which of the following is not an advantage of a corporation?
- a) No personal liability of owners
  - b) Easy to transfer ownership
  - c) More owner control of operations
  - d) Easier to raise funds
11. Which of the following statements about stockholders' equity is true?
- a) The issuance of stock to owners for cash would increase assets and decrease owners' equity
  - b) Purchasing equipment for cash would increase one type of asset and decrease stockholders' equity
  - c) Paying a dividend to stockholders would decrease assets and decrease stockholders' equity
  - d) Making a payment on a bank loan would decrease liabilities and stockholders' equity

12. The income statement reports all of the following *except*:
- Revenues earned by a business.
  - Expenses incurred by a business.
  - Dividends paid by a business.
  - Net income or loss earned by a business.
13. A balance sheet lists:
- The types and amounts of the revenues and expenses of a business.
  - The types and amounts of assets, liabilities, and equity of a business as of a specific date.
  - The inflows and outflows of cash during the period.
  - The assets and liabilities of a company but not the retained earnings.
14. Net Income is:
- Revenue – expenses – dividends
  - Revenue – expenses + dividends
  - Assets – liabilities
  - Revenue - expenses
15. The financial statement that shows the beginning balance of retained earnings; the changes in retained earnings that resulted from, net income (or net loss); dividends; and the ending balance, is the:
- Statement of cash flows.
  - Balance sheet.
  - Income statement.
  - Statement of retained earnings.



## Solutions to Practice Problems

### **Problem #1 – Accounting Equation**

a) Owner's equity December 31 this year	\$100,000 – 75,000 =	\$25,000
b) Owner's equity December 31 this year	\$100,000 – 75,000	
	+25,000 – 15,000	
Owner's equity December 31 next year	\$125,000 – 90,000 =	<u>\$35,000</u>
c) Increase in owners' equity		\$10,000

### **Problem #2 – Financial Statements**

L Company  
Income Statement  
For the Year Ended October 31

Fees earned		\$23,300
Expenses:		
Salaries expense		12,200
Rent expense		1,000
Supplies expense		600
Depreciation expense		1,000
		14,800
Net Income		\$8,500

L Company  
Statement of Retained Earnings  
October 31

Retained earnings October 1		\$18,000
Add: Net Income		8,500
		26,500
Less: Dividends		2,000
Retained earnings October 31		\$24,500

L Company  
Balance Sheet  
October 31

<u>Assets:</u>		<u>Liabilities:</u>	
Cash	\$9,000	Notes payable	\$2,000
Accounts receivable	11,000	Accounts payable	<u>9,000</u>
Supplies	5,500	Total liabilities	<u>\$11,000</u>
Equipment	22,000		
	<hr/>	<u>Stockholders' Equity</u>	
		Common stock	\$12,000
		Retained Earnings	<u>24,500</u>
		Total Stockholders' Equity	<u>\$36,500</u>
Total Assets	<u>\$47,500</u>	Total Liabilities and Stockholders' Equity	<u>\$47,500</u>

**Problem #3 – Characteristics of Ownership**

	<b><u>Proprietorship</u></b>	<b><u>Partnership</u></b>	<b><u>Corporation</u></b>
a)	No	No	Yes
b)	Yes	No	Yes
c)	Yes	Yes	No
d)	No	No	Yes
e)	Yes	Yes	Yes
f)	No	Yes	No
g)	No	No	Yes

**Problem #4 – Using the Accounting Equation**

	<u>October 1</u>
Cash	\$40,000
Accounts receivable	40,000
Total Assets	<u>\$80,000</u>

Accounts payable	<u>6,000</u>
Total Liabilities	<u>6,000</u>

Total Equity (a) \$74,000

	<u>October 1</u>		<u>October 31</u>
Total Assets	\$80,000		\$98,000
Total Liabilities	6,000		(c) 4,000
Total Equity	\$74,000	+ \$20,000 = Net Income	(b) \$94,000

## Solutions to Multiple Choice Questions

- |     |   |
|-----|---|
| 1.  | B |
| 2.  | D |
| 3.  | D |
| 4.  | A |
| 5.  | C |
| 6.  | D |
| 7.  | C |
| 8.  | A |
| 9.  | B |
| 10. | C |
| 11. | C |
| 12. | C |
| 13. | B |
| 14. | D |
| 15. | D |