Financial Accounting

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Chapter 01

Introducing Accounting in Business

Conceptual Chapter Objectives

C1: Explain the purpose and importance of accounting.

C2: Identify users and uses of accounting.

C3: Explain why ethics are crucial to accounting.

C4: Explain generally accepted accounting principles and define and apply several accounting principles.

C5: Appendix 1B – Identify and describe the three major activities of organizations.

Analytical Chapter Objectives

A1: Define and interpret the accounting equation and each of its components.

A2: Compute and interpret return on assets.

A3: Appendix 1A – Explain the relation between return and risk.

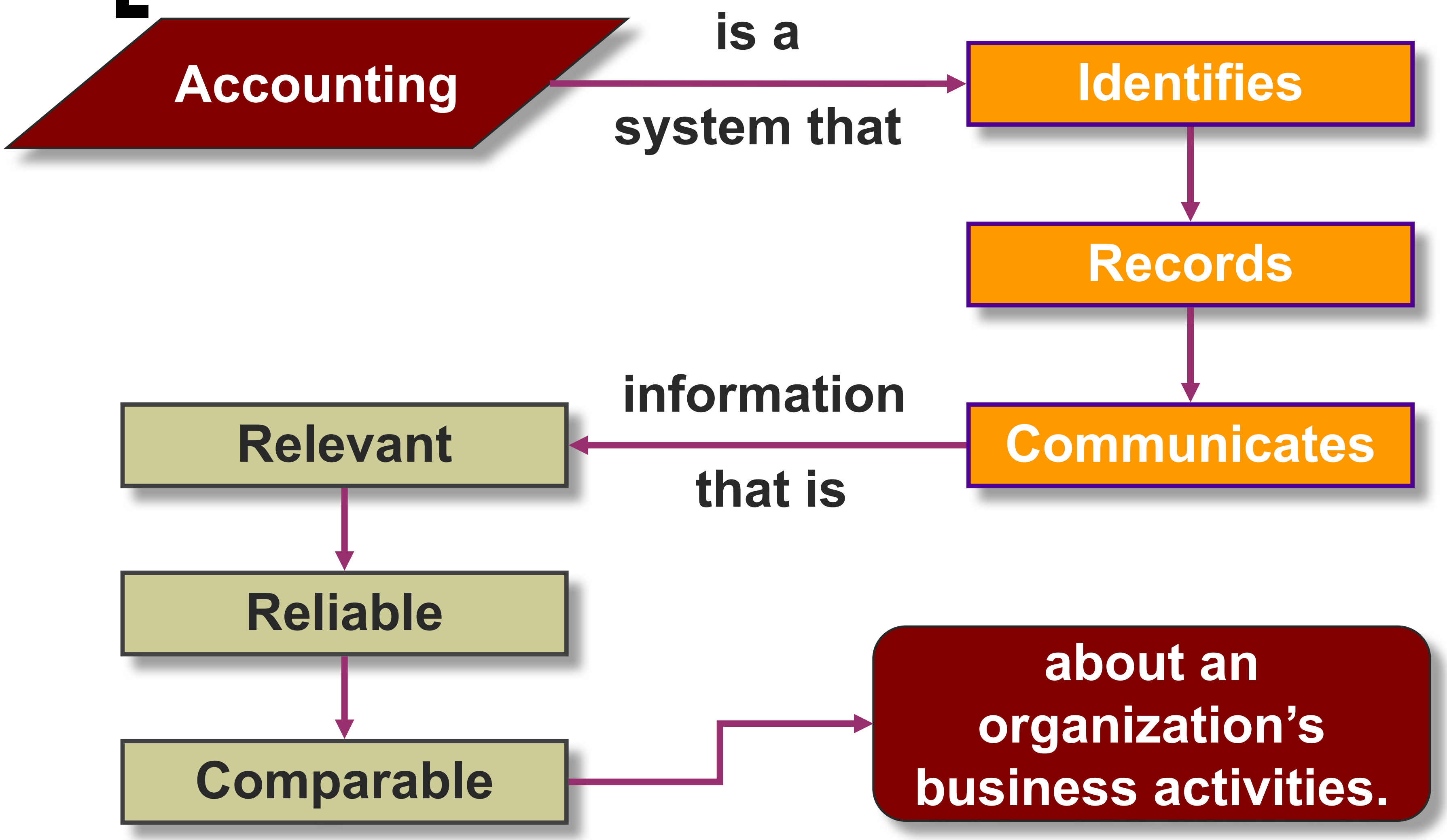
Procedural Chapter Objectives

P1: Analyze business transactions using the accounting equation.

P2: Identify and prepare basic financial statements and explain how they interrelate.

C1

Importance of Accounting



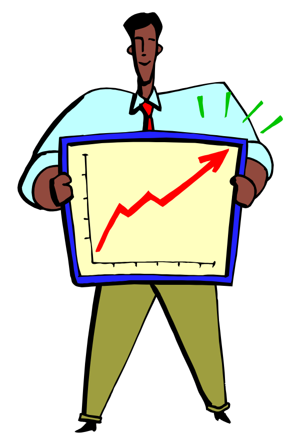
C 1

Accounting Activities

Œ Identifying Business Activities

❷ Recording Business Activities

❸ Communicating Business Activities



C 2

Users of Accounting Information

External Users

- Lenders
- Shareholders
- Governments
- Consumer Groups
- External Auditors
- Customers

Internal Users

- Managers
- Officers
- Internal Auditors
- Sales Staff
- Budget Officers
- Controllers

C 2

Users of Accounting Information

External Users	Internal Users
	
Financial accounting provides external users (shareholders, lenders, etc.) with financial statements.	Managerial accounting provides information needs for internal decision makers (officers, managers, etc.).

C 2

Opportunities in Accounting

Financial

- Preparation
- Analysis
- Auditing
- Regulatory
- Consulting
- Planning
- Criminal investigation

Managerial

- General accounting
- Cost accounting
- Budgeting
- Internal auditing
- Consulting
- Controller
- Treasurer
- Strategy

Taxation

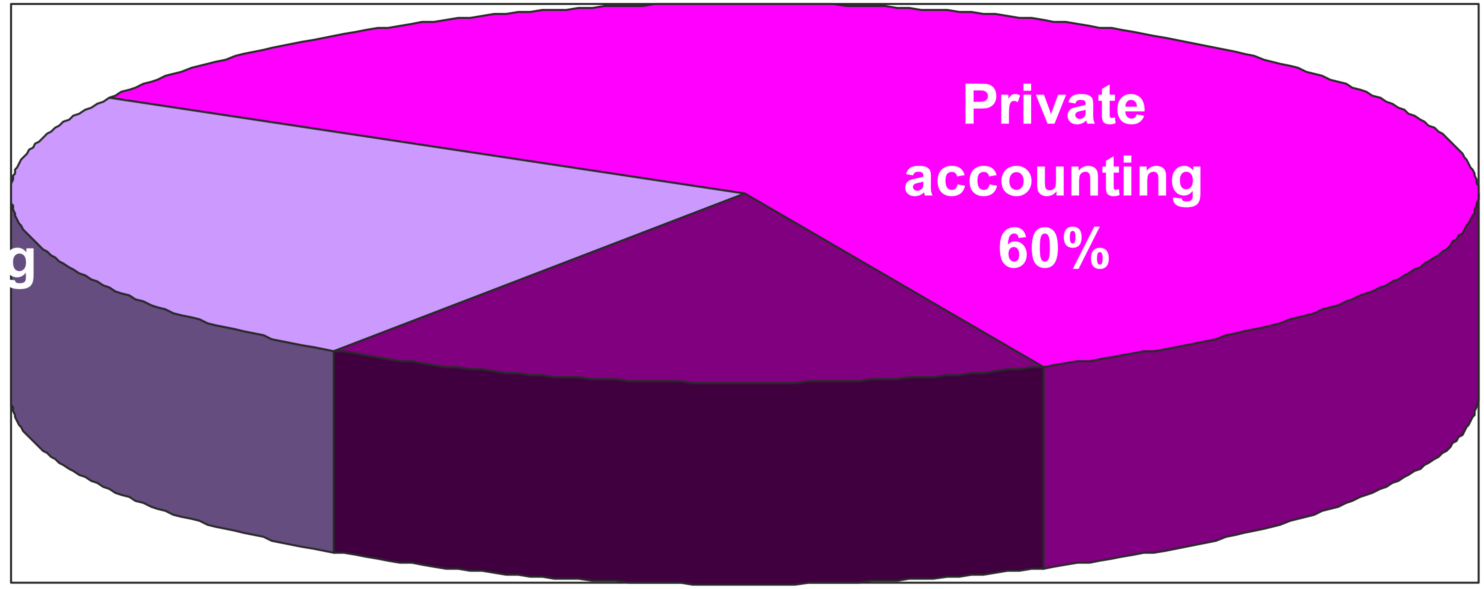
- Preparation
- Planning
- Regulatory
- Investigations
- Consulting
- Enforcement
- Legal services
- Estate plans

Accounting-related

- Lenders
- Consultants
- Analysts
- Traders
- Directors
- Underwriters
- Planners
- Appraisers
- FBI investigators
- Market researchers
- Systems designers
- Merger services
- Business valuation
- Forensic accountant
- Litigation support
- Entrepreneurs

C2

Accounting Jobs by Area



C 3

Ethics—A Key Concept

Ethics

Beliefs that distinguish right from wrong

Accepted standards of good and bad behavior

C3

Guidelines for Ethical Decisions

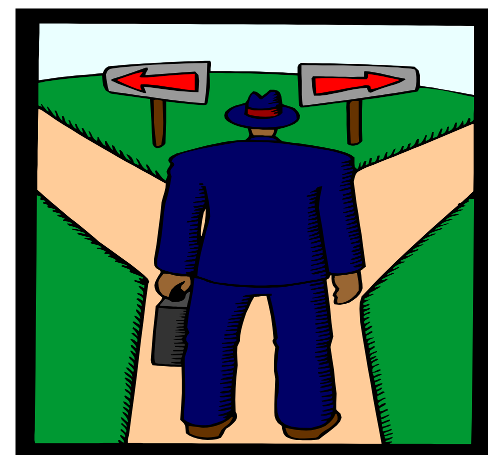
Œ Identify ethical concerns

Use personal ethics to recognize an ethical concern.

❷ Analyze options

Consider all good and bad consequences.

❸ Make ethical decision



Choose best option after weighing all consequences.

C 4

Generally Accepted Accounting Principles

Financial accounting practice is governed by concepts and rules known as generally accepted accounting principles (GAAP).

Relevant Information	**Affects the decision of its users.**
Reliable Information	**Is trusted by users.**
Comparable Information	**Used in comparisons across years & companies.**

C4

Setting Accounting Principles

In the United States, the Securities and Exchange Commission, a government agency, has the legal authority to establish reporting requirements and set GAAP for companies that issue stock to the public.

The Financial Accounting Standards Board is the private group that sets both broad and specific principles.

The International Accounting Standards Board (IASB) issues international standards that identify preferred accounting practices in other countries. More than 100 countries now require or permit companies to prepare financial reports following IFRS.

C 4

Principles and Assumptions of Accounting

Measurement principle (also called cost principle) means that accounting information is based on actual cost.

Going-concern assumption means that accounting information reflects a presumption the business will continue operating.

Revenue recognition principle provides guidance on when a company must recognize revenue.

Monetary unit assumption means we can express transactions in money.

Matching principle (expense recognition) prescribes that a company must record its expenses incurred to generate the revenue.

Time period assumption presumes that the life of a company can be divided into time periods, such as months and years.

Full disclosure principle requires a company to report the details behind financial statements that would impact users' decisions.

Business entity assumption means that a business is accounted for separately from its owner or other business entities.

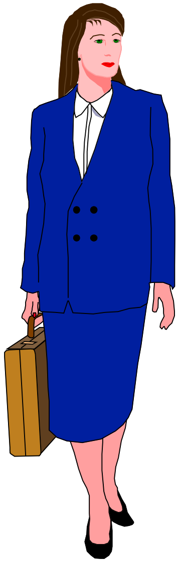
C 4

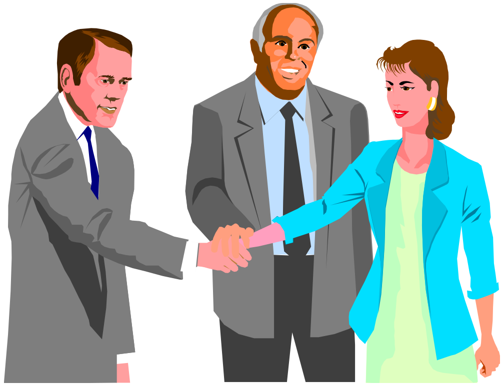
Business Entity Forms

Sole Proprietorship

Partnership

Corporation





C 4

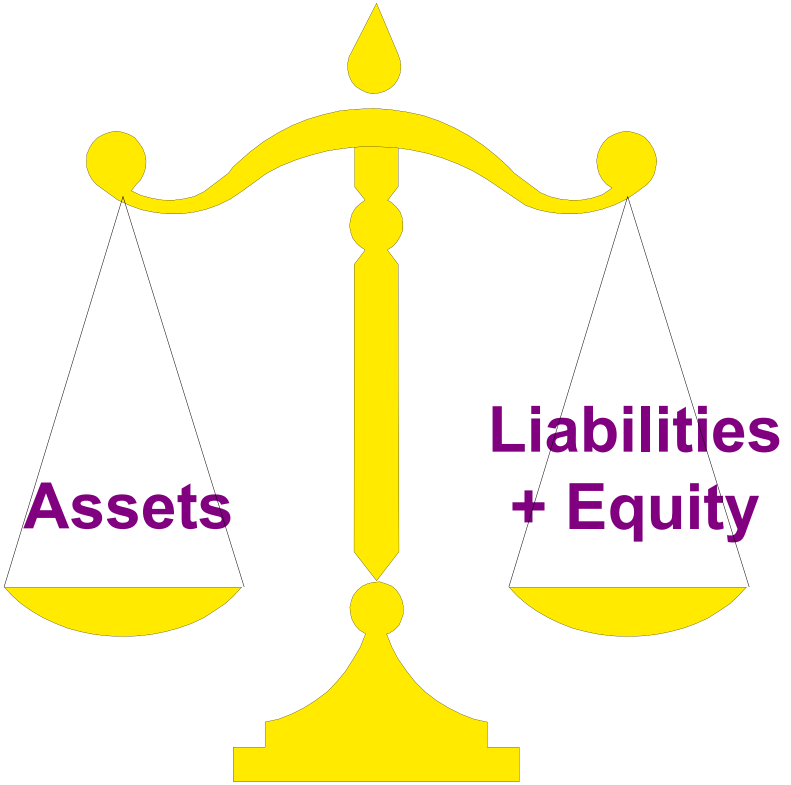
Sarbanes-Oxley Act

In response to a number of publicized accounting scandals (Enron, WorldCom, Tyco, ImClone), Congress passed the Sarbanes-Oxley Act (also called SOX) in 2002 to help curb financial abuses at companies that issue their stock to the public. The act requires that public companies apply both accounting oversight and stringent internal controls. The desired results include more transparency, accountability, and truthfulness in reporting transactions.

A1

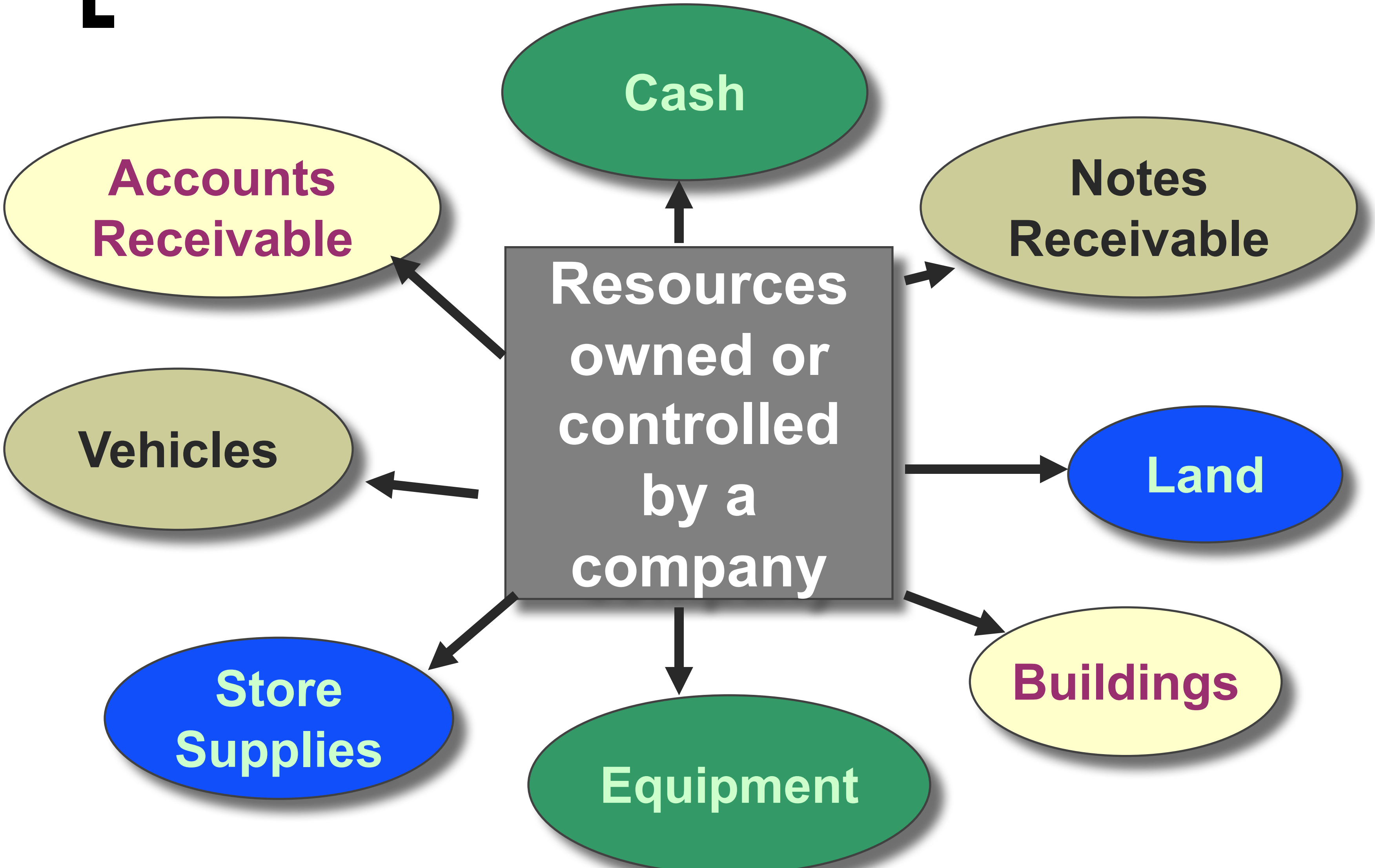
Accounting Equation

Assets = Liabilities + Equity



A1

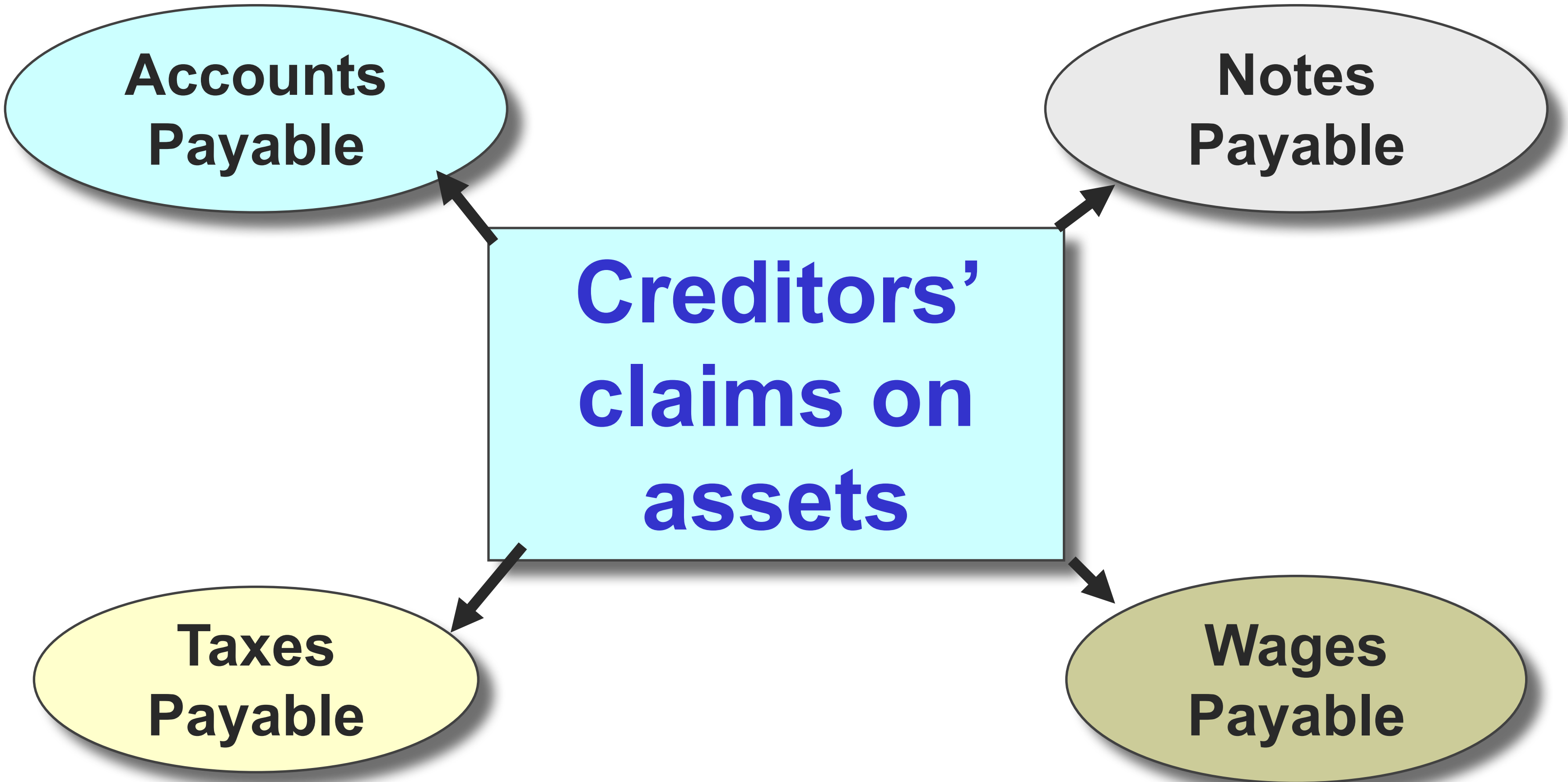
Assets



Cash
Accounts Receivable
Notes Receivable
Resources owned or controlled by a company
Vehicles
Land
Store Supplies
Equipment
Buildings

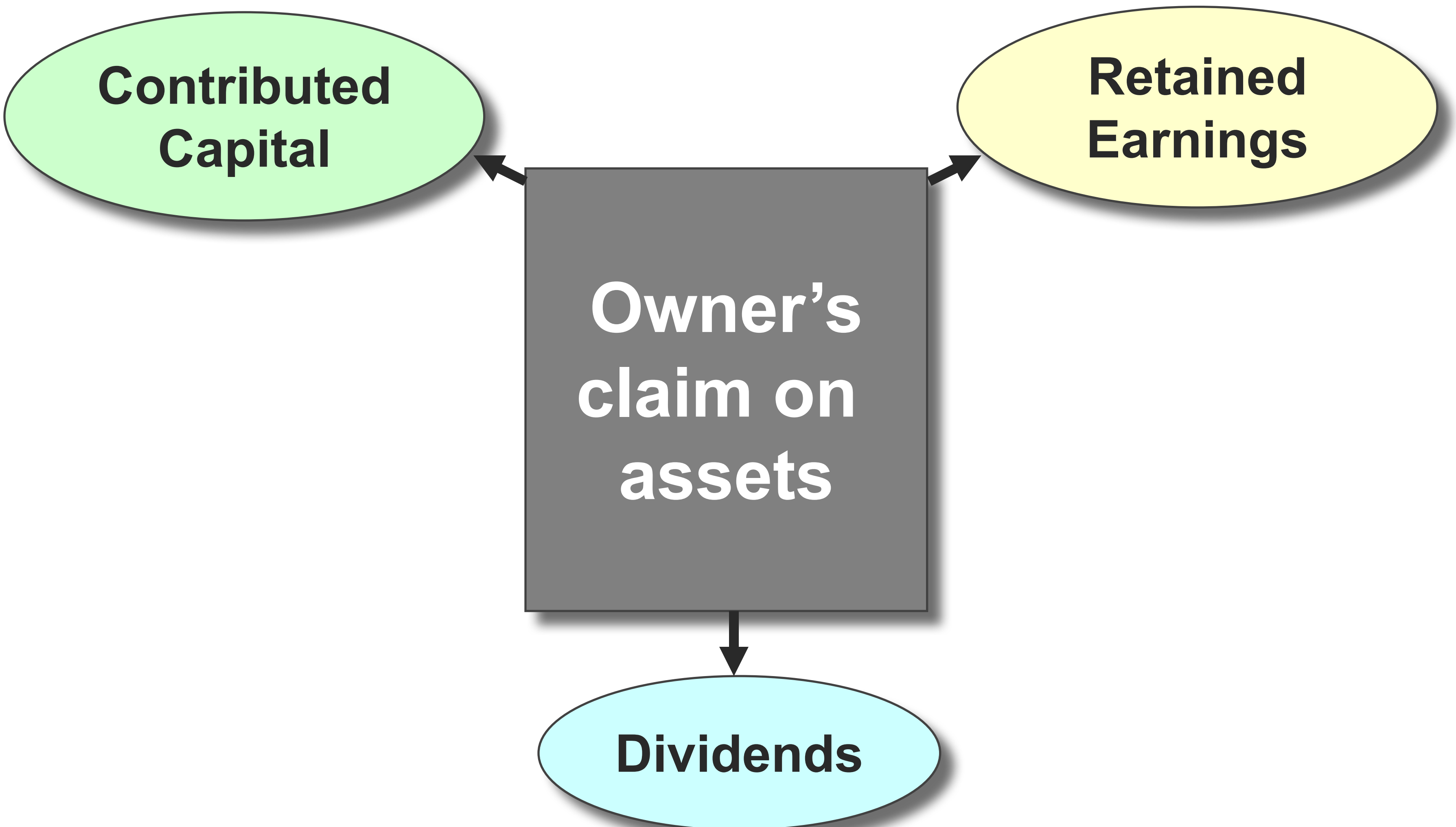
A1

Liabilities



A1

Equity


Contributed Capital
Retained Earnings
Owner's claim on assets
Dividends

A1

Expanded Accounting Equation

Assets = Liabilities + Equity

$$\text{Contributed Capital} - \underbrace{\text{Dividends} + \text{Revenues} - \text{Expenses}}_{\text{Retained Earnings}}$$

P1

Transaction Analysis

Business activities can be described in terms of transactions and events. External transactions are exchanges of value between two entities, which yield changes in the accounting equation. Internal transactions are exchanges within any entity; they can also affect the accounting equation. Events refer to happenings that affect an entity’s accounting equation and can be reliably measured. Transaction analysis is defined as the process used to analyze transactions and events.

P1

Transaction Analysis

J. Scott invests $20,000 cash to start the business in return for stock.

	Assets			=	Liabilities		+	Equity
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock
(1)	$ 20,000							$ 20,000
	$ 20,000	$ -	$ -		$ -	$ -		$ 20,000
		$ 20,000		=		$ 20,000		

P1

Transaction Analysis

Purchased supplies paying $1,000 cash.

	Assets			=	Liabilities		+	Equity
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock
(1)	$ 20,000							$ 20,000
(2)	(1,000)	$ 1,000						
	$ 19,000	$ 1,000	$ -		$ -	$ -		$ 20,000
		$ 20,000		=		$ 20,000		

P1

Transaction Analysis

Purchased equipment for $15,000 cash.

	Assets			=	Liabilities		+	Equity
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock
(1)	$ 20,000							$ 20,000
(2)	(1,000)	$ 1,000						
(3)	(15,000)		$ 15,000					
	$ 4,000	$ 1,000	$ 15,000		$ -	$ -		$ 20,000
		$ 20,000		=		$ 20,000		

P1

Transaction Analysis

Purchased Supplies of $200 and Equipment of $1,000 on account.

	Assets			=	Liabilities		+	Equity
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock
(1)	$ 20,000							$ 20,000
(2)	(1,000)	$ 1,000						
(3)	(15,000)		$ 15,000					
(4)		200	1,000		$ 1,200			
	$ 4,000	$ 1,200	$ 16,000		$ 1,200	$ -		$ 20,000
		$ 21,200		=		$ 21,200		

P1

Transaction Analysis

Borrowed $4,000 from 1st American Bank.

	Assets			=	Liabilities		+	Equity
					Accounts	Notes		Common
	Cash	Supplies	Equipment		Payable	Payable		Stock
(1)	$ 20,000							$ 20,000
(2)	(1,000)	$ 1,000						
(3)	(15,000)		$ 15,000					
(4)		200	1,000		$ 1,200			
(5)	4,000					$ 4,000		
	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000
		$ 25,200		=		$ 25,200		

P1

Transaction Analysis

The balances so far appear below. Note that the Balance Sheet Equation is still in balance.

	Assets			=	Liabilities		+	Equity
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock
Bal.	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000
	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000
		$ 25,200		=		$ 25,200		

P1

Transaction Analysis

Now, let's look at transactions involving revenue, expenses, and dividends.

P1

Transaction Analysis

Provided consulting services receiving $3,000 cash.

	Assets			=	Liabilities		+	Equity	
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock	Revenue
Bal.	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000	
(6)	3,000								$ 3,000
	$ 11,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000	$ 3,000
		$ 28,200		=		$ 28,200			

P1

Transaction Analysis

Paid salaries of $800 to employees.

Assets				=	Liabilities		+	Equity		
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock	Revenue	Expenses
Bal.	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000		
(6)	3,000								$ 3,000	
(7)	(800)									$ (800)
	$ 10,200	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000	$ 3,000	$ (800)
		$ 27,400		=		$ 27,400				

Remember that expenses decrease equity.

P1

Transaction Analysis

Dividends of $500 are paid to shareholders.

	Assets			=	Liabilities		+	Equity			
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		Common Stock	Dividends	Revenue	Expenses
Bal.	$ 8,000	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000			
(6)	3,000									$ 3,000	
(7)	(800)										$ (800)
(8)	(500)								$ (500)		
	$ 9,700	$ 1,200	$ 16,000		$ 1,200	$ 4,000		$ 20,000	$ (500)	$ 3,000	$ (800)
		$ 26,900		=		$ 26,900					

Remember that dividends decrease equity.

P2

Financial Statements

Let's prepare the Financial Statements reflecting the transactions we have recorded.

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

P2

Income Statement

SCOTT COMPANY Income Statement For Month Ended December 31, 2011		
Revenues:		
Consulting revenue	$	3,000
Expenses:		
Salaries expense		800
Net income	$	2,200

Net income is the difference between Revenues and Expenses.

The income statement describes a company's revenues and expenses along with the resulting net income or loss over a period of time due to earnings activities.

P2

Statement of Retained Earnings

SCOTT COMPANY Income Statement For Month Ended December 31, 2011		
Revenues:		
Consulting revenue	$	3,000
Expenses:		
Salaries expense		800
Net income	$	2,200

The net income of $2,200 increases Retained Earnings by $2,200.

SCOTT COMPANY Statement of Retained Earnings For Month Ended December 31, 2011		
Retained Earnings, Dec. 1, 2011	$	-
Plus: Net income		2,200
Less: Dividends		500
Retained Earnings, Dec. 31, 2011	$	1,700

P2

Balance Sheet

The **Balance Sheet** describes a company's financial position at a point in time.

SCOTT COMPANY
Statement of Retained Earnings
For Month Ended December 31, 2011

Retained Earnings, Dec. 1, 2011	$	-
Plus: Net income		2,200
Less: Dividends		500
Retained Earnings, Dec. 31, 2011	$	1,700

SCOTT COMPANY
Balance Sheet
December 31, 2011

Assets			Liabilities		
Cash	$	9,700	Accounts payable	$	1,200
Supplies		1,200	Notes payable		4,000
Equipment		16,000	Total liabilities		5,200
			Equity		
			Common stock		20,000
			Retained earnings		1,700
Total assets	$	26,900	Total liabilities and equity	$	26,900

P2

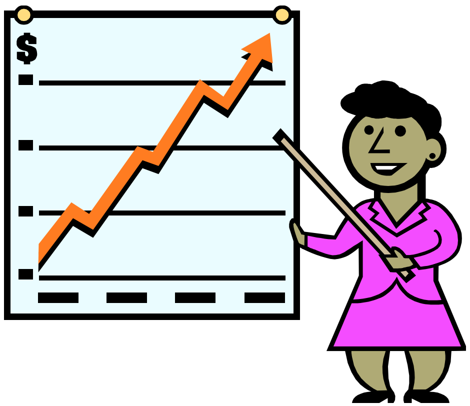
Statement of Cash Flows

SCOTT COMPANY Statement of Cash Flows For Month Ended December 31, 2011		
Cash flows from operating activities:		
Cash received from clients	$ 3,000	
Purchase of supplies	(1,000)	
Cash paid to employees	(800)	
Net cash provided by operating activities		$ 1,200
Cash flows from investing activities:		
Purchase of equipment	(15,000)	
Net cash used in investing activities		(15,000)
Cash flows from financing activities:		
Investment by Shareholders	20,000	
Borrowed at bank	4,000	
Dividends Paid	(500)	
Net cash provided by financing activities		23,500
Net increase in cash		$ 9,700
Cash balance, December 1, 2011		-
Cash balance, December 31, 2011		$ 9,700

A2

Return on Assets (ROA)

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Average total assets}}$$



ROA is a profitability measure.

End of Chapter 01