

CHAPTER 1

INTRODUCTION TO FINANCIAL ACCOUNTING

Key Terms and Concepts to Know

Accounting Principles:

- GAAP – Generally Accepted Accounting Principles
- Business Entity, Cost, Going Concern, Monetary Unit, Objectivity, Revenue Recognition

Accounting Equation and components:

- Assets, Liabilities, Stockholders Equity
- Revenue, Expense, Dividends, Stock, Retained Earnings
- The accounting equation must always balance

Transactions:

- External transactions occur between two different entities and are easy to record because there are always source documents evidencing the transaction
- Internal transactions occur within a single entity and are more difficult to record because source documents may not always be present

Basic Financial Statements:

- Income Statement
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows
- Interrelationship among the financial statements

Profitability:

- Revenues – Expenses = Net Income
- Net Income vs. Net Loss

Return on Assets ratio

- Sales divided by average assets
- Measures how well the company uses its assets to generate sales

- Average assets are used because sales are made throughout the period and the average assets approximates the different amounts of assets used throughout the period.

Key Topics to Know

Accounting Equation

Assets = Liabilities + Stockholder's Equity

OR

Assets - Liabilities = Stockholder's Equity

The equation means that:

- The value of the property the company owns equals the funding sources the company used to acquire the property.
- The value of the property the company owns equals the claims of creditors to the property plus the claims of the company's owners to the property (remember that the claims of the creditors are satisfied first, so the owners are entitled to claim only the remaining property.)
- Stockholder's Equity is also called Net Worth because it represents what the company is worth to its owners after all liabilities have been paid.

Owners' Equity is NOT a single account in the general ledger. It is a collection of accounts, some of which add to the value of the company and others which reduce the value of the company to its owners:

- Capital stock increases Owners' Equity because it is an investment of capital in the company.
- Dividends decrease Owners' Equity because they are a return of assets to the owners, reducing what the company is worth to the owners.
- Revenue (or sales or fees earned) increases Owners' Equity because the company receives assets for providing its goods or services, increasing what the company is worth to the owners.
- Expenses, the costs incurred to produce revenue, reduce Owners' Equity because the company uses up or consumes assets, reducing what the company is worth to the owners.

- Net Income is Revenue minus Expenses, also known as profit. Net Income may be negative if Expenses exceed Revenues, when it is known as Net Loss. Net Income increases Owners' Equity whereas Net Loss reduces Owners' Equity.
- Retained earnings, in the simplest terms, is the accumulation of all Net Income and Net Losses less all the dividends paid to the owners since the company's formation.

Example #1: John Smith is the sole stockholder and operator of Just-In-Time, a consulting firm. At the end of its accounting period, December 31, 2010, Just-In-Time has assets of \$375,000 and liabilities of \$125,000.

Required: Using the accounting equation and considering each case independently, determine the following amounts:

- Stockholder's equity on 12/31/2010.
- The amount and direction (increase or decrease) change in stockholder's equity if, during 2011, assets increased by \$32,000 and liabilities decreased by \$8,000.
- Net income (or net loss) during 2011, assuming that as of December 31, 2011, assets were \$367,000, liabilities were \$110,000, capital stock of \$40,000 was issued, and dividends of \$60,000 were paid.

Solution #1:

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
a) 12/31/2010	\$375,000	=	\$125,000	+	?
	375,000	=	125,000	+	250,000
b) Change in 2011	+ 32,000	=	-8,000	+	?
	32,000	=	-8,000	+	40,000
c) <u>Step 1: solve for change in equity</u>					
12/31/2011	\$367,000	=	\$110,000	+	\$257,000
12/31/2010	375,000	=	125,000	+	250,000
Change in 2011	- \$8,000	=	-\$15,000	+	\$7,000

Step 2: solve for net income

<u>Capital stock</u>	-	<u>Dividends</u>	+	<u>Net Income</u>	=	<u>Change in Equity</u>
\$40,000	-	-60,000	+	?	=	\$7,000
Net Income	=	\$27,000	=	7,000 - 40,000 + 60,000		

Practice Problem #1: Sarah Jones is the sole stockholder and operator of Sarah's Catering Company. At the end of the accounting period, December 31, 2000, Sarah's Catering has assets of \$135,000 and liabilities of \$72,000.

Required: Using the accounting equation and considering each case independently, determine the following amounts:

- a) Stockholder's equity on 12/31/2000.
- b) The amount and direction (increase or decrease) of the period's change in stockholder's equity if, during 2001, assets decreased by \$22,000 and liabilities decreased by \$7,000.
- c) Net income (or net loss) during 2001, assuming that as of December 31, 2001, assets were \$148,000, liabilities were \$75,000, capital stock of \$25,000 was issued and dividends of \$12,000 were paid.

Effects of Transactions on the Accounting Equation

The accounting equation must always be in balance. Each transaction must also be in balance. Transactions which "cross the equal sign" must either increase or decrease both sides of the accounting equation. Transactions which are entirely on one side of the equal sign must contain offsetting increases and decreases, such as an increase in a liability offset by a decrease in owners' equity.

Example #2: For each of the following transactions, indicate which elements of the accounting equation are affected (minimum of 2 per transaction) and whether the element has increased or decreased as a result.

- | | |
|---|----------|
| a) Paid rent for August | \$3,000 |
| b) Received cash from cash customers | \$7,500 |
| c) Received cash for capital stock | \$15,000 |
| d) Paid creditors on account | \$800 |
| e) Received cash from customer's on account | \$1,200 |

Solution #2:

- | | |
|---------------------|---------------------------|
| a) Asset – decrease | Owners' equity – decrease |
| b) Asset – increase | Owners' equity – increase |
| c) Asset – increase | Owners' equity – increase |
| d) Asset – decrease | Liabilities – decrease |
| e) Asset – increase | Asset – decrease |

Practice Problem #2: For each of the following transactions, indicate which elements of the accounting equation are affected (minimum of 2 per transaction) and whether the affected elements have increased or decreased as a result.

- a) Purchased supplies for cash, \$1,200
- b) Paid cash dividends, \$1,000
- c) Billed customers for services rendered on account, \$2,800
- d) Paid utilities for September, \$85
- e) Purchased equipment on account, \$3,200
- f) Received cash for services rendered, \$900
- g) Determined that the cost of supplies on hand was \$30; therefore, \$90 of supplies had been used
- h) Paid \$1,000 equipment purchased in (e) above

Financial Statements

There are four basic financial statements:

- Income statement
- Statement of retained earnings
- Balance sheet
- Statement of cash flows

The financial statements are linked together in several ways:

- The income statement reports net income which is used on the statement of retained earnings
- The statement of retained earnings reports the balance in retained earnings on the balance sheet date
- The balance sheet includes the balance in retained earnings as of the balance sheet date
- The statement of cash flows reports the changes in the balance sheet from one period to the next from the perspective of how these changes affect cash, either by providing cash or by using cash.

The accounts appear on the following financial statements:

- Revenues and expenses are on the income statement
- Dividends and retained earnings are on the statement of retained earnings
- Assets, liabilities, stock and retained earnings are on the balance sheet

Example #3: Indicate the financial statement on which each of the following accounts would appear.

- a) Prepaid rent
- b) Cash
- c) Capital stock
- d) Rent expense
- e) Dividends
- f) Fees earned
- g) Accounts payable
- h) Retained earnings

Solution #3:

- | | |
|----------------------|--|
| a) Prepaid rent | balance sheet - asset |
| b) Cash | balance sheet - asset |
| c) Capital stock | balance sheet – owners' equity |
| d) Rent expense | income statement - expense |
| e) Dividends | retained earnings |
| f) Fees earned | income statement - revenue |
| g) Accounts payable | balance sheet - liabilities |
| h) Retained earnings | statement of retained earnings
and balance sheet - equity |

Example #3: The following table shows financial data for Cuddly Pets, Inc. as of June 30, 2010. Prepare a balance sheet using this data.

Accounts receivable	\$419,200
Accounts payable	349,200
Inventory	58,400
Capital stock	662,100
Other assets	69,400
Notes payable	268,900
Cash	732,600
Equipment	118,500
Retained earnings	117,900

Solution #3:

Assets

Cash	\$732,600	
Accounts receivable	419,200	
Inventory	58,400	
Equipment	118,500	
Other assets	69,400	
Total Assets		<u>\$1,398,100</u>

Liabilities

Accounts payable	\$349,200	
Notes payable	268,900	
Total liabilities		618,100

Stockholders' Equity

Capital stock	\$662,100	
Retained earnings	117,900	
Total Stockholders' Equity		<u>780,000</u>

Total Liabilities and Stockholders' Equity		<u>\$1,398,100</u>
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Practice Problem #3: Tim Burr's Tree Service has reported the following financial information as of 12/31/10, the end of its first year in business. Prepare the Income Statement, Statement of Retained Earnings, and Balance Sheet using this information.

Accounts receivable	\$40,000
Accounts payable	30,000
Cash	10,000
Capital stock	20,000
Notes payable	10,000
Equipment	50,000
Fees earned	100,000
Fuel expense	10,000
Rent expense	15,000
Advertising expense	5,000
Wages expense	20,000
Retained earnings	?
Dividends	10,000

Sample True / False Questions

1. Accounting is a system that collects and processes financial information about an organization and reports that information to decision makers.
True False
2. Assets are recorded at market value or replacement cost.
True False
3. In accounting and reporting for a business entity, the accounting and reporting for the business must be kept separate from other economic affairs of its owners.
True False
4. The accounting period in which service revenue is recognized (i.e., revenue for services rendered) is generally the period in which the cash is collected.
True False
5. Total assets are \$70,000, total liabilities, \$40,000 and contributed capital is \$20,000; therefore, retained earnings are \$15,000.
True False
6. Payment of a cash dividend to stockholders increases stockholders' equity.
True False
7. The accounting model for the balance sheet is: $\text{Assets} + \text{Liabilities} = \text{Stockholders' Equity}$.
True False
8. A decision maker who wants to understand a company's financial statements must carefully read the notes to the financial statements because the notes provide useful supplemental information.
True False
9. The financial statement that shows an entity's economic resources and its liabilities is the statement of cash flows.
True False

10. Companies prepare financial statements at the end of each year and more often as needed.
True False
11. The income statement equation is Expenses - Revenues = Net Income.
True False
12. Generally accepted accounting principles almost never change once created.
True False
13. Stockholders are creditors of a company.
True False
14. The stockholders' equity of a company is the difference between assets and liabilities.
True False
15. Accounts payable, notes payable and wages payable are liability accounts.
True False
16. Expenses are the necessary costs a business incurs to earn revenue.
True False
17. For a new business, the beginning balance of Retained Earnings is zero.
True False
18. The Sarbanes-Oxley Act (SOX) requires top management of companies to sign a report certifying their responsibilities for financial statements.
True False
19. Revenue is reported on the income statement only if cash was received at the point of sale.
True False
20. Accounts payable and accounts receivable are reported on the income statement.
True False

Sample Multiple Choice Questions

1. Which of the following best describes accounting?
 - a) Can be thought of as the “language of business”
 - b) Is of limited or little use by individuals outside of the business
 - c) Records economic data but does not communicate the data to users
 - d) Relies upon concepts and principles that are independent of specific user needs

2. The two most common specialized fields of accounting in practice are:
 - a) environmental accounting and financial accounting
 - b) managerial accounting and tax accounting
 - c) financial accounting and accounting systems
 - d) managerial accounting and financial accounting

3. Equipment with an estimated market value of \$80,000 is offered for sale at \$85,000. The equipment is acquired for \$10,000 in cash and a note payable of \$65,000. The amount used in the buyer’s accounting records to record this acquisition is:
 - a) \$80,000
 - b) \$85,000
 - c) \$10,000
 - d) \$75,000

4. The business entity concept means that:
 - a) An entity is organized according to state or federal statutes.
 - b) An entity is organized according to the rules set by the FASB
 - c) The entity is an individual economic unit separate and apart from its owners
 - d) The owner is the entity.

5. Properties owned by a business are referred to as:
 - a) stockholder’s equity
 - b) liabilities
 - c) assets
 - d) equities

6. If total assets decreased by \$1,000 during a period of time and liabilities increased by \$2,000 during the same period, then the amount and direction (increase or decrease) of the period's changes in stockholder's equity is:
 - a) \$1,000 increase
 - b) \$3,000 increase
 - c) \$3,000 decrease
 - d) \$1,000 decrease

7. How does the rendering of services on account affect the accounting equation?
 - a) Liabilities increase; stockholder's equity decreases
 - b) Assets increase; liabilities increase
 - c) Assets decrease; stockholder's equity increases
 - d) Assets increase; stockholder's equity increases

8. If assets and liabilities at the beginning of the year were \$205,000 and \$140,000 respectively and at the end of the year were \$225,000 and \$175,000 respectively, calculate the net income if dividends of \$35,000 were paid and \$10,000 of additional capital stock was issued.
 - a) Net income of \$10,000
 - b) Net income of \$15,000
 - c) Net loss of \$15,000
 - d) Net income of \$25,000

9. Which of the following financial statements reports information as of a point in time?
 - a) Retained earnings statement
 - b) Statement of cash flows
 - c) Income statement
 - d) Balance sheet

10. Transactions affecting owner's (stockholder's) equity include:
 - a) only the issuance of capital stock and dividends
 - b) only the issuance of capital stock and net income or loss
 - c) only dividends and net income or loss
 - d) issuance of capital stock, dividends, and net income or loss

11. Which of the following would not appear on the income statement?
 - a) Service Revenue
 - b) Interest Expense
 - c) Net income
 - d) Dividends paid

12. Which of the following would not appear on the Retained Earnings Statement?
 - a) Beginning retained earnings balance
 - b) Dividends
 - c) Service Revenue
 - d) Net Income

13. The financial statements are usually prepared in which of the following sequences?
 - a) Income Statement, Balance Sheet, Retained Earnings Statement, Statement of Cash Flows
 - b) Balance Sheet, Retained Earnings Statement, Statement of Cash Flows, Income Statement
 - c) Balance Sheet, Retained Earnings Statement, Income Statement, Statement of Cash Flows
 - d) Income Statement, Retained Earnings Statement, Balance Sheet, Statement of Cash Flows

14. Cindy's Maid Service began the year with total assets of \$120,000 and stockholders' equity of \$40,000. During the year the company earned \$90,000 in net income and paid \$20,000 in dividends. Total assets at the end of the year were \$215,000. Stockholder's equity at the end of the year was:
 - a) \$130,000
 - b) \$110,000
 - c) \$150,000
 - d) \$135,000

15. Using the information in Question 14, total liabilities at the end of the year were:
 1. \$80,000
 2. \$90,000
 3. \$110,000
 4. \$105,000

16. Use the following appropriate amounts to calculate net income:

Revenues, \$12,000; Liabilities, \$5,000; Expenses, \$4,000; Assets, \$19,000; Dividends, \$4,000.

- a) \$6,000
 - b) \$8,000
 - c) \$4,000
 - d) \$14,000
17. Liabilities are best defined as:
- a) Amounts the company expects to collect in the future from customers.
 - b) Debts or obligations the company owes resulting from past transactions.
 - c) The amounts that owners have invested in the business.
 - d) Payments to stockholders.
18. Sooner Company has had a net income of \$8,000, \$5,000, \$12,000, and \$10,000 over the first four years of the company's existence. If the average annual amount of dividends paid over the last four years is \$3,000, what is the ending retained earnings balance?
- a) \$47,000
 - b) \$35,000
 - c) \$23,000
 - d) \$7,000
19. The financial statement that represents activity over the entire life of the company is the:
- a) A. Income statement.
 - b) B. Statement of financial accounting.
 - c) C. Balance sheet.
 - d) D. Statement of cash flows.
20. Which financial statement is prepared at a point in time?
- a) Income statement.
 - b) Balance sheet.
 - c) Statement of retained earnings.
 - d) Statement of cash flows.

SOLUTIONS TO PRACTICE PROBLEMS

Practice Problem #1

Net income (or net loss) during 2001, assuming that as of December 31, 2001, assets were \$148,000, liabilities were \$75,000, capital stock of \$25,000 was issued, and dividends of \$12,000 were paid

a)		<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
	12/31/2000	\$135,000	=	\$72,000	+	?
		135,000	=	72,000	+	<u>63,000</u>

b)	Change in 2001	-22,000	=	-7,000	+	?
		-22,000	=	-7,000	+	<u>-15,000</u>

c) Step 1: solve for 12/31/2001 equity

	12/31/2001	\$148,000	=	\$75,000	+	?
		148,000	=	75,000	+	73,000

	12/31/2000	135,000	=	72,000	+	63,000
	Change in 2001	\$13,000	=	\$3,000	+	<u>\$10,000</u>

Step 2: solve for net income

	<u>Capital stock</u>	-	<u>Dividends</u>	+	<u>Net Income</u>	=	<u>Change in Equity</u>
	\$25,000	-	-12,000	+	?	=	\$10,000

$$\text{Net Loss} = \underline{\$3,000} = 10,000 - 25,000 + 12,000$$

Practice Problem #2

- | | |
|---------------------|---------------------------|
| a) Asset – increase | Asset – decrease |
| b) Asset – decrease | Owners' equity - decrease |
| c) Asset – increase | Owners' equity - increase |
| d) Asset – decrease | Owners' equity - decrease |
| e) Asset – increase | Liabilities – increase |
| f) Asset – increase | Owners' equity - increase |
| g) Asset – decrease | Owners' equity - decrease |
| h) Asset – decrease | Liabilities - decrease |

SOLUTIONS TO TRUE / FALSE QUESTIONS

1. True
2. False - assets on the balance sheet are recorded at historic or acquisition cost.
3. True
4. False - the accounting period in which service revenue is recognized is the period when services rendered, regardless of the period in which the cash is collected.
5. False - total assets are \$70,000, total liabilities, \$40,000 and contributed capital is \$20,000; therefore, retained earnings are \$10,000.
6. False - the payment of a cash dividend to stockholders decreases stockholders' equity.
7. False - the accounting model for the balance sheet is: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
8. True
9. False - the financial statement that shows an entity's economic resources and its liabilities is the balance sheet.
10. True
11. False - the income statement equation is $\text{Revenues} - \text{Expense} = \text{Net Income}$.
12. False - Generally Accepted Accounting Principles (GAAP) will change in response to changes in the business environment.
13. False - stockholders are owners of a company.
14. True
15. True
16. True
17. True
18. True
19. False - revenue is reported on the income statement when earned.
20. False - accounts payable and accounts receivable are reported on the balance sheet.

SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. A
2. D
3. D
4. C
5. C
6. C
7. D
8. A
9. D
10. D
11. D
12. C
13. D
14. B
15. D
16. B
17. B
18. C
19. C
20. B