

INTRODUCTION TO FINANCIAL ACCOUNTING

Key Terms and Concepts 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

Accounting Equation and components:

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

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

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

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.

Example #1

At the end the year, December 31, J Company has assets of \$735,000 and liabilities of \$215,000.

Required: Using the accounting equation, determine stockholders' equity on December 31.

Solution #1

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
December 31:	\$735,000	=	\$215,000	+	?
	735,000	=	215,000	+	520,000

Example #2

At the end of the year, December 31, J Company has assets of \$735,000 and liabilities of \$215,000. Assets increased by \$32,000 and liabilities decreased by \$8,000 during the current year.

Required: Using the accounting equation, determine the amount and direction (increase or decrease) change in stockholder's equity

Solution #2

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
Change	+ 32,000	=	-8,000	+	?
	32,000	=	-8,000	+	40,000

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

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

Required: Indicate the financial statement on which each of the accounts would appear.

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 |

Practice Problems

Practice Problem #1

On June 30, S Company has assets of \$135,000 and liabilities of \$75,000. On December 31 of the same year, assets were \$355,000 and stockholders' equity was \$172,000.

- Required:
- Using the accounting equation, determine stockholders' equity on June 30
 - Using the accounting equation, determine total liabilities on December 31

Practice Problem #2

On December 31, S Company provided the following information for her company:

Accounts receivable	65,000
Accounts payable	80,000
Cash	15,000
Common stock	70,000
Loan payable	103,000
Equipment	70,000
Revenue	160,000
Inventory	55,000
Building	150,000
Expenses	50,000
Dividends	8,000

- Required: Prepare an income statement, statement of retained earnings and balance sheet as of December 31.

Practice Problem #3

T Company has reported the following financial information as of December 31, the end of its first year in business.

Accounts receivable	\$40,000
Accounts payable	30,000
Cash	10,000
Common stock	20,000
Notes payable	110,000
Equipment	50,000
Building	150,000
Inventory	55,000
Fees earned	380,000
Fuel expense	85,000
Rent expense	15,000
Advertising expense	5,000
Wages expense	120,000
Retained earnings	?
Dividends	10,000

Required: Prepare an income statement, statement of retained earnings and balance sheet as of December 31.

Practice Problem #4

On December 1, 2016, G Company opened for business with the following assets and liabilities:

Accounts payable	\$1,100
Cash	3,950
Equipment	26,200
Prepaid rent	6,000
Loans payable	15,500
Supplies	1,250

Required: Complete the accounting equation for the firm

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. 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
3. Total assets are \$70,000, total liabilities, \$40,000 and contributed capital is \$20,000; therefore, retained earnings are \$15,000.
True False
4. Payment of a cash dividend to stockholders increases stockholders' equity.
True False
5. Owners of a corporation are called shareholders or stockholders.
True False
6. The financial statement that shows an entity's economic resources and its liabilities is the statement of cash flows.
True False
7. The income statement equation is $\text{Expenses} - \text{Revenues} = \text{Net Income}$.
True False
8. Stockholders are creditors of a company.
True False
9. A sole proprietorship is a business owned by one or more persons.
True False
10. Expenses are the necessary costs a business incurs to earn revenue.
True False
11. Revenues are increases in equity from a company's sales of products and services to customers.
True False

12. A net loss occurs when revenues exceed expenses.
True False

13. Assets are the resources a company owns or controls that are expected to yield future benefits.
True False

14. The accounting equation can be restated as: $\text{Assets} - \text{Equity} = \text{Liabilities}$.
True False

15. External users include lenders, shareholders, customers, and regulators.
True False

Multiple Choice Questions

1. Which of the following is not a primary business activity?
 - a) Investing
 - b) Operating
 - c) Selling
 - d) Financing

2. Net income is:
 - a) The excess of assets over liabilities
 - b) The excess of liabilities over assets
 - c) The excess of revenues over expenses
 - d) The excess of expenses over revenues

3. Which of the following lists three liability accounts?
 - a) Accounts payable, loans payable, unearned revenue
 - b) Accounts payable, accounts receivable, unearned revenue
 - c) Accounts payable, earned revenue, unearned revenue
 - d) Accounts payable, loans payable, earned revenue

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

5. If assets decreased by \$1,000 and liabilities increased by \$2,000 during the year, then the change in stockholder's equity is:
 - a) \$1,000 increase
 - b) \$3,000 increase
 - c) \$3,000 decrease
 - d) \$1,000 decrease

6. Which of the 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

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

8. 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

9. C Company 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

10. The financial statement that does not present the results of activity for a period of time is the:
 - a) Income statement.
 - b) Balance sheet.
 - c) Statement of retained earnings.
 - d) Statement of cash flows.

11. 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.

12. The accounting equation is defined as:
 - a) $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
 - b) $\text{Assets} = \text{Liabilities} - \text{Stockholders' Equity}$.
 - c) $\text{Net Income} = \text{Revenues} - \text{Expenses}$.
 - d) $\text{Liabilities} + \text{Revenues} = \text{Assets}$.

13. Transactions of a company involving external sources of funding are referred to as:
 - a) Investing activities.
 - b) Financing activities.
 - c) External activities.
 - d) Operating activities.

14. Transactions of a company that include the purchase and sale of long-term productive assets are referred to as:
 - a) Investing activities.
 - b) Financing activities.
 - c) Expenditure activities.
 - d) Operating activities.

15. Which statement below best describes the accounting equation?
 - a) The change in retained earnings equals net income less dividends.
 - b) Equality of revenue and expense transactions over time.
 - c) Resources of the company equal creditors' and owners' claims to those resources.
 - d) Financing activities equal investing and operating activities.

Solutions to Practice Problems

Practice Problem #1

a)		<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owners' Equity</u>
June 30:	\$135,000		=	\$75,000	+	?
	135,000		=	75,000	+	<u>60,000</u>
b) December 31:	335,000		=	?	+	172,000
	335,000		=	<u>163,000</u>	+	172,000

Practice Problem #2

S Company
Income Statement
For the Year Ended December 31

Revenue	\$160,000
Expenses	50,000
Net Income	<u><u>\$110,000</u></u>

S Company
Statement of Retained Earnings
December 31

Retained earnings January 1	\$0
Add: Net Income	110,000
	<u>110,000</u>
Less: Dividends	8,000
Retained earnings December 31	<u><u>\$102,000</u></u>

S Company
Balance Sheet
December 31

<u>Assets:</u>		<u>Liabilities:</u>	
Cash	\$15,000	Accounts payable	\$80,000
Accounts receivable	65,000	Loan payable	<u>103,000</u>
Inventory	55,000	Total liabilities	<u>\$183,000</u>
Equipment	70,000		
Building	150,000	<u>Stockholders' Equity</u>	
	<hr/>	Common stock	\$70,000
		Retained Earnings	<u>102,000</u>
		Total Stockholders' Equity	<u>\$172,000</u>
Total Assets	<u>\$355,000</u>	Total Liabilities and Stockholders' Equity	<u>\$355,000</u>

Practice Problem #3

T Company
Income Statement
For the Year Ended December 31

Fees earned	\$380,000
Expenses:	
Fuel expense	85,000
Rent expense	15,000
Advertising expense	5,000
Wages expense	<u>120,000</u>
	<u>225,000</u>
Net Income	<u><u>\$155,000</u></u>

T Company
Statement of Retained Earnings
December 31

Retained earnings January 1	\$0
Add: Net Income	<u>155,000</u>
	155,000
Less: Dividends	<u>10,000</u>
Retained earnings December 31	<u><u>\$145,000</u></u>

T Company
Balance Sheet
December 31

<u>Assets:</u>		<u>Liabilities:</u>	
Cash	\$10,000	Accounts payable	\$30,000
Accounts receivable	40,000	Notes payable	<u>110,000</u>
Inventory	55,000	Total liabilities	<u>\$140,000</u>
Equipment	50,000	 <u>Stockholders' Equity</u>	
Building	150,000	Common stock	\$20,000
		Retained Earnings	<u>145,000</u>
		Total Stockholders' Equity	<u>\$165,000</u>
		Total Liabilities and Stockholders' Equity	<u>\$305,000</u>
 Total Assets	 <u>\$305,000</u>		

Practice Problem #4

	Assets =	Liabilities +	Owners' Equity
Accounts payable		\$1,100	
Cash	3,950		
Equipment	26,200		
Prepaid rent	6,000		
Loans payable		15,500	
Supplies	1,250		
Total	<u>\$37,400</u>	<u>\$16,600</u>	<u>\$20,800</u>

Solutions to True / False Problems

1. True
2. True
3. False - total assets are \$70,000, total liabilities, \$40,000 and contributed capital is \$20,000; therefore, retained earnings are \$10,000.
4. False - the payment of a cash dividend to stockholders decreases stockholders' equity.
5. True
6. False - the financial statement that shows an entity's economic resources and its liabilities is the balance sheet.
7. False - the income statement equation is Revenues – Expense = Net Income.
8. False - stockholders are owners of a company.
9. False – a sole proprietorship is owned by one person.
10. True
11. True
12. False – a net loss occurs when expenses exceed revenues
13. True
14. True
15. True

Solutions to Multiple Choice Questions

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