BASIC CONCEPTS OF FINANCIAL ACCOUNTING

Learning Goals

1. Explain the functions and importance of accounting, and identify the three basic activities involving accounting.
2. Describe the roles played by public, management, government and not-for-profit accountants.
3. Identify the foundations of the accounting system, including GAAP and the role of the Financial Accounting Standards Board (FASB).
4. Outline the steps in the accounting cycle, and define double-entry bookkeeping and the accounting equation.
5. Explain the functions and major components of the four principal financial statements: the balance sheet, the income statement, the statement of owner's equity, and the statement of cash flows.

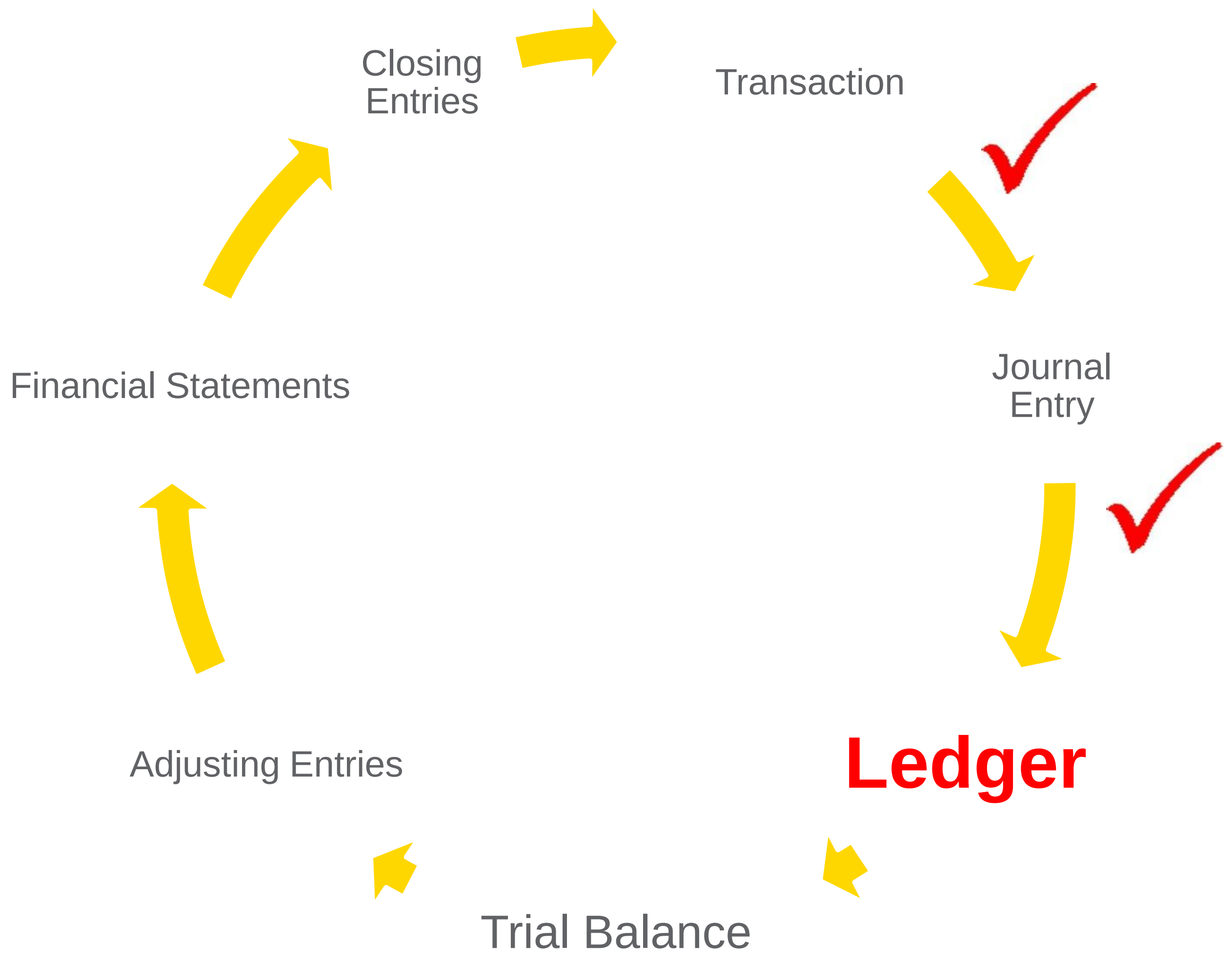
The Accounting Equation

- ***Assets -*** anything of value owned or leased by a business.
- ***Liability -*** claim against a firm's assets by a creditor.
- ***Owner's equity -*** all claims of the proprietor, partners, or stockholders against the assets of a firm, equal to the excess of assets over liabilities.
- ***Basic accounting equation -*** relationship that states that assets equal liabilities plus owners' equity.

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

- ***Double-entry bookkeeping -*** process by which accounting transactions are entered; each individual transaction always has an offsetting transaction.

THE ACCOUNTING CYCLE



The Ledger

The ledger is a group of all of the business' accounts

- The group of them together is known as the ledger
- May be a binder or kept on the computer
- T-Form

In reality...

- The Ledger is organized in much the same fashion as the journal
- Rather than use the LS and the RS of a T-Account, accountants will post transactions to the debit or credit side of the ledger journal paper
- Referred to as the Balance Column form

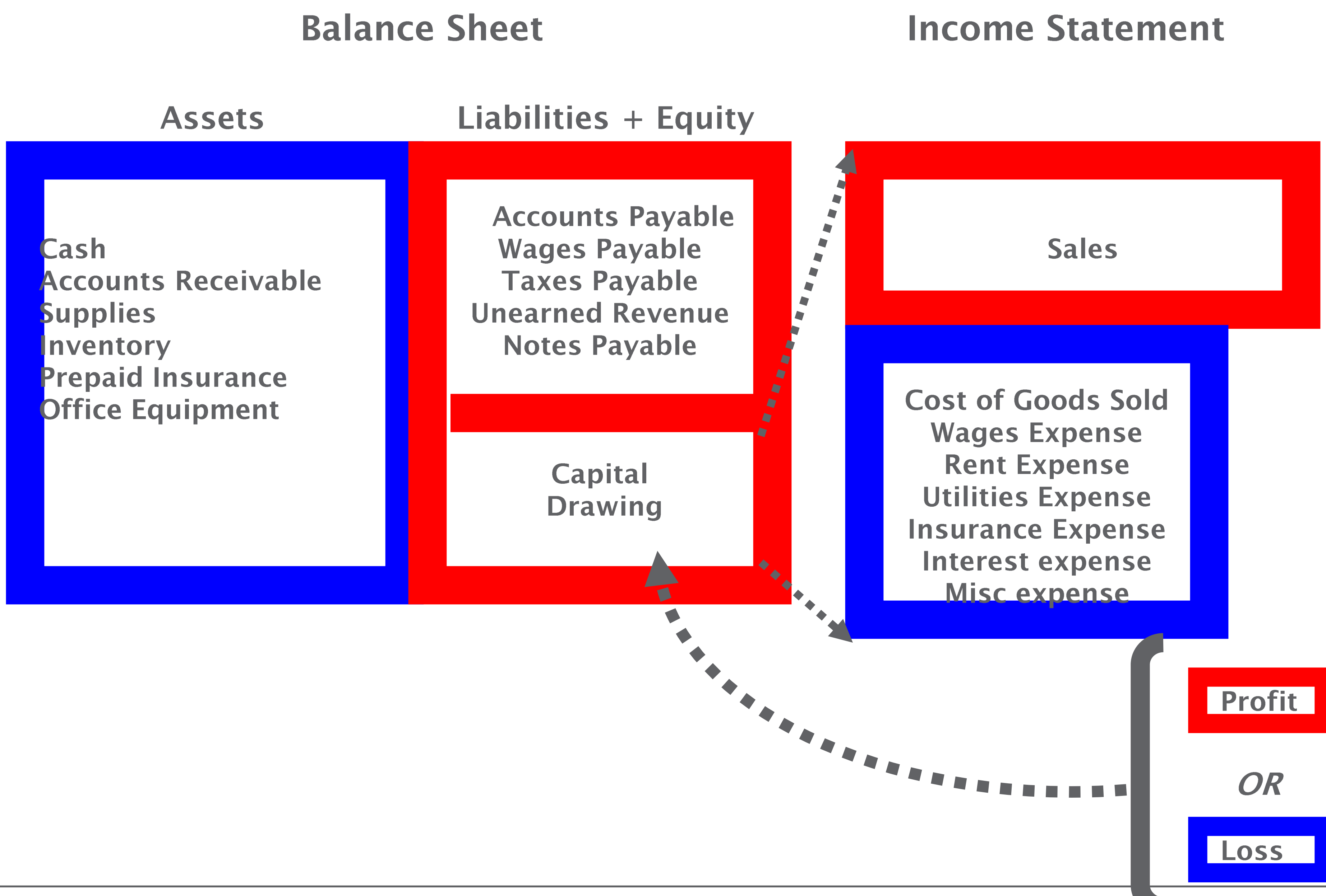
Items of Note

- Each account has a separate page/section in the ledger
- For each transaction that happens in the business, we record it in the journal
- **THEN** Post the total to the ledger

The ledger will keep a running total of each account

- Step 1:
- Opening the Accounts
- Opening Journal Transactions and Opening Balances in the Ledger
- Step 2:
- Performing Transactions in the journal
- Step 3:
- Posting the transactions to the ledger accounts

Balance Sheet / Income Statement

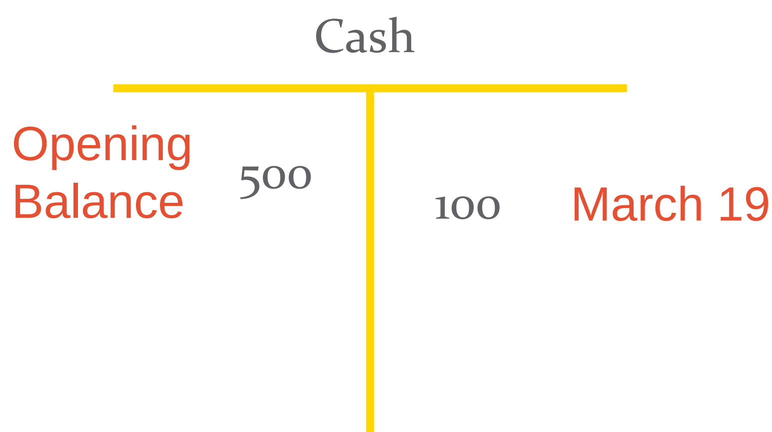


Transactions

- The Owner had $500 cash beginning on March 1st
- The Owner then bought a microphone for $100

The Ledger

USED TO BE....



BECOMES.....

This is the Page # of the General Journal

This is your running balance. You update this after every entry

General Ledger

General Ledger									
K. Dub Lip Singing									
Account: Cash				Chart of Account # 101					
	Date		Particulars	P.R.	Debit	Credit	DR/CR	Balance	
1	Mar	1	Opening Entry	J1	500		Dr	500	1
2		19	Bought Microphone	J1		100	Dr	400	2
3									3

Chart of Accounts

Since we are going to be "Posting", we need to reference all of our accounts.

• Assets	100-199
• Liabilities	200-299
• Capital (including Drawings)	300-399
• Revenues	400-499
• Expenses	500-599

The numbers are used for identification.

• Assets	100-199	In order of Liquidity and then Longevity (useful life)
• Liabilities	200-299	In order of Maturity
• Capital	300-399	Will be only 1 account + drawings
• Revenues	400-499	List <u>Core</u> revenues 1st
• Expenses	500-599	Alphabetical order

The Basic Accounting Equation

If assets total $300 and liabilities total $200, then owners' equity must be $100.

The balance sheet is an expanded expression of the accounting equation.

Balance Sheet			
Assets		**Liabilities and Owners' Equity**	
Cash	5,000	Liabilities	
Accounts receivable	7,000	Accounts payable	8,000
Inventory	10,000	Notes payable	2,000
Equipment	7,000	Total liabilities	10,000
		Owners' equity	19,000
Total assets	29,000	Total liabilities and owners' equity	29,000

The Foundation of Accounting Systems

Generally accepted accounting principles (GAAP) encompass the conventions, rules, and procedures for determining acceptable accounting practices at a particular time.

Financial Accounting Standards Board (FASB) is primarily responsible for evaluating, setting, or modifying GAAP in the U.S.

Sarbanes-Oxley Act responded to cases of accounting fraud.

Created the **Public Accounting Oversight Board**, which sets audit standards and investigates and sanctions accounting firms that certify the books of publicly traded firms.

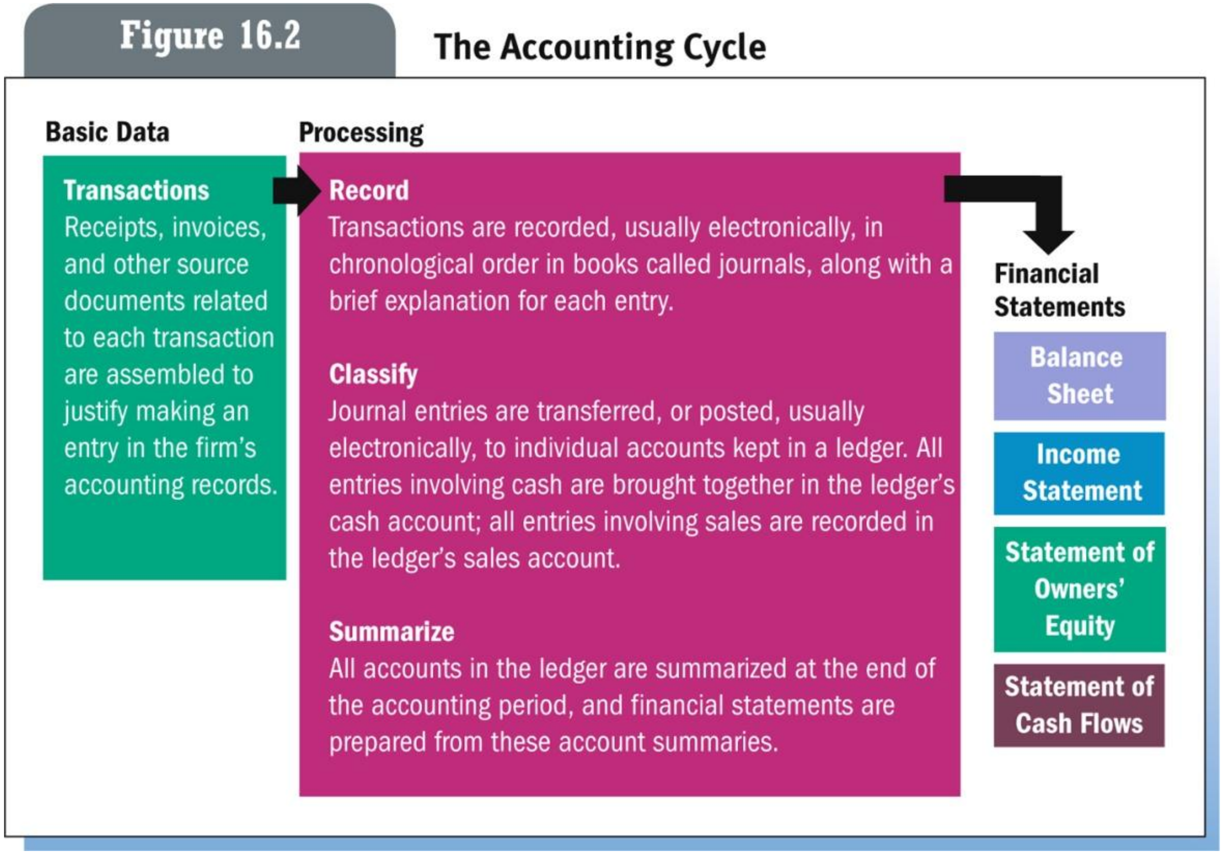
Senior executives must personally certify that the financial information reported by the company is correct.

Resulted in increase in demand for accountants.

International Accounting Standards Committee (IASC) promotes worldwide consistency in financial reporting practices. In 2001, became the ***International Accounting Standards Board (IASB). International Financial Reporting Standards (IFRS) are the standards. Exchange Rates -*** ratio at which a country's currency can be exchanged for other currencies. Consolidated financial statements must reflect gains and losses due to changes in exchange rates.

The Accounting Cycle

Accounting process - set of activities involved in converting information about transactions into financial statements.



Assets are valuable resources that are owned by a firm.

- They represent probable future economic benefits and arise as the result of past transactions or events.

Liabilities are present obligations of the firm. Liabilities are claims by people external to the business.

- They are probable future sacrifices of economic benefits which arise as the result of past transactions or events.

Owners' equity represents the owners' residual interest in the assets of the business. Owners may make a direct investment in the business or operate at a profit and leave the profit in the business. Owners' equity is a claim by the owners.

- Yet another name for owners' equity is net assets, Indicates that owners' equity results when liabilities are subtracted from assets.
- ***Owners' Equity = Assets – Liabilities***

Analyzing Transactions

- **Transaction analysis** is the central component of the financial accounting process.
  - Remember that every transaction must keep the accounting equation in balance.

The Entity Assumption

- The entity assumption dictates that business records must be kept separate and distinct from the personal records of the owners.
  - If a person owns more than one business, then each business must have its own set of records.

A transaction may do one of several things:

- It may increase both the asset side and the liabilities and owners' equity side.
- It may decrease both the asset side and the liabilities and owners' equity side.
- It may cause both an increase and a decrease on the asset side.
- It may cause both an increase and a decrease on the liabilities and owners' equity side.
- Regardless of what transaction occurs, the accounting equation must be in balance after the transaction is analyzed.

Transaction Analysis

Owners' Original Investment				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash +$50,000				H.Jacobs, capital +$50,000

Bank Loan				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash +$20,000		Notes Payable +$20,000		

Transaction Analysis

Rent				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash –$12,000 Prepaid rent +$12,000				

Inventory				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Inventory +$30,000		Accounts Payable +$30,000		

Equipment				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash –$25,000 Equipment +$25,000				

Transaction Analysis

ASSETS			
Cash	Prepaid Rent	Inventory	Equipment
+50,000			
+20,000			
–12,000	+12,000		
		+30,000	
–25,000			+25,000
33,000	12,000	30,000	25,000

Transaction Analysis

LIABILITIES			OWNER'S EQUITY
Accounts Payable	Notes Payable		H.Jacobs, Capital
			+50,000
	+20,000		
+30,000			
30,000	20,000		50,000

Transaction Analysis

Balance Sheet			
Assets		Liabilities and Owners' Equity	
Cash	33,000	Liabilities	
Accounts receivable	12,000	Accounts payable	30,000
Inventory	30,000	Notes payable	20,000
Equipment	25,000	Total liabilities	50,000
		H.Jacobs, capital	50,000
Total assets	100,000	Total liabilities and owners' equity	100,000

Historical Cost

- Historical cost is used for the recording of an asset.
- It is the exchange price on the date of the acquisition of the asset.
- Even though over time an asset's value may increase above the historical cost, that cost is still kept on the books because the number is considered to be reliable.

Revenues are inflows of assets (or reductions in liabilities) in exchange for providing goods and services to customers.

- A retail store such as Wal-Mart earns revenues by selling goods to customers.
- A CPA firm earns revenues by providing services such as tax return preparation or auditing.
- **Critically important point:**
- Cash need not be received in order for revenue to be recorded.
- Revenues are earned when a company does what it is supposed to do according to a contract.
- **Accounts receivable** are promises by a customer or client to pay cash in the future.

Expenses occur when resources are consumed in order to generate revenue.They are the cost of doing business.

- Examples include rent, salaries and wages, insurance, electricity, utilities, and the like.
- A business need not pay out cash in order to have to record that an expense has occurred.
- A critically important point similar to that for revenues holds true for expenses.
- The company will have a liability which it will settle later with the payment of cash.
- The word "payable" is usually used in a liability title.

Revenues and Expenses

Remember that four transactions affect owners' equity.

- Owner investments increase owners' equity.
- Owner withdrawals decrease owners' equity.
- Revenues increase owners' equity.
- Expenses decrease owners' equity.

Consider the following example:

- A magazine company receives $24, which represents a year's subscription.
- The subscriber, of course, pays in advance.
- The magazine company may not record revenue because it has not earned revenue yet.
- To earn revenue, it must send the subscriber one magazine a month for twelve months.
- It owes magazines to the subscriber and thus has a liability (called Unearned Revenue), not revenue.
- As magazines are sent, revenues may be recorded.
- Unearned revenues are usually settled by the performance of a service, unlike other liabilities which are usually settled by the payment of cash.

Revenues

Accounts Receivable				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash +$200 Accounts receivable +$400				H.Jacobs, capital Service revenue +$600

Unearned Revenue				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash +$100		Unearned revenue +$100		

Expenses

Expenses				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash –$700				H.Jacobs, capital Salary expense –$700

Examples of Payables

Notes payable—written obligations.

Accounts payable—unwritten obligations that arise in the normal operations of a business.

Wages payable.

Payable Accounts				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
		Utilities payable +120		H.Jacobs, capital Utility expense –$120

Sales of Inventory

- Sales of inventory contain both revenue and expense components.
- A revenue transaction exists because an asset has been obtained and goods have been provided to customers.
- An expense transaction exists because an asset has been consumed to generate the revenue.
- The resulting expense is called cost of goods sold.

Sales of Inventory				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Accounts receivable +$4,000				H.Jacobs, capital Sales revenue +$4,000
Inventory –2,200				Cost of goods sold –$2,200

Adjustments to Accounts

- Several adjustments must be made to accounting records at the end of the accounting period.
- A balance in an account may need to be adjusted because of the passage of time and the occurrence of events in that time period.
- An amount may not have been recorded in an account at all.
  - The amount will have to be recorded before the financial statements are prepared so that all the information will be correct.

Interest Payable				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
		Interest payable +$133		H.Jacobs, capital Interest expense –$133

Prepaid Rent				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Prepaid rent –$1,000				H.Jacobs, capital Rent expense –$1,000

Depreciation				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Equipment –$208				H.Jacobs, capital Depreciation expense –$208

Unearned Revenue				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
		Unearned revenue –$50		H.Jacobs, capital Service revenue +$50

Withdrawal by Owner

- A withdrawal by owner is treated exactly the opposite of a contribution by the owner.

Withdrawal by Owner				
ASSETS	=	LIABILITIES	+	OWNERS' EQUITY
Cash –$100				H.Jacobs, capital Withdrawal –$100

Balance Sheet

- The balance sheet shows a firm's assets, liabilities, and owner's equity at one point in time.
- The date on the balance sheet will be a single date, such as December 31 or June 30.
- ***Balance sheet -*** statement of a firm’s financial position—what it owns and the claims against its assets—at a particular point in time.
- Photograph of firm’s assets together with its liabilities and owner’s equity
- Follows the accounting equation

Balance Sheet Differences

- Differences in balance sheets lie mainly in the equity section.
- A sole proprietorship has one capital account.
- In a partnership, each partner has his or her own capital account.
- Shareholders' equity of a corporation consists of two components:
- **Invested capital**—results from direct contributions by the shareholders.
- **Retained earnings**—reflects the increases and decreases in the shareholders' interest in the company that arose from operations since the company's inception.

Balance Sheet

January 31, 2000

Assets		**Liabilities and Owners' Equity**	
Cash	$ 32,500	Liabilities	
Accounts receivable	4,400	Accounts payable	$ 30,000
Prepaid rent	11,000	Unearned revenue	50
Inventory	27,800	Utilities payable	120
Equipment	27,792	Interest payable	133
Total assets	$100,492	Notes payable	20,000
		Total liabilities	50,303
		H.Jacobs, capital	50,189
		Total liabilities and owners' equity	$100,492

Income Statement

- The income statement summarizes a firm's revenues and expenses for a period of time.
- The date on the income statement will be a phrase such as, "For the month ended July 31," or "For the year ended December 31."
- ***Income Statement -*** financial record of a company's revenues and expenses, and profits over a period of time.
- Firm's financial performance in terms of revenues, expenses, and profits over a given time period.
- Reports profit or loss.
- Focus on revenues and costs associated with revenues
- If revenues exceed expenses, then the result is net income.
- If expenses exceed revenues, then the result is a net loss.
- Only revenues and expenses appear on the income statement.
- Students sometimes think that cash is a good thing and should appear on the income statement.
- Cash is an asset and so will appear on the balance sheet.

Relationship Between Balance Sheet and Income Statement

Changes in net income, owner contributions, and owner withdrawals, all of which affect owners' equity, explain changes in net assets.

Income Statement **For the Month Ended January 31, 2000**		
Revenues		
Sales	$ 4,000	
Service	650	Receivables 400 200 50earned revenue
Total revenue		4,650
Expenses		
Cost of goods sold	2,200	
Rent	1,000	
Salary	700	
Depreciation	208	
Interest	133	
Utilities	120	
Total expenses		4,361
Net income		$ 289

The Statement of Owners' Equity

Statement of Owner's Equity - is designed to show the components of the change in equity from the end of one fiscal year to the end of the next.

The statement of owners' equity summarizes the changes that took place in owners' equity during the period under review.

It will have the same date as does the income statement.

It shows results over a period of time, not just at one point in time.

The statement starts with the beginning balance of owners' equity and adds in any owner investment and net income.

If there are withdrawals, then they are subtracted, as is a net loss.

A business will have either a net income or a net loss, not both.

The Statement of Owners' Equity

Statement of Owners' Equity For the Month Ended January 31, 2000	
Balance, January 1	$ 0
Investment by owner	$ 50,000
Net income	289
Withdrawal by owner	(100)
Balance, January 31	$ 50,189

The Accrual Basis of Accounting

- The accrual basis of accounting records revenues when goods have been delivered or services have been performed, regardless of when cash is received.
- This basis also records expenses when resources are consumed, regardless of when payment is made.

The Cash Basis of Accounting

- The cash basis of accounting records revenue when cash is received.
- This basis also records expenses when cash is paid.

Accrual vs. Cash-Basis Accounting

During 2014, Fill Fast Staffing Consulting billed its client for $48,000.

On December 31, 2014, it had received $41,000, with the remaining $7,000 to be received in 2015.

Total expenses during 2014 were $31,000 with $3,000 of these costs not yet paid as on December 31st.

Determine net income under both methods.

Cash-Basis Accounting		Accrual-Basis Accounting	
Cash receipts	$41,000	Revenues earned	$48,000
Cash disbursement	$28,000	Expenses incurred	$31,000
Income	$13,000	Income	$17,000

The Accrual Basis Is Preferable

- The accrual basis is preferable for providing the most useful information to financial statement users.
  - GAAP requires use of the accrual basis.
- The accrual basis keeps in place the matching principle.
  - All resources consumed in generating revenue should be shown on the same income statement (that is, during the same time period) as that revenue.

QUESTION 1

Xyz Enterprise has the following assets and liabilities.

Assets: cash in bank \$9,500; accounts receivable \$500; computer equipment \$3,500; car wash equipment \$75,000; building \$450,000

Liabilities: alto's equipment service \$2,500; first national bank (mortgage on building) \$200,000

what is the owner's equity for Xyz Enterprise ?

ANSWER 1

Step 1: Calculate total assets.

\$9,500 + \$500 + \$3,500 + \$75,000 + \$450,000 = \$538,500

Step 2: Calculate total liabilities.

\$2,500 + \$200,000 = \$205,500

Step 3: Calculate owner's equity.

\$538,500 - \$202,500 = \$336,000

QUESTION 2

A business owner invests $12,000 cash in the business.
how would you analyze this transaction?

ANSWER 2

1. Identify the accounts affected.
   a. **Cash in Bank** is affected.
   b. **Owner's Capital** is affected.
2. Classify the accounts affected
   a. **Cash in Bank** is an asset account.
   b. **Owner's Capital** is an owner's equity account.
3. Determine the amount of increase or decrease for each account affected.
   a. **Cash in Bank** is increased by $12,000.
   b. **Owner's Capital** is increased by $12,000.
4. Make sure the accounting equation remains in balance.

Assets	=	Liabilities	+	Owner's Equity
$12,000	=	0	+	$12,000