ACCOUNTING

The Language of Business

1.

Have you ever thought that you might want to start and run your own business?

Your Own Boss

Take an Idea and Run

Big Money

American Dream

2.

A business is an organization which seeks to provide goods or services to customers.

Three Basic Kinds of Business

1. **Manufacturing**
2. **Merchandising**
   - **Retail**
   - **Wholesale**
3. **Service**

Some businesses provide a combination of these goods or services to customers

Restaurant:

Prepare Meals
Deliver Directly to Customers
Provide Services

3.

What would a person need to start a successful business?

1. Idea- A good idea for a product or service that can be sold at a profit.

2. Capital- Money or resources to bring that product or service to life.

3. Management Skill- The ability to effectively employ those resources and produce a profit.

Some businesses may be operated on a non-profit basis but they still provide goods or services and require capital and management skills to operate effectively.

4.

"It takes money to make money"

Besides using your own money or resources, there are only two ways to access capital.

Option 1: Borrow resources from creditors or lenders.
(Debt Financing)

Option 2: Contributions from investors/owners.
(Equity Financing)

The "financing" of a business has to do with how capital is obtained for a business.

5.

Financing a Business

Characteristics of Debt Financing

1. Borrowed resources/capital must be repaid at specified future dates, usually with interest. Debt is temporary financing.
2. The consequences of a failure to repay debts and related interest on a timely basis can be harsh (i.e. bankruptcy or foreclosure)
3. It can be difficult to qualify for.

1.

Characteristics of Equity Financing

1. Investors contribute resources/capital in exchange for ownership interests in a business. In a corporation this ownership is evidenced by shares of stock. Ownership typically grants the following rights:
   A. A right to vote or have a say in the affairs of the business.
   B. A right to share in any profits of the business. This cost of capital could be very expensive.
   C. A right to share in any remaining resources in the event of business termination.
2. Investor contributions of resources are not subject to repayment at a future date and there are no interest charges. Equity financing is permanent financing.

2.

The Key Advantage of Debt Financing:

- No sacrifice of ownership rights (voting, profit sharing)

The Key Advantage of Equity Financing:

- No requirement to repay the capital contributed.

3.

How does an owner/investor get their investment back if the business has no obligation to repay the contributed capital?

1. **Distributions upon discontinuance of the business** - If a business terminates, any excess resources of the business after the payment of all debts are distributed to owners. There is no assurance this distribution will be the same as the amount invested. If it results in a higher or lower amount, the investor realizes a gain or loss on investment, respectively.
2. **Subsequent sale of ownership interests to other investors -** Original investors of capital in corporations receive shares of stock as evidence of their ownership interests and rights. This stock can be subsequently sold to other investors, usually through a stock exchange (ie. NYSE, NASDAQ, etc.). The amount received upon sale may be more or less than the amount originally invested resulting in capital gains or losses for the investor.

4.

The Two Ways Owner/Investors Make a Profit/Loss on Investment

1. **Sharing in the business operating profits. Distributions of resources created through profitable operations to owners is referred to as a dividend.**
2. **Capital gains or losses on the sale of stock or distributions upon the termination of the business.**

5.

Most Investors and Creditors Require Information for Their Investment Decisions

- **Creditors** want to evaluate a company's credit worthiness. "Will the business be able to repay the debt plus interest on a timely basis?"
- **Investors** want to evaluate the profit potential of an investment in a company's stock. "What are the possibilities that stock will increase in value or that there will be substantial dividends in the future?"

The primary purpose of **financial accounting** is to provide information that assists investors and creditors in such evaluations.

6.

Financial vs. Managerial Accounting

Financial Accounting seeks to provide information to current or future providers of capital (investors or creditors) and other interested parties outside of management (ie. government regulatory bodies). This is accomplished through periodic general purpose financial statements which provide summarized historical information on the company's financial position and results of operations.

Managerial Accounting seeks to provide information to assist managers in the effective operation of a business. This is accomplished through customized management reports that tend to be more detailed in nature and may include future budgets and forecasts as well as historical data. These reports are not generally available to the public and seek only to improve management's future performance.

7.

Financial Statements

Financial Accounting's Focus is the General Purpose Financial Statements

1. Balance Sheet or Statement of Financial Position
2. Income Statement or Statement of Operations
3. Statement of Cash Flows

These financial statements can be found in a company's annual report which is readily available to the public. To prove this, you are to complete the Financial Statement Review Assignment as noted in the syllabus.

1.

Two critical conditions must exist for financial statements to be truly useful.

1. **Comparability**
2. **Credibility**

2.

- Generally accepted accounting principles (GAAP) are the rules and standards of accounting used to create comparable information.
- The Security Exchange Commission (SEC) is the federal regulatory agency charged with the responsibility of regulating the issuance and trading of securities of publicly held Companies. The SEC requires that financial statements by prepared in accordance with GAAP and audited by an independent CPA firm.
- The SEC delegated the responsibility of the establishment of GAAP to the Financial Accounting Standards Board (FASB).

3.

Two critical conditions must exist for financial statements to be truly useful.

1. **Comparability**
2. **Credibility**

Credibility refers to the need for the financial statements to provide information that is materially accurate and reliable.

4.

-A company's management is responsible for its accounting system and the preparation of its financial statements.

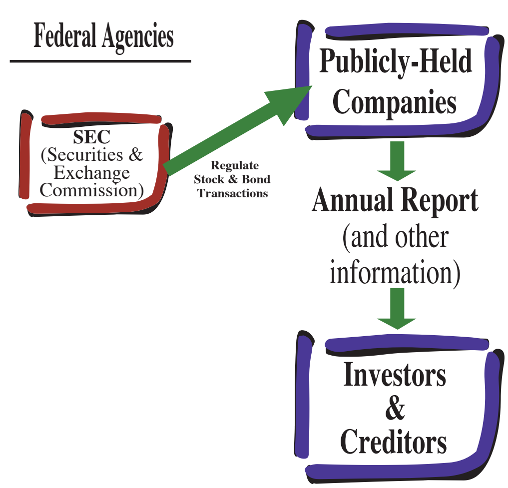
-Management may have conflicts of interest in the accurate preparation of the statements.

-Materially innacurate financial statements are at best worthless and at worst, may actually deceive and severely damage the user of financial statements.

-As a result, the SEC requires that all financial statements of publicly-held companies be subject to outside independant audit for accuracy by an independent certified public accounting firm (CPA).

-The CPA must issue an auditor's report which must accompany a company's financial statements and clearly state the material reliability of the information and its compliance with GAAP.

5.



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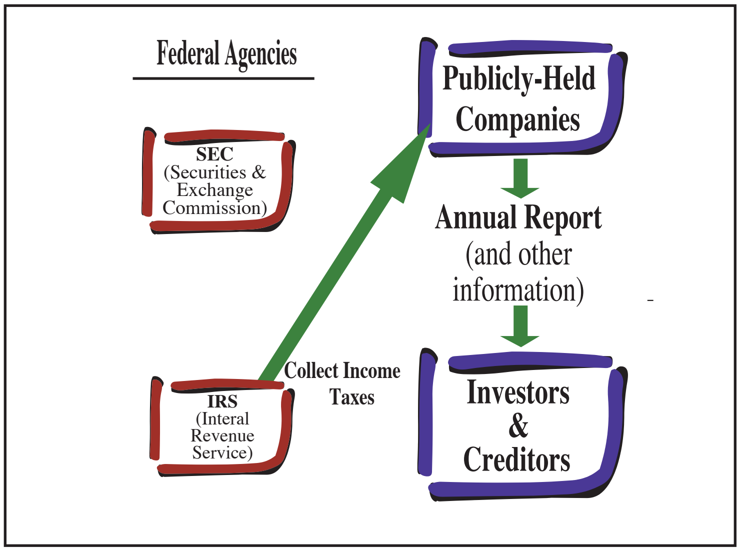

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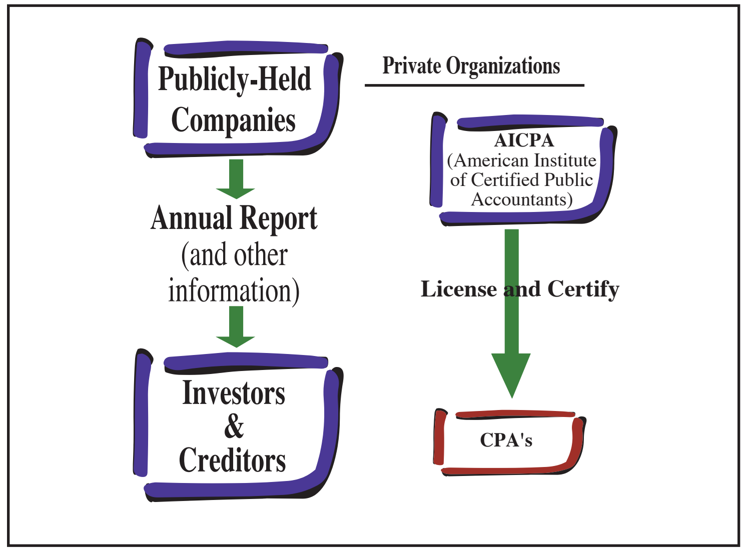

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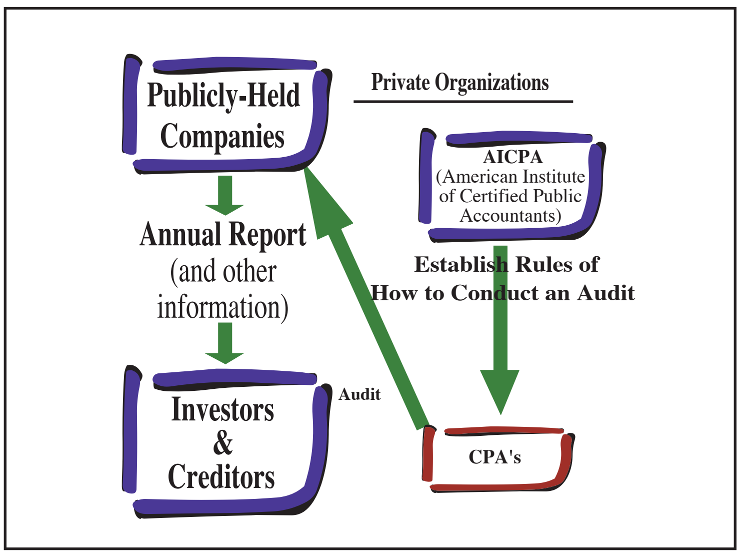

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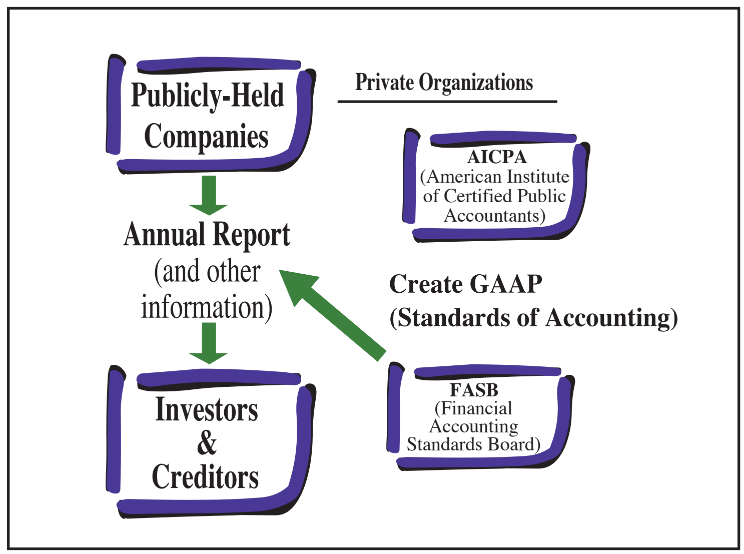

10.

Lesson Summary

What is a business? (Manufacturing, Merchandising, Service businesses)
Successful businesses need:
- **-Good Idea**
- **-Capital**
- **-Management Skill**

Two ways businesses access capital:
1. **Borrow it.**
2. **Investment from owners/investors.**

Investors and creditors need infromation in making their capital investment decisions.
Financial accounting seeks to provide financial statements for investor and creditor use in those decisions.
Useful financial statements must be comparable and credible.
GAAP, established by the FASB, provides the key to comparable financial statements among differing companies.
CPA audits required by the SEC for publicly-held companies seek to insure financial statement credibilty.

11.

The Value of an Accounting Education

- Studying and understanding the language of business and understanding the kinds of information available to decision makers (investors, creditors and management) is great preparation to become a business decision maker.

- Career opportunities in CPA firms.
  - Partner/Ownership in large international firms or small local firms
  - Stepping stone to other opportunities:
    CFO, CEO and other management positions
    Entrepreneurship

12.

Legal Forms of Business Ownership

Business Ownership:
Three Basic Legal Forms

1. Proprietorship:
   - One owner.
   - No legal red tape except if employees hired.
   - No seperation of business and personal legal liability. (This can be addressed through insurance.)
   - No separate income taxation.

2. Partnership: Same as proprietorship except there is more than one owner.
   - No legal red tape except if employees hired.
   - A formal partnership agreement is recommended but not required.
   - No separation of business and personal liability.
   - No separate income taxation.

3. Corporation: A separate legal entity apart from its owners
- **Legal red tape in formation and operation imposed by the state.**
- **One or more owners. A corporate form of business greatly facilitates many owners and the transfer of ownership interests.**
- **Separation of business and personal liability of owners.**
- **Seperation of business and personal taxation (double taxation)**

Effects of Separate Corporate Taxation

\$10 million	**Profit**
x 36%	**Corporate federal income tax**
\$6.4 million	**After tax corporate profit paid as a dividend to owners**
x 40%	**Personal federal income tax**
\$3.8 million	**Owners' after tax return on investmvent**

Example of Double Taxation

Assume that after years of effort a business begins to operate successfully and generates a \$1,000,000 profit in the current year. If that business operates as a proprietorship, the \$1,000,000 of profit is then included in the owner's personal income tax return and taxed at his or her personal rate. If we assume a federal income tax rate of 28% and a state rate of 7% then the 35% combined rate would result in a \$350,000 tax payable which leaves \$650,000 as the net after-tax profit to the owner. By the way, as mentioned previously, partnerships are taxed similar to proprietorships in that their profits are allocated to the partners and then included in their personal income tax returns. There is no separate or additional tax charged to the partnership.

On the other hand, if this business operates as a corporation then its profits are taxed first at a corporate rate before an additional tax is charged to the owners on any distribution of the remaining profits. For example, using the maximum federal corporate income tax rate of 35% and an assumed 7% state income tax rate the combined 42% would result in a \$420,000 corporate income tax payable on the \$1,000,000 of profit. That leaves \$580,000 for the owners which is then taxed again if it's distributed as a dividend. Dividend income is currently taxed at a 15% federal rate which means an additional \$87,000 tax payable by the owners.

Shareholders (Invest Capital)
↓ **Elect**
Board of Directors (Advise for a fee)
↓ **Hires**
Top Management Personnel (Manage for a salary)
↓ **Hires**
Other Employees (Work for a salary/wage)
↓
Produce Profits for Owners