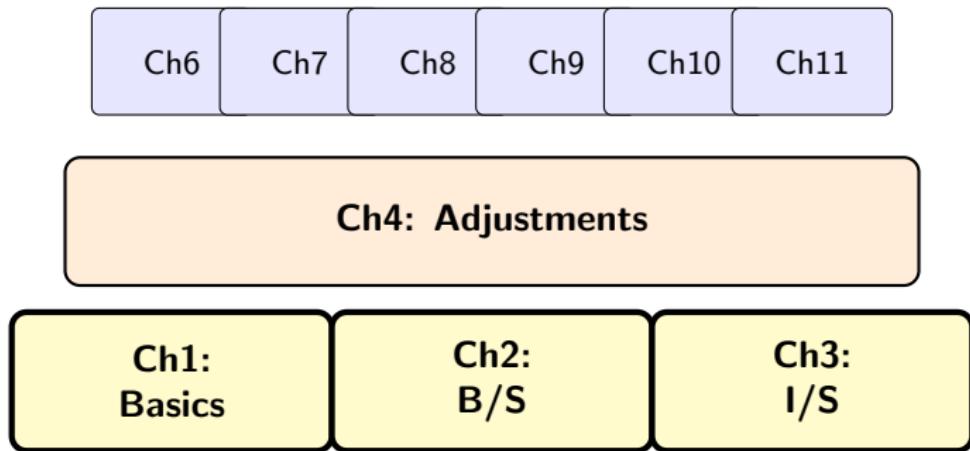
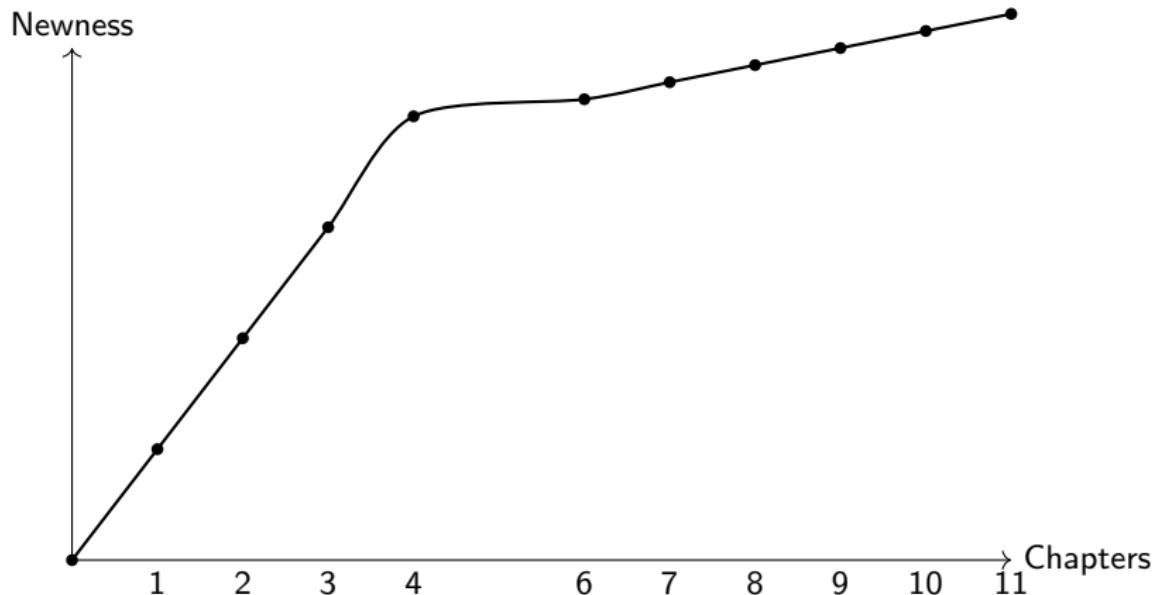


ACC250: Intro to Financial Accounting

Ch1. Business Decisions and Financial Accounting

Jaeyoon Yu, Ph.D.
Central Michigan University





You have reasons to stay focused in the **first part** of the course!

Once you understand **Ch1-Ch4**, you will have a solid foundation for the rest of the course!

Table of Contents

- 1 Corporations as a Common Form of Business Organization
- 2 Accounting for Business Decisions
- 3 Basic Accounting Equation: $A = L + SHE$
 - Assets
 - Liabilities
 - Shareholders' Equity
 - $A = L + SHE$
- 4 Financial Statements
 - Income Statement
 - Statement of Retained Earnings
 - Balance Sheet
 - Statement of Cash Flows
 - Relationship between Financial Statements
- 5 Types of Business Activities
- 6 Closing Illustration
- 7 List of A & L accounts

- Year 1:
 - ▶ Imagine you open a lemonade stand all by yourself.
 - ▶ You're the only owner—this is called a sole proprietorship.
- Year 2:
 - ▶ After a while, you ask your sister to help you run the stand.
 - ▶ Now, there are two owners working together—this is a partnership.
- Year 3:
 - ▶ Some local friends want to invest and become part-owners.
 - ▶ Now, you all become shareholders in a corporation.



① Sole proprietorship:

- ▶ A business owned and operated by one individual.
- ▶ The owner is personally responsible for all debts and obligations.

② Partnership:

- ▶ Similar to a sole proprietorship, but with multiple owners.
- ▶ Partners share profits, losses, and responsibility for managing the business.

③ Corporation:

- ▶ A separate legal entity owned by shareholders.
- ▶ Owners have limited liability.
- ▶ The business can raise capital by issuing stock.
- ▶ A common form of business organization (e.g., Apple, Microsoft, etc.).

Form	N (owners)	Limited Liab?	Separate Entity?
Sole Prop.	1	No	No
Partnership	2+	No	No
Corporation	1+*	Yes	Yes

* Usually 1K+

- A corporation is **distinguished** from its owners (shareholders).
- Shares can be bought and sold, allowing for easy transfer of ownership.
- A corporation can enter into contracts, sue and be sued, and own property in its own name.
- A corporation's liabilities are **not the liabilities of its owners**.
- Shareholder losses are **limited to their investment** in the corporation.

Corporations - Limited Liability

- Owners' liabilities are limited to their investment in the corporation.
- This limited liability protects shareholders' personal assets from being used to satisfy the corporation's debts.

In this course, we focus on corporations.



Corporations can be classified into two types:

- **Private companies**: companies with shares not publicly traded
- **Public companies**: companies with shares listed on a stock exchange (e.g., NYSE, NASDAQ)

A couple more facts:

- There are more than **4,000** public companies in the US.
- **S&P 500 index** covers 500 public companies that are large and well-established.
- You can invest in the S&P 500 index by buying an index fund (e.g., **ETFs** like **SPY**, **VOO**).

1 Corporations as a Common Form of Business Organization

2 Accounting for Business Decisions

3 Basic Accounting Equation: $A = L + SHE$

- Assets
- Liabilities
- Shareholders' Equity
- $A = L + SHE$

4 Financial Statements

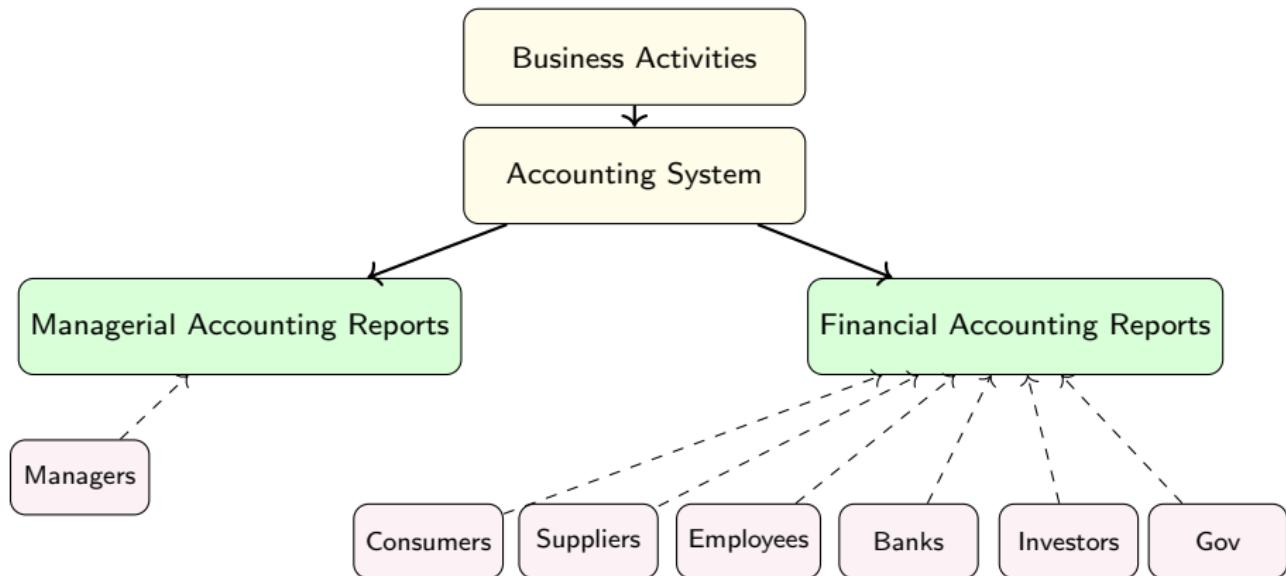
- Income Statement
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows
- Relationship between Financial Statements

5 Types of Business Activities

6 Closing Illustration

7 List of A & L accounts

- Accounting is the **language of business**.
- Accounting provides information for decision-making.



- **Managers:** Use accounting information to help run the business.
- **Consumers:** Decide whether to buy the business's products or services.
- **Suppliers:** Check if the business can pay for goods and services.
- **Employees:** Look at the business's finances for job security and pay.
- **Banks:** Decide whether to lend money to the business.
- **Investors:** Decide whether to buy or sell shares in the business.
- **Governments:** Use information to set taxes and check rules are followed.

Usefulness of Accounting

Accounting is used to help stakeholders make decisions.

1 Corporations as a Common Form of Business Organization

2 Accounting for Business Decisions

3 Basic Accounting Equation: $A = L + SHE$

- Assets
- Liabilities
- Shareholders' Equity
- $A = L + SHE$

4 Financial Statements

- Income Statement
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows
- Relationship between Financial Statements

5 Types of Business Activities

6 Closing Illustration

7 List of A & L accounts

Basic Accounting Equation

- Assets (A) = Liabilities (L) + Stockholders' Equity (SHE)
(Resources) = (Sources of Resources)

Assets (A) **Resources** owned or controlled by a company that are expected to provide future economic benefits.

Liabilities (L) **Obligations** of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

SHE **Residual interest** in the assets of a company after deducting liabilities; represents the owners' claims on the business; **Defined by A - L.**

Assets (A)

Resources owned by a company that are expected to provide future economic benefits.

Examples:

- Cash: \$10,000
- Equipment: \$20,000
- Inventory: \$10,000

EX 1. What assets do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Cash: \$60,000 (50,000 - 20,000 - 0 + 30,000)

Equipment: \$20,000

Total Assets: \$80,000

EX 2. What assets do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Cash: \$80,000 (50,000 - 0 - 0 + 30,000)

Equipment: \$20,000

Total Assets: \$100,000

Liabilities (L)

Obligations of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

Examples:

- Accounts Payable: \$10,000 (owed to suppliers)
- Salaries Payable: \$10,000 (owed to employees)
- Notes Payable: \$20,000 (owed to banks)

EX 1. What liabilities do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Salaries Payable: \$10,000

Accounts Payable: \$0

Total Liabilities: \$10,000

EX 2. What liabilities do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Salaries Payable: \$10,000

Accounts Payable: \$20,000

Total Liabilities: \$30,000

Stockholders' Equity (SHE)

The residual interest in the assets of a company after deducting liabilities; represents the owners' claims on the business.

- SHE consists of 2 components:
 - ▶ Contributed Capital (a.k.a. Paid-in Capital or Common Stock)
 - ▶ Retained Earnings (a.k.a. Earned Capital)

Retained Earnings (Earned Capital, Equity)

The cumulative amount of net income retained in the business after dividends are paid.

Retained Earnings Equation

$$\text{End. RE} = \text{Beg. RE} + \text{Net Income} - \text{Dividends}$$

Contributed Capital (Paid-in Capital, Equity)

The total amount of cash that investors or owners have directly invested into a company in exchange for an ownership stake.

EX 1. How much shareholders' equity do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Hint:

- \$20,000 equipment is **not expensed** immediately. It's a long-term asset.
- It will be recognized as an expense over time (we will learn this later).
- \$10,000 wages are **expensed** as it incurred though cash will be paid later.

Contributed Capital: \$50,000

Retained Earnings: \$20,000

Shareholders' Equity: \$70,000

EX 2. How much shareholders' equity do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Hint:

- \$20,000 equipment is not expensed immediately. It's a long-term asset.
- It will be recognized as an expense over time (we will learn this later).
- \$10,000 wages are expensed as it incurred though cash will be paid later.

Contributed Capital: \$50,000

Retained Earnings: \$20,000

Shareholders' Equity: \$70,000

Calculate Contributed Capital (CC), Retained Earnings (RE), and Shareholders' Equity (SHE) at the end of each year.

EX. Year 1 transactions:

- Initial investment from shareholders: \$10,000.
- Borrowed \$20,000 from a bank.
- Net Income in year 1: \$1,000.

At the end of year 1:

CC	<u>\$10,000</u>
RE	<u>\$1,000</u>
SHE	<u>\$11,000</u>

EX. Year 2 transactions:

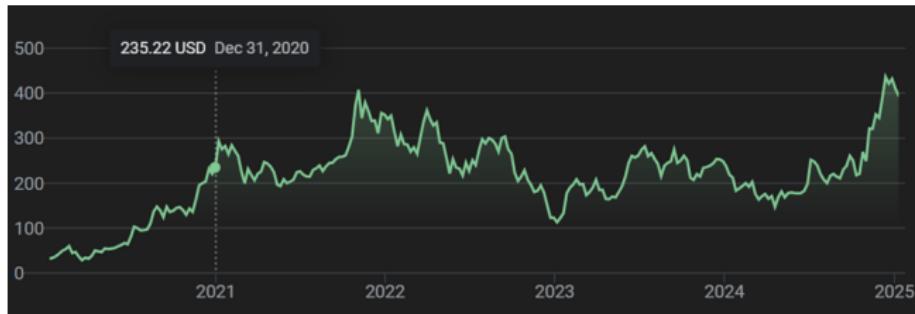
- Net Income in year 2: \$3,000.
- Dividends in year 2: \$2,000.

At the end of year 2:

CC	<u>\$10,000</u>
RE	<u>\$2,000</u>
SHE	<u>\$12,000</u>

If the business goes well, the retained earnings will increase (good for shareholders).

- **Shareholders** are the owners of the corporation.
- Shareholders are residual claimants.
- They enjoy all ups-and-downs of the corporation (and its stock price).



- Unlike shareholders, **other stakeholders** have fixed claims on the corporation.
 - ▶ Suppliers: the amount promised to be paid for goods and services.
 - ▶ Employees: the amount promised to be paid for work.
 - ▶ Banks: the amount promised to be paid for loans.

Let's confirm the equation $A = L + SHE$ with examples.¹

EX 1.

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

A: \$80,000
L: \$10,000
SHE: \$70,000

EX 2.

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

A: \$100,000
L: \$30,000
SHE: \$70,000

¹It's not easy to get the numbers here. You should check again the previous slides to get A, L, and SHE for these examples. We will study a systematic way to get these numbers in the next chapters.

1 Corporations as a Common Form of Business Organization

2 Accounting for Business Decisions

3 Basic Accounting Equation: $A = L + SHE$

- Assets
- Liabilities
- Shareholders' Equity
- $A = L + SHE$

4 Financial Statements

- Income Statement
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows
- Relationship between Financial Statements

5 Types of Business Activities

6 Closing Illustration

7 List of A & L accounts

- Used to make business decisions.
- Used to communicate with stakeholders.
- Four main financial statements:
 - ① Income Statement
 - ② Statement of Retained Earnings²
 - ③ Balance Sheet
 - ④ Statement of Cash Flows

²**S of Retained Earnings** is not a standalone financial statement. It's part of **S of Shareholders' Equity**. As an introductory course, we will not cover **S of Shareholders' Equity** but will cover **S of Retained Earnings**.

- ① Public companies are required to report financial statements to the Securities and Exchange Commission (SEC).
- ② Each company has its own **fiscal-year end** and **fiscal-year period**.
- ③ For example, Crocs' fiscal-year end is **December 31st**.
- ④ The company reports financial statements for the fiscal year ended **December 31st**.
- ⑤ In addition to the annual reports, quarterly reports are also required.
 - ▶ **Q1**: Jan 1st to Mar 31st
 - ▶ **Q2**: Apr 1st to Jun 30th
 - ▶ **Q3**: Jul 1st to Sep 30th
 - ▶ **Q4**: Oct 1st to Dec 31st (i.e., **annual**)

1. Income Statement

Income Statement

A financial statement that reports a company's revenues, expenses, and net income over a period of time.

Lemonade Stand, Inc.
Income Statement
For the Year Ended December 31, 2025

Revenues	\$500
Salaries Expense	\$200
Supplies Expense	\$100
<u>Net Income</u>	<u>\$200</u>

2. Statement of Retained Earnings

Statement of Retained Earnings

A financial statement that shows changes in retained earnings over a period, including net income and dividends.

Lemonade Stand, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2025

Beg. Retained Earnings	\$0
+) Net Income	<u>\$200</u>
-) Dividends	(\$100)
End. Retained Earnings	<u>\$100</u>

3. Balance Sheet

Balance Sheet

A financial statement that shows a company's assets, liabilities, and equity at a specific point in time.

Lemonade Stand, Inc.
Balance Sheet
As of December 31, 2025

Assets

Cash	\$300
Equipment	\$300
Total Assets	\$600

Liabilities

Accounts Payable	\$100
Salaries Payable	\$0

Shareholders' Equity

Contributed Capital	\$400
Retained Earnings	\$100

Total Liabilities & Equity

\$600

4. Statement of Cash Flows [Appendix]

Statement of Cash Flows

A financial statement that summarizes the cash inflows and outflows from operating, investing, and financing activities over a period.

Lemonade Stand, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2025

Operating Cash	\$300
Investing Cash	(\$300)
Financing Cash	\$300
Net Cash Change	\$300
Beg. Cash	\$0
End. Cash	\$300

- The ending balance of cash should be the same as the ending balance of cash in the balance sheet.
- The S of Cash Flows is included here for reference, but we do **not** cover this statement in this course.

Income Statement Equation

$\text{Net Income} = \text{Revenues} - \text{Expenses}$

Retained Earnings Equation

$\text{End. RE} = \text{Beg. RE} + \text{Net Income} - \text{Dividends}$

Balance Sheet Equation

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

Relationship between Financial Statements

Cash Balance from
Cash Flows Statement

Lemonade Stand, Inc.
Income Statement
For the Year Ended December 31,
2025

Revenues	\$500
Salaries Expense	\$200
Supplies Expense	\$100
Net Income	\$200

Lemonade Stand, Inc.
Statement of Retained Earnings
For the Year Ended December 31,
2025

Beg. Retained Earnings	\$0
+) Net Income	\$200
-) Dividends	(\$100)
End. Retained Earnings	\$100

Lemonade Stand, Inc.
Balance Sheet
As of December 31, 2025

Assets	
Cash	\$300
Equipment	\$300
Total Assets	\$600
Liabilities	
Accounts Payable	\$100
Salaries Payable	\$0
Shareholders' Equity	
Contributed Capital	\$400
Retained Earnings	\$100
Total Liabilities & Equity	\$600

1 Corporations as a Common Form of Business Organization

2 Accounting for Business Decisions

3 Basic Accounting Equation: $A = L + SHE$

- Assets
- Liabilities
- Shareholders' Equity
- $A = L + SHE$

4 Financial Statements

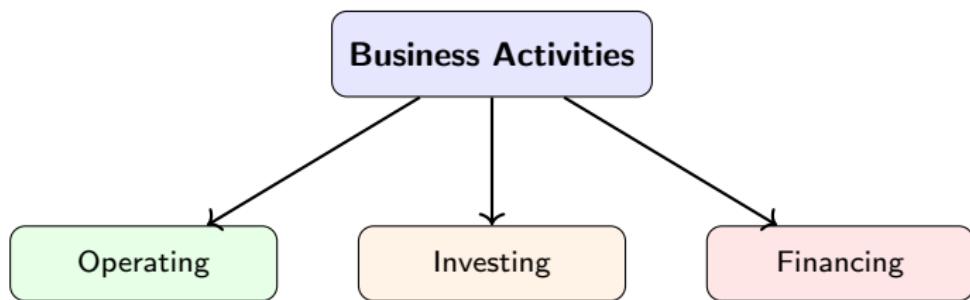
- Income Statement
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows
- Relationship between Financial Statements

5 Types of Business Activities

6 Closing Illustration

7 List of A & L accounts

Three Types of Business Activities



Three Types of Business Activities

Operating Activities:

- Those related to the day-to-day operations of the business.
 - ▶ Generating **revenues**;
 - ▶ Using resources to generate revenues (i.e., **Expenses**).
 - ▶ (*) Paying interests.³

Financing Activities:

- Those related to obtaining or repaying funds used to finance the business.
 - ▶ Raising capital from shareholders (**issuing stock**)
 - ▶ Borrowing from creditors (taking **loans**)
 - ▶ Paying dividends to shareholders
 - ▶ Repaying loans
 - ▶ (*) Paying interests.

Investing Activities:

- Those related to acquiring or disposing of **long-term assets**.
 - ▶ Purchasing equipment, land, or buildings
 - ▶ Selling long-term assets

³(*) Repaying the principal is a financing activity, while **paying interest** is usually classified as an **operating activity** under U.S. GAAP. because interest is a cost of doing business. But it could be classified as a **financing activity**. Firms have discretion for this.

Closing Illustration

Required:

- Classify each transaction into one of the three types of business activities.
- Enter the amount of the transaction in the appropriate column.

Description	Type	A	L	R	E	CC
You invested \$10,000 into your business.	F	+10K				+10K
Your business used \$5,000 to buy kitchen appliances.	I	+5K -5K ¹				
Your business borrowed \$20,000 from PNC bank.	E	+20K	+20K			
Your business recorded \$3,000 revenues (and collected \$3,000 cash).	O	+3K		+3K		
Your business paid \$1,000 interest to PNC bank.	O	-1K			+1K	
Your business paid \$10,000 wages to employees.	O	-10K			+10K	
You convinced your friends to invest \$20,000 into your business.	F	+20K				+20K

¹Asset composition changes: cash decreases, equipment increases by \$5,000; total assets unchanged.

Closing Illustration

Recall:

- $A = L + SHE$.
- $SHE = CC + RE$.
- $RE_t = RE_{t-1} + NI_t - \text{Div}_t$. (where t is the current year)
- $NI_t = R_t - E_t$.

Complete the below table:

Description	A	L	SHE
You invested \$10,000 into your business.	+10K		+10K
Your business used \$5,000 to buy kitchen appliances.	+5K -5K ¹		
Your business borrowed \$20,000 from PNC bank.	+20K	+20K	
Your business recorded \$3,000 revenues (and collected \$3,000 cash).	+3K		+3K
Your business paid \$1,000 interest to PNC bank.	-1K		-1K
Your business paid \$10,000 wages to employees.	-10K		-10K
You convinced your friends to invest \$20,000 into your business.	+20K		+20K

¹Asset composition changes: cash decreases, equipment increases by \$5,000; total assets unchanged.

Asset Accounts

Asset Account	Definition
Cash	Money available for immediate use, including currency, coins, and balances in checking accounts.
Accounts Receivable	Amounts owed to the business by customers for goods or services delivered but not yet paid for.
Inventory	Goods held for sale in the ordinary course of business.
Prepaid Expenses	Payments made in advance for goods or services to be received in the future (e.g., prepaid rent, prepaid insurance).
Equipment	Tangible long-term assets used in operations, such as machinery, computers, and vehicles.
Supplies	Items used in the course of business operations that are not intended for sale (e.g., office supplies).
Land	The cost of land owned by the business, not subject to depreciation.
Buildings	Structures owned and used in business operations.

Liability Accounts

Liability Account	Definition
Accounts Payable	Amounts owed to suppliers for goods or services received but not yet paid for.
Notes Payable	Amounts owed to banks for loans taken.
Interest Payable	Amounts owed to banks for interest not yet paid.
Salaries Payable	Amounts owed to employees for wages not yet paid.
Taxes Payable	Amounts owed to government for taxes not yet paid.
Deferred Revenue	Revenue received in advance for goods or services to be provided in the future (e.g., prepaid rent, prepaid insurance).