

# Financial Accounting

For Owners, Managers, and Administrators

## Learn Difficult Concepts The Quick Notes Way

- ★ Easy to follow outline format
- ★ Concise 1- and 2-page learning units
- ★ Three quizzes stress important concepts
- ★ Complete solutions to quizzes help with difficult concepts

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**21st Century Learning Products**

# Financial Accounting

## For Owners, Managers, and Administrators

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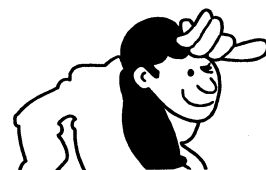
# Part I Introduction to Financial Accounting

## Unit 1 Introduction to Business

### I. The Concept of Business

- A. Business turns natural and human resources into goods and services and distributes them to users.
- B. Businesses are for profit or not for profit.
  - 1. Profit is what is left after accounting for all financial obligations.
  - 2. Non-profit organizations include some colleges, governments, charities, and social organizations.
- C. Business terms often have more than one meaning.
  - 1. The term capital is defined by the financial community as **the money** used to buy items that aid production. An economist defines capital as **something that aids production**.
  - 2. Profit earned by an entrepreneur is different than taxable profit reported by the accounting community.
  - 3. Units 15 and 16 on Financial Statement Analysis will use financial measurements to explore business terms such as *capital* and *profit*.

Remember to look at the key points of a learning unit before studying the detail. This unit covers The Concept of Business, Legal Forms of Business Enterprise, and Business Classifications.



### II. Legal Forms of Business Enterprise

- A. There are three legal forms of business.
  - 1. A sole proprietorship is owned by one person.
  - 2. A partnership has two or more owners.
  - 3. A corporation is a legal entity distinguishable from its owners.
- B. These basic characteristics of the three legal forms of business should be considered when determining which legal form is appropriate for a business.

Characteristic Legal Form	Ease of Formation	Length of Life	Raising Capital	Owner's Liability	Taxes
<b>Sole Proprietorship</b>	Easy, just start	Limited to owner's life	Difficult, resources of one owner	Unlimited, personal assets at risk	Once, as personal income
<b>Partnership</b>	Easy, just start	Shortest, death or disagreement ends partnership	Easier, resources of the owners	Unlimited, personal assets at risk <sup>1</sup>	Once, as personal income
<b>Corporation</b>	Somewhat difficult, file forms, pay state	Unlimited	Easiest, resources of anyone interested	Limited to investment	Twice, as corporate income <sup>2</sup> & dividend income

<sup>1</sup> Partners of a **limited liability partnership** are not financially responsible for the actions of their partners.  
<sup>2</sup> A subchapter S corporation has up to 35 owners and is not subject to corporate taxes. Owners are taxed as individuals.

### III. Business Classifications

- A. **Manufacturers** make goods (computers, cars, TVs).
- B. **Merchandisers** sell goods.
  - 1. **Wholesalers** move goods from one business to another business.  
A wholesaler of beverages might gather many kinds of your favorite liquid refreshment and distribute them to stores, colleges, and restaurants.
  - 2. **Retailers** sell goods to end users (Sears, The Gap).
- C. **Services** sell intangibles, such as insurance, education, and housecleaning

## Unit 2 Decision Making

### I. Basic Functions of Management

Plan	Organize	Coordinate	Control	Evaluate
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### II. Performing Management Functions Requires Decision Making.

### III. Steps to Decision Making

Identify problem.	Gather the relevant information.	Determine alternative solutions.	Analyze alternative solutions.	Choose an alternative solution.	Implement solution and monitor results.
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### IV. Group Decision Making

- A. As the world becomes more complicated, group decision making becomes more important.
- B. Psychologist Howard Gardner's **Theory of Multiple Intelligence**<sup>1</sup> lists eight kinds of human intelligence. Lately, the business community has stressed the sixth kind, the ability of people to work in groups.
1. **Mathematical-logical** (problem solving, fixing or repairing, programming)
  2. **Spatial** (dancing, sports, driving a bus)
  3. **Bodily-kinesthetic** (acting, mime, sports)
  4. **Musical-rhythmic** (composing, playing music, clapping)
  5. **Verbal-linguistic** (reading, using words, reading, public speaking, storytelling)
  6. **Interpersonal** (social skills, reading other people, **working in a group**)
  7. **Intrapersonal** (introspection, self-assessment, goal making, vision, planning)
  8. **Naturalist** (able to classify items)
- Note:** Traditional accounting books are written for people with high mathematical-logical intelligence. While this book is useful for these people, it is particularly useful for the other people who's high intelligence is in one or more of the other areas.

### V. Decision Making Requires Accounting Information.

- A. **Accounting information** is financial data put into a useful form. A balanced checkbook is financial information because financial data, checks written and deposits, has been made more useful.
- B. The **Financial Accounting Standards Board (FASB)** has set the following criteria for determining the usefulness of "**financial accounting**" information.
1. **Understandability**
  2. **Usefulness** requires information be **relevant and reliable**.
  3. **Comparability** requires information be **consistent**.
  4. **Materiality** requires information be important enough to affect a reader's interpretation.
- C. In addition, FASB requires accountants to follow the principle of **conservatism** in the measurement of value. This means subjective analysis should not overstate revenue and asset value or understate expenses and liabilities. FASB also requires **full disclosure** of all relevant information.
- D. External users often require certified information for making decisions.
1. External users include banks, investors, customers, vendors, and governments.
  2. Certified information is provided by financial accounting.
- E. Internal users need accounting information to make decisions.
1. These users do not require certified information.
  2. **Managerial accounting** provides this type of information.

<sup>1</sup> *The Learning Brain*, Eric Jensen, self-published, 1995, and "How Many Smarts Do You Have," *Business Week*, September 16, 1996, pp 104-108.

# Unit 3 Financing a Business With Equity

## I. The Balance Sheet

- A. A balance sheet is based on the accounting equation.
- B. This view of the **accounting equation** is used to show how assets of **Quick Company** were financed.

**Assets = Liability + Owner's Equity**  
 $\$15,000,000 = \$7,000,000 + \$8,000,000$

- 1. **Assets** are items of value. **Quick Company** has items with a value worth \$15,000,000.
  - 2. **Liabilities** are amounts owed. Quick Company used liabilities (debt) to finance assets worth \$7,000,000.
  - 3. **Owner's equity** is the net worth of a business. Quick Company owners have invested \$8,000,000 to finance assets.
- C. This view of the **accounting equation** is used to show the value of a company.

**Assets - Liability = Owner's Equity**  
 $\$15,000,000 - \$7,000,000 = \$8,000,000$   
 Quick Company has **net worth** of \$8,000,000

- D. The balance sheet is a **statement of financial position** because it shows where the company is financially at a point in time.
- E. The balance sheet is also a **statement of financial condition** because it shows the financial health of a company at a point in time.

## II. Types of Balance Sheets

- A. The **account form** of balance sheet depicts categories horizontally. →
- B. The **report form** of balance sheet, shown below, depicts categories vertically.

Quick Company Opening Balance Sheet January 1, 1997			
<b>Assets</b>		<b>Liabilities</b>	
Cash	\$ 1,000,000	Notes Payable	\$ 7,000,000
Land	9,000,000	<b>Owner's Equity</b>	
Fixed Assets	<u>5,000,000</u>	Mr. C, Capital	<u>8,000,000</u>
<b>Total Assets</b>	<u><u>\$15,000,000</u></u>	<b>Total Liabilities and Owner's Equity</b>	<u><u>\$15,000,000</u></u>

← Sole proprietorship



Partnership →

Quick Company Opening Balance Sheet January 1, 1997		
<b>Assets</b>		
Cash	\$1,000,000	
Land	9,000,000	
Fixed Assets	<u>5,000,000</u>	
<b>Total Assets</b>		<u><u>\$15,000,000</u></u>
<b>Liabilities</b>		
Notes Payable		\$ 7,000,000
<b>Partners' Equity</b>		
Mr. C, Capital	\$4,000,000	
Mr. A, Capital	<u>4,000,000</u>	<u>8,000,000</u>
<b>Total Liabilities and Owner's Equity</b>		<u><u>\$15,000,000</u></u>

### III. The Corporate Balance Sheet

- A. People wishing to form a corporation must obtain a **state corporate charter**.
1. States also require **articles of incorporation** containing basic information on ownership and purpose.
  2. **Corporate bylaws**, defining how the corporation will be governed, are also required.
- B. Ownership shares called **stocks** are then sold to interested parties. Owners are called **stockholders**.
- C. A **board of directors** and **corporate officers** manage a corporation.
1. The **president**, often called the **chief executive officer (CEO)**, is appointed by the board of directors and is responsible for all company activity.
  2. The **controller** manages accounting activity.
  3. The **treasurer** manages cash.
- D. Owner's equity of a corporation is called **stockholders' equity**.
1. **Authorized shares** are granted for issue by the state.
  2. **Issued shares** have been sold to stockholders.
  3. **Outstanding shares** are still in the hands of stockholders.
  4. **Treasury stock** has been issued and bought back by the corporation.  
A corporation buys its own shares to use in stock-option plans, to influence the stock's market price, and because they are a good buy.
- E. **Types of Corporate Stock**
1. **Common stock** is the strongest form of corporate ownership because its owners elect the board of directors.
    - a. Common stock has a **par or stated value**. Par value is usually very small and does not relate to the amount received by the issuing corporation.
      - 1) Common stock usually sells above par value.
      - 2) The amount received above par value is called **contributed capital in excess of par**.
      - 3) One million shares of \$1.00 par value common stock sold for \$5.00 per share is valued as follows:
        - a) **Common stock** equals \$1.00 par x 1,000,000 shares = \$1,000,000.
        - b) **Contributed capital in excess of par** for common stock equals \$4.00 x 1,000,000 shares = \$4,000,000.
        - c) **Common stockholders' equity** equals \$1,000,000 + \$4,000,000 = \$5,000,000.
      - 4) **No par stock** came into existence when some states stopped requiring stock to have a par value.
    - b. Periodic payments to stockholders are called dividends.
    - c. The board of directors determine the amount of a common stock dividend and whether it is paid.
  2. **Preferred stock**
    - a. Preferred stock has this name because its owners receive dividends before common stockholders do.
    - b. In the case of **liquidation (the closing of a business)**, preferred stockholders also have a prior claim over common stockholders in reference to return of their investment.
    - c. Preferred stockholders do not vote for the board of directors.
    - d. A preferred dividend is a percentage of the stock's par value. An 8% dividend paid on a \$100 par value preferred stock would be .08(\$100) = \$8.00.
    - e. 25,000 shares of \$100 par value preferred stock sold for \$120 per share is valued as follows:
      - 1) **Preferred stock** equals \$100 par x 25,000 shares = \$2,500,000.
      - 2) **Contributed capital in excess of par** for preferred stock equals \$20 x 25,000 shares = \$500,000.
      - 3) **Preferred stockholders' equity** equals \$2,500,000 + \$500,000 = \$3,000,000.
- F. **Total contributed capital** is the amount received from stockholders to finance assets.

Quick Company Opening Balance Sheet January 1, 1997			
<b>Assets</b>		<b>Liabilities</b>	
Cash	\$ 1,000,000	Notes Payable	\$ 7,000,000
Land	9,000,000	<b>Stockholders' Equity</b>	
Fixed Assets	<u>5,000,000</u>	Preferred Stock (\$100 x 25,000 shares)	\$2,500,000
<b>Total Assets</b>	<u><u>\$15,000,000</u></u>	Common Stock (\$1 x 1,000,000 shares)	1,000,000
		<b>Contributed Capital in Excess of Par</b>	
		Preferred Stock (\$20 x 25,000 shares)	500,000
		Common Stock (\$4 x 1,000,000 shares)	<u>4,000,000</u>
		<b>Total Contributed Capital</b>	<u>8,000,000</u>
		<b>Total Liabilities and Stockholders' Equity</b>	<u><u>\$15,000,000</u></u>

# Unit 4 Financing a Business With Liabilities

## I. Introduction

- A. Unit 3 explained how assets are financed **with equity**.
- B. This unit explains how assets are financed **with liabilities** (debt).

## II. Accounts Payable

- A. These informal oral obligations are incurred to buy merchandise, supplies, services, and other common everyday items.
- B. Similar liabilities, important enough to be given their own name, include Wages Payable, Rent Payable, Taxes Payable, and Interest Payable.

## III. Notes Payable

- A. A **note payable** is a written statement of the conditions of a loan.
- B. **Loan conditions**
  - 1. **Principal (P)** is the amount of the loan.
  - 2. **Time (n)** is the length (term) of the loan.
  - 3. **Interest rate (i)** is the percentage paid or earned on the principal.
    - a. Interest is normally stated annually.
    - b. A three month loan (one-fourth of a year) at 8% would require that 2%, (8%÷4), be paid on the principal.
  - 4. Loans often require collateral.
    - a. **Collateral** is something of value that must be forfeited if a loan is **defaulted** on (not paid back).
    - b. A **mortgage** states the parties' agreement concerning collateral.
- C. Calculating interest
  - 1. **Interest** is either the cost of borrowing or the benefit of lending.
  - 2. The interest paid on a \$7,000,000 loan at 12% for six months would be calculated as follows:

$$\text{Interest} = (\text{principal})(\text{interest rate})(\text{time})$$

$$I = pin$$

$$= (\$7,000,000)(.12)\left(\frac{6}{12}\right) = \$420,000$$

## IV. Bond Financing

- A. When a large amount of debt financing is required, a **bond issue**, described with a **bond indenture**, may be used.
- B. A bond issue consists of many notes payable having the same conditions.
- C. A company may raise \$7,000,000 by selling 1,400 bonds with a **par (face) value** of \$5,000.
- D. Bond interest
  - 1. The specified annual rate **paid on the par value** of a bond is called the **nominal interest rate**. Other names for this rate include stated, coupon, and contract.
  - 2. Bonds often sell below or above par.
    - a. A bond's **nominal interest rate** is stated on the bond, used to determine interest paid on the bond, is determined months before the bonds will be sold, and based on these factors:
      - 1) Debt market conditions at the time the bond indenture is written
      - 2) An estimate of what potential bond buyers think about the financial condition of the company borrowing the money
    - b. If debt market conditions worsen (interest rates increase) and/or the financial condition of the company worsens, a bond will sell at a **discount (below par)**. Since the company receives less than face value, the **effective interest rate** they pay is higher than the bond's nominal rate.
      - 1) A \$5,000, 12% bond pays interest of  $I = Pin = \$5,000(.12)(1) = \$600/\text{year}$ .
      - 2) If market conditions worsen and the company receives only \$4,900, the effective interest rate would be 12.2%.
    - c. If debt market conditions improve (interest rates decrease) and/or the financial condition of the company improves, a bond will sell at a **premium (above par)**. This means the company would pay an effective interest rate below 12%.

$$\frac{I}{\text{Amount Received}} = \frac{\$600}{\$4,900} \approx 12.2\%$$

## V. Financial Markets

- A. Stocks and bonds are called financial securities. They are originally sold by financial companies to customers in the **primary financial markets**.
- B. These financial securities may then be sold and resold many times in the **secondary financial markets**.
  - 1. The **Dow Jones Industrial Average** is the technically adjusted total selling price of 30 very well known companies (IBM, ATT, etc.) listed on the New York Stock Exchange. These stocks were originally sold many years ago for a much lower price.
  - 2. A 30-year bond selling 2% above par is quoted in the financial markets as selling for 102. This means a \$10,000 bond listed at 102 is selling for  $1.02 \times \$10,000 = \$10,200$ .

## Part I Quiz

**Instructions:** Answer the following questions and problems. Show all work.

I. Complete this chart concerning the characteristics of the three legal forms of business.

Characteristic Legal Form	Ease of Formation	Length of Life	Raising Capital	Owner's Liability	Taxes
		Limited to owner's life		Unlimited, personal assets at risk	Once, as personal income
	Easy, just start		Easier, resources of the owners		

II. Match each term with the most appropriate description.

1) _____ Howard Gardner	(A) Items of value
2) _____ Managerial accounting	(B) Amounts owed
3) _____ Deferred revenue	(C) The closing of a business
4) _____ Assets	(D) Provides certified information
5) _____ Liabilities	(E) Multiple intelligence
6) _____ $A + L =$	(F) Received but not earned
7) _____ Liquidation	(G) Earned but not received
8) _____ Effective interest per period	(H) Owner's equity
9) _____ Accrued revenue	(I) $\frac{I}{\text{amount received}}$
10) _____ Financial accounting	(J) Provides information for internal decision making

III. Place the five functions of management in the proper location.

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IV. Make an account form balance sheet after year one operations for ZIP Corporation. Retained earnings of \$600,000 is the result of a \$400,000 dividend being subtracted from net income of \$1,000,000. Total stockholders' equity should equal retained earnings added to total contributed capital. Use a 1999 calendar year.

Buildings	\$2,000,000
Contributed Capital in Excess of Par/Preferred Stock	500,000
Taxes Payable	90,000
Equipment	1,000,000
Preferred Stock	1,500,000
Contributed Capital in Excess of Par/Common Stock	4,000,000
Cash	1,700,000
Common Stock	2,000,000
Salaries Payable	20,000
Land	8,000,000
Retained Earnings	600,000
Supplies	10,000
Notes Payable	4,000,000


## Suggested Project

- I. This project provides an opportunity to apply accounting concepts and procedures to a realistic situation. You may find it helpful to work with others when completing this project.
- II. The project consists of **pro forma financial statements and financial analysis** for the first five years of a corporation. The development of these statements, and not the actual data, are the central theme of this project.
- III. The project should be completed with spreadsheet computer software.
- IV. The project should include these items.
  - A. Opening day balance sheet dated January 1, 2001.
  - B. A Multi-Step income statement for 2001.
  - C. A statement of stockholders' equity dated December 31, 2001.
  - D. A December 31, 2001, balance sheet using information from the 2001 statement of stockholders' equity.
  - E. A statement of cash flows dated December 31, 2001.
  - F. Projected income statements for 2002 through 2005.
  - G. Horizontal and vertical analysis using beginning and ending 2001 balance sheets.
  - H. Horizontal and vertical analysis using 2001 through 2002 income statements.
  - I. Trend analysis using 2001 through 2005 income statements.
  - J. Ratio analysis for the December 31, 2001, balance sheet.
  - K. Additional material may include, but is not limited to, additional research material, graphs, charts, and other material.

## Part I Quiz Solutions

**Instructions:** Answer the following questions and problems. Show all work.

I. Complete this chart concerning the characteristics of the three legal forms of business.

Characteristic Legal Form	Ease of Formation	Length of Life	Raising Capital	Owner's Liability	Taxes
<b>Sole Proprietorship</b>	Easy, just start	Limited to owner's life	Difficult, resources of one owner	Unlimited, personal assets at risk	Once, as personal income
<b>Partnership</b>	Easy, just start	Shortest, death or disagreement ends partnership	Easier, resources of the owners	Unlimited, personal assets at risk	Once, as personal income
<b>Corporation</b>	Somewhat difficult, file forms, pay state	Unlimited	Easiest, resources of anyone interested	Limited to investment	Twice, as corporate income & dividend income

II. Match each term with the appropriate description.

1) <u>E</u> Howard Gardner	(A) Items of value
2) <u>J</u> Managerial accounting	(B) Amounts owed
3) <u>F</u> Deferred revenue	(C) The closing of a business
4) <u>A</u> Assets	(D) Provides certified information
5) <u>B</u> Liabilities	(E) Multiple intelligence
6) <u>H</u> $A + L =$	(F) Received but not earned
7) <u>C</u> Liquidation	(G) Earned but not received
8) <u>I</u> Effective interest per period	(H) Owner's equity
9) <u>G</u> Accrued revenue	(I) $\frac{I}{\text{amount received}}$
10) <u>D</u> Financial accounting	(J) Provides information for internal decision making

III. Place the five functions of management in the proper location.

Plan	Organize	Coordinate	Control	Evaluate
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IV. Make an account form balance sheet after year one operations for ZIP Corporation. Retained earnings of \$600,000 is the result of a \$400,000 dividend being subtracted from net income of \$1,000,000. Total stockholders' equity should equal retained earnings added to total contributed capital. Use a 1999 calendar year.

ZIP Corporation Opening Balance Sheet December 31, 1999			
<b>Assets</b>		<b>Liabilities</b>	
Cash	\$ 1,700,000	Taxes Payable	\$ 90,000
Supplies	10,000	Salaries Payable	20,000
Buildings	2,000,000	Notes Payable	<u>4,000,000</u>
Equipment	1,000,000	<b>Total Liabilities</b>	<b>\$ 4,110,000</b>
Land	<u>8,000,000</u>		
<b>Total Assets</b>	<b><u>\$12,710,000</u></b>	<b>Stockholders' Equity</b>	
		Preferred Stock	\$1,500,000
		Common Stock	2,000,000
		<b>Contributed Capital In Excess of Par</b>	
		Preferred Stock	500,000
		Common Stock	<u>4,000,000</u>
		Total Contributed Capital	\$8,000,000
		Retained Earnings	<u>600,000</u>
		Total Stockholders' Equity	<u>8,600,000</u>
		<b>Total Liabilities and Stockholders' Equity</b>	<b><u>\$12,710,000</u></b>