
FINANCIAL ACCOUNTING

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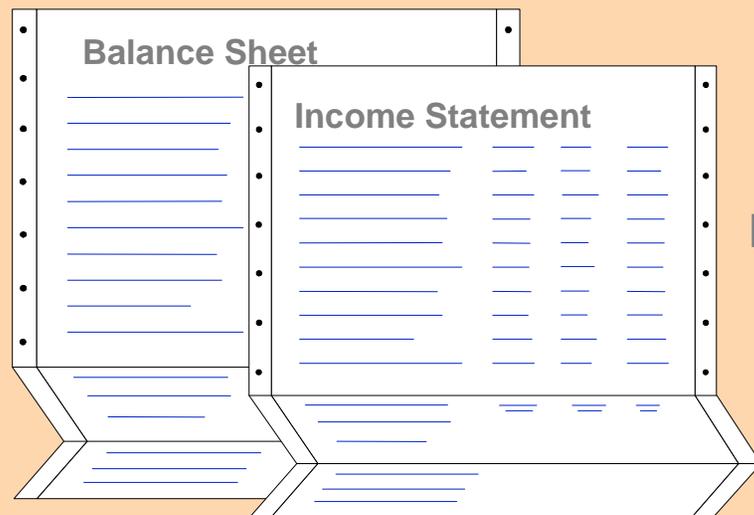
Chapter 1



Financial Statements and Business Decisions

The Objectives of Financial Accounting

Financial statements are the primary means of communicating financial information to parties outside the business organization.



Stakeholders

Business Background

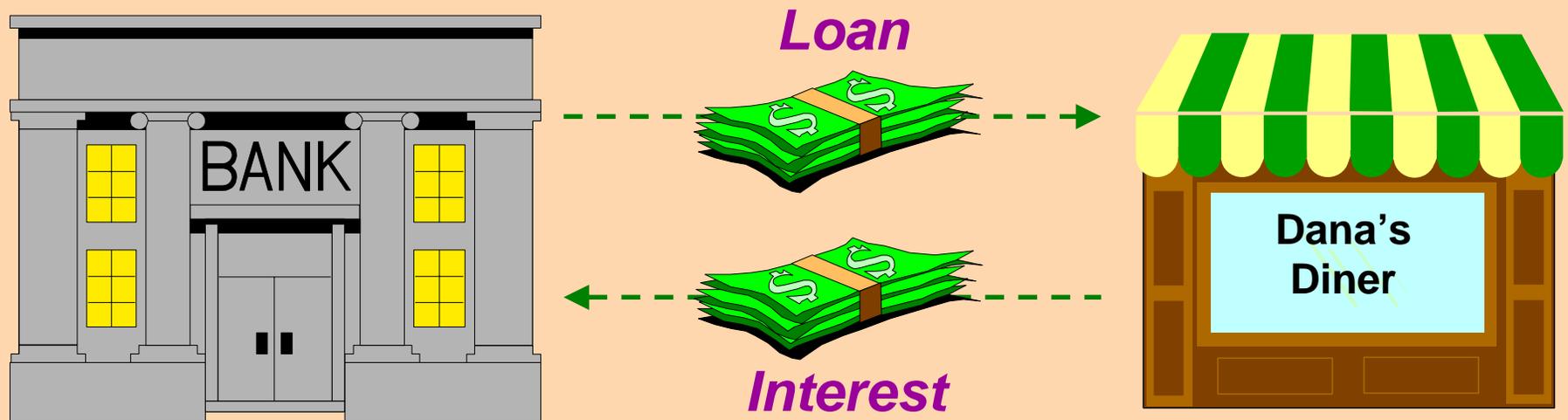
Business owners (called investors or stockholders) look for two sources of possible gain:

Sell ownership interest in the future for more than they paid.

Receive a portion of the company's earnings in cash (dividends).

Business Background

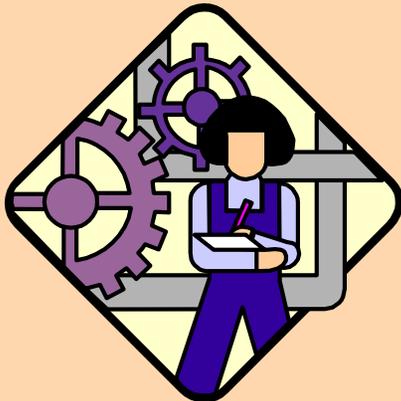
Creditors lend money to a company for a specific length of time and gain by charging **interest on the money loaned.**



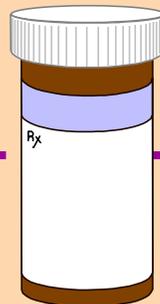
Understanding Business Operations

Manufacturers either make the parts needed to produce its products or buy the parts from suppliers.

Manufacturer



Product



Customer



Understanding Business Operations

All businesses have an accounting system that . . .

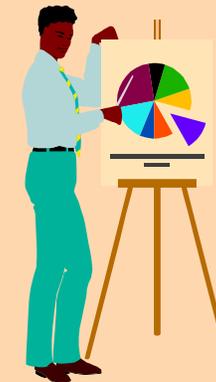


Collects and processes financial information about an organization.

Reports information to decision makers.



Business managers (internal)



Investors (external)

Understanding Business Operations

Accounting System

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graph TD; A[Accounting System] --> B[Financial Accounting System (preparation of four basic financial statements)]; A --> C[Managerial Accounting System (preparation of detailed plans, forecasts and reports)]; B --> D[External Decision Makers (investors, creditors, suppliers, customers, etc.)]; C --> E[Internal Decision Makers (managers throughout the organization)];
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Financial Accounting System
(preparation of four basic financial statements).

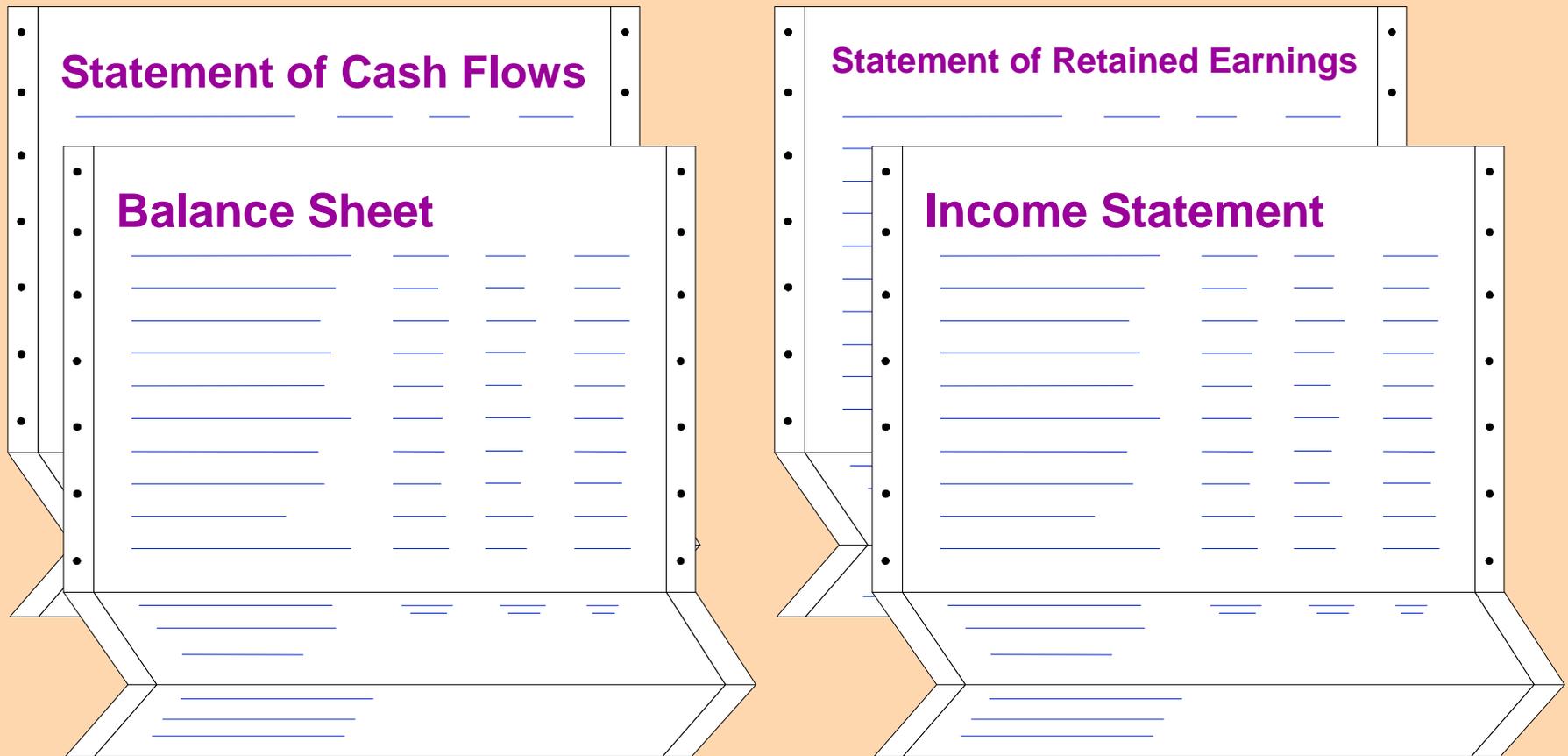
External Decision Makers
(investors, creditors, suppliers, customers, etc.).

Managerial Accounting System
(preparation of detailed plans, forecasts and reports).

Internal Decision Makers
(managers throughout the organization).

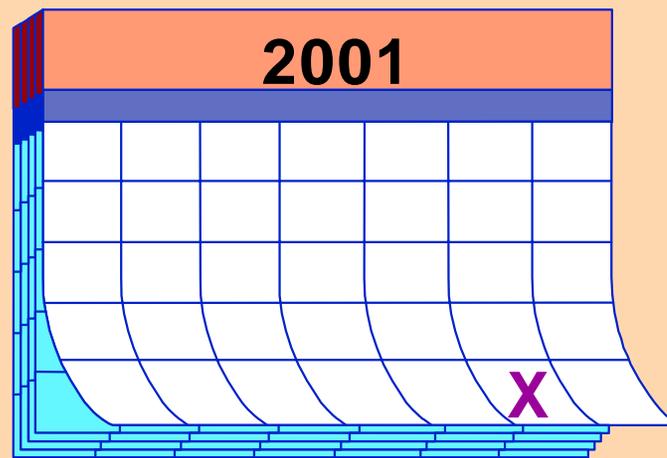
Information Conveyed in Financial Statements

The four basic financial statements . . .



Information Conveyed in Financial Statements

Most companies prepare financial statements at the end of the quarter (called quarterly reports) and the end of the year (called annual reports).





**Let's look at
MAXIDRIVE
CORP.'s
financial
statements.**

MAXIDRIVE CORP.
Balance Sheet
At December 31, 20A
(In thousands of dollars)

Assets		
Cash		\$ 4,895
Accounts receivable		5,714
Investments		,517
Plant and equipment		,154
Land		981
T		,261
Liabilities		
Accounts payable		
Notes payable		
T		,156
Contributed capital	\$ 2,000	
Retained earnings	9,105	
Total stockholders' equity		11,105
Total liabilities and stockholders' equity		\$ 27,261

1. Name of entity
(the separate-entity assumption)
 2. Title of statement
 3. Specific date
(financial snapshot at a specific point in time)
 4. Unit measure
(thousands of dollars)

The Balance Sheet

Body of the Statement

Assets

- Economic benefits owned by the business as a result of past transactions.

Liabilities

- Debts or obligations of the business that result from past transactions.

Stockholders' Equity

- Amount of financing provided by owners of the business and operations.

The Balance Sheet

Basic Accounting Equation

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

Economic
resources

=

Sources of financing . . .
Liabilities: from creditors
Equity: from stockholders.



MAXIDRIVE CORP.
Balance Sheet
At December 31, 20A
(In thousands of dollars)

Assets are listed by their ease of conversion into cash.

Assets		
Cash		\$ 4,895
Accounts receivable		5,714
Inventories		8,517
Plant and equipment		7,154
Land		981
Total assets		\$ 27,261



Cash	Amount of cash in the company's bank account.
Accounts receivable	Amounts owed by customers from prior sales.
Inventories	Partial and completed but unsold product.
Plant and equipment	Factories and production machinery.
Land	Property on which factories are located.

MAXIDRIVE CORP.
Balance Sheet
At December 31, 20A
(In thousands of dollars)

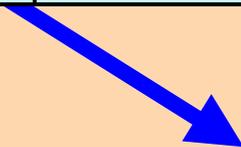
Assets			
Cash			\$ 4,895
Accounts receivable			5,714
Accounts payable	Amounts owed to suppliers for prior purchases.		8,517
Notes payable	Amounts owed on written debt contracts.		7,154
			981
			\$ 27,261
Liabilities and Stockholders' Equity			
Liabilities			
Accounts payable		\$7,156	
Notes payable		9,000	
Total liabilities			\$ 16,156
Stockholders' Equity			
Contributed capital		\$2,000	
Retained earnings		9,105	
Total stockholders' equity			11,105
Total liabilities and stockholders' equity			\$ 27,261

MAXIDRIVE CORP.
Balance Sheet
At December 31, 20A
(In thousands of dollars)

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Accounts receivable		5,714
Inventories		8,517
Plant and equipment		7,154
Land		981
Total assets		\$ 27,261
Liabilities and Stockholders' Equity		

Contributed capital	Amounts invested in the business by stockholders.		\$7,156	
Retained earnings	Past earnings not distributed to stockholders.		9,000	
				\$ 16,156

Stockholders' Equity		
Contributed capital	\$2,000	
Retained earnings	9,105	
Total stockholders' equity		11,105
Total liabilities and stockholders' equity		\$ 27,261



MAXIDRIVE CORP.
Balance Sheet
At December 31, 20A
(In thousands of dollars)

Use \$ on the first item in a group and on the group total.

Assets		
Cash		\$ 4,895
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Liabilities and Stockholders' Equity		
Liabilities		
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Notes payable	9,000	
		\$ 16,156
Stockholders' Equity		
Contributed capital	\$2,000	
Retained earnings	9,105	
Total stockholders' equity		11,105
Total liabilities and stockholders' equity		\$ 27,261

Assets = Liabilities + Stockholders' Equity

MAXIDRIVE CORP.
Income Statement
For the Year Ended December 31, 20A
(In thousands of dollars)

Revenues

1. Name of entity
2. Title of statement
3. Specific date (Unlike the balance sheet, this statement covers a specified period of time.)
4. Unit measure (in thousands of dollars)

Interest expense	450	
Total expenses		33,036
Pretax income		\$ 4,400
Income tax expense		1,100
Net income		\$ 3,300

MAXIDRIVE CORP.
Income Statement

The income statement is divided into three major captions.

① Revenues		
Sales revenue		\$ 37,436
② Expenses		
Cost of goods sold	\$ 26,980	
Selling, general and administrative	3,624	
Research and development	1,982	
Interest expense	450	
Total expenses		33,036
Pretax income		\$ 4,400
Income tax expense		1,100
③ Net income		\$ 3,300

MAXIDRIVE CORP.
Income Statement
For the Year Ended December 31, 20A
(In thousands of dollars)

Revenues		
Sales revenue		\$37,436

Revenues are earnings from the sale of goods or services.

Revenue is recognized in the period in which goods and services are sold, not necessarily the period in which cash is received.

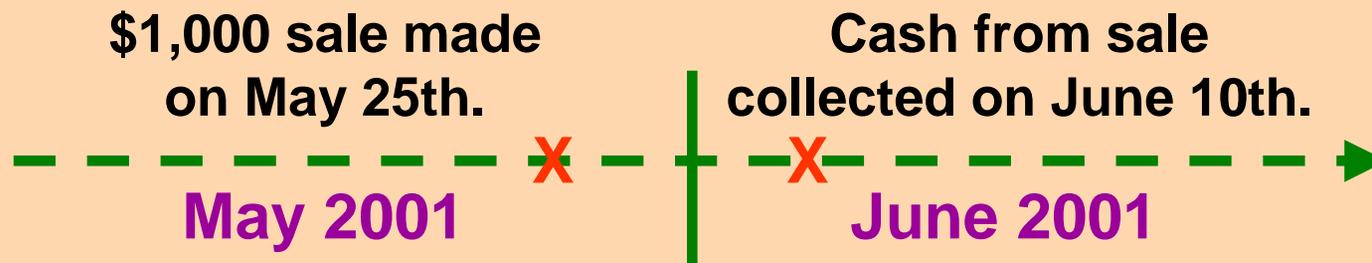
Pretax income		\$ 4,400
Income tax expense		1,100
Net income		\$ 3,300

The Income Statement

① Revenues

Earnings from the sale of goods or services.

When will the revenue from this transaction be recognized?



The Income Statement

① Revenues

Earnings from the sale of goods or services.

When will the revenue from this transaction be recognized?



Expenses are the dollar amount of resources used up by the entity to earn revenues during a period.

An expense is recognized in the period in which goods and services are used, not necessarily the period in which cash is paid.

Expenses		
Cost of goods sold	\$ 26,980	
Selling, general and administrative	3,624	
Research and development	1,982	
Interest expense	450	
Total expenses		33,036
Pretax income		\$ 4,400
Income tax expense		1,100
Net income		\$ 3,300

MAXIDRIVE CORP.
Income Statement
For the Year Ended December 31, 20A
(In thousands of dollars)

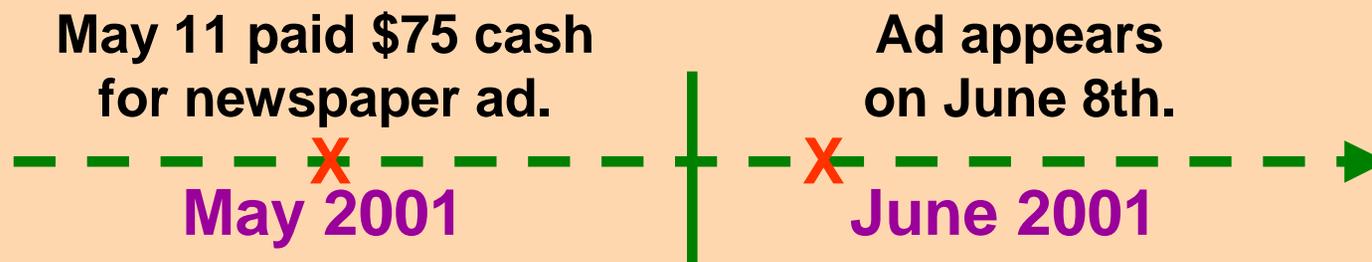
Cost of goods sold	The cost of the products sold this period.
Selling, general and administrative	Operating expenses not directly related to production.
Research and development	Expenses incurred to develop new products.
Interest expense	The cost of using borrowed funds.
Income tax expense	Income taxes on current period's pretax income.

The Income Statement

② Expenses

The dollar amount of resources used up by the entity to earn revenues during a period.

When will the expense for this transaction be recognized?

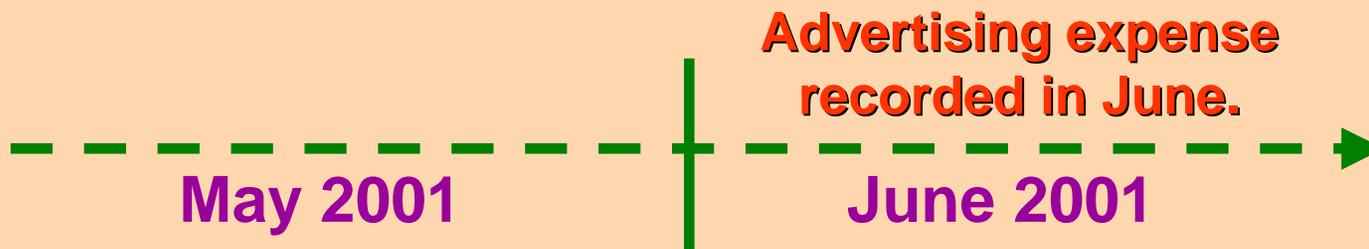


The Income Statement

② Expenses

The dollar amount of resources used up by the entity to earn revenues during a period.

When will the expense for this transaction be recognized?



MAXIDRIVE CORP.
Income Statement
For the Year Ended December 31, 20A
(In thousands of dollars)

Revenues		
Sales revenue		\$ 37,436
Expenses		
Cost of goods sold	\$ 26,980	
Selling, general and administrative	3,624	
Research and development	1,982	
Interest expense	450	
Total		036
Pretax		400
Income tax expense		1,100
Net income		\$ 3,300

**When revenues exceed expenses,
we report net income.**

MAXIDRIVE CORP.
Income Statement
For the Year Ended December 31, 20A
(In thousands of dollars)

Revenues		
Sales revenue		\$ 37,436
Expenses		
Cost of goods sold	\$ 26,980	
Selling, general and administrative	3,624	
Research and development	1,982	
Interest expense	450	
Total expenses		33,036
Pretax income		\$ 4,400

When expenses **exceed revenues,
we report **net loss**.**

Statement of Retained Earnings

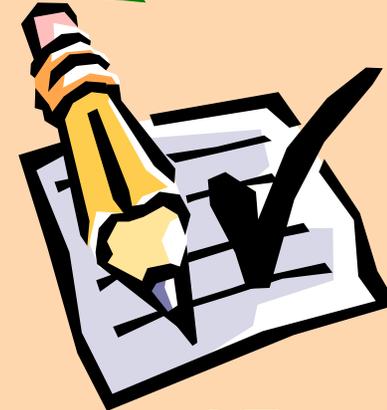
Income of the enterprise.

Dividends

Retained
by enterprise



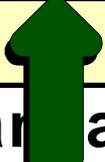
Stockholders



Retained Earnings

MAXIDRIVE CORP.
Statement of Retained Earnings
For the Year Ended December 31, 20A
(In thousands of dollars)

Retained earnings, January 1, 20A	\$ 6,805



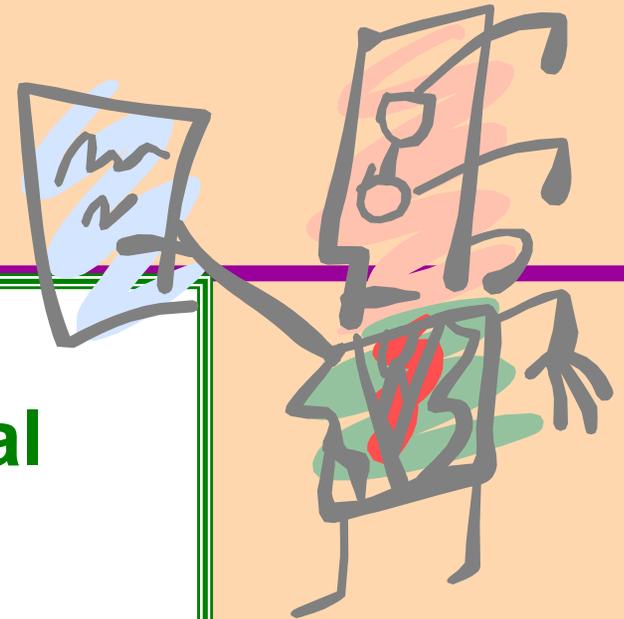
1. Name of entity
2. Title of statement
3. Specific date (Like the income statement, this statement covers a specified period of time.)
4. Unit measure (in thousands of dollars)

MAXIDRIVE CORP.
Statement of Retained Earnings
For the Year Ended December 31, 20A
(In thousands of dollars)

Retained earnings, January 1, 20A	\$ 6,805
Net income for 20A	3,300
Dividends for 20A	(1,000)
Retained earnings, December 31, 20A	\$ 9,105

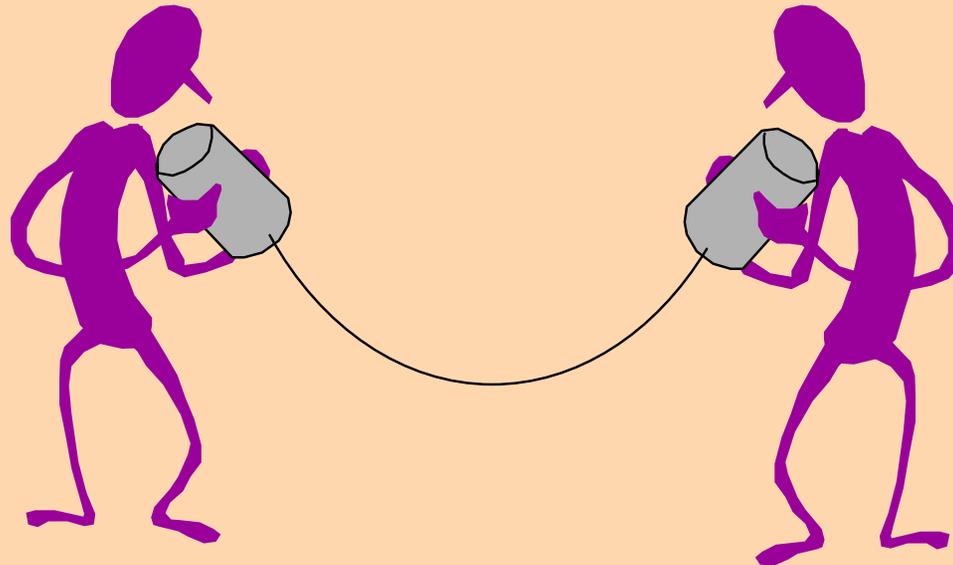
Notes

- ✓ Notes provide supplemental information about the financial condition of a company.
- ✓ Three types . . .
 - ① Describe accounting rules applied.
 - ② Present additional detail about an item on the financial statements.
 - ③ Provide additional information about an item **not** on the financial statements.



Responsibilities for the Accounting Communication Process

Effective communication means that the recipient understands what the sender intends to convey.



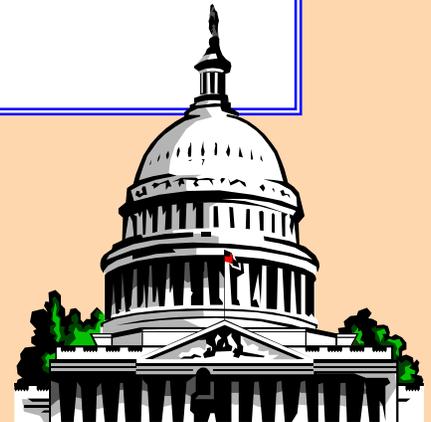
Decision makers need to understand accounting measurement rules.

Generally Accepted Accounting Principles (GAAP)

Securities Act of 1933
Securities and Exchange Act of 1934



The Securities and Exchange Commission (SEC)
has been given broad powers to determine
measurement rules for
financial statements.



Generally Accepted Accounting Principles (GAAP)

The SEC has worked closely with the accounting profession to work out the detailed rules that have become known as GAAP.



Currently, the **Financial Accounting Standards Board (FASB)** is recognized as the body to formulate GAAP.



Generally Accepted Accounting Principles (GAAP)



Companies are interested in GAAP because methods of reporting can have the following economic consequences . . .

- ① Affect the selling price of stock.**
- ② Affect the amount of bonuses received by managers and other employees.**
- ③ Cause a loss of competitive advantage.**

Management Responsibility and the Demand for Auditing

To ensure the accuracy of the company's records **management:**

- ① Maintains a system of controls.
- ② Hires an outside independent auditor.
- ③ Board of directors review these two safeguards.



Independent Auditors

- Auditors express an opinion as to the **fairness** of the financial statement presentation.
- Independent auditors have responsibilities that extend to the general public.

Overall, I believe these financial statements are fair.



Independent Auditors

An audit involves . . .

- Examining the financial reports to ensure compliance with GAAP.
- Examining the underlying transactions incorporated into the financial statements.
- Expressing an opinion as to the fairness of presentation of financial information.



Ethics, Reputation, and Legal Liability

The American Institute of Certified Public Accountants requires that all members adhere to a professional code of ethics.



Ethics, Reputation, and Legal Liability

A CPA's reputation for honesty and competence is his/her most important asset.



**Like physicians, CPAs have
liability for malpractice.**

End of Chapter 1

