

# Basic Recording Process

## Topics to be Discussed

- Classification of Business Activity
- Classification of Legal Organization
- Characteristics of Legal Organization
- Financing Business Operations
- Bonds
- Equity Securities
- Advantages and Disadvantages of issuing Bonds vs. Stock
- Primary Investment Market
- Issuing New Securities
- Investment Bankers
- Mechanics of Underwriting
- Disclosure Requirements
- Tombstone
- Secondary Investment Market
- Function of Accounting
- Essential Characteristics of Accounting
- Conceptual Framework of Accounting
- Users and Uses of Accounting Information
- First Basic Objective of Financial Accounting
- Basic Recording Process
  - Basic Underlying Assumption #1
    - Accounting Entity Concept
  - Accounting Data
  - Accounting Equation
  - Basic Underlying Assumption #2
    - Monetary Unit
  - Debit/Credit Concept
  - Nature of Account Titles
  - Chart of Accounts
  - Accounting Principle #1
    - Revenue Principle
  - Journalizing Process
  - Posting Process

## Classification of Business Activity

- Manufacturing Activity
- Product Handling Activity
  - Wholesaler - engaged in the business of selling to retailers or jobbers rather than consumers. Generally sells goods in large quantities.
  - Retailer - engaged in the sale of small quantities directly to the consumer
- Service Activity

## Classification of Legal Organizations

### Sole Proprietorship

- ☛ one owner
- ☛ owner provides capital of the business and usually directs activities of business

### Partnership

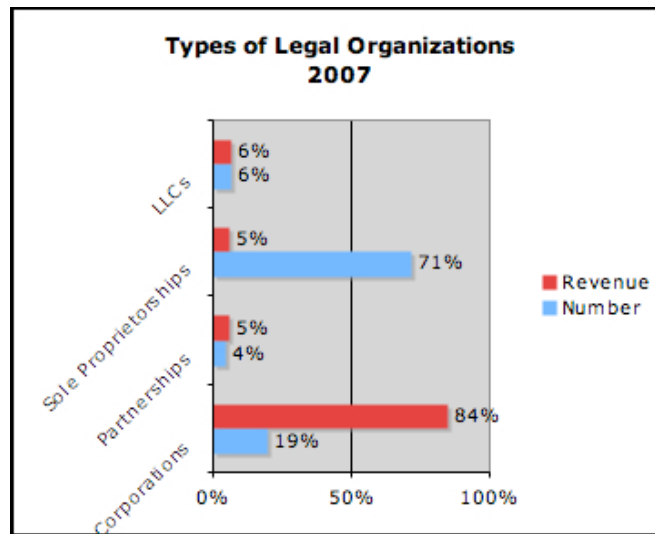
- ☛ two or more owners
- ☛ contractual arrangement
- ☛ partners provide capital and usually direct activities of business

### Corporation

- ☛ in 1819, Chief Justice Marshall described a corporation as

. . . an artificial person, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly only incidental to its very existence.

- ☛ this definition implies that
  - corporation is a separate legal entity, separate and distinct from the natural persons who are its owners
  - a corporation is created by an act of a sovereign state
  - a corporation has only those powers given it by the state and either expressed or implied in its charter
- ☛ additional factors
  - a legal entity, separate and distinct from its owners
  - ownership evidenced by shares of stock
  - capital usually provided by many stockholders
  - hired managers usually direct activities of business



**Characteristics of Legal Organization**

Characteristic	Sole Proprietorship	Partnership	Corporation
Liability of Owners			
Mutual Agency			
Taxation			
Ease of Capital Assembly			
Transferability of Ownership			
Ownership Serves As Collateral			
Continuity of Existence			
Government Intervention			
Expense of Starting Business			

**Financing Business Operations**

Short Term - 5 years or less

- ☛ bank loan
- ☛ promissory note
  - an unconditional written promise by one party (maker) to pay another party (payee) a definite sum of money at some fixed or determinable future date.

Long-Term

- ☛ equity (ownership) financing
- ☛ debt financing

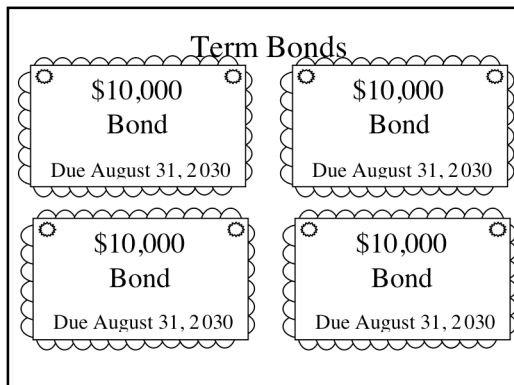
**Bonds**

A bond is a written unconditional promise wherein the borrower promises to pay a specific sum at a determinable future date together with interest at a stated rate and at stated dates

- ☛ bonds differ from some other forms of debt because they are placed in the hands of numerous public investors rather than channeled directly to a single lender
- ☛ usual denomination, \$1,000+

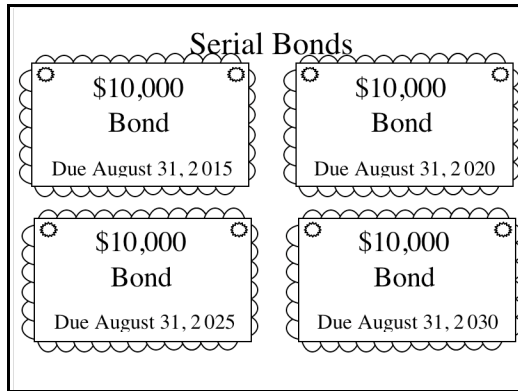
The terms of the borrowing are contained in a master contract between the corporation and the bondholders. This master contract is known as the bond indenture.

At the time of arranging for the bond issue, the borrowing corporation selects a bond trustee -- a bank or trust company -- to hold the bond indenture and to act as an independent third party to protect the interests of both the borrower and the lenders.



Characteristics of bonds

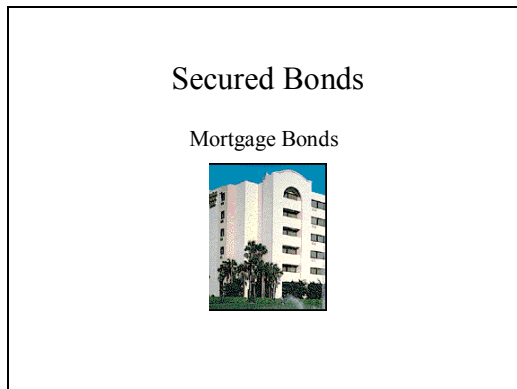
- ☛ maturity of bonds
  - term bonds – all the bonds of a particular bond issue mature on the same date



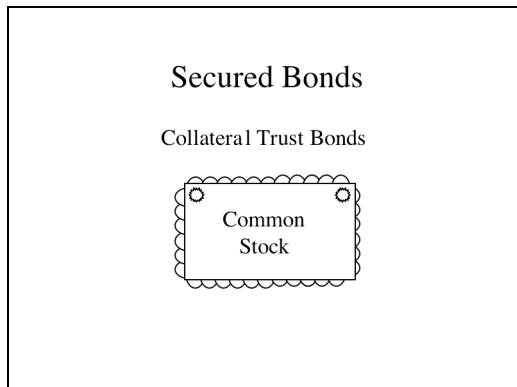
- serial bonds – all the bonds of a particular bond issue mature in installments

☛ secured vs. unsecured bonds

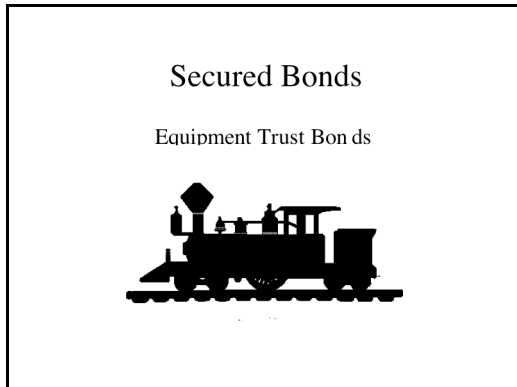
- secured bonds



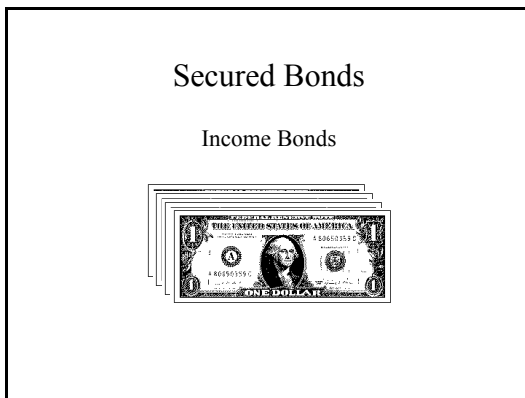
⇒ mortgage bonds - the investor's protection rests upon the pledge of the real assets (such as real estate) of the corporation. If the company defaults (fails to pay interest or repay principal) the bondholders may foreclose the mortgage and take over the pledged property.



⇒ collateral trust bonds - this financing procedure pledges a portfolio of securities, held in trust by a commercial bank, as protection for the holders of these debt instruments



⇒ equipment trust bonds - pledges machinery, such as the working equipment the corporation normally employs in its everyday operation, as collateral for the loan



⇒ income bonds - promises to pay interest only when, as, and if earned by the corporation

⇒ guaranteed bonds - debt securities backed by another party, e.g., a strong corporation might guarantee the securities of their lesser-known subsidiary

- unsecured bond - debenture

- ☛ callable bonds - at the option of the issuer, the bond may be retired, prior to maturity, at a designated price
- ☛ convertible bonds - at the option of the holder of the bond, the bond may be converted into another type of security such as common stock
- ☛ manner of interest payment
  - registered bonds - bondholder of record will receive interest
  - coupon (bearer) bonds - bearer of bond interest coupons will receive interest

## Equity Securities

### Types of Stock

- ☛ common stock
- ☛ preferred stock



### Values assigned to stock

- ☛ par value
- ☛ no-par stock, with stated value
- ☛ true no-par stock (no par, no stated value)

### Basic Rights of Stockholders

- ☛ right to vote
- ☛ right to share in earnings
  - form of compensation
    - ⇒ *cash dividends* - paid at the discretion of the management of the corporation
- ☛ right to share in assets upon liquidation
- ☛ preemptive right - the right to maintain present percentage ownership interest by having first opportunity to acquire any new issuances of stock of the same class

### Characteristics of stocks

- ☛ callable stock - at the option of the issuer, the stock may be retired at a designated price
- ☛ convertible stock - at the option of the holder of the stock, the stock may be converted into another type of security e.g., preferred stock convertible into common stock
- ☛ redeemable stock - at the option of the holder of the stock, the stock may be redeemed for cash
- ☛ cumulative preferred stock - if any dividends have been omitted on preferred stock in the past, they must be paid out to preferred shareholders first, before common shareholders can receive dividends (alternative: non-cumulative preferred stock)
- ☛ participating preferred stock - in addition to paying a stipulated dividend, the preferred stock holder has the right to participate with the common stockholder in additional distributions of earnings under specified conditions.

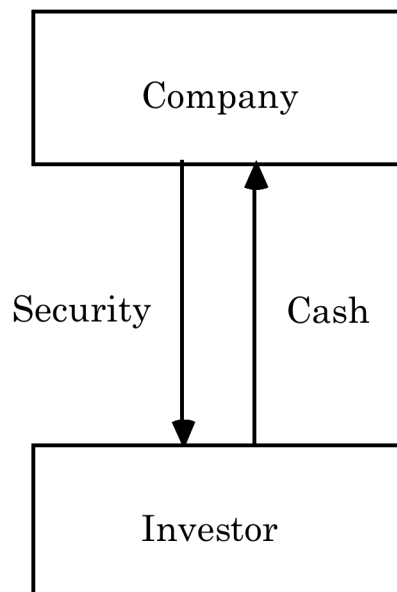
## Advantages and Disadvantages of Issuing Bonds vs. Stock

### Advantages of Issuing Bonds

- ☛ to the corporation
  - interest is tax deductible; dividends are not
- ☛ to the current owners
  - if the company can earn a higher rate of return on borrowed funds than the cost of borrowing funds, additional benefits will accrue to the current stockholders. (financial leverage, trading on the equity)
  - present owners retain current ownership percentage without an additional investment on their part while still raising funds for the corporation

### Disadvantages of Issuing Bonds

- ☛ to the corporation
  - interest must be paid; dividends need not be paid
- ☛ to the current owners
  - if the company return on investment is less than the cost of the additional funds, the current stockholders will suffer a reduction in their earnings



### Primary Investment Market

Primary market for corporate issues is one in which new issues (bonds, preferred stock, common stock) are sold by companies to acquire new cash.

## Issuing New Securities

Options for marketing new securities

- ☛ ask current creditors to purchase new securities
- ☛ advertise the securities
- ☛ peddle the securities door to door
- ☛ employ the services of investment banker

## Investment Bankers

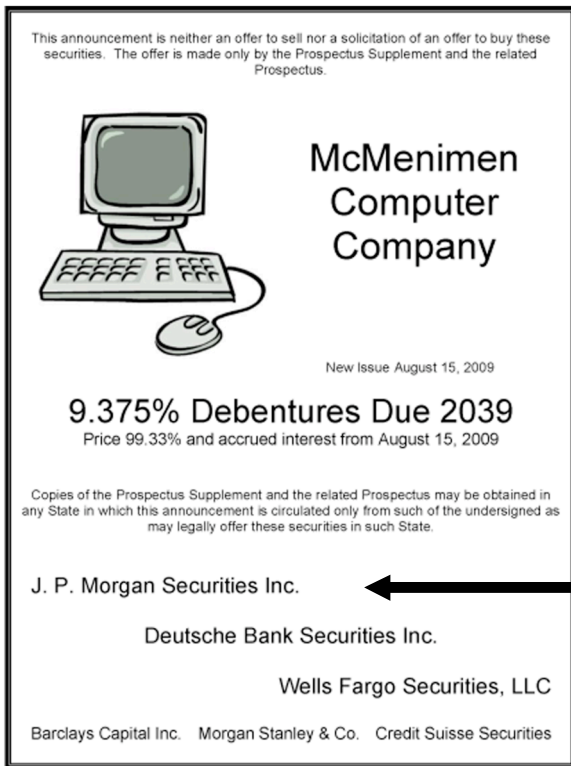
Middleperson to channel money from investors to firm that needs capital

- ☛ investment bankers have many customers; thus able to avoid costly search for potential buyers
- ☛ expense of employing investment banker could be less than expense of selling securities without investment banker

Alternative services regarding new issues

- ☛ underwriting - refers to the guarantee by the investment banker that the issuer of the new securities will receive a certain minimum amount
  - underwriter will buy securities from issuer at less than expected selling price
  - potential loss for underwriter
- ☛ private placement - investment banker finds one or more buyers for a new issue and the investors
  - buyer certifies to issuer that purchase is for investment purposes, without intention to re-offer the securities publicly

**Mechanics of Underwriting**



← Originator - manages the security issuance

⌋ Syndicate – a group of investment bankers who purchase securities from issuer and re-offer them to the public

**Disclosure Requirements**

purpose is to protect the public against issuance and distribution of fraudulent securities

requires filing of registration statement disclosing relevant information pertaining to specific offering

- ☛ two parts to registration statement
  - preliminary prospectus (red herring) - red lettering informs prospective buyer that securities are being registered with SEC and may subsequently be offered for sale
  - final prospectus - no final sales until registration becomes effective; final prospectus indicates “offer” price
- ☛ second part deals with more technical matters
  - marketing arrangements
  - expense of the distribution
  - historical financial information not required in the prospectus

after filing, 20-day waiting period before new issue may be offered for sale


SEC does not take position regarding the investment merits of an offering

**Tombstone**

Public offering is advertised in one or more newspapers/periodicals

Lack-luster nature of advertisement inspired designation “tombstone”

This announcement is neither an offer to sell nor a solicitation of an offer to buy these securities. The offer is made only by the Prospectus Supplement and the related Prospectus.



**McMenimen  
Computer  
Company**

New Issue August 15, 2009

**9.375% Debentures Due 2039**  
Price 99.33% and accrued interest from August 15, 2009

Copies of the Prospectus Supplement and the related Prospectus may be obtained in any State in which this announcement is circulated only from such of the undersigned as may legally offer these securities in such State.

J. P. Morgan Securities Inc.

Deutsche Bank Securities Inc.

Wells Fargo Securities, LLC

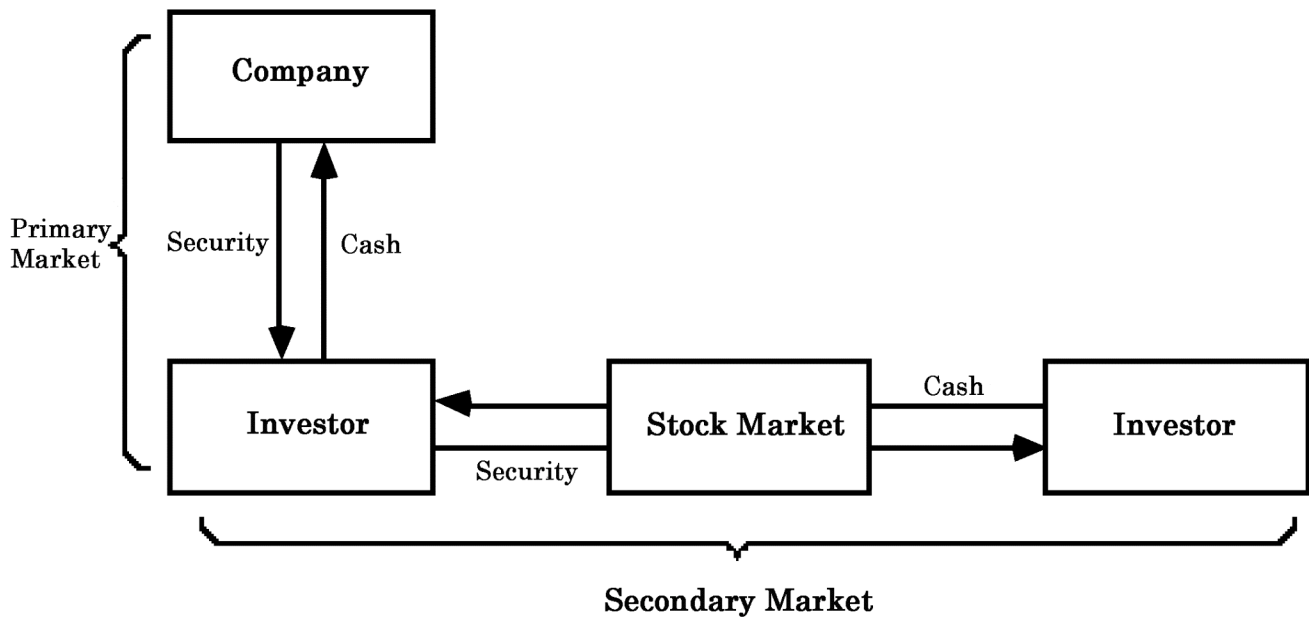
Barclays Capital Inc.      Morgan Stanley & Co.      Credit Suisse Securities

**Secondary Investment Market**

Primary market for corporate issues is one in which new issues (bonds, preferred stock, common stock) are sold by companies to acquire new cash.

Secondary market for corporate issues involves trading securities that have previously been sold to the public. The securities are traded between current and future owners.

- proceeds of sale of securities goes to prior owner, not company



## Securities Markets

### The New York Stock Exchange (The Big Board)

- ☛ of all corporations in business today, less than 1% are listed on the New York Stock Exchange

### American Stock Exchange

- ☛ listing requirements not as strict as those of the New York Stock Exchange

### NASDAQ (National Association of Security Dealers Automated Quotation system)

- ☛ a highly sophisticated computerized trading system
- ☛ no central location, but rather numerous computerized trading desks
- ☛ listing requirements not as strict as those of the New York Stock Exchange

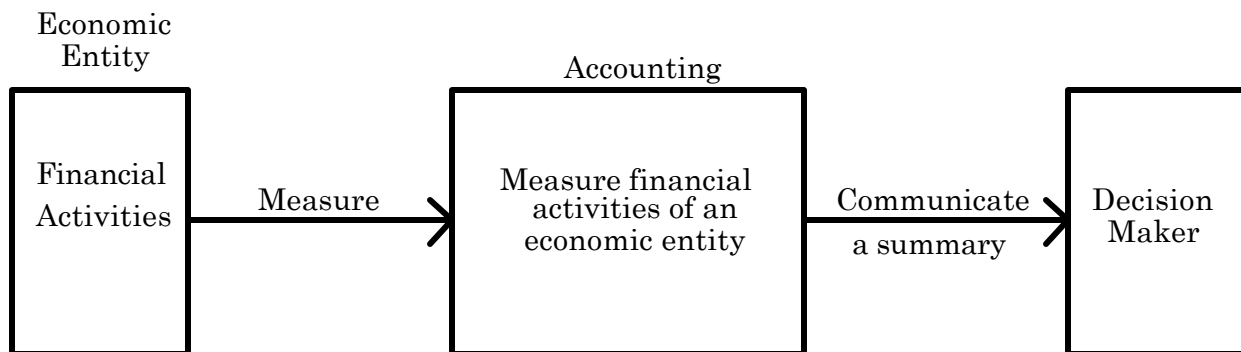
### Regional exchanges

- ☛ significant regional exchanges
  - Chicago
  - Pacific Stock Exchange (San Francisco/Los Angeles) (acquired by NYSE in 2006)
  - Philadelphia Stock Exchange (Philadelphia/Pittsburgh) (acquired by NASDAQ in 2007)
  - Boston Stock Exchange (acquired by NASDAQ in 2007)
  - National Stock Exchange (formerly Cincinnati Stock Exchange)
- ☛ main reasons for regional exchanges
  - they provide trading facilities for securities of local companies
  - local brokers, who are not members of a national exchange, can trade securities traded on national exchanges

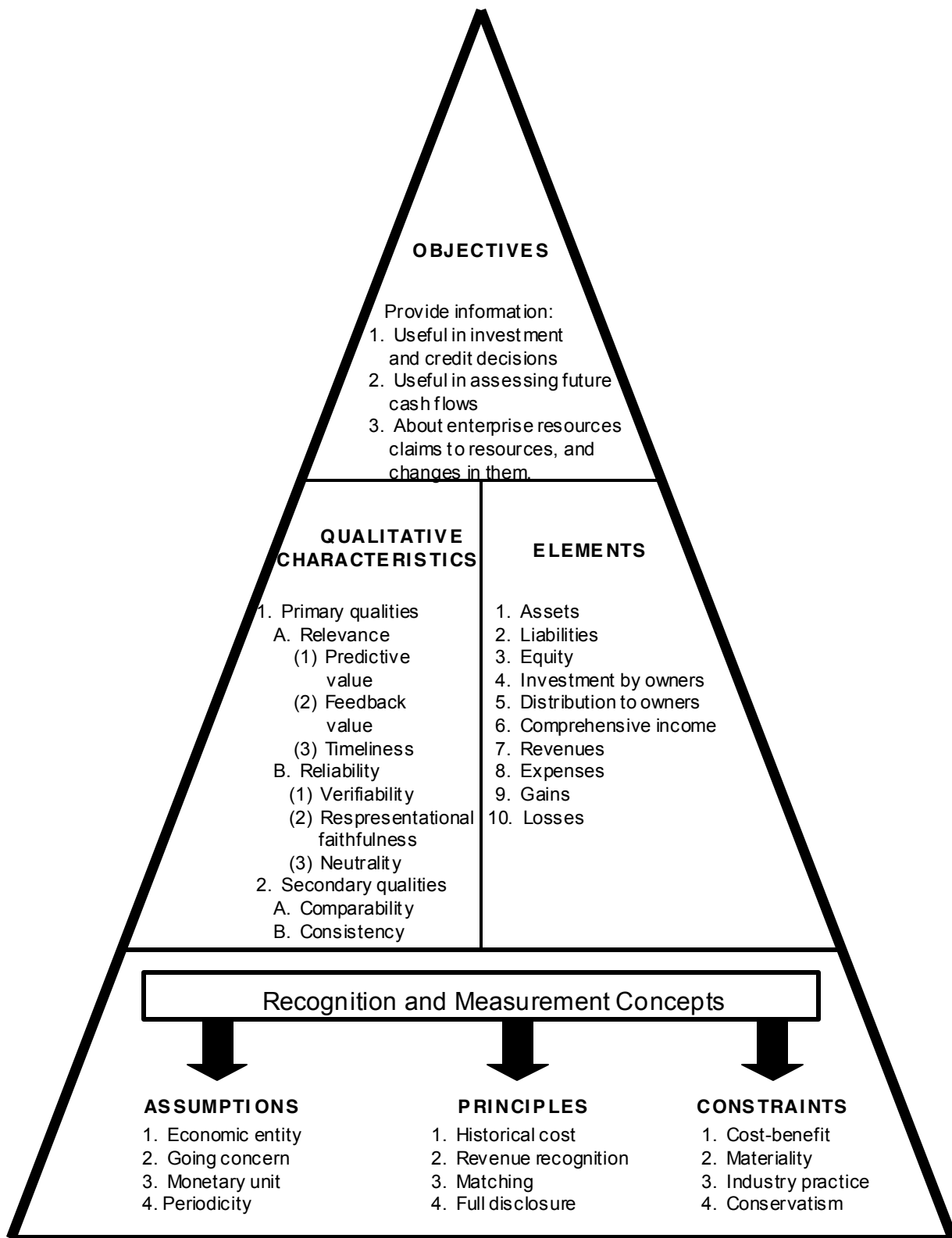
### Function of Accounting

Accountants attempt to provide information and analysis of information so that decision makers' beliefs regarding the consequences of their actions might more closely approximate the actual consequences that would follow their actions than if no accounting information was provided.

### Essential Characteristics of Accounting



- Accounting is concerned with the financial activities of an economic entity
- Accounting is involved with the measurement of the financial activities of an economic entity
- Accounting is involved with the communication of a summary of the economic entity's financial activities to decision makers



Source: Kieso and Weygant, Intermediate Accounting, Seventh Edition

## Users and Uses of Accounting Information

Examples of users of financial accounting information and the types of evaluations and decisions for which they use financial accounting information are:

- Owners - *retain, increase, or decrease proportionate ownership; evaluate the use and stewardship of resources by management*
- Creditors and suppliers - *extend credit; determine terms of credit; require security or restrictive covenants in terms; enter suit or force bankruptcy or receivership; increase or decrease reliance on the enterprise as a customer*
- Potential owners, creditors, and suppliers - *commit resources to the enterprise; determine amount of commitment; evaluate the use and stewardship of resources by management*
- Management (including directors and officers) - *assess nature and extent of financing needs; evaluate results of past economic decisions; set dividend policy; project future financial position and income; assess merger and acquisition possibilities; recommend reorganization or dissolution*
- Taxing authorities - *evaluate tax returns; assess taxes or penalties; make investigations and audits*
- Employees - *negotiate wages; terminate employment; or, for prospective employees, apply for employment*
- Customers - *anticipate price changes; seek alternative sources or broader bases of supply*
- Financial analysts and advisors - *advise investors and potential investors to retain, increase, decrease, or acquire an investment in the enterprise; evaluate prospects of investment in the enterprise relative to alternative investments*
- Stock exchanges - *accept or cancel listings; suspend trading; encourage changes in accounting practices or additional disclosure of information*
- Lawyers - *determine whether covenants and contractual provisions are fulfilled; advise on legality of dividends and profit sharing and deferred compensation agreements; draft pension plan terms*
- Regulatory or registration authorities - *assess reasonableness of rate of return; allow or require increases or decreases in prices or rates; require or recommend changes in accounting or disclosure practices; issue cease-and-desist or stock-trading-suspension orders*
- Financial press and reporting agencies - *prepare descriptive analyses; combine, summarize, or select information to present in descriptions; conform information to uniform presentation arrangements; compute trends and ratios*
- Trade associations - *compile industry statistics and make comparisons; analyze industry results*
- Labor unions - *formulate wage and contract demands; assess enterprise and industry prospects and strengths*

**Users and Use of Accounting Information (continued)**

## Summary

Owners  
Creditors and suppliers  
Potential owners, creditors and suppliers  
Management  
Taxing authorities  
Employees  
Customers  
Financial analysts and advisors  
Stock exchanges  
Regulatory or registration authorities  
Financial press and reporting agencies  
Trade associations  
Labor unions

## Observe

all except management are “external users”  
taxing authorities and rate making bodies have statutory authority to obtain needed information  
the objectives of financial accounting information need a focus to avoid being vague or highly abstract

investors and creditors and their advisors are the most obvious prominent external groups who use the information provided by financial reporting and who generally lack the authority to prescribe the information they want

uses of information by information by investors and creditors and their advisors have been studied  
such information is likely to be generally useful to other groups

**Statement of Financial Accounting Concepts No. 1 (SFAC 1)**

## Objectives of Financial Reporting by Business Enterprises

Provide information

USEFUL IN INVESTMENT AND CREDIT DECISIONS  
includes those advising investors and creditors

**Basic Recording Process**

Based on person-made rules

Basic Underlying Assumption #1 (BUA #1)

Economic Entity - the economic activities of an entity can be accumulated and reported in a manner that assumes the entity is separate and distinct from its owners or other business units

Accounting Data

financial exchange transactions between our designated accounting entity and other entities

Accounting Equation

Assets = Liabilities + Owners' Equity

ASSETS - probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events

LIABILITIES - probable future sacrifices of economic benefits arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events

OWNERS' EQUITY - the financial interest of the owners arising from initial, and possibly subsequent, investments and accumulated profits

Basic Underlying Assumption #2 (BUA #2)

MONETARY UNIT

the monetary unit is the most effective means of expressing changes in capital and exchanges of goods and services  
the unit of measure remains reasonably stable

**Demonstration Problem**

Record the following transactions for the Charlie Brown Company:

	Assets	Liabilities	Owners' Equity
(a) On May 1, 20x1, Charlie Brown, owner of the Charlie Brown Company, invested \$1,000 cash in a bank on behalf of the company.			
(b) On May 1, 20x1, the Charlie Brown Company borrowed \$500 cash from a bank, giving a promissory note in exchange.			
SUBTOTAL			
(c) On June 20, 20x1, the Charlie Brown Company repaid \$300 of the loan.			
TOTAL			

Debit/Credit Concept

Assets		Liabilities		Owners' Equity	
Debit	Credit	Debit	Credit	Debit	Credit
+	-	-	+	-	+

DEBITS SHOULD ALWAYS EQUAL CREDITS

**Demonstration Problem**

- (a) On May 1, 20x1, Charlie Brown, owner of the Charlie Brown Company, invested \$1,000 cash in a bank on behalf of the company
- (b) On May 1, 20x1, the Charlie Brown Company borrowed \$500 cash from a bank giving a promissory note in exchange
- (c) On June 20, 20x1, the Charlie Brown Company repaid \$300 of the loans

Assets		Liabilities		Owners' Equity	
Debit	Credit	Debit	Credit	Debit	Credit
+	-	-	+	-	+

Nature of Account Titles

Factors determining account titles

1.

2.

## Chart of Accounts

The complete listing of the names (and possibly the account numbers) of all of the accounts in the accounting system of a particular entity

CHART OF ACCOUNTS

<u>Assets</u>		<u>Revenue</u>	
11	Cash	41	Sales
12	Accounts Receivable		
14	Supplies		<u>Expenses</u>
15	Prepaid Rent		
18	Printing Equipment	51	Salary Expense
19	Accumulated Depreciation	52	Supplies Expense
		53	Rent Expense
	<u>Liabilities</u>	54	Depreciation Expense
		59	Miscellaneous Expense
21	Accounts Payable		
22	Salaries Payable		
	<u>Owners' Equity</u>		
31	Charles Bell, Capital		
32	Charles Bell, Drawing		
33	Income Summary		

**Demonstration Problem**

The following selected transactions were completed by the M & H Laundry during the month of September:

- (a) Mr. J. Doe, the sole owner, deposited \$1,000 in the bank on behalf of the company
- (b) Purchased supplies on account, \$160
- (c) Paid rent for September, \$100
- (d) Purchased laundry equipment for cash, \$600
- (e) Paid miscellaneous expenses, \$60
- (f) Paid creditor on account, \$110
- (g) Charged customer for services sold on account, \$170
- (h) Received \$350 from cash customers
- (i) Received \$120 from customer on account
- (j) Withdrew \$150 in cash for personal use
- (k) Determined by taking an inventory that \$130 of supplies had been used during the month

Cash

---

|

Accounts Receivable

---

|

Supplies

---

|

Prepaid Rent

---

|

Laundry Equipment

---

|

Accounts Payable

---

|

J. Doe, Capital

---

|

J. Doe, Withdrawals

---

|

Service Income

---

|

Miscellaneous Expense

---

|

Supplies Expense

---

|



Demonstration Problem (continued)

- Posting - the process by which entries in the journal are transferred to accounts in the ledger
- Posting - Notes on Recording Procedure
  - ▶ DATE - same procedure as used for the general journal
  - ▶ AMOUNT - same procedure as used for the general journal
  - ▶ explanation is optional. If used, it would usually consist of clarification of specific part of entry
  - ▶ do not skip a line between entries

GENERAL LEDGER

CASH

ACCOUNT NO. 11

DATE	ITEMS	POST REF.	DEBIT	CREDIT	BALANCE	
					DEBIT	CREDIT

NOTES PAYABLE

ACCOUNT NO. 23

DATE	ITEMS	POST REF.	DEBIT	CREDIT	BALANCE	
					DEBIT	CREDIT

C. BROWN, CAPITAL

ACCOUNT NO. 31

DATE	ITEMS	POST REF.	DEBIT	CREDIT	BALANCE	
					DEBIT	CREDIT