Financial Accounting

-The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information

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1. Accounting as a form of communication

The nature of organizations:

Business: All of the activities necessary to provide the members of an economic system with goods and services.

Business entity: An organization operated to earn a profit.

Nonbusiness entity: An organization operated for some purpose other than to earn a profit.

Economic entity concept: The assumption that a single, identifiable unit must be accounted for in all situations. For example, a business owner must keep his own personal affairs separate from those of the business.

Sole proprietorship: A form of organization with a single owner.

Partnership: A business owned by two or more individuals; the organization form often used by accounting firms and law firms.

Corporation: A form of entity organized under the laws of a particular state; ownership evidenced by shares of stock.

Business activities: simply stated, businesses raise money through financing which they invest in assets in order to operate the business and generate revenues, which in turn can be used for financing -> investing -> grow operating activities -> financing -> etc.

Obtaining financing:

Share of stock: A certificate that acts as evidence of ownership in a corporation. A corporation can issue shares of stock, allowing people to purchase a part of the corporation in order for the corporation to obtain financing.

Stockholder: One of the owners of a corporation.

Bond: A certificate that represents a corporation's promise to repay a certain amount of money and interest in the future.

Creditor: Someone to whom a company or person has a debt.

Capital stock: Indicates the owners' contributions to a corporation.

Investing:

Asset: A future economic benefit; cash, buildings, land, inventory, licenses etc.

Operating activities:

Revenue: An inflow of assets resulting from the sale of goods and services.

Expense: An outflow of assets resulting from the sale of goods and services; salaries, taxes, purchase of inventory etc.

<u>Accounting:</u>

Accounting: The process of identifying, measuring, and communicating economic information to various users.

Management accounting: The branch of accounting concerned with providing management with information to facilitate planning and control (internal users).

Financial accounting: The branch of accounting concerned with the preparation of financial statements for outsider use (external users). *This is what this course is mainly concerned with.*

<u>Balance sheet:</u>

Balance sheet: The financial statement that summarizes the assets, liabilities, and owners' equity at a specific point in time. Shows what obligations will be due in the near future and what assets will be available to satisfy them.

The accounting equation: The foundation of the entire accounting system.
Assets = Liabilities + Owner's equity.

Liability: An obligation of a business.

Owners'/stockholders'/shareholders' equity: The owners' claims on the assets of an entity.

<u>Income statement:</u>

Income statement: A statement that summarizes revenues and expenses -> stating net income.

<u>Statement of retained earnings:</u>

Statement of retained earnings: The statement that summarizes the income earned and dividends paid over the life of a business. I.e. the statement seeks to explain the changes to retained earnings and capital stock.

Dividends: A distribution of the net income of a business to its owners.

Retained earnings: The part of owners' equity that represents the income earned less dividends paid over the life of an entity, i.e. the amount the entity has earned through its entire life minus the dividends payed to all shareholders.

<u>Statement of cash flows:</u>

Statement of cash flows: The financial statement that summarizes an entity's cash receipts and cash payments during the period from operating, investing, and financing activities, i.e. where cash came from and what it was used for.

Note:
Relationship between the four statements: The income statement calculates net income, which is used in the statement of retained earnings to calculate retained earnings, which in turn goes on the balance sheet. To explain the cash account on the balance sheet, the statement of cash flows is made, summarizing cash flows throughout the period.

<u>Concepts of accounting:</u>

Cost principle/historical cost/original cost: Assets are recorded at the cost to acquire them.

Going concern: The assumption that an entity is not in the process of liquidation and that it will continue indefinitely (liquidation: the entity shuts down and everything is turned into liquid assets (cash)).

Monetary unit: The yardstick used to measure amounts in financial statements; the dollar in the United States.

Time period: An artificial segment on the calendar used as the basis for preparing financial statements.

Accounting standards: Several organizations govern the rules of accounting; the generally accepted accounting principles (GAAP). These include:
-*Securities and Exchange Commission (SEC)*: The federal agency with ultimate authority to determine the rules for preparing statements for companies whose stock is sold to the public.
-*Financial Accounting Standards Board (FASB)*: The group in the private sector with authority to set accounting standards.
-*American Institute of Certified Public Accountants (AICPA):* The professional organization of certified public accountants.
-*Certified Public Accountant (CPA):* The designation for an individual who has passed a uniform exam administered by the AICPA and has met other requirements as determined by individual states.
-*Public Company Accounting Oversight Board (PCAOB):* The five-member body created by the Sarbanes-Oxley Act that was given the authority to set auditing standards in the United States.
-*International Accounting Standards Board (IASB):* The organization formed to develop worldwide accounting standards.

Auditing: The process of examining the financial statements and the underlying records of a company to render an opinion as to whether the statements are fairly presented.

2. Financial statements and the annual report

Accounting quality:

Understandability: The quality of accounting information that makes it comprehensible to those willing to spend the necessary time.

Relevance: The capacity of information to make a difference in a decision.

Faithful representation: The quality of information that makes it complete, neutral, and free from error.

Comparability: For accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences.

Consistency: For accounting information, the quality that allows a user to compare two or more accounting periods for a single company.

Materiality: The magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information.

Conservatism: The practice of using the least optimistic estimate when two estimates of amounts are about equally likely.

Working capital and current ratio:

Operating cycle: The period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory.

Current asset: An asset that is expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year.

Noncurrent/long-term asset: An asset that is not expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year, i.e. property, plant, equipment, intangibles.

Current liability: An obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year.

Long-term liability: An obligation that will not be satisfied within one year or the current operating cycle.

Liquidity: The ability of a company to pay its debts as they come due. Measured to some extend by the amount of working capital and the current ratio.

Working capital: Current assets minus current liabilities.

Current ratio: Current assets divided by current liabilities.

Income statements:

Single-step income statement: An income statement in which all expenses are added together and subtracted from all revenues.

Multiple-step income statement: An income statement that shows classifications of revenues and expenses as well as important subtotals.

Gross profit: Sales minus cost of goods sold.

Profit margin: Net income divided by sales.

3. Processing accounting information

Economic events and the tracking of these:

Event: A happening of consequence to an entity.

External event: An event involving interaction between an entity and its environment.

Internal event: An event occurring entirely within an entity.

Transaction: Any event that is recognized in a set of financial statements.

Source document: A piece of paper that is used as evidence to record a transaction.

Account: A record used to accumulate amounts for each individual asset, liability, revenue, expense, and component of stockholders' equity.

Chart of accounts: A numerical list of all accounts used by a company.

General ledger: A book, a file, a hard drive, or another device containing all of the accounts.

T-account: a format of writing out the general ledger. So named because it resembles the capital letter T. The name of the account appears across the horizontal line. One side is used to show increases to that account; the other side, decreases. However, same side is *not* used for increases for every account.

Debit: An entry on the left side of an account, nothing more than this. It is neither good or bad. It is just an entry on the left side. The accounts increased with a debit are the following:
Dividends, Expenses, Assets, Losses

Note: for easier remembering, the first letter of each of these accounts (that are all increased with a debit entry) spell out the word "DEAL".

Credit: An entry on the right side of an account, nothing more than this. It is neither good or bad. It is just an entry on the right side. The accounts increased with a debit are the following:
Gains, Income, Revenue, Liabilities, Stockholders' equity

Note: for easier remembering, the first letter of each of these accounts (that are all increased with a credit entry) spell out the word "GIRLS"

Double entry system: A system of accounting in which every transaction is recorded with equal debits and credits and the accounting equation is kept in balance.

Journal: A chronological record of transactions.

Posting: The process of transferring amounts from a journal to the ledger accounts.

Journalizing: The act of recording journal entries.

General journal: The journal used in place of a specialized journal

Trial balance: A list of each account and its balance; used to prove equality of debits and credits.

4. Income measurement and accrual accounting

Principles behind accrual accounting:

Recognition The process of recording an item in the financial statements as an asset, a liability, a revenue, an expense, or the like.

Historical cost: The amount paid for an asset and used as a basis for recognizing it on the balance sheet and carrying it on later balance sheets.

Current value: The amount of cash or its equivalent that could be received by selling an asset currently.

Accrual accounting:

Cash basis: A system of accounting in which revenues are recognized when cash is received, and expenses are recognized when cash is paid

Accrual basis: A system of accounting in which revenues are recognized when earned and expenses are recognized when incurred (in time adjusting entries are then needed).

Expenses: Outflows of assets or incurrences of liabilities resulting from delivering goods, rendering services, or carrying out other activities.

Revenues: Inflows of assets or settlements of liabilities from delivering or producing goods, rendering services, or conducting other activities.

Revenue recognition principle: Revenues are recognized when a performance obligation is satisfied.

Matching principle: The association of revenue of a period with all of the costs necessary to generate that revenue.

Adjusting entries: Journal entries made at the end of a period by a company using the accrual basis of accounting. This is not just needed in direct relation to the accrual basis of accounting. As assets depreciate adjusting entries are also needed. This is though done through a contra account.

Contra account: An account with a balance that is opposite that of a related account. E.g. to know the original value of an asset, accountants do not decrease the asset as it depreciates, but instead create an account for "accumulated depreciation" – a contra account.

Accruals and deferrals:

Accrual: Situation where cash has not yet been paid but expense has been incurred, or where cash has not yet been received but revenue has been recognized.

Accrued liability: A liability resulting from the recognition of an expense before the payment of cash.

Accrued asset: An asset resulting from the recognition of a revenue before the receipt of cash.

Deferral: Situation where cash has been paid but expense has not yet been recognized, or where cash has been received but revenue has not yet been recognized.

Deferred expense: An asset resulting from the payment of cash before the incurrence of expense.

Deferred revenue: A liability resulting from the receipt of cash before the recognition of revenue.

Accounting cycle and closing entries:

Accounting cycle: A series of steps performed each period and culminating with the preparation of a set of financial statements.

Work sheet: A device used at the end of the period to gather the information needed to prepare financial statements without actually recording and posting adjusting entries.

Real accounts: The name given to balance sheet accounts because they are permanent and are not closed at the end of the period.

Nominal accounts: The name given to revenue, expense, and dividend accounts because they are temporary and are closed at the end of the period.

Closing entries: Journal entries made at the end of the period to return the balance in all nominal accounts to zero and transfer the net income or loss and the dividends to Retained Earnings.

Interim statements: Financial statements prepared monthly, quarterly, or at other intervals less than a year in duration.

5. Inventory and cost of goods sold

Goods:

Merchandise Inventory: The account wholesalers and retailers use to report inventory held for resale.

Raw materials: The inventory of a manufacturer before the addition of any direct labor or manufacturing overhead.

Work in process: The cost of unfinished products in a manufacturing company.

Finished goods: A manufacturer's inventory that is complete and ready for sale.

Gross profit: Sales less cost of goods sold.

Sales revenue: A representation of the inflow of assets.

Net sales: Sales revenue less sales returns and allowances and sales discounts. (Allowances: money given to the buyer as compensation for spoiled or damaged merchandise).

Cost of goods available for sale: Beginning inventory plus cost of goods purchased. The cost of a good should include all costs associated with acquiring the good. I.e. good cost (minus discounts), transportation cost and installation cost. Keep in mind not to include extra unordinary expenses to the good like e.g. insurance purchased for the good or repairs because something broke during the installation.

Cost of goods sold: Cost of goods available for sale minus ending inventory.

Purchases: An account used in a periodic inventory system to record acquisitions of merchandise.

Transportation-In: An adjunct account used to record freight costs paid by the buyer.

FOB destination point: Terms that require the seller to pay for the cost of shipping the merchandise to the buyer.

FOB shipping point: Terms that require the buyer to pay for the shipping costs.

Gross profit ratio: Gross profit divided by net sales.

Inventory systems:

Perpetual system: A system in which the Inventory account is increased at the time of each purchase and decreased at the time of each sale.

Periodic system: A system in which the Inventory account is updated only at the end of the period.

Inventory costing methods:

Specific identification method: An inventory costing method that relies on matching unit costs with the actual units sold.

Weighted average cost method: An inventory costing method that assigns the same unit cost to all units available for sale during the period.

FIFO method: (first-in-first-out) An inventory costing method that assigns the most recent costs to ending inventory.

LIFO method: (last-in-last-out) An inventory method that assigns the most recent costs to cost of goods sold.

LIFO liquidation: The result of selling more units than are purchased during the period, which can have negative tax consequences if a company is using LIFO. If the company begins selling older layers of inventory bought at a lower cost, their income before taxes rises and thus also the taxes they must pay.

LIFO conformity rule: The IRS requirement that when LIFO is used on a tax return, it must also be used in reporting income to stockholders.

LIFO reserve: The excess of the value of a company's inventory stated at FIFO over the value stated at LIFO.

Inventory profit: The portion of the gross profit that results from holding inventory during a period of rising prices.

Replacement cost: The current cost of a unit of inventory. (alternative to the historical cost principle. It is *not* accepted in accounting standards. However, it is used if the LCM rule is deemed necessary to apply).

Lower-of-cost-or-market (LCM) rule: A conservative inventory valuation approach that is an attempt to anticipate declines in the value of inventory before its actual sale. According to this, inventory should be valued at the lowest price: either acquisition cost or current market value.

Inventory management:

Inventory turnover ratio: A measure of the number of times inventory is sold during the period. Found by dividing the cost of goods sold with the average inventory.

Number of days' sales in inventory: A measure of how long it takes to sell inventory. Found be dividing the number of days in the period by the inventory turnover ratio.

6. Cash and internal control

Cash accounting:

Cash equivalent An investment that is readily convertible to a known amount of cash and has an original maturity to the investor of three months or less.

Bank statement: A detailed list, provided by the bank, of all activity for a particular account during the month.

Outstanding check: A check written by a company but not yet presented to the bank for payment.

Deposit in transit: A deposit recorded on the books but not yet reflected on the bank statement.

Bank reconciliation: A form used by the accountant to reconcile or resolve any differences between the balance shown on the bank statement for a particular account with the balance shown in the accounting records.

Credit memoranda: Additions on a bank statement for such items as interest paid on the account and notes collected by the bank for the customer.

Debit memoranda: Deductions on a bank statement for items such as NSF checks and various service charges.

Petty cash fund: Money kept on hand for making minor disbursements in coin and currency rather than by writing checks.

Internal control:

Internal control system: Policies and procedures necessary to ensure the safeguarding of an entity's assets, the reliability of its accounting records, and the accomplishment of overall company objectives.

Internal control report: A report required by Section 404 of the Sarbanes-Oxley Act to be included in a company's annual report in which management assesses the effectiveness of the internal control structure.

Sarbanes-Oxley Act: An act of Congress in 2002 intended to bring reform to corporate accountability and stewardship in the wake of a number of major corporate scandals.

Public Company Accounting Oversight Board (PCAOB): The five-member body created by the Sarbanes-Oxley Act that was given the authority to set auditing standards in the United States.

Board of directors: A group composed of key officers of a corporation and outside members responsible for general oversight of the affairs of the entity, including setting up an internal control system.

Audit committee: A board of directors subset that acts as a direct contact between the stockholders and the independent accounting firm.

Accounting system: Methods and records used to accurately report an entity's transactions and to maintain accountability for its assets and liabilities.

Administrative controls: Procedures concerned with efficient operation of the business and adherence to managerial policies.

Accounting controls: Procedures concerned with safeguarding the assets or the reliability of the financial statements.

Internal audit staff: The department responsible for monitoring and evaluating the internal control system.

<u>Controlling cash disbursements:</u>
Purchase requisition form: A form a department uses to initiate a request to order merchandise.

Purchase order: A form sent by the purchasing department to the supplier.

Invoice: A form sent by the seller to the buyer as evidence of a sale.

Blind receiving report: A form used by the receiving department to account for the quantity and condition of merchandise received from a supplier.

Invoice approval form: A form the accounting department uses before making payment to document the accuracy of all information about a purchase.

7. Receivables and investments

Accounts receivable:

Account receivable: A receivable arising from the sale of goods or services with a verbal promise to pay.

Control account: The general ledger account that is supported by a subsidiary ledger.

Subsidiary ledger: The detail for a number of individual items that collectively make up a single general ledger account.

Net receivable value: The amount a company expects to collect on an account receivable. Some goods may be damaged, or some customers might not pay (bad debts), therefore the total amount is not always collectable.

Bad debt: The part of the account receivable that is uncollectable for the company because the costumer simply does not pay.

Direct write-off method: The recognition of bad debts expense at the point an account is written off as uncollectible.

Allowance method: A method of estimating bad debts on the basis of either the net credit sales of the period or the accounts receivable at the end of the period. If the company has been in business for several years, this might be calculated as a percentage of either of net credits or simply the accounts receivable based on experiences from previous years.

Allowance for doubtful accounts: A contra-asset account used to reduce accounts receivable to its net realizable value.

Aging schedule: A form used to categorize the various individual accounts receivable according to the length of time each has been outstanding. The longer, the lower the chance of collecting the cash.

Accounts receivable turnover ratio: A measure of the number of times accounts receivable are collected in a period. Found by dividing net sales by average accounts receivable.

Notes receivable:

Promissory note: A written promise to repay a definite sum of money on demand or at a fixed or determinable date in the future.

Maker: The party that agrees to repay the money for a promissory note at some future date.

Payee: The party that will receive the money from a promissory note at some future date.

Note receivable: An asset resulting from the acceptance of a promissory note from another company.

Note payable: A liability resulting from the signing of a promissory note.

Key terms for promissory notes: These are common terms when talking about promissory notes
- Principal: the amount of cash received, or the fair value of the products or services received, by the maker when a promissory note is issued.
- Maturity date: the date the promissory note is due.
- Term: the length of time a note is outstanding, that is, the period of time between the date it is issued and the date it matures.
- Maturity value: the amount of cash the maker is to pay the payee on the maturity date of the note.
- Interest: the difference between the principal amount of the note and its maturity value.

Discounting: The process of selling a promissory note. Companies can do this to speed up the collection of cash from accounts receivable. They can exchange the note for cash at the bank – however, is the customer fails to pay the bank at the note's maturity date, the company is responsible.

<u>Investments:</u>
Equity securities: Securities issued by corporations as a form of ownership in the business. E.g. common stock and preferred stock.

Debt securities: Securities issued by corporations and governmental bodies as a form of borrowing.

8. Operating assets: property, plant, and equipment, and intangibles

Noncurrent assets and depreciation:

Acquisition cost: The amount that includes all of the cost normally necessary to acquire an asset and prepare it for its intended use, i.e. purchase price, taxes, transportation, installation. *Not* including e.g. insurance or repair expenses.

Capitalization of interest: Interest on constructed assets is added to the asset account. I.e. normally interest on borrow money is treated as an expense. However, if the borrowed money is used in construction of an asset and interest occurs during the construction, this interest is treated as part of the acquisition cost of the asset.

Land improvements: Costs that are related to land but that have a limited life, e.g. construction of a plant.

Depreciation: The process of allocating the cost of a long-term tangible asset over its useful life. It is *not* a continuous re-evaluation of the asset, but merely a way of adhering to the matching principle.

Accumulated depreciation: The total amount of depreciation assigned to an asset at a point in time.

Book value: The original cost of an asset minus the amount of accumulated depreciation, i.e. acquisition cost minus accumulated depreciation

Residual value: the amount that could be obtained from selling an asset at the end of its useful life.

Straight-line method: The assignment of an equal amount of depreciation to each period. Calculated by dividing acquisition cost minus residual value with the lifetime of the asset.

Units-of-production method: Depreciation is determined as a function of the number of units the asset produces.

Accelerated depreciation: A higher amount of depreciation is recorded in the early years and a lower amount in the later years.

Double-declining-balance method: A form of accelerated depreciation. Depreciation is recorded at twice the straight-line rate, but the balance is reduced each period, i.e. the amount that should be depreciated is recalculated each period, getting lower and lower.

Change in estimate: A change in the life of the asset or in its residual value.

Capital expenditure: A cost that improves the asset and is added to the asset account, i.e. the cost is added to the acquisition cost of the asset because it enhances the asset

Revenue expenditure: A cost that keeps an asset in its normal operating condition and is treated as an expense.

Gain on sale of asset: The excess of the selling price over the asset's book value. Treated as an income statement account.

Loss on sale of asset: The amount by which selling price is less than book value. Treated as an income statement account.

Intangible asset:

Intangible assets: Assets with no physical properties; licenses, patents, goodwill, R&D, etc.

Goodwill: The excess of the purchase price to acquire a business over the value of the individual net assets acquired.

Research and development costs: Costs incurred in the discovery of new knowledge. Treated as expenses, but because of the uncertainty of the outcome, it is not treated as an asset and do not appear on the balance sheet.

Amortization: If the intangible asset has a finite life, depreciation must be accounted for. However, when dealing with intangibles, depreciation is called amortization. It works the exact same way though.

9. Current liabilities, contingencies and the time value of money

Current liabilities:

Current liability: An obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year.

Accounts payable: Amounts owed for inventory, goods, or services acquired in the normal course of business.

Note payable: A liability resulting from the signing of a promissory note.

Discount on notes payable: A contra liability that represents interest deducted from a loan in advance. E.g. terms may be stated as 2/10, n/30. This means that if the payment is made within 10 days, a 2% discount is available. After this there is no discount and the payment must be made within 30 days.

Current maturities of long-term debt: The portion of a long-term liability that will be paid within one year.

Accrued liability: A liability that has been incurred due to the passage of time but has not yet been paid, e.g. wages payable.

Contingent liability: An existing condition for which the outcome is not known but depends on some future event.

Estimated liability: A contingent liability that is accrued and reflected on the balance sheet.

Contingent asset: An existing condition for which the outcome is not known but by which the company stands to gain. Contingent assets are never reported before they are realized due the conservatism of accounting, i.e. contingent assets are never accrued.

Time value of money:

Time value of money: An immediate amount should be preferred over an amount in the future. This is due to the fact that money can be invested and through this increased over time with interest.

Simple interest: Interest is calculated on the principal amount only. Calculated by multiplying the principle amount with the interest rate per year and the time in years.

Compound interest: Interest calculated on the principal plus previous amounts of interest, i.e. interest on interest.

Annuity: A series of payments of equal amounts.

Future value of a single amount: Amount accumulated at a future time from a single payment or investment, future value = present value times (1 + interest rate)^number of periods.

Present value of a single amount: The amount at a present time that is equivalent to a payment or an investment at a future time. In many situations we want to determine how much should be invested to achieve a given amount in the future.
present value = future value times (1 + interest rate)^(minus)number of periods**.**

Future value of an annuity: The amount accumulated in the future when a series of payments is invested and accrues interest.

Present value of an annuity: The amount at a present time that is equivalent to a series of payments and interest in the future. In many situations we want to determine how much should be invested to achieve a given amount in the future.

Note: To calculate the future or present value of a single amount or annuity, table values have been made. Simply multiply with the corresponding table value to find the amount you need. These tables are on page 435-438 in Financial Accounting 10th edition (table 9-1, 9-2, 9-3, 9-4).

10. Long-term liabilities

Issuance of bonds:

Long-term liability: An obligation that will not be satisfied within one year or the current operating cycle.

Debenture bonds: Bonds that are not backed by specific collateral. Normally the bond certificate indicates the collateral on the loan.

Serial bonds: Bonds that do not all have the same due date; a portion of the bonds comes due each time period.

Callable bonds: Bonds that may be redeemed or retired before their specified due date.

Face value: The principal amount of the bond as stated on the bond certificate.

Face rate of interest: The rate of interest on the bond certificate.

Market rate of interest: The rate that investors could obtain by investing in other bonds that are similar to the issuing firm's bonds.

Bond issue price: The present value of the annuity of interest payments plus the present value of the principal. E.g. in the following situation:

Face value: 10.000
Face rate of interest: 8% (payed annually)
Maturity date: 4 years from now
Market rate of interest: 10%

This will give the investor interest payment of 800 (10.000*8%) for 4 year and 10.000 at the maturity date. The present value of these are:

800 times 3,16987 (factor from Table 9-4 (annuity) for 4 periods, 10%) = 2536
10.000 times 0,68301 (factor from Table 9-2 (single amount) for 4 periods, 10%) = 6830

So the bonds should be issued at a price of 9366 (a so-called discount (see below)).

Premium: The excess of the issue price over the face value of the bonds.

Discount: The excess of the face value of bonds over the issue price.

Note:
If Market Rate = Face Rate, then bonds are issued at face value amount.
If Market Rate > Face Rate, then bonds are issued at a discount.
If Market Rate < Face Rate, then bonds are issued at a premium.

Bond amortization and bond retirement:

Carrying value: The face value of a bond plus the amount of unamortized premium or minus the amount of unamortized discount.
It is equal to the issue price of the bond in the first year. The next year the carrying value will increase/decrease by the amount of amortized discount/premium, i.e. the difference between the interest of the bond and the interest one could get by investing in similar bonds on the market.
In the previous example, this would be 9366 times 10% (market rate of interest) (=936) minus the interest on the bond (=800) = 936 – 800 = 136. This means that in the second year, the carrying value is 9366+136 = 9503

Effective interest method of amortization: The process of transferring a portion of the premium or discount to interest expense; this method results in a constant effective interest rate. The effective rate is equal to annual interest expense divided by the carrying value.

Redemption of bonds: The retirement of a bond by repaying the principal amount.

Gain or loss on redemption: The difference between the carrying value and the redemption price at the time bonds are redeemed.

Leases:

Capital lease: A lease that is recorded as an asset by the lessee. For this to be the case it has to meet one or more of the following criteria:
1. The lease transfers ownership of the property to the lessee at the end of the lease term.
2. The lease contains a bargain-purchase option to purchase the asset at an amount lower than its fair market value.
3. The lease term is 75% or more of the property's economic life.
4. The present value of the minimum lease payments is 90% or more of the fair market value of the property at the inception of the lease.

Operating lease: A lease that does not meet any of the four criteria above and is not recorded as an asset by the lessee.

Analyzing long-term liabilities:

Dept-to-Equity Ratio: total liabilities divided by total stockholders' equity.

Times Interest Earned Ratio: income before interest and tax divided by interest expense.

11. Stockholder's equity

Shares of stock:

Authorized shares: The maximum number of shares a corporation may issue as indicated in the corporate charter.

Issued shares: The number of shares sold or distributed to stockholders.

Outstanding shares: The number of shares issued less the number of shares held as treasury stock.

Common stock: A share of a company

Preferred stock: A share of a company with special attributes, which could include some of the following:
-Convertible feature: Allows preferred stock to be exchanged for common stock.
-Redeemable feature: Allows stockholders to sell stock back to the company.
-Callable feature: Allows the firm to eliminate a class of stock by paying the stockholders a specified amount
-Cumulative feature: The right to dividends in arrears before the current-year dividend is distributed.
-Participating feature: Allows preferred stockholders to share on a percentage basis in the distribution of an abnormally large dividend.

Treasury stock: Stock issued by the firm and then repurchased but not retired. This is done by using assets, decreasing stockholders' equity. It does not affect the income statement.

Stock split: The creation of additional shares of stock with a reduction of the par value of the stock. This will lower the market price of the stock, making it available to more investors.

Par value: An arbitrary (made up) amount that represents the legal capital of the firm. It does not represent the price of the share or how much it is worth. It is just a number made up for legal reasons.

Dividends:

Dividend payout ratio: The annual dividend amount divided by the annual net income.

Stock dividend: The issuance of additional shares of stock to existing stockholders. This could be done for a number of reasons; it does not require cash, it reduced the market price of the stock, it is not taxable income, thus being attractive to some wealthy investors, etc.

Stockholders' equity and share ratios:

Statement of stockholders' equity: Reflects the differences between beginning and ending balances for all accounts in the Stockholders' Equity category of the balance sheet. It may be relevant to some shareholders to understand the exact reasons for changes in stockholders' equity.

Comprehensive income: Total change in net assets from all sources except investments by or distributions to the owners.

Book value per share: Total stockholders' equity divided by the number of shares of common stock outstanding.

Market value per share: The selling price of the stock as indicated by the most recent transactions.