

chapter 1 Financial Statements and Business Decisions

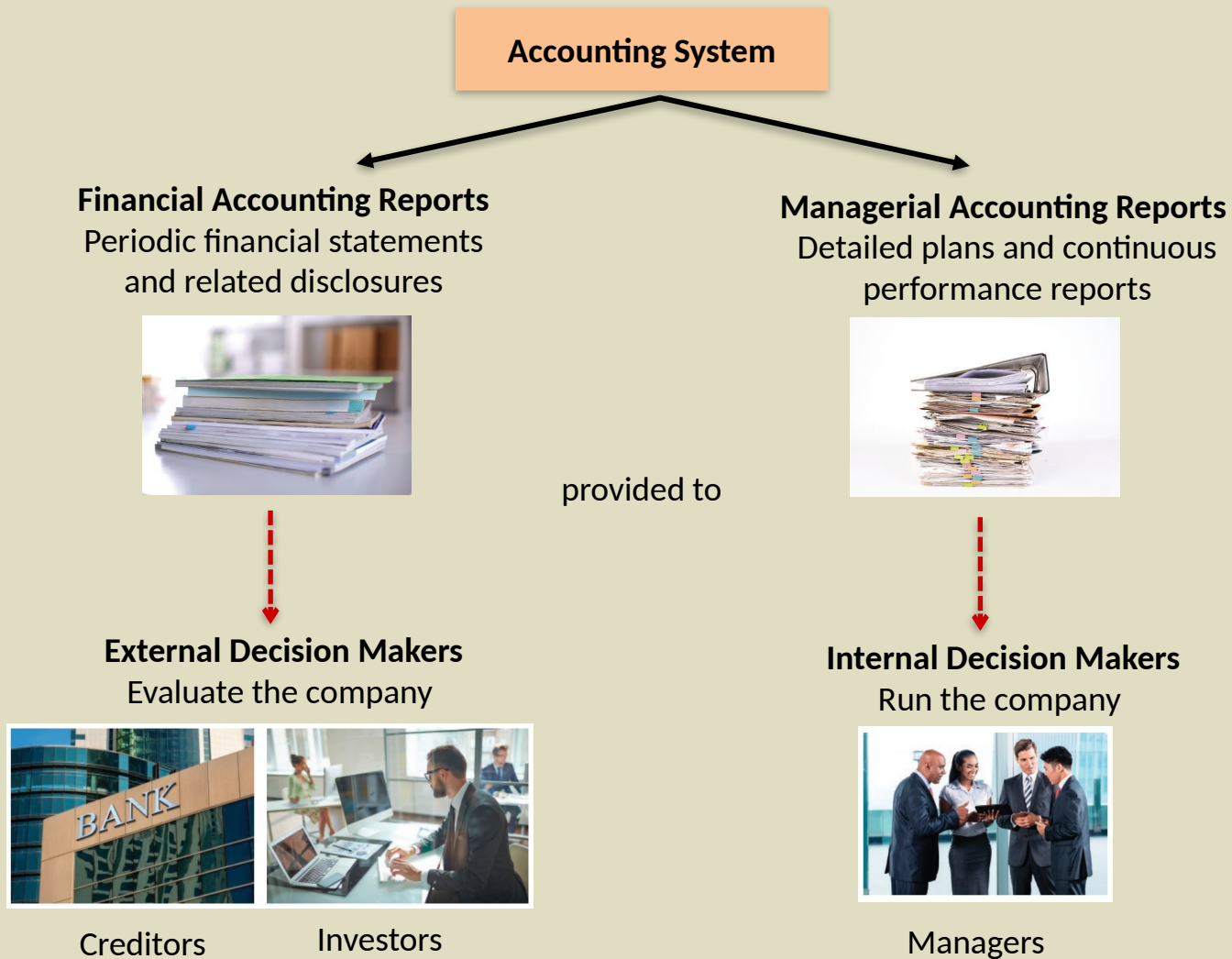
Financial Accounting

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Exhibit 1.1

The Accounting System and Decision Makers



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The Four Basic Financial Statements: An Overview

BALANCE SHEET – reports the financial position (amount of assets, liabilities, and stockholders' equity) of an accounting entity at a point in time.

INCOME STATEMENT – reports the revenues less the expenses during the accounting period.

STATEMENT OF STOCKHOLDERS' EQUITY – reports the changes in each of the company's stockholders' equity accounts, including the change in the retained earnings balance caused by net income and dividends, during the reporting period.

STATEMENT OF CASH FLOWS – reports inflows and outflows of cash during the accounting period in the categories of operating, investing, and financing.

The notes are an integral part of these financial statements.

Financial Statement Time Period & Structure

The four basic financial statements can be prepared at any point in time such as:

- **End of the year** (for the year ended, annual reports)
- **Quarterly** (for the quarter ended, quarterly reports)
- **Monthly** (for the month ended, monthly reports)

The financial statement heading includes:

- **Name of the entity** (Company name)
- **Title of the statement** (e.g., Balance Sheet)
- **Specific date of the statement** (e.g., At December 31, 2020)
- **Unit of measure** (in millions of dollars)

Balance Sheet

Assets

Cash
Short-Term Investments
Accounts Receivable
Notes Receivable
Inventories
Supplies
Prepaid Expenses
Long-Term Investments
Equipment
Buildings
Land
Intangibles

Liabilities

Accounts Payable
Accrued Expenses
Notes Payable
Taxes Payable
Unearned Revenue
Bonds Payable

Stockholders' Equity

Common Stock
Retained Earnings

Elements of the
Balance Sheet

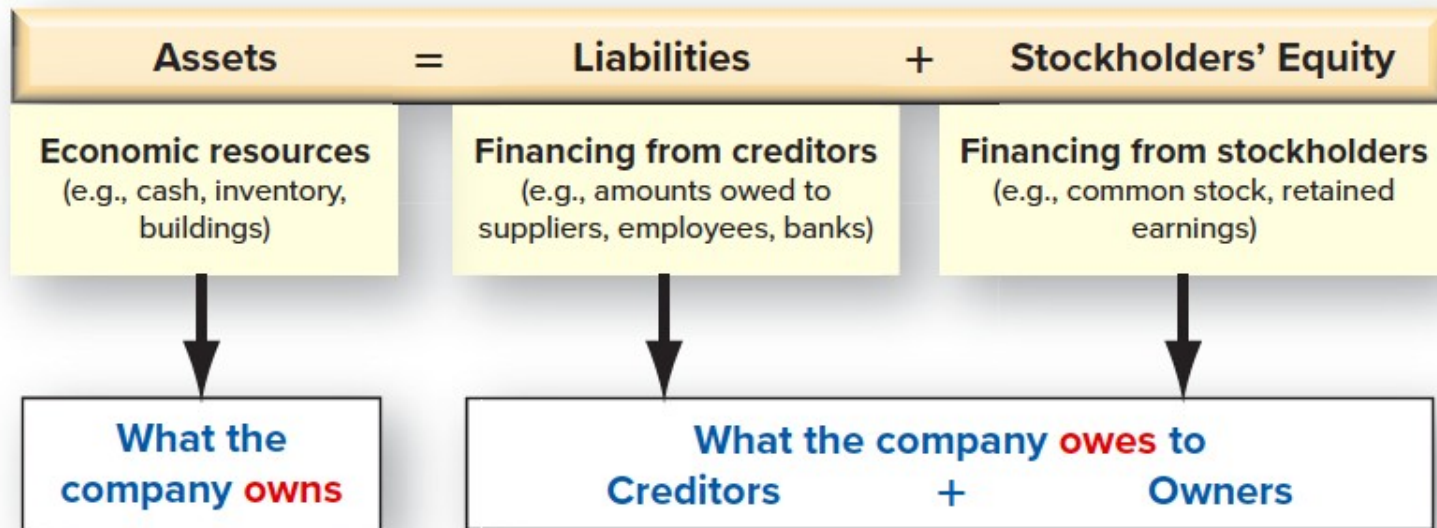
*The Balance Sheet is a
financial snapshot at a
specific point in time.*

Exhibit 1.2 Balance Sheet

LE-NATURE'S INC. Balance Sheet At December 31, 2020 ¹ (in millions of dollars)		EXPLANATION
Assets:		<i>Name of the entity</i>
Cash	\$ 10.6	<i>Title of the statement</i>
Accounts receivable	6.6	<i>Specific date of the statement</i>
Inventories	51.2	<i>Unit of measure</i>
Property, plant, and equipment	459.0	Resources controlled by the company
Total assets	<u>\$527.4</u>	<i>Amount of cash in the company's bank accounts</i>
Liabilities and stockholders' equity:		<i>Amounts owed by customers from prior sales</i>
Liabilities		<i>Ingredients and beverages ready for sale</i>
Accounts payable	\$ 26.0	<i>Factories, production equipment, and land</i>
Notes payable to banks	381.7	Total amount of company's resources
Total liabilities	<u>407.7</u>	Sources of financing for company's resources
Stockholders' equity		<i>Financing supplied by creditors</i>
Common stock	55.7	<i>Amounts owed to suppliers for prior purchases</i>
Retained earnings	64.0	<i>Amounts owed to banks on written debt contracts</i>
Total stockholders' equity	<u>119.7</u>	<i>Financing provided by stockholders</i>
Total liabilities and stockholders' equity	<u>\$527.4</u>	<i>Amounts invested in the business by stockholders</i>
		<i>Past earnings not distributed to stockholders</i>
		Total sources of financing for company's resources

The notes are an integral part of these financial statements.

The Basic Accounting Equation



*The basic accounting equation refers to a company's **financial position**: the **economic resources** that the company owns and the **sources of financing** for those resources.*

Income Statement

Revenues

Cash and promises received from delivery of goods and services.

Examples:

Sales Revenue
Service Revenue
Rental Revenue
Interest Revenue

The Income Statement is a measure of performance of the business.

Elements of the Income Statement

Expenses

Resources used to earn period's revenues.

Examples:

Cost of Goods Sold
Wages Expense
Rent Expense
Depreciation Expense
Insurance Expense
Repair Expense
Income Tax Expense

The Income Statement Equation

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



Resources earned
from delivery of
goods and
services



Resources
used
(incurred) to
earn period's
revenue



Revenues earned
minus expenses
incurred.

*Also called "profit",
"net earnings", or
"the bottom line."*

If total expenses exceed total revenues, a net loss is reported.

Exhibit 1.3 Income Statement

LE-NATURE'S INC. Income Statement For the Year Ended December 31, 2020 (in millions of dollars)		EXPLANATION <i>Name of the entity</i> <i>Title of the statement</i> <i>Accounting period</i> <i>Unit of measure</i>
Revenues		
Sales revenue	\$ 275.1	<i>Cash and promises received from sale of beverages</i>
Expenses		
Cost of goods sold	140.8	<i>Cost to produce beverages sold</i>
Selling, general, and administrative expenses	77.1	<i>Other operating expenses (utilities, delivery costs, etc.)</i>
Interest expense	17.2	<i>Cost of using borrowed funds</i>
Income before income taxes	40.0	
Income tax expense	17.1	<i>Income taxes on period's income before income taxes</i>
Net income	<u>\$ 22.9</u>	<i>Revenues earned minus expenses incurred</i>
The notes are an integral part of these financial statements.		

³Comprehensive income is sometimes presented in a separate statement titled Statement of Comprehensive Income, but may be part of the Income Statement. This advanced topic is discussed in Chapter 5.

Statement of Stockholders' Equity

Common Stock

Amounts invested in the business by stockholders.

$$\begin{array}{r} \text{Beginning Common Stock} \\ + \quad \text{Stock Issuance} \\ \hline \text{Ending Common Stock} \end{array}$$

Retained Earnings

Past earnings not distributed to stockholders.

$$\begin{array}{r} \text{Beginning Retained Earnings} \\ + \quad \text{Net Income} \\ - \quad \text{Dividends} \\ \hline \text{Ending Retained Earnings} \end{array}$$

Elements of the
Statement of
Stockholders'
Equity

*The Statement of
Stockholders' Equity reports
the change in each
stockholders' equity account
during the period.*

Exhibit 1.4 Statement of Stockholders' Equity

LE-NATURE'S INC. Statement of Stockholders' Equity For the Year Ended December 31, 2020 (in millions of dollars)		
	Common Stock	Retained Earnings
Balance December 31, 2019	\$55.7	\$43.1
Net income for 2020		22.9
Dividends for 2020		(2.0)
Balance December 31, 2020	<u>\$55.7</u>	<u>\$64.0</u>
The notes are an integral part of these financial statements.		

EXPLANATION

Name of the entity

Title of the statement

Accounting period

Unit of measure

Last period's ending balances

Net income reported on the income statement

Dividends declared during the period

Ending balances on the balance sheet

Exhibit 1.5

Relationship Among LeNature's Statements

Income Statement (in millions)		Statement of Stockholders' Equity (in millions)			Balance Sheet (in millions)		
Revenues	\$275.1		Common Stock	Retained Earnings	Cash	\$ 10.6	
— Expenses	252.2				Other Assets	516.8	
Net Income	\$ 22.9	➔ 1	Beginning	\$55.7	\$43.1	Total Assets	\$527.4
			+ Net Income		22.9	Liabilities	\$407.7
			— Dividends		(2.0)	Common Stock	55.7
			Ending	\$55.7	\$64.0	Retained Earnings	64.0
						Total Liabilities and Stockholders' Equity	\$527.4

Statement of Cash Flows

+/- Cash Flows from Operating Activities (CFO)

+/- Cash Flows from Investing Activities (CFI)

+/- Cash Flows from Financing Activities (CFF)

Change in Cash

+ Beginning Cash Balance

Ending Cash Balance



Note that each of the three cash flow sources can be **positive** (net cash inflow) or **negative** (net cash outflow)

Statement of Cash Flows

Cash Flows from Operating Activities

Cash flows directly related to earning income, such as cash collected from customers less cash paid for operating expenses, such as cash paid to suppliers and employees.

Cash Flows from Investing Activities

Cash flows related to acquisition or sale of the company's plant and equipment and investments.

Cash Flows from Financing Activities

Cash flows directly related to the financing of the enterprise, such as the receipt or payment of money to investors and creditors (except suppliers)

The Statement of Cash Flows reports inflows and outflows of cash during the accounting period.

Elements of the
Statement of Cash
Flows

Exhibit 1.6 Statement of Cash Flows

LE-NATURE'S INC.*

Statement of Cash Flows (Summary) For the Year Ended December 31, 2020 (in millions of dollars)

Cash flows from operating activities	\$ 87.5
Cash flows from investing activities	(125.5)
Cash flows from financing activities	<u>47.0</u>
Net increase (decrease) in cash	9.0
Cash balance December 31, 2019	<u>1.6</u>
Cash balance December 31, 2020	<u>\$ 10.6</u>

The notes are an integral part of these financial statements.

*The Le-Nature's statements presented are a simplified version of its audited 2005 statements.

EXPLANATION

Name of the entity

Title of the statement

Accounting period

Unit of measure

Cash flows directly related to earning income

Cash flows from purchase/sale of plant, equipment, & investments

Cash flows from investors and creditors

Change in cash during the period

Last period's cash on the balance sheet

Ending cash on the balance sheet

Notes (or Footnotes)

“The notes are an integral part of these financial statements.”

Did you notice this sentence at the bottom of each financial statement?

All financial statements should be accompanied by notes that provide the reader with supplemental information to help the reader better understand the financial statements.

Exhibit 1.7

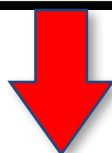
Summary of the Four Basic Financial Statements

Financial Statement	Purpose	Structure	Examples of Content
Balance Sheet (Statement of Financial Position)	Reports the financial position (economic resources and sources of financing) of an accounting entity <i>at a point in time</i> .	Balance Sheet Assets = Liabilities + Stockholders' Equity	Cash, accounts receivable, plant and equipment, long-term debt, common stock
Income Statement (Statement of Income, Statement of Earnings, Statement of Operations)	Reports the accountant's primary measure of economic performance <i>during the accounting period</i> .	Income Statement Revenues +Increases -Expenses <u>Net Income</u>	Sales revenue, cost of goods sold, selling expense, interest expense
Statement of Stockholders' Equity	Reports changes in the company's common stock and retained earnings <i>during the accounting period</i> .	Statement of Stockholders' Equity Beginning balance +Increases -Decreases <u>Ending balances</u>	Beginning and ending stockholders' equity balances, stock issuances, net income, dividends
Statement of Cash Flows (Cash Flow Statement)	Reports inflows (receipts) and outflows (payments) of cash <i>during the accounting period</i> in the categories operating, investing, and financing.	Statement of Cash Flows +/-CFO +/-CFI +/-CFF <u>Change in Cash</u>	Cash collected from customers, cash paid to suppliers, cash paid to purchase equipment, cash borrowed from banks

The rules that determine the content and measurement rules of the statements are called generally accepted accounting principles, or GAAP.

How are GAAP Principles Determined?

Congress created the Securities and Exchange Commission (SEC) and gave it broad powers to determine measurement rules for financial statements for publicly traded companies.



The SEC has worked closely with accountants and other interested parties to work out the detailed rules that become GAAP principles.

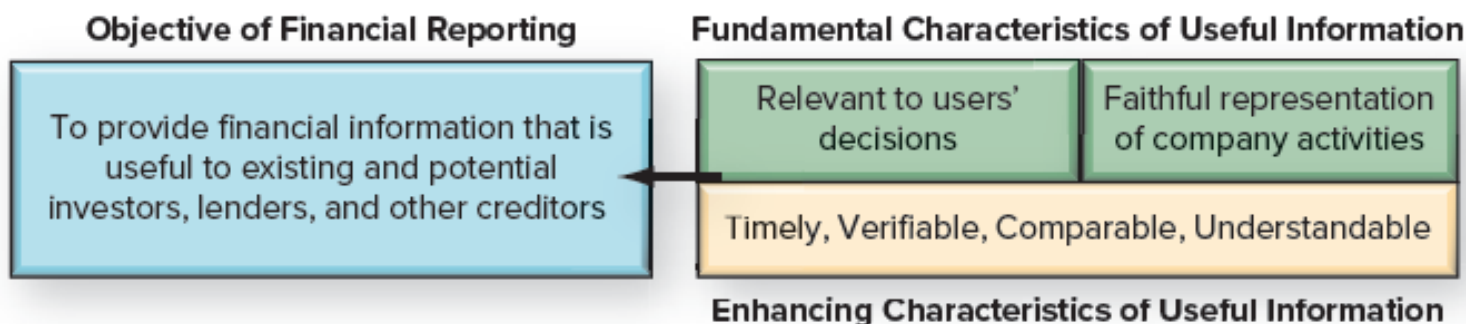


Today, the Financial Accounting Standards Board (FASB) has the responsibility to formulate GAAP. The official pronouncements of the FASB are called the FASB Accounting Standards Codification.

What Concepts Guide the Setting of Accounting Standards?

The FASB relies on a **conceptual framework** to provide a structure for developing specific accounting standards.

Exhibit 1.8 Conceptual Framework for Financial Reporting



International Perspective

Financial accounting standards and disclosure requirements are adopted by national regulatory agencies.

Since 2002, 144 jurisdictions have adopted **International Financial Reporting Standards (IFRS)** issued by the **International Accounting Standards Board (IASB)**.

Examples of jurisdictions requiring the use of IFRS:

- European Union (Germany, France, the Netherlands, Belgium, Poland, etc.) and United Kingdom
- Australia and New Zealand
- Hong Kong (S.A.R. of China), Malaysia, and Republic of Korea
- Israel and Turkey
- Brazil and Chile
- Canada and Mexico

In the U.S., the SEC now allows foreign companies whose stock is traded in the United States to use IFRS.