Comm 2010 gg

Patrick Sanders

August 2016

1 Introduction to Business Activities

1.1 Overview of Business Activities

1. Establish Goals and Strategies
   (a) Goals - the results toward which the firm directs its energies; maximizing returns
   (b) Strategies - the means for achieving those results; management determining the firm's line of business
   (c) Factors affecting goals and strategies
      i. Goals and strategies of competitors
      ii. Barriers to entry of industry
      iii. Nature of demand for firm's goods and services
      iv. Existence and nature of government regulation
2. Obtain Financing
   (a) Financing - Funds from owners and creditors
   (b) Publicly traded - Shares trade on active markets
   (c) Creditors - Provides funds that firm must repay over specific amount of time
      i. Long term - Period of time exceeding one year
      ii. Short term - Payment over the next year
   (d) Bond - Specifies amount borrowed and time of repayment
3. Make Investments
   (a) Land, Building, and Equipment - Provide capacity to sell/manufacture goods, typically long term
   (b) Patents, Licenses, and other Contractual Rights - Rights to use ideas, intangible
   (c) Common shares or bonds of other firms

(d) Inventories

(e) Accounts Receivable from Customer - Amount owed by customer for short periods of time

(f) Cash

4. Carry Out Operations

    (a) Purchasing

    (b) Production - Combining raw materials, labor services for to produce goods for sale

    (c) Marketing - Oversees selling and distribution

    (d) Administration - Data-processing, HR management, legal services

    (e) Research and Development

1.2 Principal Financial Statements

1. Annual Report to Shareholders - Describes firm's goals, strategies; if traded publicly, will file an annual report with a regulator, typically government agency

2. Management Discussion and Analysis (MD&A)

3. Financial Reporting Conventions

    (a) Length of Reporting Period

        i. Fiscal year

        ii. Calendar year

    (b) Number of Reporting Period

        i. GAAP and IFRS require firms to include results for multiple reporting periods in each report

        ii. Must include two balance sheets describing beginning and ending balances for current and prior fiscal year

    (c) Terminology and Level of Detail

        i. IFRS contains relatively more guidance

4. Balance Sheet - Statement of financial position

    (a) Concepts of Assets, Liabilities, and Shareholders' Equity

        i. Assets - economic resources with potential to provide future economic benefits to a firm

        ii. Liabilities - Creditors' claims

        iii. Shareholders' Equity - Amount of funds owners have provided either by buying share or by retained earnings; shareholders have a claim on assets that are in excess of assets required to meet creditors' claims

        iv. Retained Earnings - Net assets
        v. Accumulated Deficit - cumulative earnings less dividends are negative

    (b) Balance Sheet Classification and Aggregation
        i. Both GAAP and IFRS require balance sheets separate current items from noncurrent items
        ii. Current assets - A firm expects to turn into cash/sell/consume with one year from the date of balance sheet
        iii. Current liabilities - Obligations a firm expects to pay within one year
        iv. Noncurrent assets - assets that will be used for several years
        v. Noncurrent liabilities and shareholders' equity - Sources of funds whose suppliers do not expect to receive payment within the next year

    (c) Balance Sheet Measurement
        i. Both GAAP and IFRS use two bases to measure monetary amounts for assets/liabilities/S.E.
        ii. Historical Amount - Reflects acquisition cost of assets or the amount of funds originally obtained from creditors/owners
        iii. Current Amount - Measure of current value as of balance sheet date

5. Income Statement

    (a) Statement of profit and loss by firms applying IFRS
    (b) Revenues - Inflows of assets from selling goods and providing services to customers
    (c) Expenses - Measures outflow of assets incurred in generating revenues
        i. Cost of goods sold
        ii. Selling and administrative expenses
    (d)

6. Statement of Cash Flows

    (a) Reports information about cash generated from or used by
    (b) Operating Activities
    (c) Investing Activities - Acquisition of buildings, equipment, and other noncurrent assets to maintain or expand to their productive capacity; capital expenditures
    (d) Financing Activities - Obtain financing by issuing debt or common shares

7. Statement of Shareholders' Equity

    (a) Presents changes in shareholders' equity

1.3 Financial Reporting Process

1. Managers and Governing Boards of Reporting Entities
   (a) Managers - Agents of shareholders and have responsibility for safeguarding and properly using the firm's resources
   (b) Governing Board/Board of Directors - Responsible for selecting, compensating, and overseeing managers; for establishing dividend policy; making decisions on major issues
2. Accounting Standard Setters and Regulatory Bodies
   (a) U.S. GAAP
      i. Securities and Exchange Commission (SEC) - Agency of federal government with authority to establish accounting Standards; enforcement agency for U.S. securities laws
      ii. U.S. SEC Registrants - Firm incorporated in US that lists and trades its securities in US
      iii. Non U.S. SEC registrant - Foreign private issuers
      iv. Financial Accounting Standards Board (FASB) - SEC largely delegates take of financial standards; private with seven voting members
      v. Generally Accepted Accounting Principles (GAAP)
      vi. Conceptual Framework for FASB
         A. Objective of financial reporting
         B. Qualitative characteristics of accounting information - Relevance, Representational faithfulness, Comparability, Verifiability, Timeliness and understandability
         C. Elements of Financial Statements
         D. Recognition and Measurement Principles
   (b) International Financial Reporting Standards (IFRS)
      i. International Accounting Standards Board (IASB) - Independent Accounting standard-setting entity, currently 15 members
   (c) Independent Auditors
      i. Audit
         A. Assessment of capability of a firm's accounting system to accumulate, measure, and synthesize transactional data
         B. Assessment of operational effectiveness of accounting system
         C. Determination of whether financial report complies with requirements of applicable authoritative guidance
      ii. Audit Opinion - auditor's conclusions
      iii. Sarbanes-Oxley Act - Established Public Company Accounting Oversight Board (PCAOB)
   (d) Users of Financial Statements

1.4 Basic Accounting Conventions and Concepts

1. Realization - Converting a noncash item to cash
2. Materiality - Financial reports need not include items so small as to be meaningless to users
3. Accounting Period Convention - Length of Financial reporting periods
4. Accounting/Reporting Period
5. Interim Report - Periods shorter than a year; does not eliminate the need to prepare an annual report

1.5 Accounting Methods for Measuring Performance

1. Cash Basis of Accounting - Firm measures performance from selling goods and services as it receives cash from customers and makes cash expenditures
   (a) Cash basis does not match cost of efforts required to generate inflows with inflows themselves
   (b) Cash Basis separates recognition of revenue from process of earning those revenues
   (c) Performance measured using cash basis is sensitive to the timing of cash expenditures
2. Accrual Basis of Accounting - Recognizes revenue when a firm sells goods or renders services
   (a) Provides a measure of performance for future periods because activities of future periods will bear share of costs of rent and other services the firm will consume
   (b) Matching Convention - Matches expenses with their related revenues by subtracting their amount in measuring performances

2 Balance Sheet

2.1 Accounts

1. Permanent Accounts - Remain open with nonzero balances at end of reporting period (Balance sheet)
2. Temporary Account - Start a period with a zero balance, accumulate information during period, and end with zero balance (Income statement)

2.2 Balance Sheet

1. Common Terminology
   (a) Typical Asset Accounts
      i. Cash
      ii. Marketable Securities
      iii. Accounts, Notes, Interest Receivable
      iv. Inventory
      v. Advances to Suppliers
      vi. Prepaid Rent, Insurance
      vii. Investments in Securities
      viii. Property, Plant, Equipment
      ix. Accumulated Depreciation
      x. Patents, Goodwill
   (b) Typical Liability Accounts
      i. Accounts, Notes, Interest, Income Taxes Payable
      ii. Advances from Customers
      iii. Mortgage, Bonds Payable
      iv. Deferred Income Taxes
   (c) Typical Shareholders' Equity Accounts
      i. Common Stock (at par)
      ii. Additional Paid-In Capital
      iii. Preferred Stock
      iv. Retained Earnings
      v. Accumulated Other Comprehensive Income

2.3 Typical Balance Sheet

1. Current vs Non-Current
2. GAAP - Assets and liabilities appear in order of decreasing closeness to cash (least liquid to most)
3. IFRS - Reversed

2.4 Dual Effect of Transactions

1. Balance Sheet Equation - Assets = Liabilities + Shareholder's Equity
2. Dual Effect of Transactions

2.5 T-Accounts

1. Device for organizing and accumulating accounting entries of transactions that affect an individual account (ex: cash, accounts receivable)
2. Debit is on left side
3. Credit is on right side
4. Assets on left side, liabilities and S.E. are on right
5. Increases in an account occur on same side, decreases on opposite

2.6 Journal Entries

1. Standard format to indicate the accounts and amounts affected by each transaction
2. Posting - Accountant should transfer amounts from journal entry to appropriate T-account

3 Income Statement

3.1 Income Statement

1. Common Terminology
   (a) Revenues or Sales
   (b) Cost of Goods Sold
   (c) = Gross Profit
   (d) Selling, General, and Administrative (costs)
   (e) Research and Development (R&D)
   (f) = Operating Profit
   (g) Interest Expense
   (h) Interest Income
   (i) Income Tax Expense
   (j) = Net Income

3.2 Relation between Balance and Income

1. Beginning balance of shareholders' equity account Retained Earnings + net income of income statement - dividends = Ending Retained Earnings
2. Calculation of net income is not purpose of income statement; rather, to display line items for components of net income, company performance

3. Closing - Transferring all non-zero balances of temporary accounts to permanent accounts (Transferring revenue and expenses to retained earnings = income to balance)

4. Would be the same as transferring directly to Retained Earnings every time, separate makes easier

3.3 Accounting Process for Revenues, Expenses, and Dividends

3.4 Adjusting Entries

1. Contra Account - Account that accumulates subtractions from another account (accumulated depreciation)

2. Correcting Entries - Adjusting entries correct recording errors that firm detects at end of period

3. Typical Adjusting Entries

   (a) Unearned Revenues
   (b) Accrued Revenues
   (c) Prepaid Expenses
   (d) Accrued Expenses

4. Cash is NOT an adjusting entry

3.5 Financial Statement Preparation

1. Preparation of Income Statement

   (a) Parentheses indicate numbers to be subtracted
   (b) Neither GAAP nor IFRS defines operating income/profit, although both often appear on income statements

2. Closing Entries

   (a) Closing process - Reducing to zero balance in each income statement and debiting/crediting Retained Earnings

3. Preparation of Balance Sheet

   (a) After closing, accounts with nonzero balances are all balance sheet accounts

4. Preparation of Cash Flows

   (a) Direct Method - Lists sources of cash from operating activities
   (b) Indirect Method - Reconciles net income to cash flows from operations by adjusting net income for noncash income statement components

4 Balance Sheet - Presenting and Analyzing Resources and Financing

4.1 Underlying Concepts

1. Balance Sheet Equality
2. Balance Sheet Classifications
   (a) Current Assets - Expected to realize during the operating cycle

4.2 Asset Recognition and Measurement

1. Asset Definition and Recognition
   (a) Probable future economic benefit
   (b) Recognition
      i. Firm owns or controls the right to use the item
      ii. Right to use the item arises as a result of a past transaction or exchange
      iii. Future benefit has a relevant measurement attribute that can be quantified with sufficient reliability
   (c) Reliability - Amount corresponds to what it purports to represent
2. Asset Measurement
   (a) Acquisition (historical) Cost - Amount of cash paid to acquire an asset
   (b) Current replacement cost - asset is the amount a firm would have to pay to obtain another asset with identical service potential
   (c) Entry value - Reflects economic conditions at the measurement date
   (d) Net Realizable Value - Net cash firm would receive if it sold asset
   (e) Fair value - Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date
   (f) Present Value of Future Net Cash Flows - Sum of present values of the individual future cash inflows and outflows associated with an asset
3. Measurement Approaches for Specific Assets
   (a) GAAP and IFRS specify asset measurement basis for financial reporting
   (b) Financial Assets - Cash and claims to cash
   (c) Nonfinancial Assets - Tangible and intangible resources firms uses in operations to generate future cash flows
   (d) Impairment - Asset's fair value falls below its carrying value

4.3 Three Conventions Underlying Asset Measurement

1. Going Concern
   (a) Realize changes in fair values of assets by using assets or selling them
   (b) Value Decreases - Impairment losses
   (c) Value Increases - GAAP forbids the recognition of unrealized gains from increases in the fair value of most nonfinancial assets
2. Relevance and Reliability
   (a) Relevance - Information could affect decisions of users of financial reports
   (b) Reliability - Information presented is reasonably free from error and bias
3. Conservatism
   (a) Possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets

4.4 Liability Recognition and Measurement

1. Liability Definition and Recognition
   (a) Probable future sacrifices of economic benefits arising from present obligations to transfer assets in future as a result of past event/transaction
   (b) Recognition
      i. Item represents a present obligation, not potential future commitment or intent
      ii. Obligation must exist as a result of a past transaction - obligating event
      iii. Obligation must require a probable future economic resource that firm has little or no discretion to avoid
      iv. Obligation has relevant measurement base that firm can quantify
   (c) Mutually Unexecuted Contract (executory)
2. Liability Measurement

4.5 Shareholders' Equity Measurement and Disclosure

1. Additional paid-in Capital (APIC)
2. par value stuff we havent talked about

5 Income Statement: Reporting the Results of Operating Activities

5.1 Reporting Expenses

1. Gross Profit - Revenue - COGS
2. Operating Expenses
3. Operating Profit - Neither GAAP nor IFRS requires
4. Income from continuing/discontinued operations - GAAP and IFRS requires separation

5.2 Revenue Recognition and Measurement

1. Revenue Recognition
   (a) Timing and measurement of revenues
   (b) Misreporting revenue is a common form of accounting fraud
   (c) Firms bundle products and services and sell in multiple-element arrangements
   (d) Distinguish revenue from gains, expenses from losses

5.3 Expense Recognition and Measurement

1. Timing of Expense Recognition - When firm consumes benefits
2. Criteria for Expense Recognition
   (a) Consumption of asset results from a transaction that leads to the recognition of revenue
   (b) Consumption of asset results from passage of time
3. Recognition of Product Costs
4. Recognition of Period Expenses
5. Expense Measurement

5.4 Comprehensive Income

1. Other Comprehensive Income (OCI) - GAAP and IFRS require firms to change carrying value of certain assets
2. Net Income + OCI = Comprehensive Income
3. Accumulated Other Comprehensive Income (AOCI) - GAAP and IFRS require firms to report cumulative effect of OCI in a balance sheet account