# **MGT 8803 ACCOUNTING MODULE**

# **WEEK 1 SCRIPTS OF VIDEOS**

## Video 1--Introduction to Financial Accounting

Hello, I'm Professor Schneider. I will be your instructor for the Accounting module. We will begin today's session by talking about the basics of financial accounting. Financial accounting involves measuring and reporting financial information, but before we can talk about how we measure and how we report, we need to talk about what forms of business organization we measure and report for. The first form is the proprietorship. That's where a business is just owned by a single owner. The second form is a partnership, where a business is owned by more than one owner, the owners being called the partners. Each of these two forms of businesses have a feature in that they are legally not separate from the owners. The business and the owners are legally one entity. And that has implications for liability and taxation. Regarding liability, we have unlimited liability for a proprietorship and a partnership. What that means is that the obligations of the business are the same as the obligations of the owners. So, for example, if a proprietorship borrows money from a bank and is unable to pay back the bank, the bank can go after the owner. With a partnership, if the partnership borrows money from the bank and the partnership does not pay back the bank, the bank can then go after the individual partners. Another feature is that there is no taxation of these businesses. There is taxation of the owners. So, in a proprietorship, the owner pays taxes. In a partnership, the partners pay taxes on their share of the partnership's profits. So, they pay as individuals, because they are legally the same as the business itself. The other form of business organization is called the corporation. A corporation is a legal, separate entity from its owners. When people want to form a corporation, they choose a state in which they want to file articles of incorporation and they do so. Then, in exchange for contributing things like cash or equipment or inventory to the business, they receive shares of stock, which entitle them, as shareholders, to elect a board of directors. After they elect a board of directors, the board of directors then makes the major policy decisions of the corporation, including hiring the top managers who run the day to day operations of the corporation. The corporation, because it is a legal separate entity from the shareholders, has limited liability. The shareholders, that is, have limited liability. This means that if the corporation borrows money from the bank and is unable to pay the bank, the bank cannot go after the shareholders. Regarding taxation, the corporation does pay taxes as its own entity and then, when the corporation distributes its earnings to the shareholders, the shareholders pay taxes again as individuals. So, there's actually double taxation in a corporation. That's a disadvantage of a corporation, but it’s really outweighed by the major advantage of having limited liability. So, the most dominant form of business in the US is the corporation and as such, when we discuss financial accounting, we'll be focusing on corporations. Corporations can be publicly traded on stock exchanges such as the New York Stock Exchange, the American Stock Exchange, or Nasdaq, or they can be privately held.

Let's now talk about some of the underlying assumptions of financial accounting. First assumption is the separate entity assumption. We just talked about how, in a partnership or proprietorship, those businesses are legally not separate from the owners. But, for accounting purposes, we treat the business and the owners as separate entities. And we're going to be focusing on the accounting for the businesses, not the owners. The second assumption is the unit of measurement assumption. What that says is that we'd like to pick a unit of measure to aggregate all the different things that we have so that there is one common unit of measure. That common unit of measure, typically, is the currency in which the company is operating, and in the US, that would be the dollar. So, the assumption is that we can convert things like buildings, land, equipment, inventories into dollar amounts and then aggregate these dollar amounts. A third assumption is called the going concern assumption. What that means is that we presume that the company will continue to operate -- that it'll be ongoing. The accounting might be different if we would presume that the company would be going out of business. A fourth assumption is called periodicity. What that says is that we presume that we can arbitrarily pick any time period that we want to and report the financial results for that time period. We can pick a year, a quarter, a month and isolate the company's activities for that time period and report the financial results of that period. The last assumption is called materiality. What that says is that the only information that needs to be disclosed in financial statements is information that will be useful for those who rely on the financial statements to make decisions. So, as an example of that, we will look at the financials of Home Depot. If you look at page 36, at the sentence right before the boldface heading, “Merchandise Inventories”, it reads, “The valuation reserve related to accounts receivable was not material to our consolidated financial statements at the end of fiscal 2018 or fiscal 2017.” What they're saying is that they did not convey information about something called a valuation reserve because they believed that it would not have a material impact. They did not believe it would affect decisions made by any users of these financial statements.

Let's now talk about those groups that use financial reports. We have investors, who, for a corporation, would be the stockholders. We have creditors, such as banks or other lenders. Users include government agencies such as the Securities and Exchange Commission and the Internal Revenue Service. Other users are company management and financial analysts. Now, what most of these groups have in common is that they're outsiders of the corporation, with the exception of company management. And because most of the users are outsiders, when developing the rules for financial reporting, we have to keep in mind that most of the users are outside the company. In the following session, we will discuss the financial reporting rules. See you next time.

## Video 2—Financial Statements

We will begin this session with a discussion of the rules that underlie financial accounting. These rules are referred to as Generally Accepted Accounting Principles, or GAAP for short. The rule-making resides under the authority of the US Securities and Exchange Commission, the SEC. However, historically the SEC has delegated rule-making to private bodies. In recent years, this private body is known as the Financial Accounting Standards Board, the FASB. The FASB consists of representatives from public accounting firms, industry, government agencies, and academia, so a cross-section of society. Now, even though the SEC has jurisdiction over publicly traded firms, the rules, GAAP, really apply to not only publicly traded firms, but privately held firms as well. Internationally, there's been a set of rules that has been developed in recent years, called International Financial Reporting Standards, IFRS for short. There was talk a few years back that, in the US, GAAP might be replaced by IFRS, however it does not look like that will happen anymore. There's been too much opposition from companies in the US and in later sessions, we'll talk about some of the specific reasons for this opposition. There's also a difference between GAAP and tax accounting. The accounting that's done for the IRS, for the tax returns, is really quite different from GAAP and in this course, we are focusing only on GAAP, not on tax accounting. Let's now talk about what qualities we would like to see financial statements possess. One quality is understandability. We'd like them to be understandable. Another is timeliness. We'd like them to come out in a timely manner for being able to make decisions at the right time. Full disclosure means that we want everything that is important for decision makers to be disclosed. For comparability, we want the financial statements to be comparable over time for a particular company to be able to see trends. We'd also like them to be comparable with other companies. Another quality is objectivity. Now, what I don't have there is something like accuracy. The reason that I don't have accuracy is because there is so much judgment and estimation involved in financial reporting that accuracy is often not applicable. At best, we can talk about objectivity or freedom from bias. As an example of reference to this estimation and judgment, let's look at the financials for UPS on page 69. If you look at the UPS financials on page 69, near the top, there's a heading that says, "Use of Estimates" and underneath, it reads, "The preparation of our consolidated financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses, and the disclosure of contingencies. Estimates have been prepared on the basis of the most current and best information and actual results could differ materially from those estimates." Another quality that we would like financial statements to have is that of decision relevance. We'd like them to be useful for decision making. As it turns out though, that objective sometimes is in conflict with the objective of objectivity. We'll talk about that in our next lesson. Companies need to provide three basic financial statements to users. One is called the balance sheet. The second is called the income statement. And the third is called a statement of cash flows. The balance sheet measures financial position at a point in time. It's as if we had a financial camera and took a snapshot of the company at a certain moment. You'd be able to see what a company has, what it owes. That's the purpose of the balance sheet. And in it there are three categories. One is Assets, the second is Liabilities, and the third is Owner's Equity. There's a relationship among the three in that Assets equals Liabilities plus Owner's Equity. This is known as the accounting equation. The left side of the equation can be viewed as the resources of the company, that is the assets are the resources. The right-hand side can be viewed as the sources of the funding. The liabilities are the sources provided by the creditors. Owner's Equity represents the sources provided by the owners. As well, the right side can be viewed as who has claims to the assets. The Liabilities represent the creditor's claims. Owners' Equity represents the owner's claims.

## Video 3—Assets

In the last session we provided an overview the balance sheet. Now we will discuss in more detail the Asset section of the balance sheet. Assets are the resources owned or rights to receive resources. They could be physical, such as cash, buildings, inventory, equipment. They can be intangible like copyrights, patents, or trademarks that have no physical substance but they are resources. Or they can be legal rights. For example, if Macy's sells merchandise to a customer on credit, Macy's has a legal right to receive payment from those customers. And that represents an Asset. Some Common Asset accounts include Cash, Accounts receivable, which in my example that I just gave about Macy's selling merchandise on credit, the asset that they would have is called an account receivable. It represents the right to receive the payment. For big ticket items like automobiles or refrigerators or furniture, often the buyer has to sign a promissory note that promises to pay at certain dates with interest payments and so on. And because of the written form of these obligations, these are referred to as notes receivable. Another common asset is inventory. This represents the merchandise that the company has either manufactured or bought from the supplier that it will be selling to customers. A company could have investments -- stocks or bonds in other companies. Another group of assets could be buildings and equipment. And then we can also have intangible assets such as copyrights or patents. The order of the presentation on the balance sheet is generally in terms of liquidity, which means the closer they are to being cash the more liquid they are. So we start with cash and then we typically have things like the receivables and inventory because they're generally going to be converted into cash within a couple of months or so. And then the things like buildings, equipment, land, copyrights -- those are typically last because you don't normally sell your buildings and equipment and copyrights and patents.

How do we determine the numbers that we put on the balance sheet for our assets? Several options: one option is to use historical cost, which is simply the price that was paid to either manufacture or purchase the asset. Another is the sales value or market value, which is what you could sell the asset for. A third is replacement cost which would be what it would cost you to replace the asset with an identical asset. And another would be general price-level adjusted cost where you're taking the original cost and adjusting it for inflation. Now, let's think about which one would be best for making a decision about whether or not to sell a building. Well, it would seem that the sales value would be the most appropriate of those to be considering for making the decision of whether or not to sell the building. However, let's now think about another criterion that we talked about in a previous lesson, and that was objectivity. If you think about which is the most objective of these four, it would have to be historical cost. The other three involve judgment or estimation. So we have a conflict here. For decision relevance, we would want to use sales value. For objectivity, historical cost is the most appropriate. So, long ago the Accounting regulators decided that objectivity is more important than decision relevance, or for that matter anything else. The regulators came up with something known as the Cost Principle, which says, that generally speaking, assets are valued at their historical cost. There are exceptions and we'll talk about the exceptions in later sessions.

## Video 4—Liabilities and Stockholders’ Equity

Liabilities are obligations owed to creditors. They can be in the form of money, or they can be in the form of goods or services. For example, suppose you have a magazine publisher that receives subscription monies from customers in advance of sending out the magazines. So before they send out the magazines they have an obligation, they have a liability to provide, not money, but to provide the magazines. Some common liability accounts include accounts payable, this is just a mirror image of accounts receivable. So in my example of Macy's selling to the customer on credit, we said Macy's has an accounts receivable. The customer on its balance sheet would show an account payable. Notes payable would be the mirror image of notes receivable. So when buying things like cars, furniture, or refrigerators, a note would typically be signed by the buyer specifying due dates, interest rates, and so forth. And so that would be referred to as a note payable. Some other liability accounts that have the words payable might include things like, interest payable, rent payable. But not all liability accounts have the word payable in it. Sometimes liabilities use word “accrued”, such as accrued wages and salaries. Let's look at the Home Depot financials, page 31. If we look at the Liabilities and Stockholders’ Equity section, you'll see that the fourth item is referred to as “accrued salaries and related expenses”. Another common liability is referred to as deferred or unearned revenue. Again, let's look at the Home Depot financials, page 31, under the Liabilities and Stockholders’ Equity section. The sixth item down is deferred revenue. Deferred revenue is when a company receives money in advance of providing the goods or services and therefore they have a liability to provide these goods or services.

Companies usually present what we call Classified Balance Sheets, where they make distinctions between current and long-term assets and also current and long-term liabilities. For assets the distinction relates to the convertibility to cash within one year. Those assets that are expected to be converted to cash within a year are referred to as current assets. Those that are not are referred to as long-term assets. For liabilities the distinction refers to when the obligation is due. Liabilities that are due within one year are current liabilities. Liabilities that are due beyond one year are non-current or long-term liabilities. Let's look at the financials of UPS on page 66. At the top, we see Assets, and then it's got a labeling of Current Assets, which includes things like cash and cash equivalents, marketable securities, accounts receivable and so forth. Then there is the total current assets. After that you would expect another heading that said something like non-current assets or long-term assets, but you don't see that here, and you typically don't see that in any company's financial statements, because they presume that, if an asset does not appear in the current assets section, you will know that it is a non-current asset. Turning to liabilities at little bit below, we see that the first section is titled Current Liabilities. It includes things like current maturities of long-term debt and commercial paper, accounts payable and so forth. Later, we have total current liabilities. And again there is no heading titled Non-Current Liabilities or Long-Term Liabilities, but rather they're just itemized next. Again, the reason being the presumption that, if a liability is not on the current liability section, you will know that it's a non-current liability.

Now, we turn to the third section of the balance sheet --owners' equity. This represents the residual interest of owners to the assets. If we think back to the accounting equation, which is assets equals liabilities plus owners' equity, recall that we can view the right hand side as the claims against assets, with liabilities being the creditor's claims and owners' equity being the owner's claims. If we rearrange this accounting equation to have assets minus liabilities equals owners' equity, we see that the right side represents the interest of the owners after the liabilities have been satisfied. So that's why we call it the residual interest of the owners to the assets because it's after the liabilities have been met. In a corporation, owners’ equity is referred to as stockholders' equity and it consists of two components, one being capital stock, which represents what the company received when selling shares of its stock. The other component is referred to as retained earnings. This represents the accumulated earnings, that is the earnings that the company has had since its inception, less dividends that have been paid to the stockholders. Dividends are a distribution of earnings, and that only occurs when the board of directors decides to distribute the earnings. The board of directors never has to distribute the earnings. It's only when they take a vote to do so that the earnings are distributed in the form of dividends to the shareholders. Companies often provide a statement of retained earnings which shows how retained earnings went from the amount at the beginning of the period to the amount at the end of the period. It starts with the beginning retained earnings and it adds the net income, the profits earned during the period. It deducts the amount of dividends paid out to the shareholders during the period and this arrives at the amount of retained earnings at the end of the period. Likewise, companies typically provide a statement of stockholders' equity, and I have a simplified version for you here because for our purposes that'll suffice. We start with the amount at the beginning of the period, and since stockholders' equity consists of both retained earnings and capital stock, we first deal with the retained earnings portion of it, so we add the net income and deduct dividends as we just saw in the statement of retained earnings. Then we deal with the capital stock portion, where we add any issuance of capital stock during the period. Now we arrive at the amount of stockholders' equity that the company shows at the end of the period. This concludes our discussion of the balance sheet. In subsequent sessions, we will turn to the next financial statement, the income statement. However, in a transition to do so, we'll need to talk about some concepts underlying the income statement, mainly the concept of a accrual basis accounting. So that'll be the subject of our next session.

## Video 5 – Cash Basis vs Accrual Accounting

In a previous session we discussed a financial statement called the balance sheet. We will be talking about a financial statement called the income statement, but before doing so we need to talk about accrual accounting and how it differs from cash basis accounting. The difference between these two approaches relates to when revenues and expenses appear on the income statement. We define revenues as value received for goods sold or services performed. And we define expenses as a payment or obligations, for goods or services received. Notice that neither of these definitions have the word cash in them. Revenue describes value received, while expenses refer to payment or obligations. So cash is not necessarily involved in the determination of revenues or expenses. This gives rise to the distinction between cash basis accounting and accrual basis accounting. With cash basis accounting, we recognize revenues and expenses only when cash changes hands. So revenues will be recognized when cash is received, and expenses will be recognized when cash is paid out. Individual income taxation uses cash basis accounting; however, GAPP financial reporting does not permit cash basis accounting -- it uses something called accrual basis accounting. So, let's discuss revenue recognition and expense recognition under accrual basis accounting.

Revenue recognition is governed by the revenue recognition principle, which says that revenues are recognized when they are earned. Generally, this means that goods have been delivered or services have been performed. The earning process is considered to be complete at those points even though cash has not yet been collected.

Expense recognition is governed by the matching principle. There are two components to the matching principle. First, costs are reported as expenses in the same time period as their related revenues. As an example, suppose Dillard’s buys merchandise from a supplier in December of 2019 and it pays for the merchandise in December of 2019, but it does not sell the merchandise until January 2020. So the question is, do they recognize the expense for the merchandise they purchased in December, when they purchased and paid for the merchandise, or do they recognize it in January of 2020 when they sold the merchandise? And the answer is, that the matching principle says we recognize the expense in January 2020, in the same period that the related revenues are recognized. Now, many expenses, cannot really be matched with specific revenues. So those expenses that cannot be matched with specific revenues are matched with future time periods that benefit from the cost. As an example, suppose a company buys a two-year property insurance policy. That cost cannot be related to any specific revenues. Suppose they spent $10,000 at the beginning of 2019 for this two-year insurance policy. The matching principle says that because the periods being benefited are both 2019 and 2020, we are going to spread out that cost as an expense over the two years. Half of it, namely $5,000, as an expense for 2019, and the other $5,000 as an expense for 2020, because that year is also benefiting from the property insurance coverage. This wraps up our discussion of accrual accounting and now we have the tools to enable us to cover the income statement, which will be the subject of our next session.

## Video 6 – The Income Statement

We have previously discussed the balance sheet and now we'll talk about the second required financial statement called the income statement. The income statement shows the results of a company's operations -- in other words, its success, or for that matter it might be its failure, over a period of time. Notice the distinction about the time reference as it relates to the balance sheet. In the balance sheet, the time reference was a point in time. The balance sheet gave you the financial position at a point in time, whereas the income statement focuses on a time interval. It looks at what happened over a period of time. And at a minimum, this period of time is a one year period. Companies may provide financial statements more often, but minimally it's yearly, and the year is referred to as the fiscal year. The fiscal year is any 12 month period that the company chooses. Usually it's the calendar year but not always. Many companies choose fiscal years according to their business cycle, or maybe to accommodate their auditors, or for various other reasons choose a year other than a calendar year. Sometimes, a company will choose fiscal years that are not necessarily the same time period each year. Let's look at the financial statements of Home Depot, page 36. In the second paragraph, look at the third line. It says, "Our fiscal year is a 52 or a 53 week period ending on the Sunday nearest to January 31st. Fiscal 2018 includes 53 weeks compared to fiscal 2017 and fiscal 2016, both of which include 52 weeks." So you see it's not the same 12 month period every year. And this is not all that uncommon.

On the income statement, you will find revenues earned and expenses incurred. The difference between those two is what we call net income, or profit, or sometimes earnings. At any rate, in this basic form, we call it the single step income statement. It just lists all our revenues and all expenses. However very often companies produce income statements that have different categories in it, and various preliminary forms of profit. Typically it starts with net sales. The word net implies that there are various adjustments made to sales. The most notable are for sales discounts and sales returns. Both of these are deducted from sales to get the net sales amount. Then there's a deduction for cost of goods sold. That represents the cost of the merchandise that the company purchased from the supplier, or that it manufactured itself. And that difference is called the gross margin, or gross profit. That's the first of several profit figures that appear on the income statement. Gross profit is important for a lot of financial statement users. They want to know how much the company received over and above what it cost them for that merchandise. Let’s look at Home Depot's financials, page 32. We see at the top, it begins with net sales. And then it deducts costs of sales, which is another term for costs of goods sold, to arrive at a gross profit figure.

After the gross profit, we deduct expenses referred to as operating expenses, or otherwise known as S, G & A, which stands for Selling, General and Administrative expenses. These are the day-to-day expenses of running the company, like utilities, salaries, insurance, rent. After these are deducted, we arrive at a second preliminary profit figure called operating income, which represents the profits from only the day-to-day kinds of activities. Let’s look again at Home Depot's financial statements. After the gross profit item, there's a heading that says operating expenses. Home Depot actually has three categories of operating expenses. It's got the Selling, General, Administrative category, which we mentioned. But in addition to that, it's got another category called depreciation and amortization and another one called impairment loss. We will cover those in future sessions. At any rate, after deduction of these operating expenses, they come up with the second preliminary profit figure called operating income.

After the operating income, we add or subtract other revenues and expenses. These include things like gains or losses on sale of assets such as buildings or equipment. We'll cover how we determine these gains or losses in a later session. It also includes things like interest expense, interest revenue, and dividend revenue. And notice I didn't say dividends paid because dividends paid would not be an expense. Dividends paid out would merely be a distribution of earnings to the shareholders, and would not be used in arriving at earnings. At any rate, after the addition or subtraction of these other revenues and expenses, we have another preliminary profit figure that's referred to as income before taxes. Let’s look at, again, Home Depot's financial statements. On page 32, after operating income, we see a section titled interest and other income or expense. And they've got three items there. They have interest and investment income. They have interest expense, and they have other. After these are added or subtracted, we have earnings before provision for income taxes.

Continuing with the income statement, after the income before taxes, we deduct the income tax expense, which is based on the amount of income before taxes, and that gives us yet another preliminary profit figure called income after taxes. Again, let's look at Home Depot's financial statements. On page 32, we see a little bit past the middle of the page the heading “earnings before provisions for income taxes”, and right after that, instead of calling it income tax expense, they call it provision for income taxes. After deducting that, they arrive at net earnings.

There may be one or two other additional categories. The first one called discontinued operations represents parts of the company they will no longer have. An example of discontinued operation would be when a company sells off one of its divisions. One of the purposes of an income statement is to be able to project the future prospects of the company. If a company has sold off a division, then the profits or the losses from that division are not going to be useful in projecting the future earnings of the company because the company no longer has that division. So that's why it is separated out. Let’s now look at the financial statements of NCR. On page 50, about the middle of the page, there's an item that says “loss from discontinued operations, net of tax”. Next on the income statement, there may be a deduction or addition for the effects of changes in accounting principles. This is when a company has changed its method of accounting for some item and the effects of those changes are reported. After that, we finally get to the bottom line profit figure called net income.

But that's not the end of the income statement because there's a ratio that needs to be reported. It's called earnings per share, and that is the ratio of the net income, or net loss, divided by the number of shares of stock. Now there's two forms of this EPS ratio. One is called basic EPS, and the other's called fully diluted EPS. The basic EPS is just as it appears -- net income is divided by actual number of shares. However, the fully diluted EPS has a different denominator. It has not only the actual number of shares of stock, but also the potential number of shares. For instance, many companies offer stock options to their top executives, which are options for them to buy stock at a later date. So, there are potentially additional shares of stock, and many financial statement users want to know what would the earnings per share be if these things like stock options were exercised in the future. Therefore, the fully diluted EPS includes in a denominator, not only the actual shares, but also the potential shares. As an example, let's look at the financial statements for NCR, page 51, at the second bold-faced item from the bottom. It says net income or loss per common share, and notice right underneath that, there are the two forms that we talked about, the basic and the diluted. And notice that the diluted for each of the years has a number that's less than or equal to the basic, and that's because the denominator is either the same or larger. NCR shows the denominator calculation for diluted shares on page 60. We see just past the middle of the page a boldface heading titled “Denominator-total”. Just above that it shows “dilutive effective of employee stock options and restricted stock units” being added to the basic number of shares to at the number of shares in the denominator of the fully diluted EPS. This concludes the discussion of the income statement. In our next session, we'll talk about a third financial statement called the statement of cash flows.

## Video 7 – Statement of Cash Flows

This lesson discusses the statement of cash flows. This is the third financial statement that we have been discussing. We talked about the balance sheet, we've talked about the income statement, now the statement of cash flows. Now, recall with the income statement we said that the revenues and expenses are governed by accrual accounting, which does not necessarily reflect cash received or cash paid out. Yet, cash is important for a company to operate its business. It has to pay employees with cash, it has to pay suppliers with cash, so it needs to have some financial statement that does focus on cash, and this is the statement of cash flows. The statement of cash flows looks at how the company received cash and how the company used its cash. It shows how cash changed from the beginning of the period to the end of the period. And, it does so by recording the amount of cash collected and paid out in three different sections -- the operating activities section, the investing activities section, and the financing activities section. And, when we put these three sections together, we get the change in cash from the beginning of the period to the end of the period.

Let's first talk about the operating activities section. This section shows the company's day-to-day activities. The major operating cash inflows will consist of cash receipts from selling goods or from providing services, and the major operating cash outflows will be for payments to purchase inventory and also to pay operating expenses like rent, utilities, salaries, insurance. There are two different approaches to displaying the operating activities section. One is called the direct method. That method explicitly states where the cash came from and where the cash went to. It'll say, "Cash received from customers." It'll say, "Cash paid to suppliers, "cash paid to employees for salaries." However, this method is seldom used by US companies. Instead, a second method is most commonly used. It's called the indirect method. The indirect method starts off with the company's net income from the income statement, and it makes some adjustments to get to the cash flow from the operating activities. Now, even though this indirect method is not very informative, it's a lot easier, because the company already has its income statement. It already has the net income from there, and it just makes a few adjustments to get to the cash flow. Whereas, the direct method involves a lot more time and effort. Now, interestingly, the international standards do not permit the use of the indirect method. They mandate the use of the direct method because the direct method is much more informative. As an example of the indirect method, let's look at the financials of Home Depot. On page 35 we see that the top section reads, "Cash Flows from Operating Activities," and it starts with net earnings. And then, it says, "Reconciliation of Net Earnings to Net Cash Provided by Operating Activities," and so it adds and subtracts a bunch of things like depreciation and amortization, stock-based compensation expense, and so on and so forth. And, at the bottom of that section, it says, "Net Cash Provided by Operating Activities."

The next section of the statement of cash flows is titled Investing Activities. It focuses on long-term assets, specifically the buying and selling of things like land, buildings, equipment. Buying these things involves cash outflows, while selling these assets involves cash inflows. As an example of this section, again let's turn to Home Depot. On page 35 we see a second section in boldface titled Cash Flows from Investing Activities. It lists things like capital expenditures, payments for business acquired, and proceeds from sales of property and equipment. And then, it shows the sum of these, which is labeled as the net cash used in investing activities. The reason it's referred to as **used** instead of **provided by** is that all three numbers have parentheses around them, therefore they're all negative, implying that they were all net cash outflows.

The third section of the statement of cash flows is titled Financing Activities. This section focuses on liabilities and stockholders' equity items. Specifically, it focuses on cash obtained from or repaid to owners and creditors. This would include loans that are made to others or loans received by the company, repayments of loans, and stock issued by the company. As an example of the financing activities section, again, let's turn to the financials of Home Depot. On page 35 we see the third boldfaced titled section that says, "Cash Flows from Financing Activities," and it lists things like proceeds from long-term debt, repayments of long-term debt, repurchases of common stock, and so forth. The total represents the net cash used in financing activities. And then finally, it shows the change in cash and cash equivalents. That represents the change in cash from the beginning of the year to the end of the year.

The most important of these three sections is generally believed to be the operating activities section, because it focuses on the day-to-day activities of the company. And, it really is important to classify the items in the correct section. One notable exception to that was committed by Enron, and what they did was they had an item that should've been reported as an investing activity, and instead, to make the operating cash flow section look real good, they put it in the operating activities section. One of the fraud examiners remarked regarding this that among all of Enron's violations of GAAP, and they had plenty of violations of GAAP, that this misclassification on the statement of cash flows from investing activities to operating activities was their most serious violation of GAAP. This concludes the statement of cash flows. Our next session will describe financial statement notes and audits.

## Video 8 – Financial Statement Notes and Audits

The financial statements that we've talked about also include notes. These notes have a couple purposes. One is that they summarize significant accounting policies, assumptions, estimates, and judgments that management is making. As an example, let’s turn to the NCR financials on p. 58. The last two paragraphs on the page explain how they compute earnings per share. The notes to the financial statements also provide additional information about summary totals that appear on the financial statements. So, as an example, let's again look at the NCR financials. Turn to page 53, and you'll see a few lines from the top of the page and item labeled “Property, plant, and equipment, net” with a 2018 amount of 359. A more detailed itemization appears on page 108, near the middle of the page. You can see that this category includes land and improvements, buildings and improvements, and so forth.

Let's now discuss audits of financial statements. I am referring to audits by an outside or independent CPA firm, as opposed to the company's own auditors. Companies often have their own internal auditors that they employ, but we're talking about when they hire CPA firms to do an independent audit of them. These outside auditors will attest to whether the financial statements are in conformity with GAAP. The language that they'll use is whether or not the financial statements are presented fairly. They will not say anything about the accuracy and they're not talking about guarantees or certifications. They will not use strong language like that. They're only talking about whether or not they're presented fairly, because a lot of what's on the financial statements, as we've talked about, are based on estimates and judgments.

There’s one of three opinions that could be given on the financial statements. And, I say opinion, because again, it's not a certification, it's not a guarantee, because of the estimation and judgment involved. The first type of opinion is called an unqualified opinion, and that just represents a clean opinion. Everything's okay. The second opinion is called a modified opinion, and that's where the auditor takes exception to something. A third possible opinion is the adverse opinion. I say possible opinion, because actually, you'll almost never see an adverse opinion. An adverse opinion would say that the financial statements are not fairly presented in accordance with GAAP. A publicly traded company can not have an adverse opinion, otherwise they'll be delisted. But, even a privately held company will do pretty much everything it needs to do in order to avoid an adverse opinion, because it's almost like a death sentence. As an example of a clean opinion, let's look at the financials of UPS. On page 65, the second sentence, which begins on the third line, reads, "In our opinion," there's that word opinion, "the financial statements present fairly," so there's that term present fairly, "in all material respects," that's referring to materiality, "the financial position of the Company." As we might recall, the financial position is referring to the balance sheet. It's the balance sheet that portrays the financial position. So, what they're saying there is that the financial position is presented fairly. Continuing on, it says, “and the results of its operations." So, recall that the results of operations are portrayed on the income statement. So, what they're saying here is that the income statement has been fairly presented. Continuing on, it says, "And its cash flows." Well, obviously that's referring to the statement of cash flows. So, they're indicating that all three financial statements are being presented fairly, and let's continue reading. It says, "For each of the three years in the period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America." In other words, presented fairly in conformity with GAAP.

The audit report typically will also say something about the responsibility for the financial statements. Many people believe that it's the CPA firm that's responsible for producing the financial statements of the company, but that's not true. The financial statements are the responsibility of the company's management, not the CPA. And, you'll generally find the CPA trying to make that perfectly clear. As an example, again let's turn to the UPS financial statements. Again, on page 65, look at the next to last paragraph. The first sentence says, "These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits."

In addition to financial statement audits, nowadays, at least for publicly traded companies, auditors must also provide opinions on the company's internal controls, and this is mandated by the Sarbanes-Oxley Act of 2002. Internal controls are policies and procedures that companies put into place in order to safeguard assets and to ensure the reliability of the financial records. So, nowadays, not only must the auditor provide an opinion about the financial statements, but also on whether or not the company's internal controls have been effective. As an example of this type of opinion, let's look at the Home Depot financial statements, on page 30. The second paragraph reads, "We also have audited, in accordance with the standards of the PCAOB, Home Depot’s internal control over financial reporting”. Then skip down to the next line, about two-thirds across the line, it reads “and our report dated March 28, 2019 expressed an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting.” This is a clean opinion on internal controls. This concludes our overview of the financial statements. Beginning with the next session, we're going down the balance sheet, starting with cash and providing more detail about each of the balance sheet items and their corresponding income statement items.