

Week 1: What is Financial Accounting?

Accounting is the Language of Business

Purpose of Financial Accounting: To provide meaningful quantitative financial information regarding an entity's activities to decision makers.

What is it not?

Who are these decision makers?

Demand for financial accounting information extends to numerous users that include:

- Shareholders (Owners)
- Debt holders (Creditors)
- Managers
- Investment analysts and information intermediaries
- Customers and strategic partners

What Makes Information Useful?

- Relevance- Capable of making a difference to a decision maker
- Faithful Representation- Dependable and reliable

Where Do Financial Accounting Rules (Standards) Come From?

Financial Accounting is not an Exact Science

- Generally Accepted Accounting Principles (GAAP) allows companies choices in preparing financial statements
- Financial statements depend on countless estimates
- Earnings Management/Manipulation

Oversight of Financial Accounting

- The Securities and Exchange Commission (SEC) oversees all publicly traded companies
- External Audits- American institute of Certified Public Accountants (AICPA)
 - Audit opinion provides reasonable assurance that the statements are free of material misstatements, not a guarantee.
- Securities Law

Accounting and Capital Allocation

- An effective process of capital allocation is critical to a healthy economy
- Better information for decision makers leads to better capital allocation
- Accounting is the primary source of information for decision makers

Required Financial Statements

- Balance Sheet
- Income Statement
- Statement of Shareholders' Equity
- Statement of Cash flows
- Statement of Comprehensive Income

Information Beyond Financial Statements

- Financial Statement Footnotes
- Independent Auditor Report
- Management Discussion and Analysis (MD&A)
- Press Releases

Balance Sheet

A balance sheet describes the sources and uses of funds of a firm at a point in time. Useful for:

- Evaluating capital structure
- Assessing risk and future cash flows

Assets: Economic resources that are owned or controlled by a company that have future economic benefit

- Examples of assets include: Cash, Accounts Receivables (A/R), Inventory, Land, Buildings, Equipment, Copyrights, and Investments.
- To be reported on a balance sheet, an asset must
 - Be owned (or controlled) by the company
 - Must possess expected future economic benefits

Many Assets are Reported at Historical Cost

- Historical Cost is
 - Objective
- Market Value is
 - Useful
- Relevance vs. Faithful Representation
- Only include items that can be reliably measured.
 - Many “assets” may not be reflected on a balance sheet such as a strong management team, a well-designed supply chain, or superior technology.

Liabilities: Future obligations to pay cash, transfer assets or provide services to another party

- Examples of liabilities include: Accounts Payable (A/P), Notes Payable (N/P), and Wages Payable.

Owners' Equity (Shareholders' Equity): The ownership interest in the net assets of an entity

- Examples of owners' equity include: Capital Stock, Preferred Stock, and Retained Earnings (RE)

Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

$$\text{Uses of funds} = \text{Sources of funds}$$

Balance Sheet Format

- Assets are listed in order of liquidity
 - Current assets comprise assets that can be converted to cash within a year
 - Long-term assets cannot be easily converted to cash within a year.
- Liabilities are listed in order of maturity
 - Current liabilities have maturities less than one year
 - Long-term liabilities have maturities longer than one year
- Shareholders' Equity has no required order

Easy Corp.
Balance Sheet
As of December 31, 2024

Assets:

Cash	\$10
A/R	25
Inventory	15
Equipment	<u>50</u>
Total Assets	100

Liabilities:

A/P	\$5
Notes Payable	<u>35</u>
Total Liabilities	40

Owners' Equity:

Capital Stock	\$55
Retained Earnings	<u>5</u>
Total Equity	60

Total Equity
and Liabilities 100

Retained Earnings is updated each period

Beginning Retained Earnings
Plus Net Income (Minus Loss)
Minus Dividends
Equals Ending Retained Earnings

$$\text{Beg. RE} + \text{NI} - \text{Dividends} = \text{End. RE}$$

Practice: With the information below prepare a balance sheet for ABC Corp. at December 31, 2024.

Cash	125	Retained Earnings	100
A/R	25	Net Income	150
Land	200	A/P	150
Building	400	Capital Stock	500
Note Payable	100	Inventory	100

Income Statement

Shows how much a company earned (not cash) over a period of time

- Helps us evaluate past performance
- Useful in predicting a firm's future performance
- Helps us assess the risk or uncertainty of achieving future cash flows

Revenues: Increase in a company's resources from the sale of goods or services

- Examples of revenues include: Sales Revenue and Rent Revenue.
- How is this different than an asset?

Expenses: Costs incurred in the normal course of business to generate revenues

- Examples of expenses include: Cost of Goods Sold (COGS), Utilities Expense, Wages Expense, and Depreciation Expense
- How is this different than a liability?
- Operating expenses are the usual and customary costs that a company incurs to support its main business activities
- Nonoperating expenses relate to the company's financing and investing activities

Gains/Losses: Money made or lost outside of normal firm operations

- Examples of gains/losses include: Gain on sale of operating equipment and Losses on sale of land

Net Income or Loss: An overall measure of the performance of a company

- Most agree that this is the most important accounting number.
- Net Income does not necessarily correspond to a net cash flow. A firm could have "good income" but "poor cash flow" or vice versa (i.e., there are two dimensions to consider).

Easy Corp.
Income Statement
For the year ended December 31, 2024

Sales Revenue	\$700
Cost of Goods Sold	<u>400</u>
Gross Profit	300
Administrative Expense	75
Utilities Expense	50
Rent Expense	<u>100</u>
Operating Income	75
Loss on Sale of Land	<u>10</u>
Income Before Taxes	65
Income Tax Expense	<u>15</u>
Net Income	50
EPS	\$0.15

Practice: Create an Income Statement for ABC Corp. for 2024 with the information below:

COGS	900	Loss on Sale	10
Sales Revenue	2200	Utilities Expense	100
Income Tax Expense	50	Depreciation Expense	225
Other Expenses	100	Bad Debt Expense	50
Interest Expense	320	Wage Expense	400

(ABC Corp has 1,000 shares of stock outstanding)

Practice

What type of account is...? (Asset, Liability, Owners' Equity, Revenue, Expense, Gain/Loss)

What statement does it go on? (Balance Sheet, Income Statement)

	<u>Type</u>	<u>Financial Statement</u>
1. Sales Revenue		
2. Accounts Receivable		
3. Cash		
4. Accounts Payable		
5. Cost of Goods Sold		
6. Loss on Sale of Land		
7. Capital Stock		
8. Rent Revenue		
9. Inventory		
10. Retained Earnings		
11. Bond Payable		
12. Rent Expense		

Statement of Shareholders' Equity

- The statement of equity is a reconciliation of the beginning and ending balances of shareholders' equity accounts.
- Main equity categories are:
 - Capital Stock
 - Retained Earnings
 - Treasury Stock
 - Other Comprehensive Income

Easy Corp.
Statement of Stockholders' Equity
For the year ended December 31, 2024

	<u>Capital Stock</u>	<u>Retained Earnings</u>	<u>Total</u>
Balance at 1/1/24	900	125	1,025
Additions	<u>100</u>	<u>50</u>	<u>150</u>
	1,000	175	1,175
Reductions	<u>0</u>	<u>(75)</u>	<u>(75)</u>
Balance at 12/31/24	1,000	100	1,100

Statement of Cash Flows

The financial statement that describes an entity's cash inflows and cash outflows during a period.

- Designed to show information about the change in the cash balance from first balance sheet to second balance sheet.
- Only required since 1983
- Cash is defined as "Cash and cash equivalents." Includes bank account balances, cash, coin, and short-term liquid investments

Three Sections:

- Operating Activities: Cash transactions that enter into the determination of net income
 - Two methods- direct/ indirect
- Investing Activities: Cash transactions involved in the purchase and sale of PPE, other long-term assets and making/collecting loans (an investment to our firm)
- Financing Activities: Cash transactions whereby resources are obtained or repaid to owners and creditors

Easy Corp	
Statement of Cash Flows	
For the Year ended December 31, 2024	
Operating Section (indirect method):	
Net Income	\$100
Change in A/R	20
Change in Inventory	(17)
Change in Interest Receivable	3
Change in A/P	9
Add Depreciation	34
Subtract Gain	<u>(12)</u>
Cash from Operations	137
Investing Section:	
Cash paid for PPE	(190)
Cash received from sale of PPE	<u>50</u>
Cash from Investing	(140)
Financing Section:	
Issued Stock	120
Retired debt	(80)
Paid Dividends	<u>(20)</u>
Cash from Financing	20
Change in Cash	17
Beginning Cash	<u>80</u>
Ending Cash	97

Easy Corp
Statement of Cash Flows
For the Year ended December 31, 2024

Operating Section (direct method):	
Collections from Customers	620
Receipt of Interest	68
Payment for Inventory	(345)
Payment for other expenses	<u>(206)</u>
Cash from Operations	137
Investing Section:	
Cash paid for PPE	(190)
Cash received from sale of PPE	<u>50</u>
Cash from Investing	(140)
Financing Section:	
Issued Stock	120
Retired debt	(80)
Paid Dividends	<u>(20)</u>
Cash from Financing	20
Change in Cash	17
Beginning Cash	<u>80</u>
Ending Cash	97

Relationships Among the Financial Statements

- Financial statements are linked within and across time – they articulate.
- Balance sheet and income statement are linked via retained earnings.
- Balance sheet and statement of cash flow are linked by changes in cash
- The operating section of the statement of cash flows is a cash-basis income statement

Conference Call Material- Have the following notes with you during our live meeting:

Where do we get financial statement information?

Accounting Cycle: The procedure for analyzing, recording, summarizing, and reporting transactions of a business.

- Step 1: Analyze transactions
- Step 2: Record effects of transactions
- Step 3: Summarize effects of transactions by account
- Step 4: Prepare Reports

Transactions: An event that causes a change in balance sheet values

Account: An accounting record in which the results of transactions are accumulated

Double Entry Accounting: A method of accounting that includes Debits and Credits

- Debit = left
- Credit = right
- Account determines whether a debit is an increase or a decrease (AED)
- Always at least one debit and one credit per transactions
- Debits = Credits

Journal Entries: a recording of a transaction or other entry

General Format:

Account #1	xxx
Account #2	xxx

T-Accounts: A place to accumulate the effect of journal entries on each account.

Accrual Accounting: A system of accounting in which revenues and expenses are recorded as they are earned and incurred, not necessarily when cash changes hands

- Accounting splits business into time-periods
- Make NI a better measure of a firm's profitability

Revenue Recognition: Companies recognize revenue when goods or services are transferred to customers for the amount the company expects to be entitled to receive in exchange for those goods or services.

Practice: When can Revenue be recognized?

- Received cash in advance for IT services to be performed in the future
- Sold inventory on account to a good customer
- Completed building a bridge and have only been paid 50% so far
- Received rent money September 1st for September's rent
- Sold inventory on account to bad credit risk customer
- Government contract to redo city's road 1 year into 6 year project
- Costco received annual membership fees

Matching Principle: All costs and expenses incurred in generating revenues must be recognized in the same period as the revenue. If you can't match with revenue, then recognize it immediately.

Practice: Should we record an expense this period?

- Prepaid yearly insurance bill (July-June)
- Used electricity in December to be paid in January
- Paid for research and development
- Workers not yet paid for work the last week of December
- Ford pays for warranty work on car sold 2 years ago