Accounting for Financial Decision
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Financial Statement Structure

Financial Statement Analysis

ACCOUNTING CONCEPTS => ASSUMPTIONS

1) **Business entity concept**: organization is separate & distinct from its owners and other organizations
2) **Going concern concept**: business is going to last indefinitely in the future
3) **Accounting period concept**: business life is split into annual intervals (calendar or fiscal year)
4) **Matching concept**: expenses match revenues in the same accounting period => only costs related to the accounting period are accounted for
5) **Cost concept**: assets/services acquired are recorded at historical cost
6) **Money measurement concept**: events/transactions are expressed in stable monetary units
7) **Dual aspect concept**: each transaction has two aspects => receiving the benefit OR giving the benefit
    a. Assets = Liabilities + Equity
8) **Revenue recognition (realization) concept**: revenue is recorded at the cash value of goods/services when it is earned (i.e. services rendered/goods delivered)
9) **Accrual concept**: events are recorded as they occur regardless when cash is paid/received

Financial Statement Analysis

ACCOUNTING CONVENTIONS => PRACTICES

1) **Materiality**: material events (i.e. knowledge of such events would influence decisions of informed investors) should be recorded and reported
2) **Consistency**: accounting practices/policies are consistent from one period to the other
3) **Conservatism (Doctrine of Prudence)**: businesses provide for all possible losses but not the anticipated gains
4) **Full disclosure**: organizations should disclose all significant information pertaining to their financial affairs

Financial Statement Analysis

FINANCIAL STATEMENTS (F/S):

1) **<u>Balance Sheet</u>:** shows a financial position on a certain date (usually, month-end or year-end)
    a. Other name(s): *Statement of Financial Position*
    b. As of specific date
    c. Focus: financial position
2) **<u>Income Statement</u>:** presents revenues & expenses and resulting net income or loss over an accounting period
    a. Other name(s): *Statement of Operations*, *Earnings Statement*, *Profit & Loss Statement*
    b. For a period in time
    c. Focus: profitability
3) **<u>Statement of Changes in Equity</u>:** shows all changes in owner's equity for a period of time
    a. Other name(s): *Owners' Equity Statement*
4) **<u>Statement of Cash Flows</u>:** summarizes information about cash outflows (payments) and inflows (receipts)
    a. Other name(s): *Cash Flow Statement*
    b. Focus: liquidity
    c. Is directly related to other 3 statements
    d. Sections:
        i. Operating activities
        ii. Investing activities
        iii. Financing activities

Financial Statement Analysis

THE ACCOUNTING EQUATION: A = L + OE

ASSETS = LIABILITIES + OWNERS' EQUITY

ASSETS = CLAIMS

Asset: economic resource expected to benefit the company's future operations

Liability: economic obligations (debts)

Owners' Equity: claims held by owners

Financial Statement Analysis: Balance Sheet

ASSETS:

Current assets: are expected to be realized in cash or be consumed during the normal operating cycle

1) **Cash & cash equivalents**: coins, currency, checks, money orders, US Treasury bills
2) **Receivables**: notes/account/employee receivables
3) **Short-term investments**: marketable securities
4) **Inventories**: goods available for sale, raw materials
5) **Prepaid expenses**: expenses paid in advance for future use of assets or receipt of services

Noncurrent assets: all other assets which are not current assets

1) **Long-term investments**: debt & equity securities, sinking funds, land (as investment) held for sale
2) **Property, plant & equipment**: land, buildings, machinery, furniture, natural resources
3) **Intangible assets**: goodwill and legal/contractual rights expected to provide future economic benefits
4) **Other assets**: deferred income taxes, bond issue costs, restricted cash

LIABILITIES:

Current liabilities: are expected to be liquidated by using current assets or creating other current liabilities during the normal operating cycle

1) **Accounts payable**: liability arising from purchasing inventory/supplies/services on account (credit)
2) **Current maturing portion of long-term debt**
3) **Dividends/wages/taxes payable**

Noncurrent liabilities: are all other liabilities which are not current liabilities

1) **Notes payable**: written agreement to pay money to the bearer on a specific date
2) **Debt/debentures**

Can be current/noncurrent:

1) **Interest payable**
2) **Unearned revenue**
3) **Warranties/premium & coupon obligations**
4) **Advances and refundable deposits**
5) **Accrued liabilities**: accumulate in a systematic manner (e.g. compensated absences)

OWNERS' EQUITY:

Paid-in (contributed) capital: contributions by owners
Retained earnings: income from operations
Treasury stock: corporate stock shares bought back by issuing corporation (contra equity account)

Financial Statement Analysis: Balance Sheet

PRESENTATION OF THE BALANCE SHEET:

Friends Company Balance Sheet Period Ended 20X0	
ASSETS	
Current Assets:	
Cash	182,060
Accounts receivable (net)	211,000
Inventory	164,000
Prepaid insurance	1,200
Total Current Assets	**558,260**
Long-term Assets:	
Land	120,000
Building (net of accum. depreciation)	68,000
Machinery (net)	240,000
Total Long-term Assets:	**428,000**
TOTAL ASSETS:	**986,260**
LIABILITIES	
Current Liabilities:	
Accounts payable	65,000
Wages payable	48,000
Unearned revenue	72,000
Total Current Liabilities	**185,000**
Long-term Liabilities:	
Notes payable	150,000
TOTAL LIABILITIES	**335,000**
STOCKHOLDERS' EQUITY	
Common stock	300,000
Paid-in excess of par	100,000
Retained earnings	251,260
TOTAL STOCKHOLDERS' EQUITY	**651,260**
TOTAL LIABILITIES & ST. EQUITY	**986,260**

Financial Statement Analysis: Income Statement

The most common income statement items include:

- Revenue/Sales. Sales Revenue. ...
- Gross Profit. Gross Profit. ...
- General and Administrative (**G&A**) Expenses. SG&A Expenses. ...
- **Depreciation** & Amortization Expense. **Depreciation**. ...
- **Operating Income** (or EBIT) ...
- Interest. ...
- Other Expenses. ...
- EBT (Pre-Tax Income)

Financial Statement Analysis: Income Statement

PRESENTATION OF THE INCOME STATEMENT:

Friends Company **Income Statement** **For the Period Ended 20X0**	
Sales	$ 500,000
Less: Sales returns & allowances	30,000
Sales discounts	20,000
Net sales	450,000
Cost of goods sold	150,000
Gross profit	**300,000**
Selling, general & administrative expenses	120,000
Income from operations	180,000
Other expense (income):	
Interest expense	400
Interest income	(1,400)
Total other expense (income)	(1,000)
Income before income taxes	181,000
Income tax expense	61,540
Net income	**$ 119,460**

Financial Statement Analysis: Cash Flow

STATEMENT OF CASH FLOWS: SECTIONS

1) **Operating activities:** cash generated through revenue and cash spent for expenses
    a. Example: changes in noncash current assets; depreciation expense
2) **Investing activities:** cash received or spent on productive assets and investments in the debt or equity of other companies
    a. Example: purchase or sale of long-term assets (e.g., land, building, equipment)
3) **Financing activities:** cash transactions associated with resource providers (i.e., owners and lenders).
    a. Example: repayment of bank loans; dividend payment; issuance of capital stock

Significant noncash activities: issuance of common stock to purchase assets; exchange of assets, issuance of debt to purchase assets

Financial Statement Analysis: Cash Flow

PRESENTATION OF THE STATEMENT OF CASH FLOWS:

Friends Company **Statement of Cash Flows** **For the Period Ended 20X0**	
Cash Flows from Operating Activities:	
Net income	$ 119,460*
Add: Depreciation	10,000
Allowance for doubtful accounts	20,000
Decrease in prepaid expenses	5,000
Deduct: Increase in inventory	(50,000)
Decrease in accounts payable	(12,000)
Net Cash Flow from Operating Activities	**92,460**
Cash Flows from Investing Activities:	
Cash received from equipment sold	24,000
Net Cash Flows from Investing Activities	**24,000**
Cash Flows from Financing Activities:	
Cash Receipts from Capital Acquisitions	60,000
Cash Payments for Distributions	(40,000)
Net Cash Flow from Financing Activities	**20,000**
Net Increase in Cash	136,460
Plus: Beginning Cash Balance	45,600
Ending Cash Balance	**$ 182,060****

Why is cash flow statement important ??

Why cash flow ? (In presence of other disclosures)

Purpose of cash flow statement

- Information on cash receipts and cash payments for a given period Cash is needed to :
  - Pay for assets
  - Settle debts
  - Pay employees
  - Pay dividends
  - Take advantage of investment opportunities
- Information on liquidity

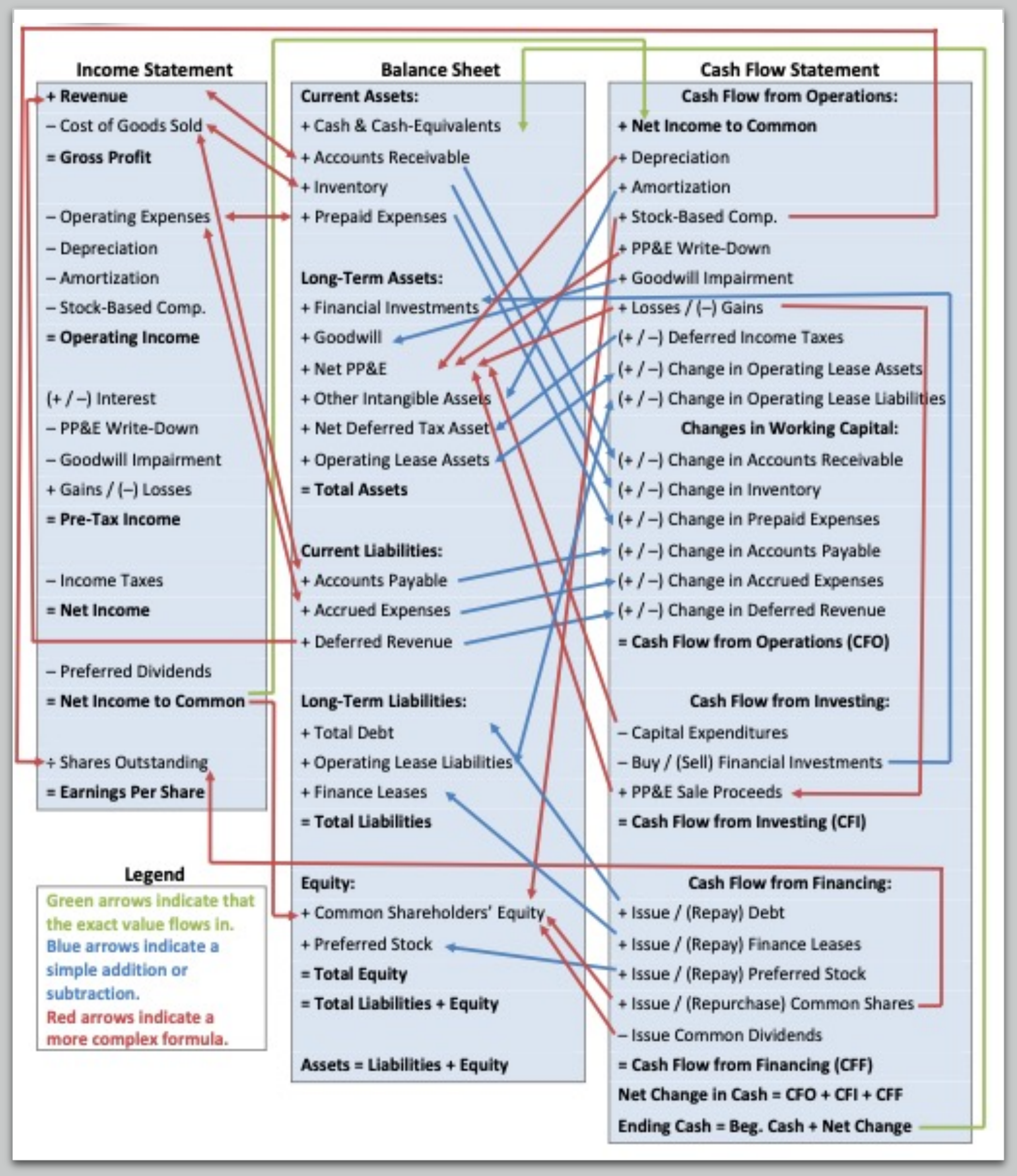
Why not focus on profit?

Cash versus profit

• The following factors will result in a company's profit figure being different from its cash figure:

- Timing differences
- Depreciation
- Changes in working capital requirements

Financial Statement Analysis: Interlink



Financial Statement Example

Financial Statement Analysis

- Preparation of financial statements is not a difficult task.

- We are **not going to record the transaction using the traditional method**; rather we are going to use the accounting equation, which is simpler to capture the transactions.

- The accounting equation is the foundation of the accounting system and is captured through the equation.

$$\text{Assets} = \text{Liabilities} + \text{Shareholder Equity}$$

- Let us illustrate how accounting statements can be prepared with the help of a few transactions.

Financial Statement Analysis: Example

John starts ABC Corporation for trading widgets.
John starts the business with $300,000 in cash.

Financial Statement Analysis: Example

Assets	=	Liabilities	+	Equity
Cash ($300)	=	0	+	Equity share capital $(300)

Financial Statement Analysis: Example

We approach a bank for a loan and the bank, based on their assessment gives a loan of \$200,000. Interest rate is 1% per month.

Financial Statement Analysis: Example

Assets	=	Liabilities + Shareholders' Equity
Cash (500)	=	Borrowings (200) + Equity share capital (300)

Financial Statement Analysis: Example

Rented an office space at $1000 per month payable on the last day of the month.

Financial Statement Analysis: Example

Assets	=	Liabilities + Shareholders' Equity
Cash (500)	=	Borrowings (200) + Equity capital (300)

No transaction as we will record the transaction at the end of the month.
Rent is not paid yet (Advance) or accrued yet.

Financial Statement Analysis: Example

Bought furniture for $5000 for the office and paid cash.

Financial Statement Analysis: Example

Furniture is an asset.
Our accounting equation now is as follows

Assets = Liabilities + Shareholders' Equity

Furniture (5) + Cash (495) = Borrowings (200) + Equity capital (300)

Note that cash comes down as we spend money.

Financial Statement Analysis: Example

Purchased widgets for $60000. Paid cash for $40000 and agreed to pay the balance in 60 days.

Financial Statement Analysis: Example

Furniture (5) + Cash (455) +Inventory (60) = Borrowings (200) + Trade Payables (20) + Equity capital (300)

Financial Statement Analysis: Example

Sold goods costing $40000 for $ 50000 in cash.

Financial Statement Analysis: Example

- This is the first time we have encountered items that do not appear directly in the accounting equation.

- To answer this, let us understand and answer the following questions:

- What is the profit made in the transaction? **Answer**: $10000

- Whom does the profit belong to?
  - **Answer**: Equity capital (Shareholders) So, rightfully this has to be added to the equity capital.

Assets = Liabilities + Equity

Assets = Liabilities + Equity (Contributed + Retained Earnings)

Assets = Liabilities + Equity (Contributed + Income - Expenses)

Financial Statement Analysis: Example

- The equation has undergone a few changes.
- Inventory stock has come down from 60 to 20 on account of inventory being sold.
- Cash is increased by $50,000 because we made cash sale.
- Revenue/sales increased by $50,000 along with an expense of $40,000 resulting in a profit of $10,000.

The accounting equation would be depicted as:

Furniture (5) + Inventory (20) + Cash (505) = Borrowings (200) + Trade Payables (2) + Equity share capital (300) + (Revenue (50) - Cost of goods sold expense (40))

Financial Statement Analysis: Example

- Since we have borrowed money to invest in the business, we have to pay the interest, which is 1% of the borrowings, i.e., $ 2000.

- Our cash holding declines by $ 2000, and expenses increase by $ 2000. Our accounting equation is as follows:

Furniture (5) + Inventory (20) + Cash (503) = Borrowings (200) + Trade Payables (2) + Equity share capital (300) + (Revenue (50) - Cost of goods sold expense (40) –Interest Expense (2)

Final Outcome

Income statement for the month ending 31 January xx

Income	$
Revenue	50,000
Other Income	-
Total Income	50,000
Expenditure	
Cost of Goods Sold	40,000
Interest Expenses	2,000
	42,000
Net Income / Profit	8000

Notice that this is the expanded version of the retained earnings.

Balance Sheet as on 31 January xx

Equity + Liability	$	
Shareholders' Fund		
Equity Share Capital	300,000	
Retained Earnings	8,000	308,000
Liabilities		
Borrowings		200,000
Trade Payables		20,000
Total		**528,000**
ASSETS		
Property Plant & Equipment (Furniture)[1]		5,000
Current Assets, Loans and Advances		
Inventory	20,000	
Cash	503,000	
	523,000	523,000
Total		**528,000**

Financial Statement Analysis: Example

The purpose of the above illustration is **<u>not to teach accounting process or preparation</u>** of financial statement but to demonstrate that they are simple and easy to follow.

Many of you will find it exciting to see that your balance sheet is 'balanced' at the end.

Question?