Financial Statements and Business Decisions

Chapter 1

Financial Accounting
ACC1002X
Lecture 1

Semester 2 of Academic Year 2011/2012

What is Accounting?

Accounting is the "language of business"

Collects and processes financial information

Reports information to decision makers

Managers (internal decision makers)

Investors and Creditors (external decision makers)

Who Cares about Accounting?

Accounting information is useful to anyone making decisions that have economic consequences.

– Management
– Employees
– Customers and Suppliers
– Creditors and Investors (Shareholders)
– Government Regulatory Agencies
– Taxing Authorities

Why do YOU care?

Top 3 Reasons to learn accounting:

– To be an accountant
– To get a job in business
– To invest in the stock market or other ventures

How Does Accounting Work?

Accounting information helps decision makers by

- showing where and when a company spends money
- evaluating financial performance
- helping predict the future effects of decisions

Business event → Analyze, measure and record → Financial Reports → Users

How Does Accounting Work?

The Annual Report

Most common source of financial information for decision makers outside the company

Components of the annual report include:

- Description of the business
- Management's discussion and analysis (MD&A)
- Report from independent auditor
- Financial Statements
  - Balance Sheet
  - Income Statement
  - Statement of Cash Flows
  - Statement of Retained Earnings
  - Notes

The Four Basic Financial Statements

1. **BALANCE SHEET** – reports the amount of resources a business entity owns and obligations it owes to outsiders at one point in time.

2. **INCOME STATEMENT** – reports the revenues generated and the expenses incurred during the accounting period.

3. **STATEMENT OF RETAINED EARNINGS** – reports the portion of net income the company "retains" (or keeps for use in the business) during the accounting period.

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

Balance Sheet

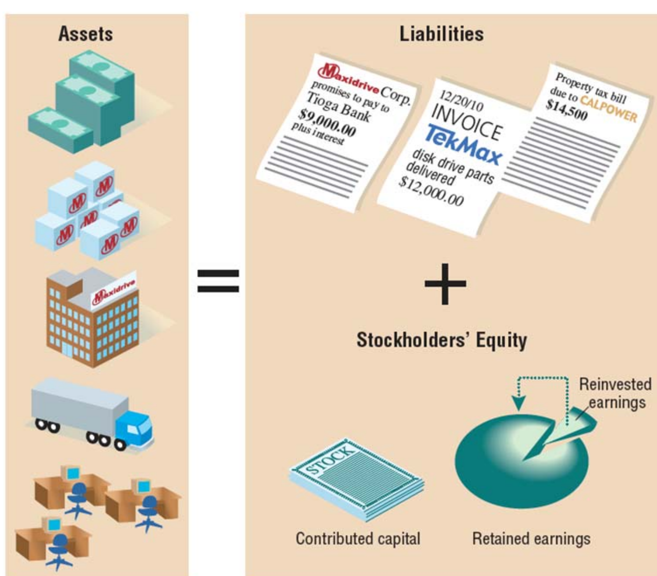
Typical Account Titles

Assets
- Cash
- Short-Term Investment
- Accounts Receivable
- Notes Receivable
- Inventory (to be sold)
- Supplies
- Prepaid Expenses
- Long-Term Investments
- Equipment
- Buildings
- Land
- Intangibles

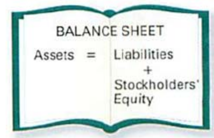
Liabilities
- Accounts Payable
- Accrued Expenses
- Notes Payable
- Taxes Payable
- Unearned Revenue
- Bonds Payable

Stockholders' Equity
- Contributed Capital
- Retained Earnings

The Accounting Equation



Balance Sheet



Sole-Man Shoe Repair, Inc.
Balance Sheet
As of December 31, 2010
(in dollars)

Assets		Liabilities	
Cash	$ 815	Wages Payable	$ 90
Accounts Receivable	300	Tax Payable	166
Plant and Equipment, net	700	Long-term debt	450
Land	100	Total Liabilities	706
		Stockholders' Equity	
		Contributed Capital	1,000
		Retained Earnings	209
		Total S.E.	1,209
Total Assets	$ 1,915	Total Liab & S.E.	$ 1,915

Income Statement

Typical Account Titles

Revenues
- Sales Revenue
- Fee Revenue
- Interest Revenue
- Rent Revenue

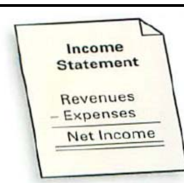
Expenses
- Cost of Goods Sold
- Wages Expense
- Rent Expense
- Interest Expense
- Depreciation Expense
- Advertising Expense
- Insurance Expense
- Repair Expense
- Income Tax Expense

Income Statement

Revenues
– Expenses
+ Gains
– Losses

Net Income

Income Statement



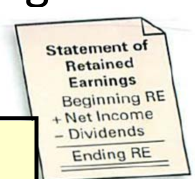
Sole-Man Shoe Repair, Inc.
Income Statement
For Year Ended December 31, 2010
(in dollars)

Revenues	$ 2,000
Expenses	
Cost of Goods Sold	200
Wage Expense	505
Office Supplies Expense	120
Gas Expense	250
Depreciation	200
Advertising Expense	200
Other Expenses	50
Total Expenses	1,525
Pretax Income	475
Income Tax Expense	166
Net Income	$ 309

Statement of Retained Earnings

Beginning Retained Earning
Plus: Net Income
Less: Dividends
Ending Retained Earnings

Statement of Retained Earnings



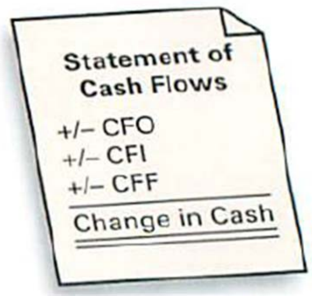
Sole-Man Shoe Repair, Inc.
Statement of Retained Earnings
For Year Ended December 31, 2010
(in dollars)

Retained Earnings, January 1, 2010	$ -
Add: Net Income for the year	309
	309
Less: Dividends	(100)
Retained Earnings, December 31, 2010	$ 209

Statement of Cash Flows

Three major components:

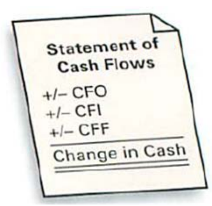
- Operating activities: Everyday business activities with customers, suppliers and employees
- Investing Activities: Buying or selling long-term assets that are used to run the business (e.g., acquiring equipment)
- Financing Activities: Companies raise funds by issuing stock and borrowing money; paying back loans



Statement of Cash Flows

Sole-Man Shoe Repair, Inc.
Statement of Cash Flows
For Year Ended December 31, 2010
(in dollars)

Cash flows from operating activities		
Cash collected from customers	$	1,700
Cash paid to suppliers and vendors		(200)
Cash paid to employees		(415)
Cash paid for interest		(570)
Cash paid for taxes		(50)
Net cash flows from operating activities	$	465
Cash flows from investing activities		
Cash paid to purchase plant, equipment, land		(1,000)
Net cash flows from investing activities	$	(1,000)
Cash flows from financing activities		
Cash proceeds from long-term debt		450
Cash proceeds from stock issuance		1,000
Cash paid for dividends		(100)
Net cash flows from financing activities	$	1,350
Total Change in Cash	$	815
Cash at beginning of year	$	-
Cash at end of year	$	815



Relationships Among the Statements

Relationships Among the Statements

1. Net income from the income statement results in an increase in ending retained earnings on the statement of retained earnings.

Income Statement	
Revenues	$ 2,000
Expenses	1,691
Net income	$ 309

Statement of Retained Earnings	
Beginning retained earnings	$ 0
Net income	309
Dividends	(100)
Ending retained earnings	$ 209

Relationships Among the Statements

2. Ending retained earnings from the statement of retained earnings is one of the two components of stockholders’ equity on the balance sheet.

Statement of Retained Earnings		Balance Sheet	
Beginning retained earnings	$ 0	Cash	$ 815
Net income	309	Other assets	1,100
Dividends	(100)	Total assets	$ 1,915
Ending retained earnings	$ 209	Liabilities	$ 706
		Contributed Capital	1,000
		Retained earnings	209
		Total liabilities and equity	$ 1,915

Relationships Among the Statements

3. The change in cash on the statement of cash flows is added to the beginning-of-year balance in cash to arrive at end-of-year cash on the balance sheet.

Statement of Cash Flows		Balance Sheet	
Cash flows from operating activities	$ 465	Cash	$ 815
Cash flows from investing activities	(1,000)	Other assets	1,100
Cash flows from financing activities	1,350	Total assets	$ 1,915
Change in cash	$ 815	Liabilities	$ 706
Beginning cash balance	0	Contributed Capital	1,000
Ending cash balance	$ 815	Retained earnings	209
		Total liabilities and equity	$ 1,915

Notes

All financial statements should be accompanied by notes which provide the reader with supplemental information about the financial condition and results of operations of the company.

Users of Financial Statements

Marketing managers and credit managers use customers' financial statements to decide whether to extend credit.

Purchasing managers use suppliers' financial statements to decide whether suppliers have the resources to meet the demand for products.

Employees' union and human resource managers use the company's financial statements as a basis for contract negotiations over pay rates.

Accounting Rules

- **Generally accepted accounting principles (GAAP)** are the rules that govern how accountants operate
  - Set by regulators and varies by country
- **Singapore Financial Reporting Standards (FRS)** are based on international GAAP (IFRS)
- The primary objective of financial reporting is to provide information useful for making investment and lending decisions!
  - Relevance
  - Reliability

Accounting Rules

	United States	International	Singapore
Standards	Generally Accepted Accounting Principles (GAAP)	International Financial Reporting Standards (IFRS)	Financial Reporting Standards (FRS) [modeled on IFRS]
Standards Setter	Financial Accounting Standards Board (FASB)	International Accounting Standards Board (IASB)	Accounting Standards Committee (ASC)
Financial Markets Regulator	Securities Exchange Commission (SEC)	n.a.	Monetary Authority of Singapore (MAS); Securities Industry Council (SIC); SGX
Securities Exchanges	AMEX, NYSE, NASDAQ, Chicago Stock Exchange, Philadelphia Stock Exchange	n.a.	Singapore Exchange (SGX) (formerly the Stock Exchange of Singapore (SES))

Types of Business Organizations

Sole Proprietorship: owned by a single individual.

Partnership: owned by two or more individuals.

Corporation: ownership represented by shares of stock.

Advantages of a Corporation

- Limited liability
- Continuity of life
- Ease of transfer of ownership
- Opportunity to raise large amounts of money

Disadvantage of a Corporation

- Double taxation

Private vs. Public Corporations

- Privately owned Corporation
  - Owned by relatively few individuals; shares in ownership are not sold to the general public.
- Publicly owned Corporation
  - Owned by the public; shares in ownership are sold to the public on a stock exchange (SGX, NYSE, NASDAQ); firm can have many thousands of shareholders.
  - Owners are shareholders (stockholders, investors)

Financial Reporting Requirements

- Public companies file financial reports with financial markets regulators, quarterly (three 10-Qs) and/or annually (one 10-K).
  - **In Singapore, only the annual report is required**
- Before filing, a firm has its annual financial statements audited, and its quarterly reports reviewed by independent auditors.
- Publicly available information:
  - Company website (Investor Relations)
  - Company press releases, conference calls
  - Regulators' websites. E.g., www.sgx.com, www.sec.gov

29

Management Responsibility and the Demand for Auditing

To ensure the accuracy of the company's financial information, management:

- **Maintains a system of controls.**
- **Hires outside independent auditors.**
- **Forms a committee of the board of directors to review these two safeguards.**

30

The Role of Accounting

Private accounting: Employed by a business, government or non-profit organization

- Preparing financial statements
- Internal Audit/Internal Control
- Budgeting
- Cost Accounting

Public accounting: Employed by accounting firm

- Auditing (Assurance Services)
- Tax Preparation
- Consulting
- Financial Planning

Credibility and Independent Auditors

- Auditors examine a company's transactions and the resulting financial statements and provide assurances about the credibility of the statements.
- These assurances should make the investors more comfortable about using the information to guide their investing activity.

Credibility and Independent Auditors

- Auditors express an opinion as to the fairness of the financial statements.
- Independent auditors have responsibilities that extend to the general public.
- Auditors must follow auditing standards set by an oversight board.

Ethical Considerations

- Accounting is not an exact science!
- Ethical standards in accounting are designed to produce *accurate information for decision making*

  - The Institute of Certified Public Accountants of Singapore (ICPAS) requires that all members adhere to a professional code of ethics
- **Earnings management** – misrepresenting financial information to financial statement users, most often to meet established goals or budgets

Today's Main Ideas

Question	Answer	Financial Stmt
What is the company's financial position at the end of the period?	Assets = Liabilities + Owners' Equity	Balance Sheet
How well did the company perform during the period?	Revenues - Expenses = Net Income	Income Statement
How did the company's retained earnings change during the period?	Beginning R.E. + Net Income - Dividends = Ending R.E.	Statement of Retained Earnings
How much cash did the company generate and spend during the period?	Operating cash flows +/- Investing cash flows +/- Financing cash flows = Change in Cash	Statement of Cash Flows

Review Problem 1

Assets = $90 at the beginning of the year

Owners' equity = $15 at the beginning of the year

Assets increased $30 during the year

Liabilities decreased $22 during the year

What is the year-end balance in owners' equity?

Review Problem 2

Given the following information, compute net income:

Interest expense	3,100
Revenue	110,000
Rent expense	3,000
Wages expense	80,000
Supplies expense	4,000
Interest income	7,100

Review Problem 2 (continued)

Review Problem 3

For the year ended May 31, 2006, Nike had revenues of $14,955 million and total expenses of $13,563 million. Nike's retained earnings were $4,397 million at the beginning of the year and $4,713 million at the end of the year.

1. Compute net income for the year.
2. Compute dividends for the year.

Review Problem 3 (continued)