

PRINCIPLES OF ACCOUNTING WINTER 2024 (WEEK 1)

Dr. Andreyia Pérez Silva

WELCOME !!!



UC San Diego

□ About this class....

- Introduction to Accounting
 - Recording business transactions (Financial reporting process)
 - Financial statements

□ Objectives

- Understanding how financial statements are created → to read, understand, and use financial statements
- Understanding accounting information to make business decisions

Applies to all fields

THE WALL STREET JOURNAL.

BUSINESS | EARNINGS

Target Stock Surges as Earnings Overshadow Sales Decline

Retailer to promote holiday gift items under \$25 to attract value-focused shoppers



By Sarah Nassauer [Follow](#)

Updated Nov. 15, 2023 10:32 am ET

People are skipping their [Target](#) TGT 0.70% runs, but the company is finding ways to boost profits.

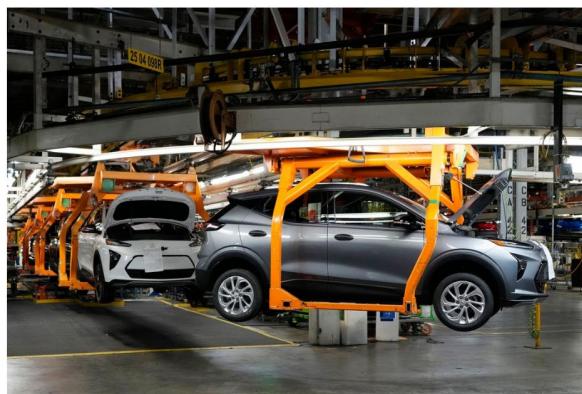
Target sales fell in the period just before the holiday shopping season as it grappled with [choosy shoppers](#) cutting spending on some products and visiting stores less often. Comparable sales, those from stores and digital channels operating at least 12 months, fell 4.9% in the three months ended Oct. 28 from the prior year.

THE WALL STREET JOURNAL.

CFO JOURNAL

GM Moves Forward After Strike, Focusing on Cost Cuts and EVs

The automaker aims to offset \$1.5 billion next year, while grappling with challenges in its electric vehicle and driverless-car businesses



Electric vehicles move along an assembly line at the General Motors plant in Lake Orion, Mich. PHOTO: CARLOS OSORIO/ASSOCIATED PRESS

By [Jennifer Williams-Alvarez](#) [Follow](#)

Dec. 13, 2023 5:30 am ET

[General Motors'](#) finance chief has a balancing act to achieve as the company moves ahead under new labor contracts that will add billions of dollars in costs over roughly four years.

Already, GM has cut over \$800 million from its marketing budget and reduced head count through a voluntary employee separation package, which will add about \$1 billion in savings annually. The cuts are being made across the company, GM said.

THE WALL STREET JOURNAL.

CFO JOURNAL

Costco Gets a Boost as Impact of Last-In, First-Out Accounting Fades

The wholesale retailer reported no LIFO charge in the latest quarter as the company benefits from some inflationary relief



Costco is seeing a slight decline in inflation, according to the retailer's finance chief.

PHOTO: PATRICK T. FALLON/BLOOMBERG NEWS

By Jennifer Williams-Alvarez [Follow](#)

Updated March 15, 2023 10:35 am ET

With inflation stuck at high levels, some U.S. companies' use of an accounting method that lowers their federal tax bill has increased costs and hit earnings. But for retail giant Costco Wholesale Corp., it is a different story.

THE WALL STREET JOURNAL.

MARKETS

Stocks Rally Despite Squeeze on Profitability

Net profit margins for S&P 500 companies are poised to drop for the sixth quarter in a row



Chipotle said it expects sales growth, which was boosted last year by price increases, to moderate.

PHOTO: JEENAH MOON/BLOOMBERG NEWS

By Charley Grant [Follow](#)

Updated Feb. 21, 2023 4:38 pm ET

This year's stock rally has a surprising feature: a smaller share of revenue at big U.S. companies is reaching the bottom line.

With fourth-quarter earnings season nearly complete, the net profit margin of companies in the S&P 500 has fallen to 11.3%, based on actual results and analyst estimates for companies that have yet to report. That would mark the sixth consecutive quarterly decline from the peak of

THE WALL STREET JOURNAL.

PRO BANKRUPTCY DISTRESS

Bed Bath & Beyond Misses Interest Payments as It Weighs Chapter 11

The home-goods retailer in January warned of a potential bankruptcy filing and said it is running low on funds



Bed Bath & Beyond has been reeling from a failed attempt to transform itself by replacing name-brand merchandise with private-label goods.

PHOTO: TAIDGH BARRON/ZUMA PRESS

By *Soma Biswas*

Feb. 1, 2023 6:28 pm ET | WSJ Pro

[Bed Bath & Beyond](#) Inc. missed interest payments on its bonds, a week after its bank lenders sent the company a default notice because it was overdrawn on its credit lines.

The home-goods retailer failed to pay more than \$28 million on three tranches of notes

Introduction

□ Achieving the Objective

	Topics
Week 1	Financial Accounting Framework
Week 2	Double-entry mechanics
Week 3	The Accounting Cycle
Week 4	Accounts Receivable
Week 5	Inventories
Week 6	MIDTERM EXAM
Week 7	Long-Term Assets
Week 8	Accounting Fraud
Week 9	Liabilities
Week 10	Stockholders' Equity
Finals Week	FINAL EXAM

□ About this class....

- Introduction to Accounting
 - Recording business transactions (Financial reporting process)
 - Financial statements

□ Objective

- Understanding how financial statements are created → to read, understand, and use financial statements
- Understanding accounting information to make business decisions

□ Other Accounting Classes – (what this class is not...)

- Managerial Accounting
 - Internal company decisions → cost allocation, budgeting, etc...
- Financial Statement Analysis (FSA)
 - Using financial statements to value companies

Introduction

□ About you....

- What is your major?
- What industry interests do you have for work?
- What is your goal for this class?
- What city/state/country do you call home?
- Give a home city or travel recommendation... favorite restaurant, beach, park, etc?

☐ Course Materials:

- Textbook: Financial Accounting by Spiceland, Thomas, and Hermann, 6th Edition
 - Please read before class!
 - Optional self-study problems
 - Solutions posted on Canvas
- Connect:
 - Weekly quizzes and homework problems
 - Solutions are available on Connect after the due date
- HBS Course pack ➔ 2 cases
- Canvas
 - Course materials
 - Announcements

□ Grading

- Final exam 30%
- Midterm exam 25%
- Quizzes 15%
- Homework assignments 15%
- Participation 15%

□ Exams

- Exams are open notes (handwritten/ printed).
- You may not collaborate with others.
- You may not discuss the exam with anyone during the exam window.
- If you perform better on the final exam than on the midterm, I will replace your midterm exam grade with your final exam grade.
 - Your final exam is effectively worth 55% of your grade.

Syllabus

□ Quizzes

- Due on Connect at **10pm on Sunday**
- You may not collaborate with others
- Lowest grade will be dropped → no late submissions

□ Homework Assignments

- Due on Connect at **10pm on Sunday**
- Lowest grade will be dropped → no late submissions

□ Quizzes and HW → 2nd and 3rd attempt

- Revise the previous attempt
- 10% deducted on new attempt → will always record the highest score

Note: Quizzes and HW vs. Exam

□ Slides

- Redacted set uploaded by Tuesday morning
- Full deck uploaded by Friday

□ Participation

- Come prepared to class – reading and homework
- Ask questions

How to Succeed in this Class

□ Quizzes and Homework

- Practice is critical
- Work through the problems on paper writing out all the details (better practice for the exam)

□ Participation

- Raise your hand - You don't need to be an expert or know all the answers!
- It's okay – no, it's encouraged to ask questions

□ Exams

- Comprehensive – Show all your work!!

□ Ethics and Academic Honesty

Additional Resources

□ Teaching assistants – B00 –

1. Miles Engelis : Menglis@ucsd.edu
2. Ash Laidlaw : Alaidlaw@ucsd.edu → please cc
3. Stephanie Smith Morrison : scs002@ucsd.edu → make an appointment

□ TA Resources

- Will hold weekly office hours → poll
- Will be available via appointment
- Review sessions before exams (wk.6 & wk.10)
- Please contact the TA ahead of time if there are specific questions you would like covered in these sessions.

□ Email

- Subject line: **MGT 45 – B00**

Additional Resources

□ Teaching assistants – C00 –

1. **Aishwarya Barve:** Abarve@ucsd.edu
2. **Ash Laidlaw :** Alaidlaw@ucsd.edu → please cc
3. **Stephanie Smith Morrison :** scs002@ucsd.edu → make an appointment

□ TA Resources

- Will hold weekly office hours → poll
- Will be available via appointment
- Review sessions before exams (wk.6 & wk.10)
- Please contact the TA ahead of time if there are specific questions you would like covered in these sessions.

□ Email

- Subject line: **MGT 45 – C00**

FINANCIAL ACCOUNTING FRAMEWORK

Objective: What is accounting? Why is it relevant?

□ Language of business

- A company's financial story
 - Successes, failures, opportunities, challenges, risks, and uncertainties
 - A better understanding of the story ➔ better decisions
- Two primary functions
 1. Recordkeeping of a company's operations ➔ identify, measure, and record economic events in value terms
 2. Communication ➔ Provide information to decision makers (external parties)

□ Users of financial information

- Investors → potential shareholders and shareholders
 - How is management performing?
 - What is the company's financial condition?
- Creditors
 - Potential borrower's ability to repay → loan terms, amounts, rates, collateral
- Suppliers
 - Establish credit sales terms
 - Commitment to supply-chain relationship → expansion of business?
- Management
 - Financial report card → incentive compensation linked to information in financials
 - Evaluate competitors
- Board of Directors – represent shareholder interests and oversee management
 - Review results of operations, evaluate future strategy, assess management performance

□ Users of financial information

- Investors
- Creditors
- Suppliers
- Management
- Board of Directors
- Employees
 - Do I accept the job?
 - Financial health of employer
- Customers
 - Making a big purchase
 - Can the company (my supplier) deliver the product or service?
 - What is the long-term reliability?
 - Service
- Others: financial analysts, regulators, consumer groups, competitors, etc...

□ Financial Accounting measures 3 business activities – (Recordkeeping)

1. Financing

- Transactions with investors and creditors
- Ex. Bank loan

2. Investing

- Acquiring and disposing of resources needed to produce and sell a company's product and services
- Long-term and short-term investments
- Ex. Building, Inventory, Equipment

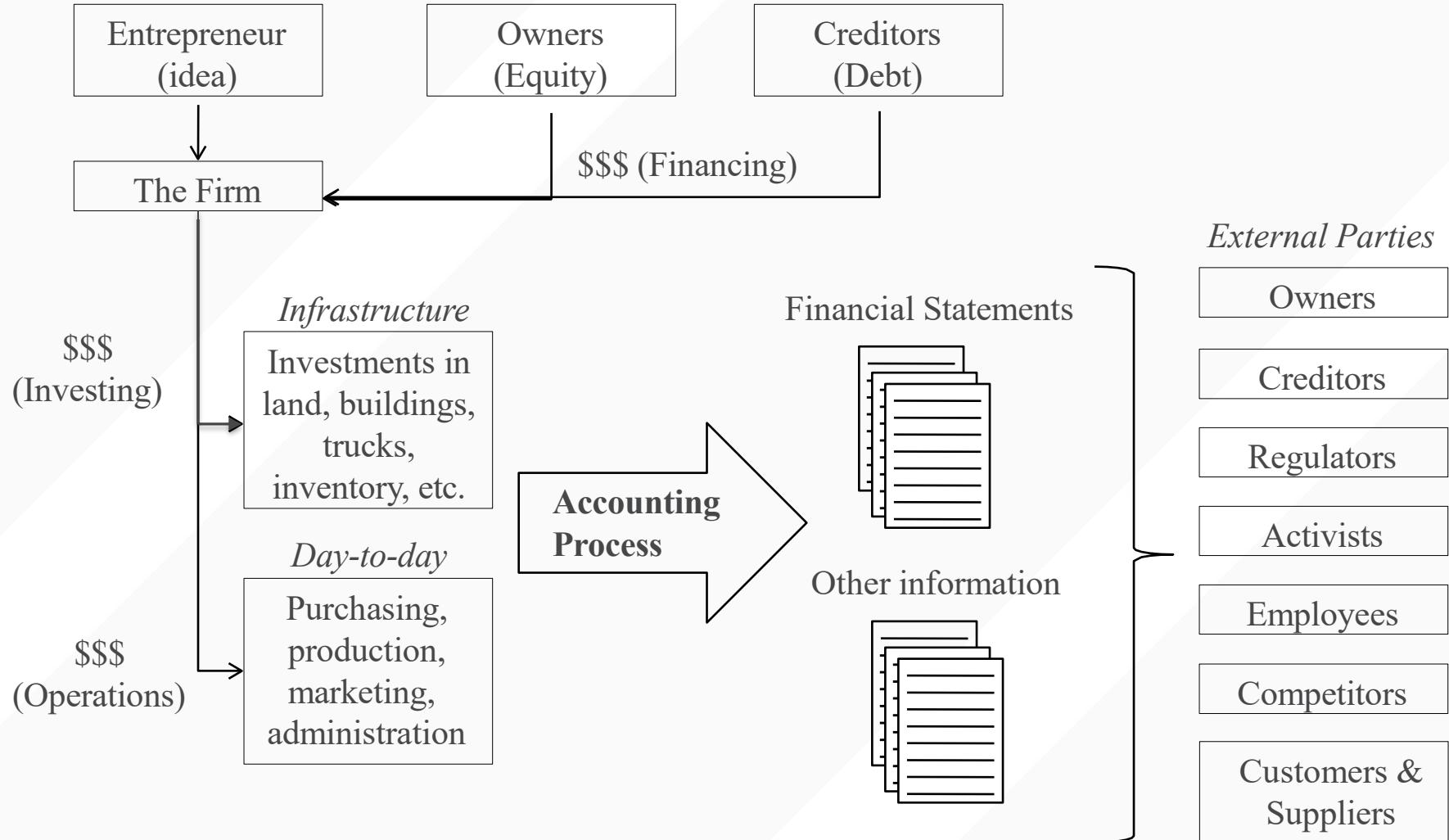
3. Operations

- Transactions related to the primary operations of the company
- Production, promotion, and selling of a company's products and services
- Ex. Advertising expense

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows

Financial Reporting Process



Financial Reporting Process

Economic Events

1. Operating Activities
Production and selling
2. Investing Activities
Acquisition and disposition of assets
3. Financing Activities
Borrowing and Repaying debt, stock issuance and Repurchase, Dividends
4. Other Occurrences



Financial Accounting

1. Generally Accepted Accounting Principles

principles, rules and procedures governing which transactions and events are to be reported, when they are to be reported and how they are to be reported
2. Analyze and record the economic effect of the transactions and events
3. Summarize, aggregate classify and report the information



Financial Reports

1. Balance Sheet
2. Income Statement
3. Cash Flow Statement
4. Shareholders' Equity
5. Footnotes

❑ Generally Accepted Accounting Principles (GAAP)

- Rules of financial accounting
- Comparable accounting information

❑ Securities and Exchange Commission (SEC)

- The power and responsibility for setting accounting and reporting standards for publicly traded firms
 - Requires public firms to prepare periodic financial statements
 - Delegates the *responsibility* for setting accounting standards → FASB

❑ FASB : Financial Accounting Standards Board

- Independent private sector body
- SEC has the power → can force a change in standards

❑ International Accounting Standards Board (IASB) → International Financial Reporting Standards (IFRS)

- **Hired by the company as an independent party to express their professional opinion about the financial statements*****

- The extent to which they are prepared in compliance with GAAP
- Whether they are free of material misstatements

***Required by the SEC for publicly traded companies

- **Play a major role for decisionmakers by adding credibility to a company's financials**

- **Four opinion types**

1. Unqualified
2. Unqualified with an explanatory or emphasis paragraph → emphasis on other important information is needed
3. Qualified → scope limitation or GAAP departure
4. Adverse → misstated or misleading financials (Rarely occurs)

MARKETS FINANCE

KPMG Gave SVB, Signature Bank Clean Bill of Health Weeks Before Collapse

Accounting firm faces scrutiny for audits of failed banks

By Jonathan Weil [Follow](#) and Jean Eaglesham [Follow](#)

Updated March 13, 2023 12:21 pm ET

Silicon Valley Bank failed just 14 days after KPMG LLP gave the lender a clean bill of health.

Signature Bank went down 11 days after the accounting firm signed off on its audit.

What KPMG knew about the two banks' financial situation and what it missed will likely be the subject of regulatory scrutiny and lawsuits.

Both bank audits were for 2022, so auditors weren't scrubbing the banks' books for the time period when they ran into trouble. But auditors are supposed to highlight risks faced by the companies they audit. They are also supposed to raise important issues that occur after companies close their books and before the audit is completed.

Auditors are supposed to warn investors if companies are in trouble. They are required to evaluate "whether there is substantial doubt about the entity's ability to continue as a going concern" for the next 12 months after the financial statements are issued.

Auditors also use their reports to highlight "critical audit matters" that involve challenging, subjective or complex judgments. KPMG in that section of its report focused on the accounting for credit losses at Silicon Valley Bank. But it didn't address Silicon Valley Bank's ability to continue holding debt securities to maturity—which, in the end, the bank lacked.

THE WALL STREET JOURNAL.



A Silicon Valley Bank branch in Wellesley, Mass., before opening on Monday morning.
PHOTO: STEVEN SENNE/ASSOCIATED PRESS

□ Financial Statements – (Communication) – How frequent?

- 10-K : Annual Report
 - End of each fiscal year
 - Audited financial statements
 - Disclosure notes → e.g. summary of significant accounting policies
- 10-Q : Quarterly Reports
 - Non-audited financials
 - Limited additional disclosure notes
- 8-K : Current Reports
 - Report certain major events
 - E.g. agreement to acquire another company, departure of director or key officer, restating prior financials, etc.
 - Typically no more than 4 business days after an event

FINANCIAL ACCOUNTING FRAMEWORK

Objective: Have a general understanding of Financial Statements and how they link

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows

□ Financial Statements – (Communication)

➤ Balance Sheet

- Reports the company's financial position at a point in time – (on a particular date)
 - Snapshot in time – e.g., December 31, 2021
- The company's investing and financing activities
- Must always be **balanced**

Financial Position

Resources

=

Claims to Resources

Financial Position

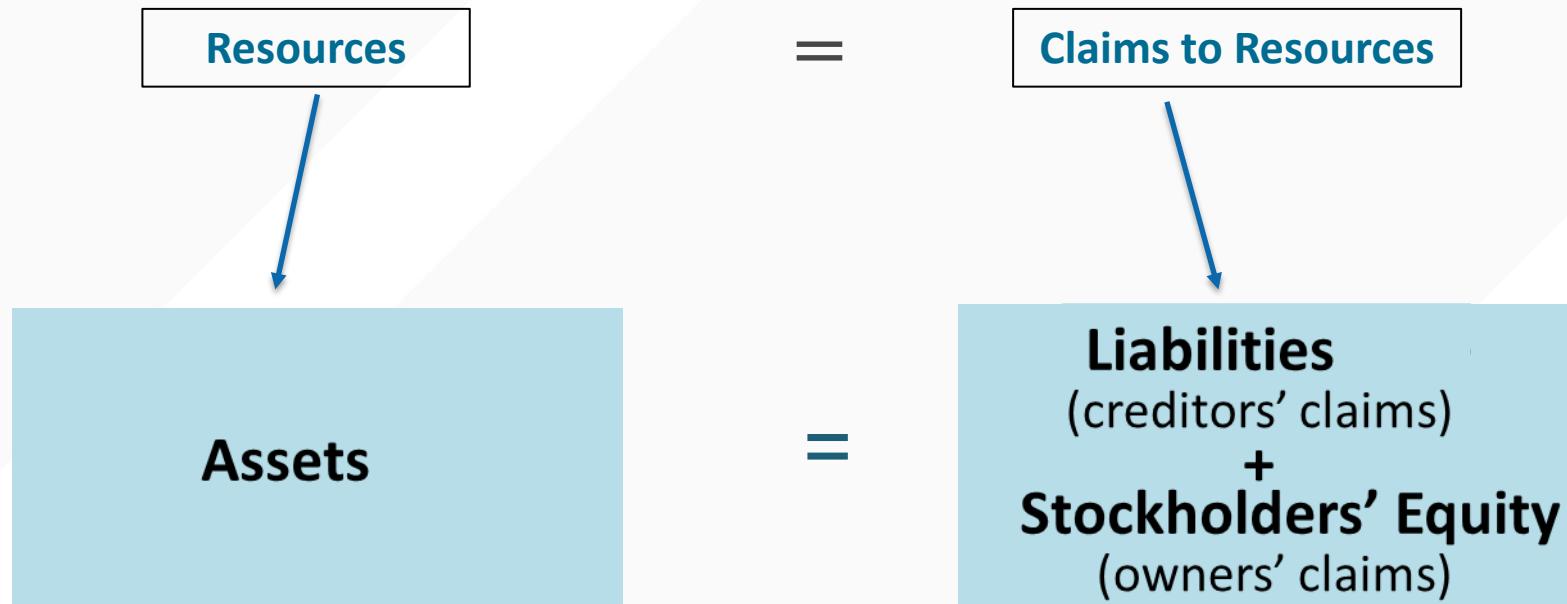


□ Assets: the total resources of the company

- What you have
- Will economically benefit future operations
- Ex. Cash, Equipment, Land, Supplies, Inventory, Patent

Balance Sheet

Financial Position



□ Liabilities: amounts owed to creditors

- What you owe
- Ex. Payables (company will pay in the future) → salaries, utilities, notes, income tax

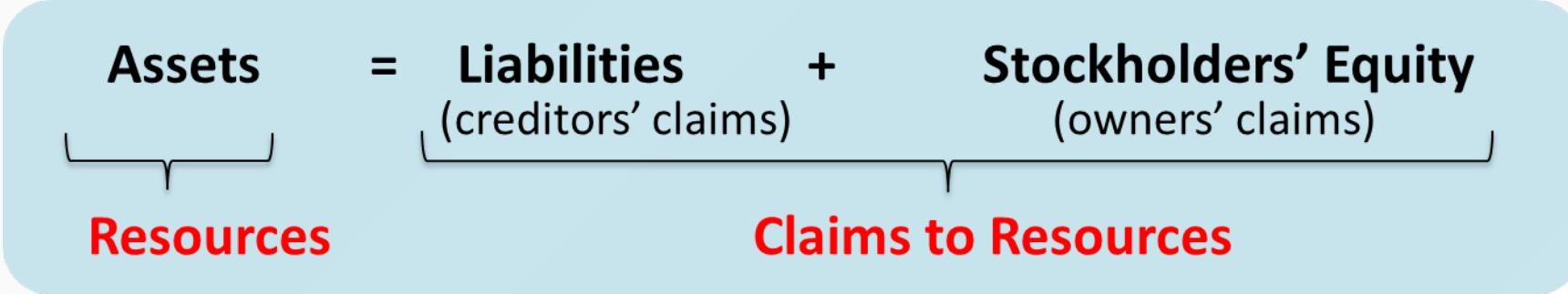
□ Stockholders Equity: owners' claims to resources

- Net worth, what's left over
- Residual claims by owners on assets after all liabilities have been satisfied
- Ex. Common stock

= Assets - Liabilities

Balance Sheet

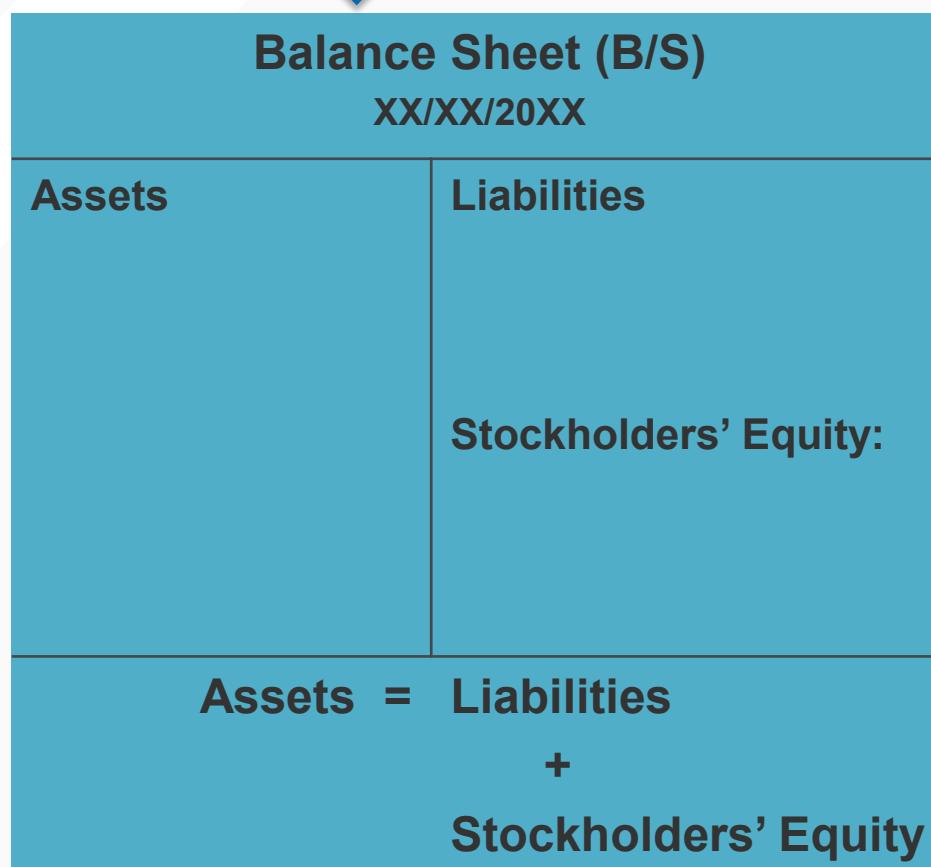
The Accounting Equation



- Must always be **balanced**
 - Left side equals right side
 - If Total Assets increase then either Liabilities or Stockholders' Equity MUST increase by the SAME amount
 - If Total Assets decrease then either Liabilities or Stockholders' Equity MUST decrease by the SAME amount
 - Each transaction has a *dual effect*

Balance Sheet

Presentation:



Balance Sheet



Presentation:



lululemon athletica inc.	
Balance Sheet	
As of February 2, 2020	
(\$ in millions)	
Current assets:	
Cash and cash equivalents	\$ 1,093
Accounts receivable, net	40
Inventories	519
Prepaid expenses	156
Total current assets	<u>1,808</u>
Property and equipment, net	672
Operating leases	690
Intangible assets, net	24
Other long-term assets	87
Total long-term assets	<u>1,473</u>
Total assets	<u>\$3,281</u>
Current liabilities:	
Accounts payable	\$ 80
Accrued expenses	140
Current lease liabilities	129
Taxes payable	26
Deferred revenue (gift cards)	120
Other current liabilities	125
Total current liabilities	<u>620</u>
Long-term liabilities:	
Non-current lease liabilities	611
Deferred taxes	92
Other long-term liabilities	6
Total liabilities	<u>\$1,329</u>
Stockholders' equity:	
Common stock	1
Additional paid-in capital	355
Retained earnings	1,821
Accumulated other comprehensive loss	(225)
Total stockholders' equity	<u>\$1,952</u>
Total liabilities and stockholders' equity	<u>\$3,281</u>

Balance Sheet

Example: Start a new business → Klein, Inc.

- Need \$1,500,000 (resource) to get started
 - Your company receives \$1,000,000 from investors (100,000 shares @ \$10 each)
 - Investor = stockholder

- How do we record this? → 3 questions

 1. What is one account affected by the transaction?
 - Did the account increase or decrease?
 2. What is the second account affected by the transaction?
 - Did the account increase or decrease?
 3. Does my accounting equation balance?

*Record the transaction from the perspective of the company



Balance Sheet

□ Example: Start a new business → Klein, Inc.

- Need \$1,500,000 (resource) to get started
 - Your company receives \$1,000,000 from investors (100,000 shares @ \$10 each)
 - Investor = stockholder

Assets	=	Liabilities	+	Stockholders' Equity
Cash				Common Stock
(1) + \$1,000,000	=			+ \$1,000,000

*Record the transaction from the perspective of the company, *NOT* the investor

Balance Sheet

□ Example: Start a new business → Klein, Inc.

- Need \$1,500,000 (resource) to get started
 - Turn to creditors
 - Lender who expects to get paid the loan amount *plus* interest
 - The local bank loans you \$500,000
 - Note payable (payable = company will pay in the future)



Balance Sheet

□ Example: Start a new business → Klein, Inc.

- Need \$1,500,000 (resource) to get started
 - Turn to creditors
 - Lender who expects to get paid the loan amount *plus* interest
 - The local bank loans you \$500,000
 - Note payable (payable = company will pay in the future)

Assets	=	Liabilities	+	Stockholders' Equity
Cash		Notes Payable		
(2) + \$500,000	=		+ \$500,000	

Balance Sheet

□ Example: Start a new business → Klein, Inc

- Need \$1,500,000 (resource) to get started
 - Your company receives \$1,000,000 from investors (100,000 shares @ \$10 each)
 - The local bank loans you \$500,000
 - Total claims to resources = \$1.5m

Financing Activities

Assets	=	Liabilities	+	Stockholders' Equity
Cash		Notes Payable		Common Stock
Bal. \$ 1,000,000				\$ 1,000,000
(2) + \$ 500,000		+ \$ 500,000		\$ _____
\$ 1,500,000		\$ 500,000		\$ 1,000,000
<hr/> \$ 1,500,000	<hr/> =	<hr/>		<hr/> \$ 1,500,000

Balance Sheet

□ Example: Start a new business → Klein, Inc

➤ With the \$1,500,000 cash (resource) you buy equipment (resource)

- The equipment costs \$240,000

Investing Activity

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Cash		Notes Payable		Common Stock
Bal. \$ 1,500,000		\$ 500,000		\$ 1,000,000

\$ 1,500,000	=	\$ 1,500,000
--------------	---	--------------

Balance Sheet

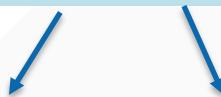
□ Example: Start a new business → Klein, Inc

➤ With the \$1,500,000 cash (resource) you buy equipment (resource)

- The equipment costs \$240,000
- \$1,260,000 cash left for future use
- Total resources = \$1.5m

Investing Activity

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Cash		Notes Payable		Common Stock
Bal. \$ 1,500,000		\$ 500,000		\$ 1,000,000



Cash \$1.26m + Equipment \$240k

Balance Sheet

□ Example: Start a new business → Klein, Inc

➤ With the \$1,500,000 cash (resource) you buy equipment (resource)

- The equipment costs \$240,000
- \$1,260,000 cash left for future use
- Total resources = \$1.5m

Investing Activity

Assets		=	Liabilities	+	Stockholders' Equity
Cash	Equipment		Notes Payable		Common Stock
Bal	\$ 1,500,000		\$ 500,000		\$ 1,000,000
(3)	- <u>\$ 240,000</u>	+ <u>\$ 240,000</u>	<u> </u>		\$ _____
Bal	\$ 1,260,000	\$ 240,000	\$ 500,000		\$ 1,000,000
	\$ 1,500,000			=	\$ 1,500,000

Balance Sheet

- What would be the effect on Total Assets if a company purchased land for \$500,000 cash?
- a) Total assets increase by \$500k
 - b) Total assets decrease by \$500k
 - c) Zero effect on assets

One asset (land) would go up and another asset (cash) would go down. There would be zero effect on total assets.

Recall: Equipment example

Assets		=	Liabilities	+	Stockholders' Equity
Cash	Equipment		Notes Payable		Common Stock
Bal	\$ 1,500,000		\$ 500,000		\$ 1,000,000
(3)	- \$ 240,000	+ \$ 240,000			\$ _____
Bal	\$ 1,260,000	\$ 240,000	\$ 500,000		\$ 1,000,000
	\$ 1,500,000			=	\$ 1,500,000

Balance Sheet

□ Example: Start a new business → Klein, Inc

- Next, you pay one year of rent in advance (resource)
 - The rent is \$180,000 – (\$15,000 per month)

Assets		=	Liabilities	+	Stockholders' Equity
			Notes Payable		Common Stock
Bal	\$ 1,260,000	\$ 240,000	\$ 500,000		\$ 1,000,000

Balance Sheet

□ Example: Start a new business → Klein, Inc

- Next, you pay one year of rent in advance (resource)
 - The rent is \$180,000 – (\$15,000 per month)
 - \$1,080,000 cash left for future use
 - Total resources = \$1.5m

Assets			=	Liabilities + Stockholders' Equity	
	Prepaid Cash	Equipment		Notes Payable	Common Stock
Bal	\$ 1,260,000	\$ 240,000		\$ 500,000	\$ 1,000,000
(4)	- <u>\$ 180,000</u>	+ <u>\$ 180,000</u>			
Bal	\$ 1,080,000	\$ 180,000	\$ 240,000	\$ 500,000	\$ 1,000,000
	\$ 1,500,000		=		\$ 1,500,000

- Other types of prepaid assets → prepaid insurance, prepaid advertising

Balance Sheet

□ Example: Start a new business → Klein, Inc

- Next, you purchase supplies (resource) on account (credit)
 - The supplies cost \$14,000
 - On account → company promises to pay in the future

Assets			=	Liabilities + Stockholders' Equity	
	Prepaid Cash	Rent	Equipment	Notes Payable	Common Stock
Bal	\$ 1,080,000	\$ 180,000	\$ 240,000	\$ 500,000	\$ 1,000,000

Balance Sheet

□ Example: Start a new business → Klein, Inc

- Next, you purchase supplies (resource) on account (credit)
 - The supplies cost \$14,000
 - On account → company promises to pay in the future → account payable
 - Total resources increase = \$1,514,000

Assets				=	Liabilities		+ Stockholders' Equity
	Cash	Supplies	Prepaid Rent Equipment		Accounts Payable	Notes Payable	Common Stock
Bal	\$ 1,080,000		180,000	\$ 240,000		\$ 500,000	\$ 1,000,000
(4)		+ \$ 14,000			+ \$ 14,000		
Bal	\$ 1,080,000	\$ 14,000	180,000	\$ 240,000	\$ 14,000	\$ 500,000	\$ 1,000,000
		\$ 1,514,000			=		\$ 1,514,000

- Other types of payables → salaries, utilities, taxes, lease

Balance Sheet



Presentation:

Balance Sheet (B/S)

12/01/2021

Balance Sheet

Presentation:

Balance Sheet (B/S)	
Assets	Liabilities
Cash	Accounts Payable
Accounts Receivable	Salaries Payable
Notes Receivable	Utilities Payable
Supplies	Income Tax Payable
Inventory	Notes Payable
Prepaid Advertising	Warranty Liability
Prepaid Insurance	
Prepaid Rent	
Long Term Investments	
Land	
Building	
Equipment	
Operating Leases	
Patents	
Trademarks	
Shareholders' Equity:	
	Common Stock
	Retained Earnings
Total Assets = Total Liabilities & Stockholders Equity	

Balance Sheet

❑ Presentation - Assets:

- Two Categories → length of the benefit
 - Current assets – expected to be used up or converted to cash within one year
 - Non-current (long-term) assets – held for longer than one year
- Assets are generally listed in order of liquidity → ease of converting noncash assets into cash

Balance Sheet (B/S)	
Assets	Liabilities
<i>Current Assets</i>	
Cash	
Accounts Receivable	
Notes Receivable	
Supplies	
Inventory	
Prepaid Advertising	
Prepaid Insurance	
Prepaid Rent	
<i>Non-Current Assets</i>	
Long Term Investments	
Land	
Building	
Equipment	
Operating Leases	
Patents	
Trademarks	
Shareholders' Equity:	
Common Stock	
Retained Earnings	
Total Assets = Total Liabilities & Stockholders Equity	

Balance Sheet

□ Current Assets:

- Cash
 - Currency, bank deposits
- Accounts Receivable
 - Amounts due from customers arising from the past sale of products and services on credit
- Notes Receivable
 - Credit arrangement (usually a loan)
 - Can also be long-term if maturity is over 1 year
- Supplies
 - Used in operating activities
- Inventory
 - Goods purchased or produced for sale to customers
- Prepaid Expenses
 - Costs paid in advance for advertising, insurance, rent, or other services

Assets
<i>Current Assets</i>
Cash
Accounts Receivable
Notes Receivable
Supplies
Inventory
Prepaid Advertising
Prepaid Insurance
Prepaid Rent
<i>Non-Current Assets</i>
Long Term Investments
Land
Building
Equipment
Operating Leases
Patents
Trademarks
Total Assets

Balance Sheet

□ Noncurrent Assets:

- Long-term investments
 - If plan to sell within 1 year → current asset instead
- Property plant and equipment
 - Land, building, equipment, and other items used in the operations of the company
- Operating Leases
 - Term of less than a year → not an asset
- Intangible and other assets
 - Items that provide future benefit but do not have physical substance
 - Patents, trademarks

Assets
<i>Current Assets</i>
Cash
Accounts Receivable
Notes Receivable
Supplies
Inventory
Prepaid Advertising
Prepaid Insurance
Prepaid Rent
<i>Non-Current Assets</i>
Long Term Investments
Land
Building
Equipment
Operating Leases
Patents
Trademarks
Total Assets

Balance Sheet

□ Presentation - Liabilities:

- Two categories → when is the obligation due
 - Current liabilities – obligations due within one year
 - Non-current (long-term) liabilities – obligations to be paid after one year
- Liabilities are generally listed in order of maturity

Balance Sheet (B/S)	
Assets	Liabilities
<i>Current Assets</i>	<i>Current Liabilities</i>
Cash	Accounts Payable
Accounts Receivable	Salaries Payable
Notes Receivable	Utilities Payable
Supplies	Income Tax Payable
Inventory	
Prepaid Advertising	
Prepaid Insurance	
Prepaid Rent	
<i>Non-Current Assets</i>	<i>Non-Current Liabilities</i>
Long Term Investments	Notes Payable
Land	Warranty liability
Building	
Equipment	
Operating Leases	
Patents	
Trademarks	
Shareholders' Equity:	
Common Stock	
Retained Earnings	
Total Assets =	Total Liabilities & Stockholders Equity

□ Current Liabilities:

- Accounts Payable
 - Amounts owed to suppliers for goods and services purchased on credit. (Aka. Trade accounts payable)
- Accrued Liabilities
 - Obligations for expenses that are due but not yet paid
 - Salaries payable – wages earned by employees but not yet paid
 - Utilities payable – utilities that are due
 - Income tax payable – income tax that is due

Liabilities

Current Liabilities

Accounts Payable
Salaries Payable
Utilities Payable
Income Tax Payable

Non-Current Liabilities

Notes Payable
Warranty liability

Balance Sheet

□ Noncurrent Liabilities:

- Notes payable
 - Long-term debt
 - Note that this can also be a current liability if due within one year instead (short-term)
- Warranty Liability
 - Obligations for warranty to be satisfied at least 1 year in the future

Liabilities

Current Liabilities

Accounts Payable

Salaries Payable

Utilities Payable

Income Tax Payable

Non-Current Liabilities

Notes Payable

Warranty liability

Balance Sheet

❑ Presentation:

- Shareholders' equity → capital provided by the shareholders (owners) of the company

Balance Sheet (B/S)	
Assets	Liabilities
<i>Current Assets</i>	<i>Current Liabilities</i>
Cash	Accounts Payable
Accounts Receivable	Salaries Payable
Notes Receivable	Utilities Payable
Supplies	Income Tax Payable
Inventory	
Prepaid Advertising	
Prepaid Insurance	
Prepaid Rent	
<i>Non-Current Assets</i>	<i>Non-Current Liabilities</i>
Land	Notes Payable
Building	Warranty liability
Equipment	
Patents	
Trademarks	
	Shareholders' Equity:
	Common Stock
	Retained Earnings
Total Assets =	Total Liabilities & Stockholders Equity

□ Shareholders' Equity

- There are 2 types of shareholder capital
 1. Contributed capital – contributions from the shareholders
 - Common stock → capital received (investment) by the primary owners of the company
 2. Earned capital – resources generated by the company
 - Retained Earnings → accumulated earnings retained by the company
 - Cumulative net income and losses (since the inception of the company) not paid out to shareholders – as dividends
 - Flows from the Income Statement

**Shareholders'
Equity:**

Common Stock
Retained Earnings

□ Shareholders' Equity

- Aka: owners' equity, book equity, equity
- Book value vs. market value
 - Market value → price at which something can be sold in an active market
 - For a public company
 - Market value (market capitalization) = share price x shares outstanding
 - BV and MV are usually **NOT** the same

**Shareholders'
Equity:**

Common Stock
Retained Earnings

Balance Sheet

❑ Klein, Inc:

Balance Sheet (B/S)			
2/01/2021			
Assets	Liabilities		
Cash	1,080,000	Accounts Payable	14,000
Supplies	14,000	Notes Payable	<u>500,000</u>
Prepaid Rent	180,000	Total Liabilities	514,000
Equipment	<u>240,000</u>		
Total Assets	1,514,000		
Shareholders' Equity:			
	Common Stock	<u>1,000,000</u>	
	Total Equity	1,000,000	
Total Assets \$1,514,000	=	\$1,514,000 Total Liabilities & Stockholders Equity	



No retained earnings yet

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows

□ Financial Statements – (Communication)

➤ Income Statement

- Aka. Profit and Loss Statement (P&L)
- Reports the results of a company's operating activities over a period of time
 - For example: Jan 1, 2021 through December 31, 2021 (between two balance sheets)
- Compares revenue and expenses to assess the company's ability to earn a profit from running its operations - (operating performance)
 - Answers the question: *How profitable is the firm?*

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$

□ What are Revenues and Expenses?

- Revenues
 - Sales
 - Inflows of assets from selling goods and services
 - Ex. Starbucks receives cash when selling a coffee
- Expenses
 - Outflows of assets used to generate revenues
 - Ex. Salaries expense of employees

Income Statement

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$

Aka.
Earnings

- If revenue > expenses, then the company reports net income
- If revenue < expenses, then the company reports net loss

Income Statement

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$

- If revenue > expenses, then the company reports net income
- If revenue < expenses, then the company reports net loss

Changes the
Retained
Earnings
account

Income Statement

Presentation:

$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$



Income Statement (I/S)

Revenues

Service Revenue

Expenses

Advertising Expense
Insurance Expense
Legal Fees Expense
Rent Expense
Salaries Expense
Utilities Expense

Net Income

Income Statement

□ Presentation:



$$\text{Revenue} - \text{Expenses} = \text{Net Income}$$



LULULEMON
Income Statement
For the fiscal year ended February 2, 2020
(\\$ in millions)

Sales revenues, net	\$ 3,979
Cost of goods sold	1,756
Gross profit	2,223
Selling, general and administrative expenses	1,334
Operating income	889
Other income (expenses)	8
Pretax income	897
Income tax expense	251
Net income	\$ 646

Income Statement

□ Presentation, Klein, Inc:

Income Statement (I/S)	
For the year ended December 31, 2021	
Revenues	
Sales revenue	<u>\$350,000</u>
Expenses	
Rent Expense	165,000
Supplies expense	10,000
Salaries expense	28,000
Utilities expense	10,000
Other expenses	65,000
Total expenses	<u>278,000</u>
Net income	<u>\$72,000</u>

Income Statement

□ How does this link to the Balance Sheet ? → Through Stockholders' Equity

Income Statement (I/S)	
For the year ended December 31, 2021	
Revenues	
Sales revenue	<u>\$350,000</u>
Expenses	
Rent Expense	165,000
Supplies expense	10,000
Salaries expense	28,000
Utilities expense	10,000
Other expenses	65,000
Total expenses	<u>278,000</u>
Net income	<u>\$72,000</u>

Net income =
↑Retained
Earnings account

- ❑ The Income Statement links the beginning and ending Balance Sheets.
- ❑ It accumulates the results of operating activities for a period.
- ❑ Retained Earnings is
 - Increased by net income
 - Decreased by net loss

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
- Income Statement
 - For the year ✓
- Statement of Stockholders' Equity
- Statement of Cash Flows

Statement of Stockholders' Equity

□ Financial Statements – (Communication)

- Statement of Stockholders' Equity
 - Reports the changes in the equity account over a period of time
 - For example: Jan 1, 2021 through December 31, 2021
 - Changes to S/E:
 1. Contributed capital → Common stock
 2. Earned capital → Retained Earnings (accumulated earnings)

Statement of Stockholders' Equity

❑ Klein, Inc : contributed capital → had \$1,000,000 from investors at start

Statement of Stockholders' Equity			
For the year ended December 31, 2021			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	\$1,000,000		\$1,000,000
Add: Net income for the period			
Less: Dividends			
Ending balance	\$1,000,000	\$0	\$1,000,000

Statement of Stockholders' Equity

❑ Klein, Inc : earned capital

Statement of Stockholders' Equity			
For the year ended December 31, 2021			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	\$1,000,000		\$1,000,000
Add: Net income for the period			
Less: Dividends			
Ending balance	<u>\$1,000,000</u>	<u>\$0</u>	<u>\$1,000,000</u>

Retained Earnings

❑ Retained Earnings → accumulated earnings retained by the company

- Cumulative net income and losses (since the inception of the company) not paid out to shareholders – as dividends

Earned Capital
(generated by the company)

Retained Earnings (beginning of the period)

+ Net Income (Loss)

- Distribution to Shareholders (Dividends, Stock Repurchases)

= **Retained Earnings (end of the period)**

B/S

I/S

What does the company do with the net income?
Can payout to shareholders or retain to help grow the company

Retained Earnings

Klein, Inc.:

Balance Sheet (B/S)

2/01/2021

Assets		Liabilities	
Cash	1,080,000	Accounts Payable	14,000
Supplies	14,000	Notes Payable	<u>500,000</u>
Prepaid Rent	180,000	Total Liabilities	514,000
Equipment	<u>240,000</u>		
Total Assets	1,514,000		
Shareholders' Equity:			
		Common Stock	<u>1,000,000</u>
		Total Equity	1,000,000
Total Assets \$1,514,000 = \$1,514,000		Total Liabilities & Stockholders Equity	

No R/E at start-up

Income Statement (I/S)	
For the year ended December 31, 2021	
Revenues	
Sales revenue	\$350,000
Expenses	
Rent Expense	165,000
Supplies expense	10,000
Salaries expense	28,000
Utilities expense	10,000
Other expenses	65,000
Total expenses	278,000
Net income	\$72,000

$$\begin{aligned}
 & \text{Retained Earnings (beginning of the period)} \\
 + & \text{Net Income (Loss)} \\
 - & \text{Distribution to Shareholders (Dividends, Stock Repurchases)} \\
 = & \text{Retained Earnings (end of the period)}
 \end{aligned}$$

$$\begin{aligned}
 & 0 \\
 + & 72,000 \\
 - & \text{Distributions} \\
 = & \text{R/E (end of the period)}
 \end{aligned}$$

Retained Earnings

❑ Klein, Inc:

Retained Earnings (beginning of the period)
+ Net Income (Loss)
- Distribution to Shareholders (Dividends, Stock Repurchases)
= Retained Earnings (end of the period)



0
+ 72,000
- Distributions
= R/E (end of the period)

❑ Distributions to Shareholders

- Dividends
 - Company resources returned to investors

❑ Ex. If Klein, Inc pays a \$4,000 Dividend at year end



0
+ 72,000
- 4,000
= 68,000

Statement of Stockholders' Equity

❑ Klein, Inc : earned capital

Statement of Stockholders' Equity			
For the year ended December 31, 2021			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	\$1,000,000		\$1,000,000
Add: Net income for the period		\$72,000	\$72,000
Less: Dividends		(4,000)	(4,000)
Ending balance	<u>\$1,000,000</u>	<u>\$68,000</u>	<u>\$1,068,000</u>

Statement of Stockholders' Equity

❑ Klein, Inc : earned capital

Statement of Stockholders' Equity

For the year ended December 31, 2021

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	\$1,000,000		\$1,000,000
Add: Net income for the period		\$72,000	\$72,000
Less: Dividends		(4,000)	(4,000)
Ending balance	<u>\$1,000,000</u>	<u>\$68,000</u>	<u>\$1,068,000</u>



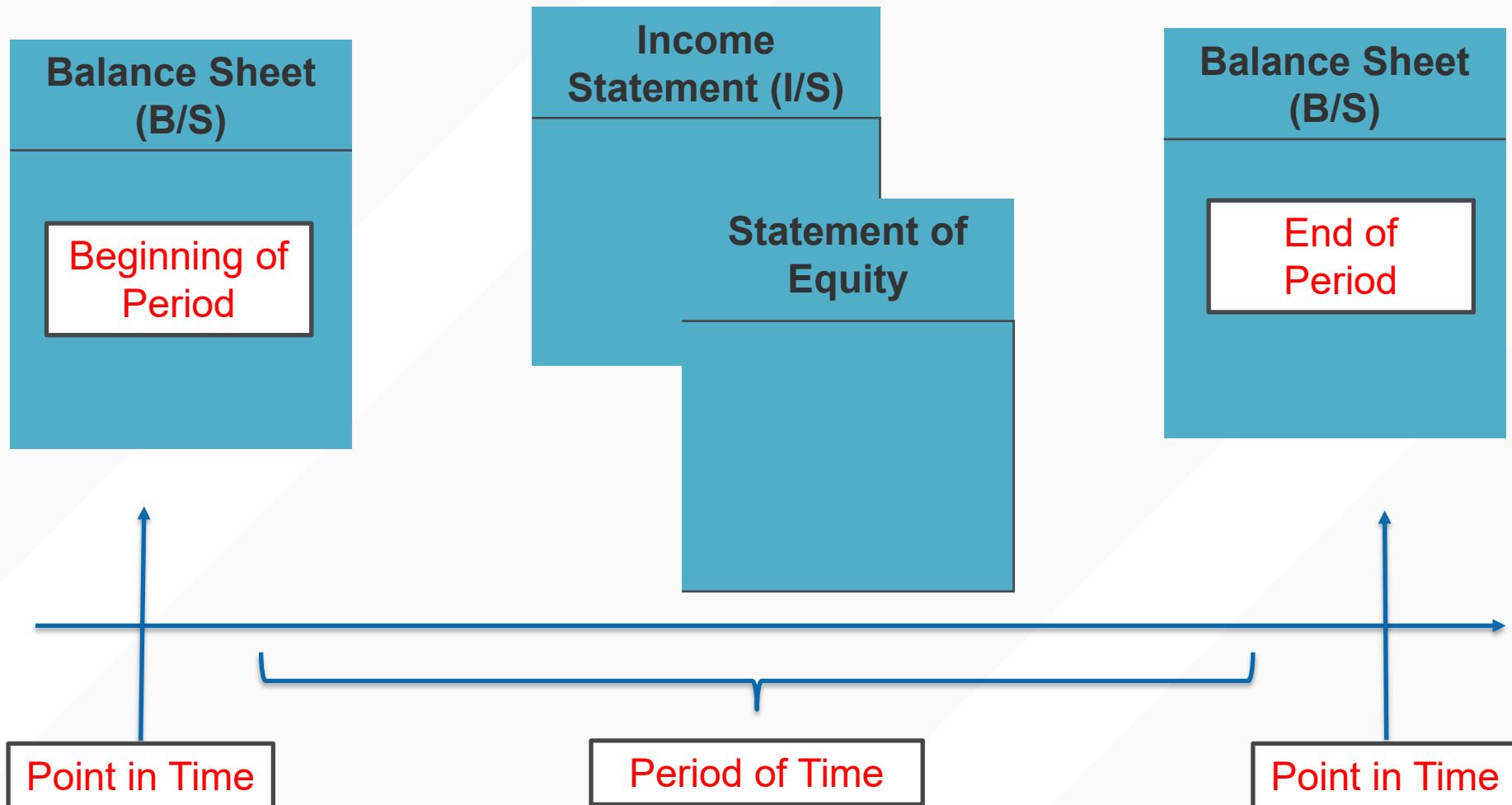
Flows to End of
year B/S

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
- Income Statement
 - For the year ✓
- Statement of Stockholders' Equity
 - For the year ✓
- Statement of Cash Flows

Financial Statements

□ Timing:



Financial Statements

□ How they link:

(\$ millions)	
Balance Sheet May 31, 2017	
Assets	
Cash	\$ 3,808
Noncash assets	19,451
Total assets	<u><u>\$23,259</u></u>
Liabilities and equity	
Liabilities	\$10,852
Stockholders' equity	12,407
Total liabilities and equity	<u><u>\$23,259</u></u>

[1]



Income Statement	
For Year Ended May 31, 2018	
Revenues	\$36,397
Expenses	34,464
Net income	<u><u>\$ 1,933</u></u>

[3]

Statement of Stockholders' Equity For Year Ended May 31, 2018

Stockholders' equity, May 31, 2017	\$12,407
Net income	1,933
Dividends	(1,265)
Stock issuances and other	(3,263)
Stockholders' equity May 31, 2018	<u><u>\$9,812</u></u>

[2]

[4]

Point in time
(Beginning of year)

Period of time
(Fiscal year)

Point in time
(End of year)

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
 - At end of year ✓
- Income Statement
 - For the year ✓
- Statement of Stockholders' Equity
 - For the year ✓
- Statement of Cash Flows

□ Financial Statements – (Communication)

➤ Statement of Cash Flows

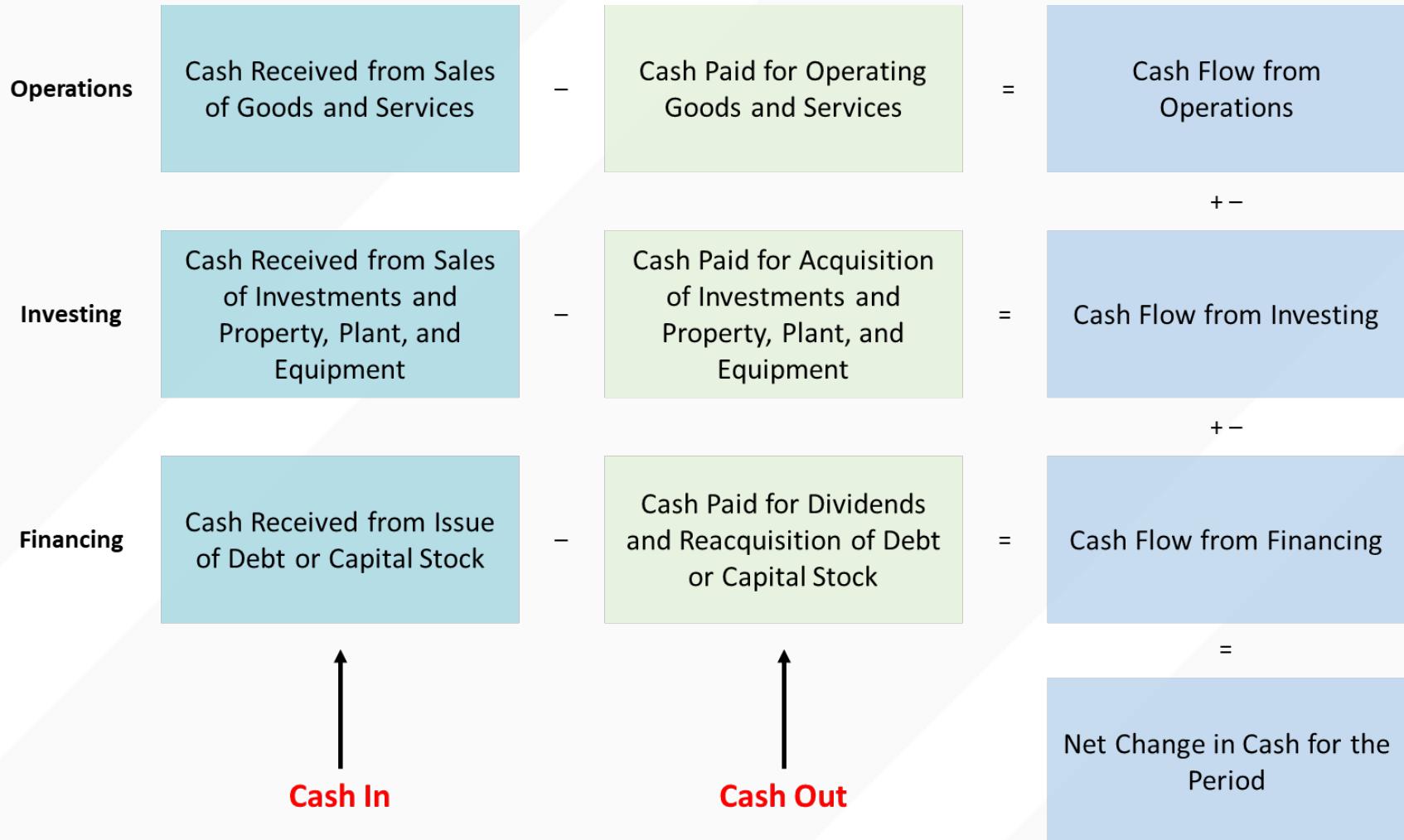
- Reports the changes in cash over a period of time
 - For example: Jan 1, 2021 through December 31, 2021
- Answers the questions, “Is the firm generating sufficient cash flows from its customers to finance operations and to acquire buildings and equipment? Must it seek new funds from lenders or owners?”
- Shows how much cash the firm has generated from different sources, as well as how the cash has been used – (cash receipts and cash payments)
 1. Operating Activities
 2. Investing Activities
 3. Financing Activities

❑ Types of Cash Flows

- Operating Cash flows
 - Cash transactions involving revenue and expense activities – (day to day activities)
 - Ex. Cash from a customer for purchasing goods/services
- Investing cash flows
 - Cash transactions for the purchase and sale of investments and long-term assets
 - Ex. Selling a piece of equipment
- Financing cash flows
 - Cash transaction with lenders and stockholders
 - Ex. Issuing stock or paying a dividend

Statement of Cash Flows

□ Inflows and Outflows



Statement of Cash Flows

□ Calculation

Links to
both B/S

- Cash from Operating Activities
- + Cash from Investing Activities
- + Cash from Financing Activities
- **= Net Cash Flow**
- + **Cash Balance (B/S) at the beginning of the period (BB)**
- **= Cash Balance (B/S) at the end of the period (EB)**

Statement of Cash Flows

❑ Klein, Inc:

Statement of Cash Flows	
For the year ended December 31, 2021	
Operating Cash Flows	(39,000)
Investing Cash Flows	(120,000)
Financing Cash Flows	<u>296,000</u>
Net increase in cash	137,000
Cash at beginning	<u>0</u>
Cash at end	<u>137,000</u>

Financial Statements

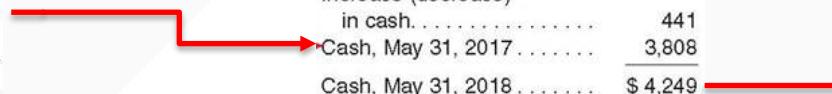


□ How they link:

(\$ millions)	
Balance Sheet May 31, 2017	
Assets	
Cash	\$ 3,808
Noncash assets	19,451
Total assets	<u>\$23,259</u>
Liabilities and equity	
Liabilities	\$10,852
Stockholders' equity	12,407
Total liabilities and equity	<u>\$23,259</u>

Statement of Cash Flows For Year Ended May 31, 2018	
Operating cash flows	\$ 4,955
Investing cash flows	276
Financing cash flows	(4,835)
Exchange rate changes	45
Increase (decrease) in cash	441
Cash, May 31, 2017	<u>3,808</u>
Cash, May 31, 2018	<u>\$ 4,249</u>

Balance Sheet May 31, 2018	
Assets	
Cash	\$ 4,249
Noncash assets	18,287
Total assets	<u>\$22,536</u>
Liabilities and equity	
Liabilities	\$12,724
Stockholders' equity	9,812
Total liabilities and equity	<u>\$22,536</u>



Statement of Cash Flows

□ How they link:

Balance Sheet at December 31, 2020

$$\text{Cash} + \text{Noncash Assets} = \text{Liabilities} + [\text{Contributed Capital} + \text{Retained Earnings}]$$

Statement of Cash Flows

For year ended, 12/31/2021

(Change in cash from
Dec. 31, 2020 to
Dec. 31, 2021)

Income Statement

For year ended, 12/31/2021

(Change in retained earnings
from Dec. 31, 2020 to
Dec. 31, 2021)

A diagram illustrating the flow of information. Two red arrows point downwards from the 'Income Statement' and 'Statement of Cash Flows' sections towards the final equation at the bottom. The 'Income Statement' arrow points to the 'Change in retained earnings' part of the 'Statement of Cash Flows'. The 'Statement of Cash Flows' arrow points to the '(Change in cash from Dec. 31, 2020 to Dec. 31, 2021)' part of the 'Statement of Cash Flows'.

$$\text{Cash} + \text{Noncash assets} = \text{Liabilities} + [\text{Contributed Capital} + \text{Retained Earnings}]$$

Balance Sheet at December 31, 2021

Financial Statements

□ How they link:

[1]

(\$ millions)

Balance Sheet May 31, 2017

Assets	
Cash	\$ 3,808
Noncash assets	19,451
Total assets	\$23,259
Liabilities and equity	
Liabilities	\$10,852
Stockholders' equity	12,407
Total liabilities and equity	\$23,259

[5]

Statement of Cash Flows For Year Ended May 31, 2018

Operating cash flows	\$ 4,955
Investing cash flows	276
Financing cash flows	(4,835)
Exchange rate changes	45
Increase (decrease) in cash	441
Cash, May 31, 2017	3,808
Cash, May 31, 2018	<u>\$ 4,249</u>

[6]

2018 FORM 10-K

Balance Sheet May 31, 2018

Assets	
Cash	\$ 4,249
Noncash assets	18,287
Total assets	<u>\$22,536</u>
Liabilities and equity	
Liabilities	\$12,724
Stockholders' equity	9,812
Total liabilities and equity	<u>\$22,536</u>

[3]

Income Statement For Year Ended May 31, 2018

Revenues	\$36,397
Expenses	34,464
Net income	<u>\$ 1,933</u>

[2]

Statement of Stockholders' Equity For Year Ended May 31, 2018

Stockholders' equity, May 31, 2017	\$12,407
Net income	1,933
Dividends	(1,265)
Stock issuances and other	(3,263)
Stockholders' equity May 31, 2018	<u>\$9,812</u>

[4]

Point in time
(Beginning of year)

Period of time
(Fiscal year)

Point in time
(End of year)

□ Financial Statements – company's periodic reports – (Communication)

- Balance Sheet
 - At start of period – (2/1) ✓
 - At end of year ✓
- Income Statement
 - For the year ✓
- Statement of Stockholders' Equity
 - For the year ✓
- Statement of Cash Flows
 - For the year ✓

Linking the F/S

□ Financial Statements – company's periodic reports – (Communication)

➤ Balance Sheet

- At start of period ✓
- At end of year ✓



Details about the
change between
two balance sheet
dates

➤ Income Statement

- For the year ✓

➤ Statement of Stockholders' Equity

- For the year ✓

➤ Statement of Cash Flows

- For the year ✓



Linking the F/S

□ Financial Statements – company's periodic reports – (Communication)

➤ Balance Sheet

- At start of period ✓
- At end of year ✓



➤ Income Statement

- Details about resource flows
Generating value

➤ Statement of Stockholders' Equity

- Changes in the equity

➤ Statement of Cash Flows

- Changes in the cash

Details about the
change between
two balance sheet
dates

Linking the F/S

□ Financial Statements – company's periodic reports – (Communication)

Statement of Cash Flows (CF/S)
Explains **change in cash** over a period of time (between consecutive B/S)

Balance Sheet (B/S) XX/XX/20XX	
Assets: economic resources	Liabilities: economic obligations
Cash	
Inventory	
Property, Plant & Equipment	
Land	
...	
	Shareholders' Equity:
	Paid-in-Capital
	Retained Earnings
Assets =	Liabilities +Equity

Statement of SE
Explains **all changes in SE** over a period of time

Income Statement (I/S)
Profit earned over a period of time

Financial statements do not exist in isolation: link between B/S, I/S, CF/S and Statement of Shareholders' Equity!

- Financial statements convey verifiable information to outsiders about the firm's underlying economics – its financial position and past performance.

- Four primary Financial Statements
 - Balance Sheet: Presents financial position at a point in time
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
 - Income Statement: Helps explain change in R/E, a component of SE
 - Statement of Stockholders' Equity: Explains total change in SE
 - Statement of Cash Flows: Explains change in cash



RADY SCHOOL OF MANAGEMENT

THANK YOU!