

Chapter 1: Financial Statements and Business Decisions

1-1

Why do we make you take this class????

Ted Baker's accounting overstatement triples to £58m

By Elias Johshan - January 22, 2020

◆ WSJ NEWS EXCLUSIVE | BUSINESS

Under Armour Is Subject of Federal Accounting Probes

Justice Department, SEC examining how sportswear maker recorded revenue; company says it is cooperating with investigators

BUSINESS NEWS MAY 6, 2019 / 6:53 AM / 9 MONTHS AGO

Kraft Heinz to restate nearly three years of financial reports after investigation

TECH

WeWork's \$47 billion valuation was always a fiction created by SoftBank

PUBLISHED TUE, OCT 22 2019 5:36 PM EDT

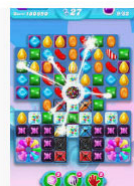
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What do these companies have in common?



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What do these characters and games have in common?



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What do these companies have in common?



MAC

HOLLYWOOD, CALIFORNIA
GLAMGLOW®

smashbox



ESTÉE LAUDER

BECCA



BOBBI BROWN



ORIGINS

Too Faced

AVEDA[®]

Bumble and bumble.

Salon born. New York raised. Hair is what we 'do.

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Why would 1 company own so many other companies?

ESTÉE LAUDER COMPANIES

Their strategy in their words:

Cultivating an Exceptional Portfolio

"Our portfolio strategy includes growing existing brands and discovering new high-potential acquisitions that align with our values and offer a long-term outlook for success," says Fabrizio Freda, President & CEO. "To maintain our leadership position, we nurture and preserve each brand's distinctive identity and purpose. At the same time, we leverage our global distribution, creative resources and operational expertise across all our brands."

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3 Sets of Accounting Records

1. Financial Accounting:
This is prepared for **external readers** and companies must follow Generally Accepted Accounting Principles or International Financial Reporting Standards
ACCRUAL-BASED
2. Tax Accounting:
Different accounting rules to comply with tax laws
3. Internal Accounting:
This is their confidential information about how their business is running; this is called Managerial or Cost Accounting.

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The Four Basic Financial Statements

1. BALANCE SHEET
2. INCOME STATEMENT
3. STATEMENT OF STOCKHOLDER'S EQUITY
4. STATEMENT OF CASH FLOWS

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The Accounting Equation

$$A = L + SE$$

(Assets)

(Liabilities)

(Stockholders' Equity)

Economic Resources with probable future benefits

Economic Obligations or Debt

Investments by owners **AND** earnings

(ie: what you "own")

(ie: what you owe)

(ie: ownership claim)

Sources of financing

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Example of a Balance Sheet

AIR & SEA TRAVEL, INC. Balance Sheet April 30, 2017

<u>Assets</u>		<u>Liabilities</u>	
Cash	\$33,300	Accounts payable	\$ 100
Accounts receivable	2,000		
Office supplies	500		
Land	18,000		
		<u>Stockholders' Equity</u>	
		Common stock	50,000
		Retained earnings	3,700
		Total stockholders' equity	53,700
Total assets	<u>\$53,800</u>	Total liabilities and stockholders' equity	<u>\$53,800</u>

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Identify the impact on the equation:

- New owner invests \$5,000 to start a business
- Owner spends \$1,000 cash to buy the coffee and pastry ingredients
- Owner goes to buy equipment for \$3,000 and the store agrees to let her pay next month
- Owner goes to the bank and borrows \$5,000 cash

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Assets = Liabilities + Owner's Equity

	Assets				=	Liabilities			+	Stockholders' Equity	
	Cash	+	Inventory	+	Equip	=	Accounts Payable	+	Loan Payable	+	Contributed Capital
END BALANCE											

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SHEHATA COFFEE STAND
Balance Sheet
September 3, 2020

Assets:

Cash	\$9,000
Inventory	1,000
Equipment	<u>3,000</u>

Liabilities:

Loan payable	\$ 5,000
Account Payable	<u>3,000</u>
Total liabilities	\$8,000

Owner's Equity:

Shehata, capital	<u>5,000</u>
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Total assets **\$13,000**

**Total liabilities and
owner's equity** **\$13,000**

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BASIC BALANCE SHEET ELEMENTS

Match each account to its classification on the balance sheet:

Account	Asset	Liability	Stockholders' Equity
a. Notes Payable			
b. Cash			
c. Contributed Capital			
d. Inventories			
e. Accounts Receivable			
f. Accounts Payable			
g. Property, Plant & Equipment			
h. Retained Earnings			

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The Four Basic Financial Statements

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Expansion of the balance sheet equation:

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

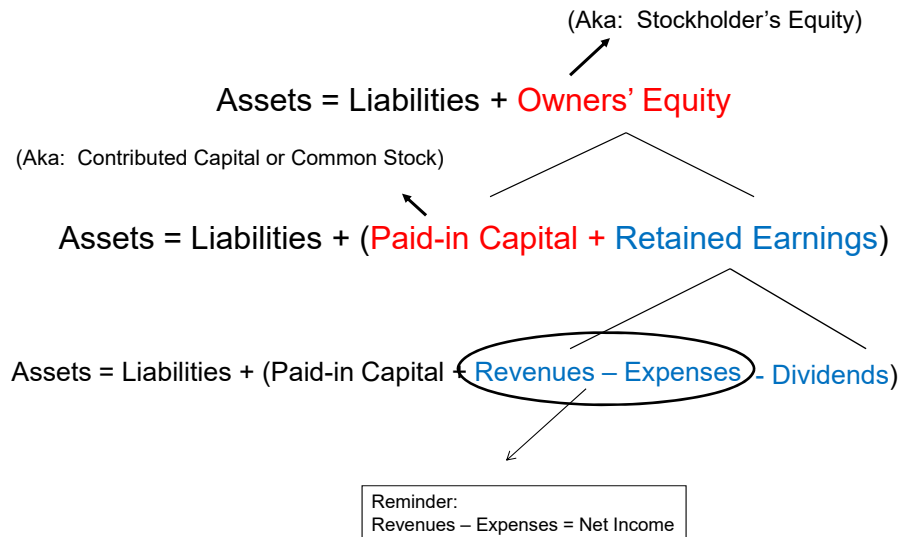
$$\text{Assets} = \text{Liabilities} + (\text{Paid-in Capital} + \text{Retained Earnings})$$

Capital contributed
by owners

Profits or earnings of the
business that are
reinvested by owners

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Expansion of the balance sheet equation:



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Income Statement Elements

Revenues
 – Expenses
 Net Income

Revenues: cash and promises received in exchange for delivering goods or services to customers (aka "Sales")

Expenses: resources used in the process of delivering goods and services;
 Examples?

Other Features:

•Fiscal Year

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AIR & SEA TRAVEL, INC.
Income Statement
Month Ended April 30, 2017

Revenue:		
Service revenue		\$8,500
Expenses:		
Salary expense	\$1,200	
Rent expense	1,100	
Utilities	<u>400</u>	
Total expenses		<u>2,700</u>
Net Income		<u>\$5,800</u>

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Problem E1-11: Breakout Rooms

Preparing an Income Statement and Balance Sheet:

Painter Corporation was organized by 5 individuals on January 1, of the current year. At the end of January, of the current year, the following monthly data are available:

Total Revenues:	305,000
Total expenses (excluding income taxes)	189,000
Income tax expense (all unpaid as of Jan 31)	35,000
Cash balance, Jan 31, of the current year	65,150
Receivables from Customers (all considered collectible)	44,700
Merchandise inventory (by inventory count at cost)	94,500
Payables to suppliers for merchandise purchased from them (but will be paid during February of the current year)	25,950
Common Stock	62,400
No dividends were declared or paid during of the current year	

Required: complete the following 2 financial statements:

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Problem E1-11

PAINTER CORPORATION
Income Statement
For the Month of January of the current year

Total revenues	\$
Less: Total expenses (excluding income tax)	
Pretax income	
Less: Income tax expense	
Net income	<u>\$</u>

SOLUTIONS ARE AT THE END OF THIS CHAP IN YOUR CHAP 1 PDF

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Problem E1-11

PAINTER CORPORATION
Balance Sheet
At January 31, of the current year

Assets	
Cash	\$
Receivables from customers	
Merchandise inventory	
Total assets	<u>\$</u>
Liabilities	
Payables to suppliers	\$
Income taxes payable	
Total liabilities	
Stockholders' Equity	
Common Stock	
Retained earnings (<i>from income statement above</i>)	
Total stockholders' equity	
Total liabilities and stockholders' equity	<u>\$</u>

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The Four Basic Financial Statements

1. BALANCE SHEET
2. INCOME STATEMENT
- 3. STATEMENT OF STOCKHOLDER'S EQUITY**
4. STATEMENT OF CASH FLOWS

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Expansion of the balance sheet equation:

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

$$\text{Assets} = \text{Liabilities} + (\text{Paid-in Capital} + \text{Retained Income})$$

$$\text{Assets} = \text{Liabilities} + (\text{Paid-in Capital} + \text{Net Income} - \text{Dividends})$$

Reminder:
Net Income = Revenues - Expenses

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Example of a Statement of Stockholder's Equity

Also Known As (AKA):
-Paid-In Capital
-Contributed Capital

AIR & SEA TRAVEL, INC. Statement of Stockholder's Equity Month Ended April 30, 2017

	Common Stock	Retained Earnings
Balance, April 1, 2017	\$50,000	\$0
+Net Income	-	5,800
-Dividends	-	(2,100)
Balance, April 30, 2017	\$50,000	\$3,700

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Problem E1-13

Plummer Stonework Corporation was organized on Jan 1, of the current year. For it's first 2 years of operations, it reported the following:

Net Income for 2017:	31,000
Net Income for 2018:	42,000
Dividends for 2017:	14,200
Dividends for 2018:	18,700
Total assets at the end of 2017:	130,000
Total assets at the end of 2018:	250,000
Common Stock at the end of 2017:	100,000
Common Stock at the end of 2018:	100,000

Prepare a statement of stockholder's equity for 2017 and 2018.
Show computations.

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PLUMMER STONEWORK CORPORATION
Statement of Stockholder's Equity
For the Year Ended December 31, 2017

	Common Stock	Retained Earnings

PLUMMER STONEWORK CORPORATION
Statement of Stockholder's Equity
For the Year Ended December 31, 2018

	Common Stock	Retained Earnings

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Extra Practice Question for you

For the year ended Dec 31, 2017, PepsiCo reported the following:

Total Revenues: \$63,769 million

Total Expenses: \$58,912 million

Retained Earnings, beginning of the year: \$52,518 million

Retained Earnings, end of the year: \$52,839 million

Calculate the following:

Net Income for Fiscal Year 2017?

Were Dividends declared that year?



SOLUTIONS ARE AT THE END OF THIS CHAP IN YOUR COURSEPACK



Total Revenues:	
Total Expenses:	
Net Income	

Beginning R/E	
+	
-	
=Ending R/E	

Example of a Balance Sheet

AIR & SEA TRAVEL, INC. Balance Sheet April 30, 2017

<u>Assets</u>		<u>Liabilities</u>	
Cash	\$33,300	Accounts payable	\$ 100
Accounts receivable	2,000		
Office supplies	500		
Land	18,000		
		<u>Stockholders' Equity</u>	
		Common stock	50,000
		Retained earnings	<u>3,700</u>
		Total stockholders' equity	53,700
Total assets	<u>\$53,800</u>	Total liabilities and stockholders' equity	<u>\$53,800</u>

The Four Basic Financial Statements

1. BALANCE SHEET
2. INCOME STATEMENT
3. STATEMENT OF STOCKHOLDER'S EQUITY
- 4. STATEMENT OF CASH FLOWS**

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AIR & SEA TRAVEL, INC. Statement of Cash Flows Month Ended April 30, 2017

Cash flows from operating activities:		
Collections from customers	\$ 6,500	
Payments to suppliers and employees	<u>(3,100)</u>	
Net cash inflow from operating activities		3,400
Cash flows from investing activities:		
Acquisition of land	\$(40,000)	
Sale of land	<u>22,000</u>	
Net cash outflow from investing activities		(18,000)
Cash flows from financing activities:		
Issuance (sale) of stock	\$ 50,000	
Payment of dividends	<u>(2,100)</u>	
Net cash inflow from financing activities		47,900
Net increase in cash		<u>\$ 33,300</u>
Cash balance, April 1, 2017		0
Cash balance, April 30, 2017		<u>\$ 33,300</u>

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Focus on Cash Flows

Companies report CASH inflows and outflows over a period in their statement of cash flows.

Operating activities (Covered in the next chapter.)	
Investing Activities	
Purchasing long-term assets and investments for cash	—
Selling long-term assets and investments for cash	+
Lending cash to others	—
Receiving principal payments on loans made to others	+
Financing Activities	
Borrowing cash from banks	+
Repaying the principal on borrowings from banks	—
Issuing stock for cash	+
Repurchasing stock with cash	—
Paying cash dividends	—

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API-3 Comparing Income with Cash Flow (Challenging) P1-3



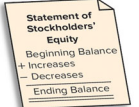
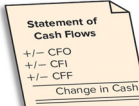
Choice Chicken Company was organized on January 1. At the end of the first quarter (three months) of operations, the owner prepared a summary of its activities as shown in transaction (a) of the following table:

Summary of Transactions	Computation of	
	Income	Cash
a. Services performed for customers, \$85,000, of which \$15,000 remained uncollected at the end of the quarter.	+\$85,000	+\$70,000
b. Cash borrowed from the local bank, \$25,000 (one-year note).		
c. Small service truck purchased at the end of the quarter to be used in the business for two years starting the next quarter: Cost, \$8,000 cash.		
d. Wages earned by employees, \$36,000, of which one-sixth remained unpaid at the end of the quarter.		
e. Service supplies purchased for use in the business, \$4,000 cash, of which \$1,000 were unused (still on hand) at the end of the quarter.		
f. Other operating expenses, \$31,000, of which one-half remained unpaid at the end of the quarter.		
g. Based only on these transactions, compute the following for the quarter: Income (or loss) Cash inflow (or outflow)		

1. For items (b) through (g), enter what you consider to be the correct amounts. Enter a zero when appropriate. The first transaction is illustrated.

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Summary of the Four Basic Financial Statements (More For You)

Financial Statement	Purpose	Structure	Examples of Content
Balance Sheet (Statement of Financial Position)	Reports the financial position (economic resources and sources of financing) of an accounting entity <i>at a point in time</i> .		Cash, accounts receivable, plant and equipment, long-term debt, common stock
Income Statement (Statement of Income, Statement of Earnings, Statement of Operations)	Reports the accountant's primary measure of economic performance <i>during the accounting period</i> .		Sales revenue, cost of goods sold, selling expense, interest expense
Statement of Stockholders' Equity	Reports changes in the company's common stock and retained earnings <i>during the accounting period</i> .		Beginning and ending stockholders' equity balances, stock issuances, net income, dividends
Statement of Cash Flows (Cash Flow Statement)	Reports inflows (receipts) and outflows (payments) of cash <i>during the accounting period</i> in the categories of operating, investing, and financing.		Cash collected from customers, cash paid to suppliers, cash paid to purchase equipment, cash borrowed from banks

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AIR & SEA TRAVEL, INC. Statement of Cash Flows Month Ended April 30, 2017			AIR & SEA TRAVEL, INC. Income Statement Month Ended April 30, 2017		
Cash flows from operating activities: Collections from customers \$ 6,500 Payments to suppliers and employees <u>(3,100)</u> Net cash inflow from operating activities 3,400 Cash flows from investing activities: Acquisition of land \$(40,000) Sale of land <u>22,000</u> Net cash outflow from investing activities (18,000) Cash flows from financing activities: Issuance (sale) of stock \$ 50,000 Payment of dividends <u>(2,100)</u> Net cash inflow from financing activities 47,900 Net increase in cash \$ 33,300 Cash balance, April 1, 2017 0 Cash balance, April 30, 2017 \$ 33,300			Revenue: Service revenue \$8,500 Expenses: Salary expense \$1,200 Rent expense 1,100 Utilities <u>400</u> Total expenses <u>2,700</u> Net Income \$5,800		
AIR & SEA TRAVEL, INC. Statement of Stockholder's Equity Month Ended April 30, 2017			AIR & SEA TRAVEL, INC. Balance Sheet April 30, 2017		
	Common Stock	Retained Earnings	Assets	Liabilities	
Balance, April 1, 2017	\$50,000	\$0	Cash \$33,300	Accounts payable	\$ 100
+Net Income	-	5,800	Accounts receivable 2,000	Stockholders' Equity	
-Dividends	-	(2,100)	Office supplies 500	Common stock	50,000
Balance, April 30, 2017	\$50,000	\$3,700	Land 18,000	Retained earnings	3,700
			Total assets \$53,800	Total stockholders' equity	53,700
				Total liabilities and stockholders' equity	\$53,800

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Supplement A: Types of Business Entities

Sole Proprietorship:

Partnership:

Corporation:

Advantages of a Corporation

Disadvantage of a Corporation

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Independent Auditors

An audit involves . . .

- Examining the financial reports to ensure compliance with GAAP.
- Examining the underlying transactions incorporated into the financial statements.
- Expressing an opinion as to the fairness of presentation of financial information.



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Financial Reporting Requirements for US Public Companies

The Securities & Exchange Commission (the “SEC”) requires:

- Quarterly reports called the 10Q (3 times/year)
- Annual Report called the 10K which includes:
 - The 4 financial statements and related footnote disclosures
 - Description of the business
 - Management discussion and analysis (MD&A)
 - Report from independent external auditor

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Standard-Setting Bodies

- Congress
- ↓
- The Securities and Exchange Commission (SEC)
- ↓
- Financial Accounting Standards Board (FASB)
- ↓
- Generally Accepted Accounting Principles (GAAP)

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Standard-Setting Bodies

- Congress



- Public Company Accounting Oversight Board (PCAOB)



- Generally Accepted Auditing Standards (GAAS)

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Solution: Problem E1-11

PAINTER CORPORATION	
Income Statement	
For the Month of January of the current year	
Total revenues	\$305,000
Less: Total expenses (excluding income tax)	<u>189,000</u>
Pretax income	116,000
Less: Income tax expense	<u>35,000</u>
Net income	<u>\$ 81,000</u>

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Solution: Problem E1-11

PAINTER CORPORATION Balance Sheet At January 31 of the current year

Assets	
Cash	\$ 65,150
Receivables from customers	44,700
Merchandise inventory	94,500
Total assets	\$204,350
Liabilities	
Payables to suppliers	\$25,950
Income taxes payable	35,000
Total liabilities	60,950
Stockholders' Equity	
Common stock	62,400
Retained earnings (<i>from income statement above</i>)	81,000
Total stockholders' equity	143,400
Total liabilities and stockholders' equity	\$204,350

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Solution: Problem E1-13

PLUMMER STONEWORK CORPORATION Statement of Stockholder's Equity For the Year Ended December 31, 2017

	Common Stock	Retained Earnings
Balance, January 1, 2017	\$100,000	\$0
+Net Income	-	31,000
-Dividends	-	(14,200)
Balance, December 31, 2017	\$100,000	\$16,800

PLUMMER STONEWORK CORPORATION Statement of Stockholder's Equity For the Year Ended December 31, 2018

	Common Stock	Retained Earnings
Balance, January 1, 2018	\$100,000	\$16,800
+Net Income	-	42,000
-Dividends	-	(18,700)
Balance, December 31, 2018	\$100,000	\$40,100

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SOLUTION: DON'T PEEK TOO SOON!



Total Revenues:	\$63,769 million
Total Expenses:	58,912 million
Net Income	4,857 million

Beginning R/E	\$52,518 million
+ Net Income	+4,857
-Dividends Declared	-4,536
=Ending R/E	\$52,839 million

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