

FINANCIAL ACCOUNTING

Robert Libby

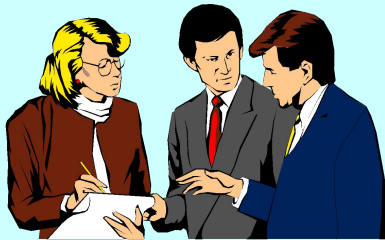
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Chapter 1

Financial Statements and Business Decisions

Understanding the Business



Owner-Managers

Founders of the business who also function as managers are called **Owner-Managers.**



Creditors

****Creditors** lend money for a specific period of time and gain by charging interest on the money they lend.**



Investors

****Investors** buy ownership in the company in the form of stock.**

The Accounting System

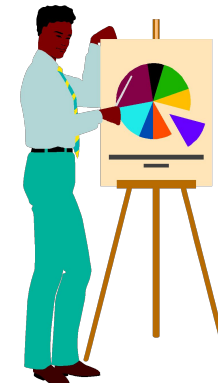


**Collects and processes
financial information**

**Reports
information
to decision
makers**

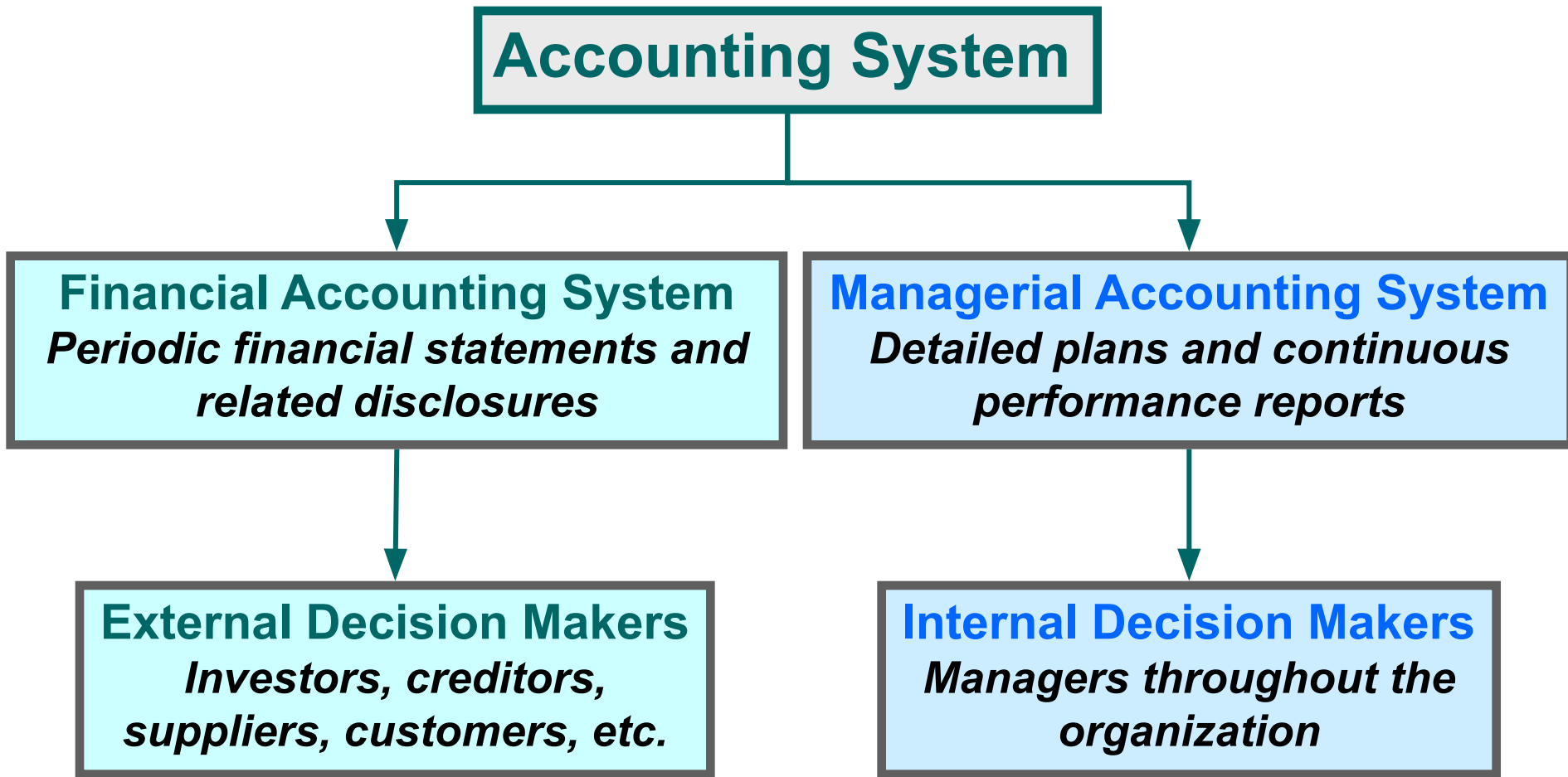


**Managers
(internal)**



**Investors
and
Creditors
(external)**

The Accounting System



The Four Basic Financial Statements

BALANCE SHEET – reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time.

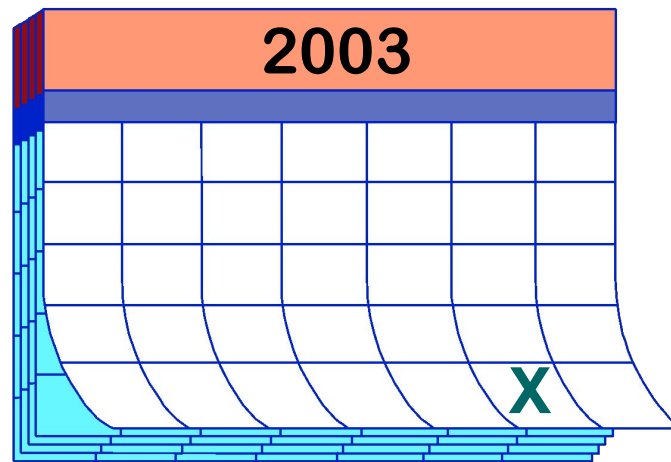
INCOME STATEMENT – reports the revenues less the expenses of the accounting period.

STATEMENT OF STOCKHOLDERS' EQUITY – reports the changes in each of the company's stockholders' equity accounts, including the change in the retained earnings balance caused by net income and dividends during the reporting period.

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

The Four Basic Financial Statements

Companies can prepare financial statements at the end of the **year, quarter or month**.



Financial statements prepared at the end of the year are called **annual reports**.

Business activities and financial statements affected

EXHIBIT 2-1 Typical Business Activities and Financial Statement Elements Affected

Assets (A), Liabilities (L), Owners' Equity (E), Revenue (R), and Expenses (X)

Operating activities	Sales of goods and services to customers: (R)
	Costs of providing the goods and services: (X)
	Income tax expense: (X)
	Holding short-term assets or incurring short-term liabilities directly related to operating activities: (A), (L)
Investing activities	Purchase or sale of assets, such as property, plant, and equipment: (A)
	Purchase or sale of other entities' equity and debt securities: (A)
Financing activities	Issuance or repurchase of the company's own preferred or common stock: (E)
	Issuance or repayment of debt: (L)
	Payment of distributions (i.e., dividends to preferred or common stockholders): (E)

The Accounting Equation

$$A = L + SE$$

Assets



**Economic
Resources**

Liabilities



Stockholders'
Equity



**Sources of Financing for
Economic Resources**

Liabilities: From Creditors
Stockholders' Equity: From Stockholders

Balance Sheet

Elements of the Balance Sheet

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

Common Stock
Retained Earnings

Balance Sheet

Balance Sheet
Assets
=
Liabilities
+
Stockholders' Equity

LE-NATURE'S INC.
Balance Sheet
At December 31, 2012
(in millions of dollars)

Assets:

Cash	\$ 10.6
Accounts receivable	6.6
Inventories	51.2
Property, plant and equipment	459.0

Total assets \$527.4

Liabilities and stockholders' equity:

Liabilities

Accounts payable	\$ 26.0
Notes payable to banks	381.7

Total liabilities 407.7

Stockholders' equity

Common stock	55.7
Retained earnings	64.0

Total stockholders' equity 119.7

Total liabilities and stockholders' equity \$527.4

The notes are an integral part of these financial statements.

CHIPOTLE MEXICAN GRILL, INC.

Consolidated Balance Sheet*

December 31, 2011

(in thousands of dollars, except per share data)

EXPLANATIONS

"Consolidated" means all subsidiaries are combined
Point in time for which the balance sheet was prepared

ASSETS

Current Assets:

Current assets

Cash	\$ 401,200
Short-term investments	55,000
Accounts receivable	8,400
Supplies	8,900
Prepaid expenses	27,700

Ownership of other companies' stocks and bonds
Payments due from customers and others
Food, beverage, and packaging supplies on hand
Rent, advertising, and insurance paid in advance

Total current assets 501,200

Noncurrent assets

Property and equipment (net)	795,900
Long-term investments	128,200

Cost of land, buildings, and equipment to be used
Ownership of other companies' stocks and bonds

Total assets \$1,425,300

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:

Current liabilities

Accounts payable	\$ 46,400
Accrued expenses payable	93,100
Unearned revenue	18,000

Payments due to suppliers
Utilities, interest, taxes, and wages due to employees
Unredeemed gift cards

Total current liabilities 157,500

Noncurrent liabilities

Notes payable	223,600
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Written obligations due beyond the next 12 months

Total liabilities 381,100

Stockholders' Equity:

Common stock (\$0.01 par per share)	300
Additional paid-in capital	372,400
Retained earnings	671,500

Total par value of stock issued by company to investors
Excess of amount received over par value of stock issued
Undistributed earnings reinvested in company

Total stockholders' equity 1,044,200

Total liabilities and stockholders' equity \$1,425,300

*The information has been adapted from actual statements
and simplified for this chapter.

Income Statement

Elements of the Income Statement

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



LE-NATURE'S INC.
Income Statement
For the Year Ended December 31, 2012
(in millions of dollars)

Revenues

Sales revenue \$275.1

Expenses

Cost of goods sold 140.8

Selling, general, and administrative
expenses 77.1

Interest expense 17.2

Income before income taxes 40.0

Income tax expense 17.1

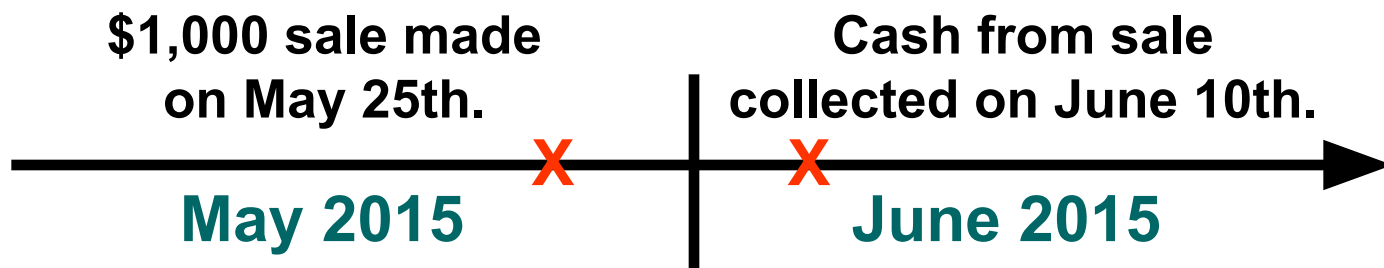
Net income \$ 22.9

The notes are an integral part of these financial statements.

Revenues

Revenue is recognized in the period in which goods and services are sold, not necessarily the period in which cash is received.

When will the revenue from this transaction be recognized?



Revenue

Earnings from the sale of goods or services.

When will the revenue from this transaction be recognized?

**\$1,000 revenue
recognized in May**

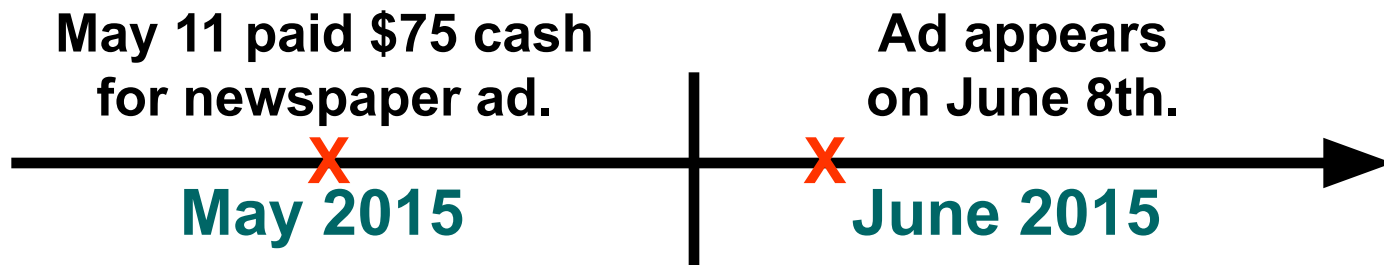
May 2015

June 2015

Expenses

An expense is recognized in the period in which goods and services are used, not necessarily the period in which cash is paid.

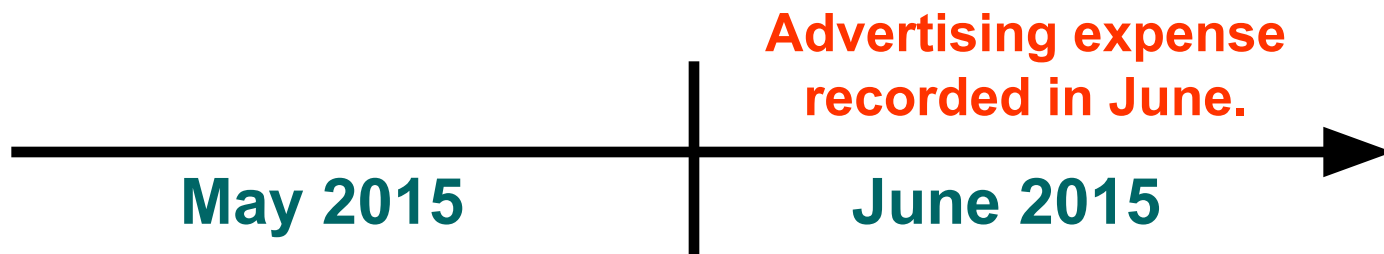
When will the expense for this transaction be recognized?



Expenses

The dollar amount of resources used up by the entity to earn revenues during a period.

When will the expense for this transaction be recognized?



Statement of Stockholders' equity

Elements of the Statement of Stockholders' Equity

Common Stock

Retained Earnings

Beginning Retained Earnings
+Net Income
-Dividends
Ending Retained Earnings

Statement of Stockholders' equity

Statement of Stockholders' Equity	
Beginning balance	
+ Increases	
- Decreases	
Ending balance	

LE-NATURE'S INC.

Statement of Stockholders' Equity For the Year Ended December 31, 2012 (in millions of dollars)

	Common Stock	Retained Earnings
Balance December 31, 2011	\$55.7	\$43.1
Net income for 2012		22.9
Dividends for 2012		(2.0)
Balance December 31, 2012	<u>\$55.7</u>	<u>\$64.0</u>

The notes are an integral part of these financial statements.

Statement of Cash Flows

Because
revenues reported
do not always equal
cash collected...

... and **expenses**
reported do not
always equal
cash paid ...

net income is
usually **not**
equal
to the change
in cash for
the period.

Statement of cash flows

Elements of the Statement of Cash Flows

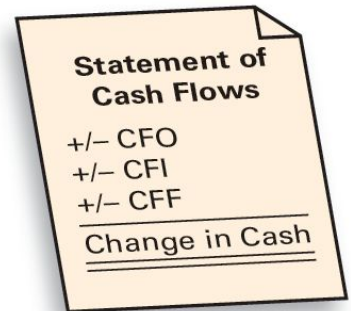


Cash Flows from Operating Activities
Cash Flows from Investing Activities
Cash Flows from Financing Activities



Note that each of the three cash flow sources can be positive (net cash inflow) or negative (net cash outflow).

Statement of Cash Flows



Statement of Cash Flows	
+/- CFO	
+/- CFI	
+/- CFF	
<hr/>	
Change in Cash	
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LE-NATURE'S INC.

Statement of Cash Flows (Summary) For the Year Ended December 31, 2012 (in millions of dollars)

Cash flows from operating activities	\$ 87.5
Cash flows from investing activities	(125.5)
Cash flows from financing activities	<u>47.0</u>
Net increase (decrease) in cash	9.0
Cash balance December 31, 2011	<u>1.6</u>
Cash balance December 31, 2012	<u><u>\$ 10.6</u></u>

The notes are an integral part of these financial statements.

Relationships Among the Statements

Income Statement

Revenues	\$275.1
– Expenses	252.2
Net Income	\$ 22.9

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Statement of Stockholders' Equity

	Common Stock	Retained Earnings
Beginning	\$55.7	\$43.1
+ Net Income		22.9
– Dividends		(2.0)
Ending	\$55.7	\$64.0

Statement of Cash Flows

+/- Cash Flows from Operating Activities	\$ 87.5
+/- Cash Flows from Investing Activities	(125.5)
+/- Cash Flows from Financing Activities	47.0
Change in Cash	9.0
+ Cash at Beginning of Period	1.6
Cash at End of Period	\$ 10.6

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Balance Sheet

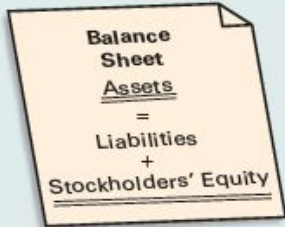

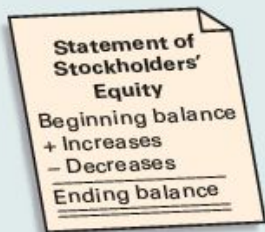
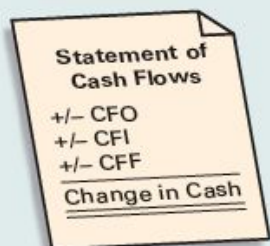
Cash	\$ 10.6
Other Assets	516.8
Total Assets	\$527.4
Liabilities	\$407.7
Common Stock	55.7
Retained Earnings	64.0
Total Liabilities & Stockholders' Equity	\$527.4

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Notes

- ❖ Notes provide supplemental information about the financial condition of a company.
- ❖ Three basic types of notes:
 - ❖ Description of accounting rules applied.
 - ❖ Presentation of additional detail about an item on the financial statements.
 - ❖ Provides additional information about an item not on the financial statements.

Financial Statement SUMMARY

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> .	 <p>Balance Sheet</p> <p><u>Assets</u></p> <p>=</p> <p>Liabilities</p> <p>+ <u>Stockholders' Equity</u></p>	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> .	 <p>Income Statement</p> <p>Revenues</p> <p>- Expenses</p> <p><u>Net Income</u></p>	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 during that period	 <p>Statement of Stockholders' Equity</p> <p>Beginning balance</p> <p>+ Increases</p> <p>- Decreases</p> <p><u>Ending balance</u></p>	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 operating, investing, and financing.	 <p>Statement of Cash Flows</p> <p>+/- CFO</p> <p>+/- CFI</p> <p>+/- CFF</p> <p><u>Change in Cash</u></p>	Cash collected from customers, cash paid to suppliers, cash paid to purchase equipment, cash borrowed from banks

Generally Accepted Accounting Principles (GAAP)

**Securities Act of 1933
Securities and Exchange Act of 1934**



The Securities and Exchange Commission (SEC)
has been given broad powers to determine
measurement rules for
financial statements.

Generally Accepted Accounting Principles (GAAP)

The SEC has worked closely with the accounting profession to work out the detailed rules that have become known as GAAP.



Currently, the Financial Accounting Standards Board (FASB) is recognized as the body to formulate GAAP.

Generally Accepted Accounting Principles

Companies incur the cost of preparing the financial statements and bear the following economic consequences of their publication .

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- Effects on the selling price of stock.
- Effects on the amount of bonuses received by managers and other employees.
- Loss of competitive information to other companies.



INTERNATIONAL PERSPECTIVE

The International Accounting Standards Board and Global Convergence of Accounting Standards

Since 2002, there has been substantial movement toward the adoption of International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

Examples of jurisdictions requiring the use of IFRS either currently or by 2012:

- European Union
- Israel and Turkey
- Australia and New Zealand
- Brazil and Chile
- Canada and Mexico
- Hong Kong, India, Malaysia, & South Korea

In the United States, the Securities and Exchange Commission now allows foreign companies whose stock is traded in the U.S. to use IFRS and is considering requiring the use of IFRS for U.S. domestic companies.

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 board of directors to review these two safeguards.