Chapter 1

Introduction to Financial Accounting

What is Accounting?

The act of gathering and reporting the financial information of a company

Accounting is a continual process of:
- Capturing financial data
- Organizing it
- Producing financial reports

Who Uses Financial Information?

Internal Users - managers use it to plan, organize and run a business.

External Users
- Investors (Current and Potential)
- Creditors
- Others
  - Taxing authorities
  - Regulatory agencies
  - Customers
  - Labor unions
  - Economic planners

Uses of Financial Information

An organization's financial statements provides managers with information to determine present and future decisions. Such actions include:
- Granting credit
- Making investments
- Borrowing money
- Adhering to regulations
- Determining executive compensation
- Evaluating competition
- Evaluating potential litigation

Framework for Constructing Financial Statements

Organization (Entity)	**"Filter"**	**Financial Reports**
Operates in an environment that makes decisions and takes actions to make it economically better or worse	Economic Concepts Accounting Conventions Institutional Context	Balance Sheet Income Statement Cash Flow Statement

Organizational Structures

Sole Proprietorship - owned by one person

Partnership - owned by more than one person

Corporation - organized as a separate legal entity and owned by stockholders

Advantages of Each Organizational Structure

- Sole Proprietorship
  - Simple to establish
  - Owner controlled
  - Tax advantages
- Partnership
  - Same as sole proprietorship except now with additional individual(s) the organization has a broader skill base (I.e., finance and marketing)
- Corporation
  - Easier to transfer ownership or raise money
  - No personal liability

The Filters of Financial Information

- Economic Concepts – The economic principles guiding the construction of accounting reports.
- Accounting Conventions – The accounting rules that apply the economic concepts to practical situations.
- Institutional Context – The environment that shapes the consequences of adopting specific accounting conventions.

What is a Filter?

The "filters" can be viewed as the financial process the organization goes through in producing the annual report, specifically the financial statements.

Framework for Understanding Accounting Information

Economic Concepts

Financial Values
Attach to individual assets, liabilities, revenues and expense items by the accounting process

Wealth
Measured by equity at a point in time

Economic Income
Change in wealth measured by net income

Financial Statements

Balance Sheet
Assets
Liabilities
Equity

Income Statement
Revenue
Expenses
Net Income

Cash Flow Statement
Operating cash flow
Investing cash flow
Financing cash flow

Financial Statements

<u>Financial Statements</u>

- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Statement of Retained Earnings

Financial Statements

The financial statements are part of a comprehensive financial report referred to as the annual report. In addition, companies must produce another report for the SEC referred to as a 10-K.

Balance Sheet

- Shows relationship between assets liabilities and equities--on a particular date (i.e., point in time).
- Assets and liabilities and stockholders' equity must balance.

Balance Sheet

- Assets – A probable future economic benefit obtained by entering into a transaction. The resources owned by the business.
- Liabilities – The probable future sacrifice of economic benefits arising from an entity's obligation to transfer assets or provide services for a past transaction. Creditors claims on total assets (obligations or debts of the business).

Balance Sheet (continued)

- Stockholders' Equity – The difference between an entity's assets and liabilities. The owners' claim on total assets.

Income Statement

- Reports success or failure of the company's operations during the period.
- Summarizes all revenue and expenses for period--month, quarter, or year. If revenues exceed expenses, the result is a net income. If expenses exceed revenue, the result is a (net loss).

Income Statement (continued)

- Revenues – increases in net assets resulting from an entity's operation over a period of time.
- Expenses – decreases in net assets resulting from an entity's operation over a period of time.
- Net Income - the excess of revenues over expenses.

Cash Flow Statement

The Cash Flow Statement - describes the flow of cash into and out of an organization during an accounting period. These flows are classified in three categories:

Operating activities – The change in cash resulting from actions intended to generate net income.

Investing activities – The change in cash resulting from actions taken to acquire or dispose of productive company assets.

Cash Flow Statement (continued)

Financing activities – The change in cash resulting from payments to or receipts from suppliers of money to the firm (e.g., common shareholders or debt holders).

Retained Earnings Statement

- Indicates amount invested by owners, amount paid out in dividends, and amount of net income or net loss for period.
- Shows changes in retained earnings balance during period covered by statement.

Economic Concepts

Financial value – The amount of money an item would bring if sold.

- Accurate financial valuation depends on how well a market functions. In a well-functioning market, goods and services will be properly valued.

Characteristics of Well Functioning Market

Competitive – The market should reflect the true financial value. No chance for a seller to make abnormal profits.

Low transaction costs – The price paid to buy/sell the good requires few operational resources to complete the transaction.

Organized and regulated – The market in which the good is traded has standard definitions for making transactions and is open to new, efficient methods for improvement.

Economic Concepts

Wealth – The sum of the financial values of all things an organization owns.

Defined by the balance sheet (i.e., accounting identity) description:

Assets = Liabilities + Equity

Economic Concepts

Economic income – The change in an organization's wealth, excluding capital transactions with its owners.

- This measure describes an organization's success using its economic resources in a period.
- Reflected in the income statement (revenues minus expenses) for a period.
- Owner investments (issuing new shares of stock) are excluded because the increase in wealth attributable to them is NOT generated by use of the organization's resources!

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles known as GAAP are the commonly understood and accepted conventions for gathering, organizing, and reporting the financial history of an organization.

Generally Accepted Accounting Principles

Generally GAAP applies to one or more of the following three broad areas:

- Accounting Valuation
- Recognition
- Disclosure

Generally Accepted Accounting Principles

Accounting Valuation - GAAP helps to specify the value of the items reported. It provides guidance and restrictions on the accounting values used in the financial statements.

Example: Exhibit 1.4 describes how Union Plaza values plant and equipment…. "Plant and equipment are carried at cost less accumulated depreciation and amortization."

Generally Accepted Accounting Principles

Recognition – How should an item be treated in the accounting records? Should an item be treated as an asset or an expense? For instance, does an advertising campaign have future benefits?

Example: Exhibit 1.4 shows how Novell utilizes GAAP to guide their recognition…. An advertising campaign is deemed to have no future value and the cost of advertising is expensed as incurred.

Generally Accepted Accounting Principles

Disclosure – The act of providing information about the organization and construction of its accounting reports. GAAP requires the disclosure of measurement methods, assumptions, etc., that add to the information content of the annual report.

Example: Exhibit 1.5 shows that Kmart values its inventory using LIFO and discloses the value of the inventory. It also discloses what the inventory would be valued if Kmart used an alternative method (FIFO).

Factors Affecting GAAP

Market richness – Where the market for a good is a well-functioning one (i.e., it is competitive and experiences low transaction costs), GAAP will use market valuations to drive the accounting.

Factors Affecting GAAP

Complexity of the transactions – When transactions are simple (e.g., exchange of cash for a Big Mac™ , GAAP is simple. When transactions are complex (e.g., CEO compensation including a salary, bonus, pension plan and stock options), GAAP will be complex.

Factors Affecting GAAP

Form of the organization – GAAP differs depending upon the type of business entity (e.g., sole proprietor, partnership, corporation, not-for-profit, governmental).

Institutional Context

GAAP cannot dictate exact accounting treatments for all situations, since new transactions are constantly being constructed (e.g., derivatives). In addition, “human interpretation ” and organizational culture are present in any decision making process. Thus, GAAP is determined by continuing dialogue between management and the auditors and their interpretation of the rules set forth by the Securities and Exchange Commission **(SEC)** and the Financial Accounting Standards Board **(FASB)** the auditors.

Institutional Context

Securities and Exchange Commission (SEC) – The federal agency that has authority to determine GAAP for public companies whose stock is traded across state lines. In essence the SEC has acquiesced its role to to establish GAAP to the FASB.

Financial Accounting Standards Board (FASB) A private, not-for-profit organization. The FASB follows extensive due process rules and seeks public input at various points in GAAP development through “Exposure Drafts” (I.e. public comments).

Other Elements of Annual Reports

- Management Discussion and Analysis
- Notes to Financial Statements
- Auditor's Report

Management Discussion and Analysis

Covers three aspects of a company:

- liquidity - ability to pay near-term obligations
- capital resources - ability to fund operations and expansions
- results of operation - profitability and efficiency

Notes to Financial Statements

- Provide additional information not included in body of statements
- Does not have to be numeric
- Examples:
  - Description of accounting policies or explanation of uncertainties and contingencies (e.g. Exhibits 1.4 and 1.5)
  - Company statistics (e.g., market share, percentage of international sales, etc.)

Auditor's Report

- Auditor, a professional accountant who conducts an independent examination of the financial accounting data presented by a company.
- Auditor gives an unqualified opinion if the financial statements present the financial position, results of operations, and cash flows in accordance with GAAP.