            - Accounting numbers = economic truth + measurement error + incentives
        - Changes to Accounting Rules and Regulation – can change due to lobbying, political pressure, economics and technological change
- Principal Activities of a Firm
    - Sources of capital
        - Creditors
        - Owners
    - Investing Activities
        - Inventory
        - PPE
    - Operating Activities
        - Creates value
    - Value creation
        - Earnings, profits, etc.
        - How can a firm return value?
            - Dividends
            - Reinvest earnings into investing activities of the firm
            - Repay your creditors
    - FINANCIAL STATEMENTS PROVIDE INFORMATION ON EACH STEP
- Role of Financial Reporting
    - Who is interested in information about the firm?
        - S/Hs, potential S/Hs
        - Creditors
        - Suppliers
        - IRS
        - Analysts, other intermediaries
    - What types of information about the firm?
        - Performance
            - Revenue, expenses,
            - Ratios
            - Cash flow
            - Assets & liabilities
    - Supply
        - Mandatory disclosures –
            - Annual audited filings with the SEC (10Ks)
            - Quarterly unaudited SEC filings (10Qs)
        - Annual reports – sent to shareholders
- Key Players in Financial Reporting
    - Preparers
        - SEC – oversight role – delegated to FASB
        - FASB – rule-making body
        - GAAP – set of rules created by FASB
        - Directors – audit committee responsible for reporting of the firm
        - Auditors – attest to the credibility of the financial reports
        - (Sarbanes-Oxley Act (SOX) – July 30, 2002 – in response to Enron, WorldCom, etc.)
    - Users
        - Analysts/Media – third party information providers
        - Investors – large institutions and individuals
- International Financial Reporting Standards (IFRS)
    - Set of global accounting standards for the preparation of public company financial statements
    - Developed by the International Accounting Standards Board (IASB)
    - IASB is an independent accounting standard-setting body based in London
    - 12,000 companies in almost 100 nations have adopted IFRS. Many more will transition in 2011

    - FASB and IASB are working towards convergence of US GAAP and IFRS
    - SEC Roadmap
        - 2011: decision whether US Firms are required to use IFRS
        - 2014: implementation year in case of positive decision
- Financial Statements
    - Basic Financial Statements
        - Balance Sheet
        - Income Statement
        - Statement of Cash Flows
    - Supplemental information about the financial condition of a company
        - Statement of Shareholder's Equity
        - Notes to Financial Statements – footnotes are ***very*** important
        - Auditor's Report
- The Balance Sheet
    - A ***point in time snapshot*** of the investing and financial activities of the firm
    - Balance sheet identity
        - **ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY**
        - E.g.
            - Investments = financial arrangements
            - Resources = claims on resources
            - Owns = owes
- The Income Statement
    - A schedule that presents the results of operations of a firm for a ***specific period of time***.
    - **NET INCOME = REVENUES – EXPENSES**
        - Revenues – inflows of assets from selling and providing goods or services
        - Expenses – outflows of assets used in generating revenues
    - Note: *there is nothing in these definitions that refer to cash*
    - Balance Sheet vs. Income Statement
        - Income statement links the balance sheet at the beginning of the period with the balance sheet at the end of the period
        - Retained Earnings (RE) is increased each period by the net income of the period and decreased by any dividends declared during the period
            - **RE (end of period) = RE (beginning of period) + NET INCOME – DIVIDENDS**
- Statement of Cash Flows
    - A schedule that reports the details of ***where cash came from and where cash went*** for a period of time.
    - Cash flows are categorized into:
        - Operating: Providing goods and services
        - Investing: Choice of assets used to run operations
        - Financial: Raising capital to pay for assets
- Financial Statements: The Link
    - CASH + NONCASH ASSETS = LIABILITIES + CONTRIBUTED CAPITAL + RETAINED EARNINGS
- Other Financial Reporting Items
    - Statement of Shareholders' Equity – schedule that reconciles the change in S/Hs equity accounts during a period of time
    - Notes to financial statements
    - Auditors' opinion
    - Financial highlights, including trends
    - Management's Discussion and Analysis
    - CEO/CFO Certification
- CHAPTER 2
- The Balance Sheet (p59-61 – nice summary of balance sheet accounts)
- Assets

- PROBLEM 3.33 – Moulton Corporation
  - Accrual basis of accounting
  - **1)** purchased inventory on account costing $1,100,000 from various suppliers
    - Dr. Inventory 1,100,000
    - Cr. Accounts Payable 1,100,000
    - We start with a beginning balance of $343,000 for cash, etc.
  - 2) Sold merchandise to customers for 2,000,000 on account
    - Dr. Accounts Receivable 2,000,000 (this goes to balance sheet)
    - Cr. Revenue 2,000,000 (this goes to income statement)
  - 3) Cost of merchandise sold to customers totaled $1,200,000
    - Dr. Cost of Goods Sold 1,200,000
    - Cr. Inventory 1,200,000
  - 4) Collected $1,400,000 from customers for sales made previously on account
    - Dr. Cash 1,400,000
    - Cr. Accounts Receivable 1,400,000
  - 5) Paid merchandise suppliers $950,000 for purchases made previously on account
    - Cr. Cash 950,000
    - Dr. Accounts Payable 950,000
  - 6) Paid various suppliers of selling and administrative services $625,000. The firm consumed all of the benefits of these services during Year 13.
    - Cr. Cash 625,000 (balance sheet)
    - Dr. SGA (Selling, General, Administrative) Expense 625,000 (income statement)
  - 7) Firm acquired equipment costing $80k and signed a 6% note payable to the supplier. The note is due on 6/30 Year 13. Equipment has estimated useful life of 5 years. In year 13, firm repaid note payable to supplier with interest.
    - Dr. Interest Expense .06*80k*(1/2 – half a year) = $2,400
    - Cr. Cash 2400
    - Dr. Notes Payable 80,000
    - Cr. Cash 80,000
  - 8) The firm borrowed $300k from a bank. The loan bears interest at an annual rate of 8% and is due in 5 yrs. The interest is payable on January 1 of each year, beginning January 1, Year 14. On December 31, Year 13 the firm recognized interest on the loan.
    - The 300,000 was from year 12 so it should have already been reflected.
    - Dr. Interest Expense .08*300,000=24000 (on income statement)
    - Cr. Interests Payable 24,000 (liability on balance sheet)
  - 9)
    - Dr. Insurance Expense 12,000
    - Cr. Prepaid Insurance 12,000 (this reverses out the asset they had)
  - 10) Recognized depreciation expense for Year 13. In Year 12, the firm had purchased a building costing $450,000 with an expected useful life of 25 years beginning on January 1, Year 13. Also, on December 31 it acquired equipment costing $80k which has an estimated useful life of 5 years.
    - Dr. Depreciation Expense 18,000
    - Dr. Depreciation Expense 16,000
    - Cr. Accumulated Depreciation 34,000 ("contra asset" account → this goes into balance sheet and is written under the building or equipment you are depreciating. It is still on the asset side of the balance sheet because it makes sense to have them together. It works like a liability because when it increases we credit.
  - 11) 12/31 Year 13, recognized income tax expense and income tax payable for Year 13. The income tax rate is 40%. Assume that income taxes for Year 13 are payable by March 15, Year 14.
    - Sales Revenue: 2,000,000
    - Expenses
      - Cost of Goods Sold: 1,200,000
      - SGA Expense: 625,000
      - Insurance: 12,000

- Expenses are outflows of assets
- Revenues and expenses can be recognized even when cash does not chance hands. Revenue recognition criteria and expense recognition

- The Statement of Cash Flows
  - Reports changes in cash ***over a period of time*** (moving picture) – between balance sheet dates – due to operating, investing, and financing activities. People want to know the sources and uses of cash (e.g. lenders, suppliers, etc.)
- Why do we need SCF?
  - Cash is important enough to warrant reconciliation
  - Cash flow as an alternative performance measure – bankruptcy risk depends more on cash flows than on profits
  - Past cash flows serve as an aid to
    - Predict future cash flows
    - Evaluate management's effectiveness in generating and using cash
    - Assess liquidity
  - Net change in Cash = Net Cash from ***operations*** + net cash from ***financing*** + net cash from ***investing***
- Types of Activities
  - Operating Activities
    - Transactsions related to providing goods and services to customers and to paying expenses related to revenue generating activities (income statement transactions)
  - Investing Activities
  - Financing Activities
- How would you classify these? REVIEW THESE DECK 3, SLIDE 4
  - Payment of accounts payable - O,
  - Proceeds from issuing common stock - F,
  - Collection of accounts receivable - O
  - Purchase of land - I,
  - F, O, O (interest on debt is operating → parallels income statement, GAAP),, F, I, O (receipt of dividends on that stock investment → parallel income statement, GAAP, even though this seems like an investment deal), NON-CASH TRANSACTION (not in statement of cash flows)

- Note
  - Be careful about
    - payments of dividends vs. "Interest and dividends collected" (operating)
    - Interest and taxes paid (operating)
- Methods of Presenting the Statement of Cash Flows
  - Direct Method
    - Lists cash receipts and disbursements by source/use of funds
    - Always used for investing and financing activities
    - Rarely used for operating activities
  - Indirect method
    - Only used for operating activities
    - Goal is to reconcile net income with cash from operations by removing noncash items from net income
      - Net Income = Cash Revenue + NonCash Revenue – Cash Expenses – Noncash expenses
      - Net Income (cash) = Cash Revenue – Cash Expenses)
    - Almost every company uses this method for operating activities
- Statement of Cash Flows: Indirect Method
  - We'll focus on ***indirect format*** which is used by most firms
    - Involves reconciling net income to cash flow from operations by accounting for non-cash items embedded in net income
      - Net Income = Cash Revenue + Noncash Revenues – Cash Expense – NonCash expense
    - Start with Net Income

    - Contributed capital (preferred stock, common stock, add'l paid in capital), retained earnings
    - SE accounts have a credit balance: credit increases, debit decreases

- Income Statement
  - Net Income = Revenue – expenses + gains – losses
  - Accrual accounting: record revenue when earned and match expenses corresponding
  - Revenues/Gains: credit balance - debits decrease, credits increase
  - Expenses/loss: debit balance - debits increase, credits decrease
  - Temporary Accounts
    - "Close" income statement accounts to RE at end of operating period
    - $RE_{end} = RE_{beg}$ + Net Income – Dividends
    - Dividends are not declared as an expense!!
- Cash Flow Statement
  - Net change in cash = net cash from operations + net cash from investing + net cash from financing
  - Cash flow from operations: Indirect Method
    - Net income
    - \+ non-cash expenses (depreciation, bad cash expense)
    - \- gains from sale of PPE
    - \+ losses from sale of PPE
    - \+ increases in operating current liab/decreases in operating current assets
      - 32000 for insurance policy for 4 months. Cost/month $8000.
      - Close books every month. End of 1st month, no entry was recorded.
      - Correct entry
        - Debit Insurance Expense 8000
        - Debit Prepaid Insurance 24000
        - Credit Cash 32000
      - +8000 NI (NI overstated → should have had an expense of 8000)
      - +32000 overstatement in cash
    - \- decreases in operating current liab/increases in operating current assets
    - = cash flow from operations
  - Cash flow from investing (Dreict Method)
    - (Purchase/sale of PPE, land, investments)
    - Sale of PPE: net book value = acquisition cost – accum. Depreciation
    - Proceeds of sale of PPE = net book value + gain on sale
    - Cash from investing includes the *proceeds* from the sale
  - Cash flow from financing (Direct Method)
    - Issue (+)/repurchase stock (-)
    - Dividends paid (-) (dividend revenue from investments is in cash flow from operations)
    - Debt issued/retired (interest payments are in cash flow from operations)
  - Non-cash transactions are not reported in the cash flow statement
- Accounts Receivable
  - At time of sale
    - Dr AR, Cr Revenue
    - Dr bad debt expense, Cr Allowance for uncollectible accounts (contra asset)
    - Bad debt expense: estimated using percentage of sales; aging of AR
  - When specific customers default
    - Dr. Allowance for Uncollectible Accounts, Cr. AR
  - When customers pay in cash
    - Dr. Cash, Cr. AR
  - Cash flow presentation
    - Net Income +- Δ net AR

- Consolidation (in depth)
  - Take 30116 and 30117
- USING financial statements
  - Financial statement analysis
  - Valuation
    - Take 30130