Chapter 1: Financial Statements and Business Decisions

CHAPTER SUMMARY

The four basic financial statements are the balance sheet, the income statement, the statement of retained earnings, and the statement of cash flows.

The balance sheet is a statement of financial position that reports dollar amounts for the assets, liabilities, and stockholders' equity at a specific point.

The income statement is a statement of operations that reports revenues, expenses (and costs), and net income for a stated period.

The statement of retained earnings explains changes to the retained earnings balance that occurred during the reporting period.

The statement of cash flows reports inflows and outflows of cash by activity for a specific period.

The financial statements and the parties to the accounting communication process are illustrated in the context of the purchase of a personal computer disk drive manufacturer (Maxidrive Corporation) that released fraudulent financial statements. The next four chapters provide an examination of the process of preparing financial statements and their use in business decision-making. The student will learn to analyze business transactions using basic accounting equations to determine exactly how the results of future business decisions will be reflected in financial statements. Students will also begin learning how to examine financial statements of other companies to draw inferences about the quality of the decisions managers make. This is the heart of financial statement analysis. The accounting equation for the balance sheet, Assets = Liabilities + Stockholders' Equity, is the foundation for the entire accounting process and the understanding of financial statements.

CHAPTER OBJECTIVES

LO1 Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).
LO2 Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.
LO3 Distinguish the roles of managers and auditors in the accounting communication process.
LO4 Appreciate the importance of ethics, reputation, and legal liability in accounting.

CHAPTER OUTLINE

I. LO1 RECOGNIZE THE INFORMATION CONVEYED IN EACH OF THE FOUR BASIC FINANCIAL STATEMENTS AND THE WAY THAT IT IS USED BY DIFFERENT DECISION MAKERS (INVESTORS, CREDITORS, AND MANAGERS)

- **A.** Understanding the Business
  - **1.** The Players
    - **a.** Managers may or may not be owners.
    - **b.** Owners (stockholders) are investors who may also be managers. Owners invest in a company in exchange for a company's stock. They hope to gain
      1. Via periodic dividend receipts (short-term investment goals), and
      2. By eventually selling stock at a profit (long-term investment goals)
    - **c.** A company might acquire additional funds by borrowing. The goals of the lender are
      1. To earn interest on the loan.
      2. To receive debt repayment.
  - **2.** The business operations
    - **a.** To understand a company's financial statement, it is essential that one understand the company's business operations.
    - **b.** Major players in a company's operations are its
      1. Suppliers – the companies from whom goods or services are purchased, and
      2. Customers – the companies or individual to whom goods or services are sold.
  - **3.** The Accounting System
    - **a.** Collects and processes financial information about an organization, and
    - **b.** Reports that information to decision makers.
- **B.** The Four Basic Financial Statements (Balance Sheet, Income Statement, Statement of Retained Earnings, and the Cash Flow Statement.)
  - **1.** General Information – Financial Statements:
    - **a.** Summarize business activities. At a minimum, financial statements are prepared annually. Interim (monthly or quarterly) statements may also be prepared in order to assist internal and external users.
    - **b.** Must be accurate and contain adequate disclosure because decision makers rely on the statements.
  - **2.** The Balance Sheet
    - **a.** Header
      1. Name of the entity (company)
      2. Title of the statement (Balance Sheet)
      3. Specific date of the statement
      4. Unit of measure (thousands, millions of dollars, pesos, etc.)
    - **b.** Reflects the financial position of the company, and proves the accounting equation

Assets	=	Liabilities + Stockholders' Equity
Economic resources	=	Sources of financing
What you have	=	Where it came from
Assets – Liabilities	=	Stockholders' Equity
Net Assets	=	Owners' equity or residual equity

- **c.** Elements
  1. Assets
     a. Economic resources owned by the company.
     b. Expected to provide future benefits to the company.
     c. Initially measured at the total acquisition cost, and generally not adjusted on the balance sheet to show market value.
  2. Liabilities
     a. The company's debts or obligations.
  3. Stockholders' Equity
     a. Amount of financing provided by owners and the businesses earnings left in the company.
     b. Contributed Capital – amounts invested by the owners.
     c. Earned Capital (Retained Earnings) – cumulative earnings of the company that have been retained (kept by the company), i.e., not paid out in dividends.

3. The Income Statement
- **a.** Header
  1. Name of the entity (company)
  2. Title of the statement (Income Statement)
  3. Period covered by the statement, and the ending date of the period
  4. Unit of measure (thousands, millions of dollars, pesos, etc.)
- **b.** Reflects the success (profitability) of the company, and illustrates the income statement equation

  Revenues – Expenses = Net Income
- **c.** Elements
  1. Revenues
     a. Income earned from the sale of goods or services to customers.
     b. Recognized even if cash is not collected. Revenue may result in an account receivable – the promise of a customer to pay in the future – rather than receipt of cash.
     c. Recognized when the service is provided or the goods are sold.
  2. Expenses
     a. The dollar amount of resources the entity used to earn revenues during the period.
     b. Recognized even if cash is not paid. Expense may result in an account payable – the promise to pay in the future – rather than in the payment of cash.
     c. It may require the use of another resource (other than cash) such as inventory.
  3. Net income
     a. Also known as net earnings, profits, or bottom line.
     b. Net income results when revenues exceed expenses.
     c. Net loss results when expenses exceed revenues.
     d. Net income is not necessarily cash. Revenues may not be cash and expenses may yet to be paid.

4. The Statement of Retained Earnings
- **a.** Header
  1. Name of the entity (company)
  2. Title of the statement (Statement of Retained Earnings)
  3. Period covered by the statement, and the ending date of the period
  4. Unit of measure (thousands, millions of dollars, pesos, etc.)
- **b.** Net income increases the balance of Retained Earnings.
- **c.** Net loss decreases the balance of Retained Earnings
- **d.** Dividends decrease Retained Earnings
- **e.** The statement reflects all of the changes in the retained earnings of the company, and illustrates the basic retained earnings equation

  Beginning Retained Earnings + Net Income – Dividends = Ending Retained Earnings

5. The Statement of Cash Flows

a. Header

1. Name of the entity (company)
2. Title of the statement (Statement of Cash Flows)
3. Period covered by the statement, including the end date.
4. Unit of measure (thousands, millions of dollars, pesos, etc.)

b. Reflects the changes in cash during an account period.

c. Elements

1. Shows cash inflows (receipts) and cash outflows (payments).
2. Three primary categories of cash flows:
   a. Operating activities – directly related to normal business activities.
   b. Investing activities – acquisitions and sales of plant and equipment, intangible assets, and long-term investments.
   c. Financing activities – directly related to the financing of the company. Involve receipt or payment of money to investors and creditors (long-term debt)

6. Relationships Among the Statements

a. Net income from the income statement results in an increase in ending Retained Earnings (as shown on the Retained Earnings Statement).

b. Ending retained earnings from the statement of retained earnings is one of the two components of Stockholders' Equity on the Balance Sheet.

c. The change in cash is added to the beginning cash balance and equals the end of the year balance in the Cash account on the Balance Sheet

7. Notes to the Financial Statements

a. An integral part of the financial statements.

b. Provide supplemental information about the financial condition of a company.

c. Three basic types of notes:

1. Descriptions of accounting rules applied in the financial statements.
2. Details about line items on the financial statements.
3. Disclosures about items not listed on the financial statements.

C. Management's Use of Financial Statements

1. Marketing and credit managers use customers' financial statements to decide whether to extend credit.

2. Purchasing managers use suppliers' financial statements to determine if the supplier has the resources to meet the needs of the company.

3. Employee unions and human resource managers use the company's financial statements as a basis for contract negotiations over pay rates

4. Top management uses the company's financial statement to determine the amount of bonuses to employees.

II. LO2 IDENTIFY THE ROLE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) IN DETERMINING THE CONTENT OF FINANCIAL STATEMENTS

1. Decision makers need to know the measurement rules a company uses in preparing its financial statements.
2. Rules are called Generally Accepted Accounting Principles
   a. The Securities and Exchange Commission (SEC) was created in 1933 and given power to establish measurement rules.
   b. The rules that have evolved over time in response to the need for some form of regulation over the preparation of financial statements.
   c. FASB (the Financial Accounting Standards Board) was established in 1973 to accomplish the task of creating and updating the detailed financial reporting rules.
3. Since GAAP sets the measurement rules for financial reporting, ultimately the stock price for a company is affected by changes in these rules. Bonuses for managers are also impacted by such rule changes. A company's competitive edge within the industry may be impaired due to "revealing" disclosures required by GAAP.
4. International Accounting Standards Board (IASB) is an international regulatory agency. Currently there is a movement to develop International Financial Reporting Standards (IFRS).

III. LO3 DISTINGUISH THE ROLES OF MANAGERS AND AUDITORS IN THE ACCOUNTING COMMUNICATION PROCESS

1. The Report of Management
   a. Management has the primary responsibility for the information in the financial statements.
   b. Management should:
      1. Maintain a system of controls over both records and assets.
      2. Hire independent auditors (CPAs) to attest to the fairness of presentations in the financial statements.
      3. Establish an audit committee to ensure that the controls are in place and the audit is properly carried out.
      4. The committee responsibilities are often reiterated in a formal report of management or management certification in the annual report.

2. Report of Independent Accountants
   a. Audit report.
   b. Contains the opinion as to the fairness (not accuracy!) of the financial statement presentations in conformity with GAAP.
   c. CPAs examining the statements must be independent of the company being examined.

IV. LO4 APPRECIATE THE IMPORTANCE OF ETHICS, REPUTATION, AND LEGAL LIABILITY IN ACCOUNTING

1. Auditors perform their services for the protection of the public. An auditor's reputation for honesty and competency are their most important assets.
2. The American Institute of Certified Public Accountants (AICPA), a professional organization for accountants, requires adherence to a professional code of ethics. Sanctions are imposed on those members who do not comply with this code of conduct. State Boards of Accountancy have similar requirements.
3. Severe repercussions result for CPAs whose honesty and competence are tarnished by substandard performance. In addition, any resulting litigation for substandard work may impose monetary penalties and incarceration.
4. Fraud involving collusion may be difficult to detect. However, CPAs must exercise due diligence in uncovering fraudulent activities of managers.

V. EPILOGUE

1. Fraudulent financial statements are not the norm, but they do exist. The recent Enron and WorldCom debacles are examples.
2. It is incumbent on the accounting profession to continue to maintain its high standards to minimize fraud.
3. Maxidrive is a fictitious company. It is based on the “real world” fraud of MiniScribe.

VI. CHAPTER SUPPLEMENTS

A. Types of Business Entities

1. Sole Proprietorship

- **a.** An unincorporated business owned by one person. Advantage: easy to form. The owner is often directly involved in the management of the company.
- **b.** A sole proprietorship is a separate accounting entity from its owner, but not a separate legal entity. As a result, the owner is personally liable for the company’s debts.

2. Partnership

- **a.** An unincorporated entity with more than one owner. Organized with a profit motive. Owners allocate profits and losses among themselves per the partnership agreement.
- **b.** A partnership is a separate accounting entity from its owners, but not a separate legal entity; therefore, the owners are personally liable for the partnership’s debts.
- **c.** Should include the preparation of a partnership agreement (contract) stating the rights and responsibilities of the partners.

3. Corporation

- **a.** An entity incorporated under state laws. Corporation must file a charter and bylaws with the state where incorporated.
- **b.** Owners are stockholders (shareholders) who own shares of capital stock in the company.
- **c.** The corporation is a separate legal entity from its owners.
- **d.** Advantages:
  1. Limited liability for owners. Generally, the most owners can lose is their investment.
  2. Continuity of life.
  3. Ease in transferring ownership (stock).
  4. Variety of means to raise large amounts of money.
- **e.** The Board of Directors is elected by stockholders to make decisions that affect the company.
- **f.** Double taxation is a disadvantage.

B. Employment in the Accounting Profession Today

1. The accounting profession:

- **a.** Subject to professional competence requirements.
- **b.** Dedicated to service to the public.
- **c.** Requires a high level of academic study.
- **d.** Rests on a common body of knowledge.

2. Certification requirements for a CPA vary among states but generally require:

- **a.** A college degree.
- **b.** A minimum number of accounting courses.
- **c.** Professional experience (1 to 5 years).
- **d.** Passage of the CPA exam.

3. Other professional certifications for accountants:

- **a.** Certified Management Accountant (CMA)
- **b.** Certified Internal Auditor (CIA)

4. Employment opportunities for accountants

a. Public Accounting Practices

1. Audit or Assurance Services: The most important of these services is financial statement auditing. The purpose of the attest function is to lend credibility to the financial reports and to insure a fair presentation of a company's financial statements in conformity with GAAP.
2. Management Consulting Services: Provide assistance to a company in the areas of accounting services, computer design and installation of accounting processing and profit planning and budgeting systems, financial advice, internal control assistance, etc.
3. Tax Services: CPAs prepare income tax returns and provide tax-planning assistance.

b. Private Accounting Practices: Accountants are employed by for-profit and not-for-profit organizations. The duties include general accounting, cost accounting, budgeting, internal auditing, computer data processing, tax planning, etc.