Accounting Fundamentals Lesson 1

1. The Financial Statements

Financial statements present the results of operations and the financial position of the company.

Publicly traded companies commonly prepare four statements:

1. Balance sheet,
2. Income statement,
3. Statement of cash flows and
4. Statement of retained earnings (statement of owner's equity.)

Balance Sheet (Statement of Financial Position)
The balance sheet tells you whether the company can pay its bills on time, its financial flexibility to acquire capital and its ability to distribute cash in the form of dividends to the company's owners.

The top of the balance sheet has three items:
1. The legal name of the entity;
2. The title (i.e., balance sheet or statement of financial position)
3. The date of the statement.

The balance sheet is always for a specific point in time: instead of just a date of, say, December 31, 2014

The balance sheet itself presents the company's assets, liabilities and shareholders' equity.

- Assets are items that provide probable future economic benefits
- Liabilities are obligations of the firm that will be settled by using assets
- Equity (variously called stockholders equity, shareowners equity or Owners equity) is the residual interest that remains after you subtract liabilities from assets

Hence the key accounting equation:

Assets = Liabilities + Owners Equity or A=L+OE

Accounting Equation Example:

Assets	=	Liabilites	+	Stockholders' (or Owner's) Equity
\$20,000	=	\$0	+	\$20,000

The assets in a balance sheet are listed on the left; they ordinarily have debit balances.

Liabilities and owners equity are on the right, and typically have credit balances. These three main categories are separated and further divided to show important relationships and subtotals.

Assets are broken down into current and noncurrent (or long-term). Assets are listed from top to bottom in order of decreasing liquidity, i.e., how fast they can be converted to cash.

Current assets are cash and other assets that are expected to be used during the normal operating cycle of the business, usually one year.

Current assets typically include:
1. Cash and cash equivalents
2. Short-term investments
3. Accounts receivables
4. Inventory
5. Prepaid expenses

Non-current assets will not be realized in full within one year. They typically include:
1. Long-term investments like property, plant and equipment
2. Intangible assets and other assets.

Liabilities are listed in order of expected payment.

Obligations expected to be satisfied within one year are current liabilities. They include:

1. Accounts payable
2. Notes payable
3. Advances and deposits

4. Current portion of long-term debt
5. Accrued expenses

Noncurrent liabilities include: bonds payable and other forms of long-term capital.

The structure of the owners' equity section depends on whether the entity is an individual, a partnership or a corporation. Assuming it's a corporation, the section will include capital stock, additional paid-in capital, retained earnings, accumulated other comprehensive income and treasury stock.

Balance sheet data can be used to compute key indicators that reveal the company's financial structure and its ability to meet its obligations. These include working capital, current ratio, quick ratio, debt-equity ratio and debt-to-capital ratio.

Mary's Design Service
Balance Sheet
September 30, 2013

ASSETS		LIABILITIES	
Cash	$ 300	Notes payable	$ 1,000
Accounts receivable	1,000	Accounts payable	325
Supplies	160	Wages payable	75
Prepaid insurance	90	Unearned revenues	100
Land	10,000	Total liabilities	1,500
		OWNER'S EQUITY	
		M.Smith, Capital	10,050
Total assets	$ 11,550	Total liabilities & owner's equity	$ 11,550

Income Statement

Net Income = Revenues - Expenses

The income statement tells you both the earnings and profitability of a business.

The income statement is always for a specific period of time, such as a month, a quarter or a year.
Because a company's operations are ongoing, from a business perspective these cut-offs are arbitrary, and they result in many of the problems in income measurement.

Nevertheless, periodic income statements are essential, because they allow users to compare results for the company over time and to the results of other firms for the same period.

In essence, a $100 sale increases both assets and owners' equity:

	Debit	**Credit**
Asset (Cash, A/R)	100	
Owners Equity (Sales)		100

The recording of $100 in expense for cost of goods sold (CGS), supplies, depreciation, insurance, etc. decreases assets and owners equity:

	Debit	**Credit**
Owners Equity (CGS, supplies, etc.)	100	
Assets (Cash, Inventory, Equipment)		100

Of course, accounting is vastly more complicated than this representation, and debits and credits are recorded under many rules and treatments for many accounts.

Ultimately, if all the credits to OE during a period are greater than the debits, you have net income and OE (in the form of retained earnings) increases; if there are more debits than credits, you have a net loss and OE decreases.

The format of the income statement has been determined by a series of accounting pronouncements; some of these are decades old, others released in the past few years. Like the balance sheet, the income statement is broken into several parts:

- Income from continuing operations
- Results from discontinued operations (if any)
- Extraordinary items (if any)

- Cumulative effect of a change in accounting principle (if any)
- Net income
- Other comprehensive income
- Earnings per share information

Income from continuing operations is the heart of the income statement. It includes sales (or revenue), cost of goods sold, operating expenses, gains and losses, other revenue and expense items that are unusual or infrequent but not both, and income tax expense.

This section of the income statement is used to compute the key profitability ratios of gross margin, operating margin, and pretax margin that help readers assess the ability of the company to generate income from its activities.

Results from continuing operations are of primary interest because they are ongoing and can be predictive of future earnings; investors put less weight on discontinued operations (which are about the past) and extraordinary items (unusual and infrequent, thus unlikely to reoccur). Companies thus have an incentive to push negative items that belong in continuing operations into other categories.

Net income is the "bottom line"

Mary's Design Service
Income Statement
For the Nine Months Ending September 30, 2013

Revenues and gains	
Revenues	$ 10,000
Gain on sale of land	5,000
Total revenues and gains	15,000
Expenses and losses	
Expenses	8,000
Loss on sale of computer	350
Total expenses and losses	8,350
Net income	$ 6,650

Statement of Retained Earnings

A separate Statement of Changes in Stockholders' (or Owners) Equity is also prepared that reconciles the various components of OE on the balance sheet for the start of the period with the same items at the end of the period. The statement recognizes the primacy of OE for investors and other readers of financial statements.

The statement of retained earnings explains the changes in retained earnings. Retained earnings appear on the balance sheet and mostly influenced by income and dividends. The statement of retained earnings uses information from the income statement and provides information to the balance sheet.

Dividends - a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders.

Sole-Proprietorship
Ending Equity = Beginning Equity + Investments – Withdrawals + Income

Corporation
+Premium on Common Stock (issued at par value)
+Preferred Stock (Recorded at par value)
+Premium on Preferred stock (Issue price minus par value)
+Retained Earnings

= Stockholders' Equity

QUARTZ CORPORATION
Statement of Retained Earnings
For the Year Ending December 31, 20X9

Retained earnings - January 1, 20X9	$400,000
Plus: Net income	115,000
	$515,000
Less: Dividends	35,000
Retained earnings - December 31, 20X9	$480,000

Statement of Cash Flows

The cash flow statement tells you the sources and uses of cash during the period. It also provides information about the company's investing and financing activities during the period.

Accountants seek to record economic events regardless of when cash is actually received or used, with a view toward matching the revenues for the period with the costs incurred to generate them. In addition to financial statements that include accounting entries that are theoretical in nature, users are vitally interested in the actual cash received and disbursed during the period.

In fact, depending on the company and the user, the cash flow statement may be of prime importance. Like the income statement, the statement of cash flows is always for some period of time.

The statement of cash flows breaks the sources and uses of cash into the following categories:

- Operating Activities
- Investing Activities
- Financing Activities

The format of a cash flow statement is typically:

- Net cash flow from operating activities (sales, inventories, rent, insurance)
- Cash flow from investing activities (buying and selling equipment)
- Cash flow from financing activities (selling common stock, paying off long-term debt)
- Exchange rate impact
- Net increase (decrease) in cash
- Cash and equivalents at start of period
- Cash and equivalent at end of period
- Schedule of non-cash financing and investing activities (conversion of bonds)

The information used to construct the statement of cash flows comes from the beginning and ending balance sheets for the period and from the income statement for the period.

1.1 Accounting Terms

Accounts payable: Liability

Accounts receivable: Asset

Common stock: Owners Equity

Long-term debt: Liability

Supplies: Asset

Merchandise inventory: Asset

Retained earnings: Owners Equity

Notes payable: Liability

Land: Asset

Accrued expenses payable: Liability

Prepaid expenses: Asset

Equipment: Asset

Double-Entry Bookkeeping

The economic events of a business are recorded as transactions and applied to the accounts (hence accounting).

For example, the cash account tracks the amount of cash on hand; the sales account records sales made. The chart of accounts of even small companies has hundreds of accounts; large companies have thousands.

The transactions are posted in journals, which were (and for some small organizations, still are) actual books; nowadays, of course, the journals are typically part of the accounting software. Each transaction includes the date, the amount and a description.

For example, On April 19, a saleswoman for an antiques company visits you, and you buy a lamp for your office for $250.

A journal entry to record the transaction as a debit to the Office Furniture account and a $250 credit to Accounts Payable could be written as follows:

Date	Account	Debit	Credit
April 19	Office Furniture	250	
	Accounts Payable		250

Each accounting transaction affects a minimum of two accounts, and there must be at least one debit and one credit.

We're accustomed to thinking of a "credit" as something "good" - our account is credited when we get a refund; you get "extra credit" for being polite. Meanwhile, a "debit" is something negative - a debit reduces our bank balance; it's used to mean shortcoming or disadvantage.

In accounting, debit means one thing: left-hand side. Credit means one thing: right-hand side. When you receive cash - a "good" thing - you increase the Cash account by debiting it.

When you use cash - a "bad" thing - you decrease Cash by crediting it.

On the other hand, when you make a sale, which is nice, you credit the Sales account; when someone returns what you sold, which is not nice, you debit sales.

"Good" and "bad" have nothing to do with debit and credit.

Debit = Left; Credit = Right. That's it. Period.

1.2 Accounting Fields

Accounting can be divided into several areas of activity. These can certainly overlap and they are often closely intertwined. But it's still useful to distinguish them because accounting professionals tend to organize themselves around these various specialties.

Financial Accounting

Financial accounting is the periodic reporting of a company's financial position and the results of operations to external parties through financial statements. Financial statements are relied upon by suppliers of capital (shareholders, bondholders, banks, customers, suppliers, government agencies and policymakers).

There's little use in issuing financial statements if each company makes up its own rules about what and how to report.

When preparing statements, American companies use U.S. Generally Accepted Accounting Principles, or GAAP.

Management Accounting

Management accounting emphasizes the preparation and analysis of accounting information within the organization.

Management Accounting includes:
1. Designing and evaluating business processes,
2. Budgeting and forecasting,
3. Implementing and monitoring internal controls,
4. Analyzing, synthesizing and aggregating information to help drive economic value.

A primary concern of management accounting is the allocation of costs; how to measure cost is critical, difficult and controversial.

Auditing

Auditing is the examination and verification of company accounts and the firm's system of internal control.

There is both external and internal auditing.

The external auditor's primary obligation is to users of financial statements outside the organization.

The internal auditor's primary responsibility is to company management.

External auditors are independent firms that inspect the accounts of an entity and render an opinion on whether its statements conform to GAAP and present fairly the financial position of the company and the results of operations.

In the U.S., four huge firms known as the Big Four dominate the auditing of large corporations and institutions. PricewaterhouseCoopers, Deloitte Touche Tomatsu, Ernst & Young, and KPMG

The internal auditor evaluates the risks the organization faces with respect to governance, operations and information systems.

Its mandate is to ensure:

1. Effective and efficient operations;
2. The reliability and integrity of financial and operational information;
3. Safeguarding of assets
4. Compliance with laws, regulations and contracts.

Tax Accounting

Tax accounting is based on laws enacted through a legislative process.

In the U.S., tax accounting involves the application of Internal Revenue Service rules at the Federal level and state and city law for the payment of taxes at the local level.

Tax accountants help entities minimize their tax payments. Within the corporation, they will also assist financial accountants with determining the accounting for income taxes for financial reporting purposes.

Fund Accounting

Fund accounting is used for nonprofit entities, including governments and not-for-profit corporations.

Rather than seek to make a profit, governments and nonprofits deploy resources to achieve objectives.

It is standard practice to distinguish between a general fund and special purpose funds. The general fund is used for day-to-day operations, like paying employees or buying supplies. Special funds are established for specific activities, like building a new wing of a hospital.

Segregating resources this way helps the nonprofit maintain control of its resources and measure its success in achieving its various missions.

Forensic Accounting

Forensic accounting is the use of accounting in legal matters, including litigation support, investigation and dispute resolution.

Forensic accounting engagements: bankruptcy, matrimonial divorce, falsifications and manipulations of accounts or inventories, etc.

Forensic accountants investigate and analyze financial evidence, give expert testimony in court, and quantify damages.