Accounting is the language of business. Every transaction that business undertakes has to be translated into an accounting entry. Almost every event has to be an entry as well. Even a hurricane requires an insurance to make entries for losses. Make an accounting provision to protect in the event that a contract may lose money. Say we estimate that 15% of receivables will go bad, must make an accounting entry. All these things must result in a journal (accounting) entry.

This course is about how we record and report accounting information for external purposes.

Financial Accounting has as it's objective external financial reporting. At some point the activities of the organization, all the finances the organization has been responsible for, have to be summarized in some fashion and reported external to the organization. Perhaps to stockholders, financers, maybe customers (may be considering a purchase contingent on the financial health of the company, buying an insurance policy for instance), creditors, stakeholders. Regulators require that these reports are made. Who do we not want to see our financial reports? Competitors! Although the competitors do get their hands on other companies reports and analysis them for strengths and weaknesses.

All companies listed on the stock exchange have to prepare and submit financial reports. What standards are required to be followed in the preparation of these reports? GENERALLY ACCPETED ACCOUNTING PRINCIPALS (GAAP) which are propagated by FASB (FINANCIAL ACCOUNTING STANDARDS BOARD) and SEC (SECURITY EXCHANGE COMMISION) and the likes. Also the AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTS which also puts out probelgations on ongoing cases to which there are no other sources of judgment (?).

Financial Accounting is a discipline which is in accordance with the GAAP because we need standards in order to compare different companies. For instance, a big problem in recent years has been companies recording sales which they have not made yet. This is not in accordance with the GAAP. We must understand what GAPP is/are so that we can put these standards into our practice.

We are concentrating on External Financial Reporting. In External Reporting we are only publishing what the regulators tell us we must. But there are other accountants as well. Cannot use external reports to do internal planning, there is not enough information. This is because we do not want to give our competitors access to certain information. Don't want to give out detailed information on our customers, research projects, product line sales, profitability, strategic thrust for next 5 years, but this information is needed for proper management. This type of accounting is called **Managerial Accounting** or **Cost & Profitability Analysis** (this is more analytical then accounting). In accounting we are accounting for transactions and summarizing them. But management takes accounting information and utilizes it to make Cost and Profitability Analysis decisions. This is the subject of the next course, ACCT323. After the numbers are compiled how do we use the information to make profitable decisions.

There are also **Tax Accounts** which comprises another set of books. Several sets of books, make the info to the stockholders look as rosy as possible and the info to the tax authority look as gloomy as possible. That is done and is permitted. For example, can use straight line depreciation for financial reporting purposes and another more accelerated method for tax purposes.

There are also **Government Accountants**. Must use this is doing work for the government on a cost plus basis. The rules for this type of accounting are made by the Government Accounting Standards Board (GASB).

All these types of accounting are one reason why accounting is called the bread and butter profession.

In the process of external financial reporting there are 3 basic financial statements which we will focus on in this course. These are the 3 required financial statements in any financial report.

1) Balance Sheet
2) Income Statement
3) Cash Flow Statement

In a typical financial report you will also see the Auditors Opinion stating weather he thinks these financial statements are presented fairly in accordance with GAAP of the United States. Will also see a component called Notes to the Financial Statement. Which further explain in more detail items which might be presented on the financial statement.

For instance, the auditor is stating to what level of assurance he is giving you.

<u>Balance Sheet</u> (pg. 9)

EXHIBIT 1.1 WAL-MART STORES, INC.
Comparative Balance Sheet (all dollar amounts in millions)

		January 31 Year 9	January 31 Year 10
REPORT OF AMOUNTS AT A MOMENT IN TIME			
INVESTING	**ASSETS**		
	Cash	$ 1,856	$ 2,054
	Accounts Receivable	1,341	1,768
	Inventories	19,793	21,442
	Prepayments	1,366	1,291
ASSETS CONSUMED OR TURNED INTO CASH WITHIN ONE YEAR	Total Current Assets	$24,356	$26,555
	Property, Plant and Equipment (net)	39,001	45,417
	Other Assets	10,024	10,641
RESOURCES	Total Assets	$73,381	$82,613
FINANCING	**LIABILITIES AND SHAREHOLDERS' EQUITY**		
	Accounts Payable	$13,105	$15,092
	Notes Payable	3,323	2,286
	Current Portion of Long-term Debt	1,085	1,375
	Other Current Liabilities	6,290	7,196
LIABILITIES REQUIRING PAYMENT WITHIN ONE YEAR	Total Current Liabilities	$23,803	$25,949
	Long-term Debt	20,706	23,138
	Other Noncurrent Liabilities	3,038	2,183
	Total Liabilities	$47,547	$51,270
	Common Stock	$ 1,160	$ 1,858
	Retained Earnings	24,674	29,485
	Total Shareholders' Equity	$25,834	$31,343
SOURCES OF, AND CLAIMS ON, RESOURCES	Total Liabilities and Shareholders' Equity	$73,381	$82,613

Two major sections: Assets and Liabilities and Shareholders Equity. These two sections agree, reach the same sum, they **Balance**! Notice the amounts are in millions, always be aware of this. (these types of errors are marked on exam).

Assets are the things owned by the organization that have future benefit (have a monetary value, not people). Liability and Shareholders Equity are how the company financed those things.

Example, buy a house:

Price	$100,000 – Asset
Down	$10,000 – Equity
Mortgage	$90,000 – Liability

You can see that equity and liability are how we financed the $100,000 asset.
Balance Sheet shows us all the things we purchased which have future value and then shows how the organization financed those assets.

What kinds of things are assets? Assets are broken into two parts, **Current Assets** and **Noncurrent Assets**. What things are there? What has a future value? Cash, Accounts

Receivable, Inventories (in stock, for sale), Prepayments (insurance, rent, until they expire they have future value), Property, Plant & Equipment, Other Assets.

Accounts Receivable: have provided the good or service but not collected for it yet.

Liabilities: the last name of most liabilities will be "payable" or "liabilities" or something along these lines.

Current Portion of Long Term Debt: the portion which will become due during the accounting period, will come due within the next year.

Initially this class will not focus on the breakdown between Current and Noncurrent but we should be aware of what they are. We will be doing Unclassified Balance Sheets. We will not be breaking down, for our purposes it is more important to recognize the difference between a balance sheet, an income statement, and a cash flow statement.

Long Term Debt: portion beyond one year.

Other Noncurrent Liabilities: could be a lot of things, long term reserves for instance.

Common Stock: stock issued by the organization and outstanding, purchases and not retired.

Retained Earnings: most interesting. The most complicated part of the balance sheet. Represents all the income which has been retained by the organization over its entire life. They may have declared a dividend but not in the full amount of earnings. The remaining amount is considered Retained Earnings. These earnings are summed from year to year, the sum of the earnings which were kept by the business, not paid out in dividend. Note that Reatined Earnings should be used to improve the standing of the company, invest, etc.

ASSETS = LIABILITIES + EQUITY

EQUITY = COMMON STOCK + RETAINED EARNINGS +
ADDITIONAL PAID IN STOCK

RETAINED EARNINGS (at end balance) = OPENING BALANCE + INCOME PER PERIOD
– DIVIDENDS DECLARED AND PAID

INCOME FOR THE PERIOD = SALES, EXPENSES, NET INCOME

Example:

$60,000	first year
+ $200,000	second year
- $100,000	Declared Dividend
= $160,000	End Balance Retained Earnings

<u>Income Statement</u> (pg. 13)

EXHIBIT 1.2 WAL-MART STORES, INC.
Comparative Income Statement (amounts in millions)

REPORT OF AMOUNTS FOR A PERIOD OF TIME

INFLOWS OF NET ASSETS FROM SALES OF GOODS AND SERVICES

OUTFLOWS OF NET ASSETS REQUIRED TO GENERATE REVENUES

NET INCOME: REVENUES − EXPENSES

	Year Ended January 31		
	Year 8	Year 9	Year 10
Revenues:			
Sales Revenue	$137,634	$165,013	$191,329
Other Revenues	1,574	1,796	1,966
Total Revenues	$139,208	$166,809	$193,295
Expenses:			
Cost of Goods Sold	$108,725	$129,664	$150,255
Marketing and Administrative	22,516	27,210	31,679
Interest	797	1,022	1,374
Income Taxes	2,740	3,338	3,692
Total Expenses	$134,778	$161,234	$187,000
Net Income	$ 4,430	$ 5,575	$ 6,295

The Income Statement is different from the balance sheet. The balance sheet shows the status of the listed accounts **<u>on a particular day</u>**. The Income Statement represents all of the revenue you've earned and all the expenses you've incurred earning that revenue. The difference between the two, revenue and expenses, represents your Net Income for the period.

The Balance Sheet looks at the status of the listed accounts on the end day of the accounting period. Then it rolls on to another accounting period. The Income Statement goes for only a 12 month period maximum. The Income Statement closes every 12 months. It actually states YEAR ENDED. Then it is CLOSED OUT into RETAINED EARNINGS which adds it into the EQUITY of the company and subtracts DIVIDENTS DECLARED AND PAID and the result shows what the increase in EQUITY is for the retention of earnings net of dividends for that period <u>and that's what makes the BALANCE SHEET balance</u>.

That is why we depict Retained Earnings in this way so that we know that that income gets closed out into retained earnings. THAT IS THE ONLY WAY THAT WE CAN BALANCE A BALANCE SHEET, BY CLOSING OUT THE NET INCOME INTO RETAINED EARNINGS.

The **Income Statement** shows us items of income and items of expense. It shows us how well we've done for the year, how much money we've made and spent for the year, did we make a profit, a loss. That's what the **Income Statement** shows us. Items of income and items of expense.

The Balance sheet is different. The Balance Sheet shows us at a point in time what we have left at the end of the year, how much cash do we have left. How much in receivables do we have to collect, what's left in inventory. Who do we owe.

Note the difference between these.

EXAM

WE WILL HAVE TO KNOW WHAT THINGS GO ON THE BALANCE SHEET AND WHAT THINGS GO ON THE INCOME STATEMENT IF WE ARE GOING TO BE EFFECTIVE IN PREPARING FINANCIAL STATEMENTS.

Stock can have what is known as a PAR value. A PAR value is the stated legal minimum that a stock can be sold for. Some states mandate a minimum PAR value and other states do not. A company can decide if it wants PAR value for it's stock or if it does not want PAR value for it's stock. If a company does declare a PAR value, the PAR value amount is what is logged into the **Common Stock** entry of the balance sheet.

If the stock is sold **at** PAR value then that entire amount is recorded in Common Stock and the entry is complete. The stock cannot be sold below PAR value. If the stock is sold ABOVE PAR VALUE then any capital paid in excess of PAR value is logged under Additional Paid In Capital.

Additional Paid in Capital = Stock Sale Price - PAR Value.

Additional Paid in Capital is an additional capital account that records how much they initially received at the point of issue of their common stock.

If the stock has NO PAR VALUE it the entire sale price is logged under common stock.

Statement of Cash Flows (pg 15)

EXHIBIT 1.3

WAL-MART STORES, INC.
Comparative Statement of Cash Flows (all dollar amounts in millions)

		Year Ended January 31		
REPORT OF AMOUNTS FOR A PERIOD OF TIME		Year 8	Year 9	Year 10
	Operations			
	Net Income	$ 4,430	$ 5,575	$ 6,295
	Depreciation	1,872	2,375	2,868
	(Increase) in Accounts Receivable	(148)	(255)	(427)
	(Increase) in Inventories	(379)	(2,088)	(1,649)
	(Increase) in Prepayments	(627)	(307)	75
	Increase in Accounts Payable	1,108	1,849	1,987
	Increase in Other Current Liabilities	1,324	1,045	906
NET CASH INFLOW FROM SALES TO CUSTOMERS	Cash Flow from Operations	$ 7,580	$ 8,194	$10,055
	Investing			
	Acquisition of Property, Plant, and Equipment	$(3,734)	$ (6,183)	$ (9,284)
	Other	(684)	(10,663)	(617)
NET CASH OUTFLOW FROM INVESTING IN RETAILING CAPACITY	Cash Flow from Investing	$(4,418)	$(16,846)	$ (9,901)
	Financing			
	Increase (Decrease) in Short-term Borrowing	$ 0	$ 4,316	$ (1,037)
	Increase in Long-term Borrowing	536	6,000	4,414
	Increase in Common Stock	0	0	891
	Decrease in Long-term Borrowing	(1,176)	(996)	(1,692)
	Acquisition of Common Stock	(1,202)	(101)	(193)
	Dividends	(693)	(890)	(1,484)
	Other	(195)	300	(855)
NET CASH FLOW FROM SHORT- AND LONG-TERM CREDITORS AND OWNERS	Cash Flow from Financing	$(2,730)	$ 8,629	$ 44
CHANGE IN CASH = NET CASH FLOW FROM OPERATING, INVESTING, AND FINANCING	Change in Cash	$ 432	$ (23)	$ 198
AMOUNTS FOR CASH ON THE BALANCE SHEET	Cash, Beginning of Year	1,447	1,879	1,856
	Cash, End of Year	$ 1,879	$ 1,856	$ 2,054

Cash Flow Statement: tells us from year to year how our cash changed and why. That is the sole purpose of the cash flow statement.

Consider the entry for CASH in the Balance Sheet above, year 9 is $1,856,000. This value matches the year 9 Cash, End of Year entry in the Cash Flow Statement above and the entry above it is the cash at the beginning of year 8 (column to the left). They are explaining that cash changed by -$23,000,000 and why it changed. They are reconciling all the transactions that went through the cash account. We understand that the income statement was done on an accrual basis but not every transaction on the income statement was collected in cash. Sold some stuff which we have not been paid for yet. Bought stuff from vendors we have not paid for yet, employees waiting for their pay, etc. All of these things are important to include on the Income

Statement because we incurred those expenses or we earned those sales but we might not have collected them in cash.

This schedule tries to reconcile the changes in cash for the period. It is divided into 3 sections.

1) How much cash flow came out of our **Operating Activities**. That shows up in the operations section.
2) How much cash came out of, or did we spend, on our **Investment Activities**?
3) What were our **Financing Activities**? How did we fair in our barrowing, in our lending, in our common stock, in our dividends, etc.

Example:
Reading year 9, from our operating activities, which is principally our income statement, we generated cash of $8,194,000. But keep in mind this entry could have come because we didn't pay our payables.

Notice there were investing outflows of $16 billion, and $10 billion was described as 'other' (these were all out of cash). In financing they barrowed a lot of money which helped them finance those acquisitions to the tune of $8.6 billion.

Generated 8 in operational cash, barrowed another 8 billion, and spent it on investing. Cash basically broke even. This, when added to the previous year cash balance gives them the end of year balance.

This schedule shows us the changes in cash flow which might not show up on the balance sheet.

Remember: an **UNCLASSIFIED** balance sheet <u>**does not**</u> break out current and noncurrent while a **CLASSIFIED** balance sheet does. We will deal mostly with Unclassified in this class. <u>An unclassified balance sheet is listed in order of liquidity</u>.

FORM HEADINGS

Financial forms MUST have the following header items:

1) Company Name
2) Date Covered
3) Name of the Statement
4) Unit of Measure

Also, the most liquid assets are listed first. Cash is the most liquid asset.

Three possibilities for ordering EXPENSES:

1) Operational then Non Operational then Income Tax
2) Larger vs Smaller
3) Alphabetical

EXAM

Single Step vs. Multistep Income Statements
Single Step: this format derives net income in a single subtraction of total expenses from total revenues. Categorizes revenue and expenses.
Multistep: this format presents several subtotals before reporting the amount of net income. Often used by manufacturing and retail.

NET: the term net refers to a value which includes the effect of accumulated depreciation.

Class 1 Homework: pg 40 pb 30.

Exercise, page 18.

(Note that Goodwill from Corporate Acquisitions and Computer Software Development Costs are entered as Intangible Long Term Assets.)

Do Income Statement first then Balance Sheet (I think you'll need some of the entries on the income statement to fill in the balance sheet). Create an UNCLASSIFIED balance sheet, no breakout of current and noncurrent.

(below)

XYZ Company
Income Statement (amounts in thousands)

	December 31 Year 4
Revenues:	
Sales Revenue	$6,293,680
Interest	28,929
Total Revenue	**$6,322,609**
Expenses:	
Cost of Goods Sold	$5,217,239
Sales, General & Administrative	786,168
Income Taxes	93,823
Interest Expense	1,740
Total Expenses	$6,098,970
Net Income	**$223,639**

XYZ Company
Balance Sheet (amounts in thousands)

	December 31 Year 4
Assets	
Cash	$593,601
Accounts Receivable	510,679
Inventories	249,224
Property, Plant & Equipment (net)	315,038
Land	$21,431
Short Term Cash Inventory	38,648
Goodwill	118,121
Other Current	152,531
Computer Software Development	39,998
Total Assets	$2,039,271
Liabilities & Shareholders Equity	
Accounts Payable	$488,717
Notes Payable	13,969
Royalities Payable	159,418
Other Current	315,292
Other Noncurrent Liabilities	$98,081
Taxes Payable	26,510
Long Term Debt	7,240
Total Liabilities	$1,109,227
Common Stock	$295,535
Retained Earnings	634,509
Total Shareholders Equity	$930,044
Total Liabilities & Shareholders Equity	**$2,039,271**

BALANCE