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Università Cattaneo

Management & Principles of Accounting
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Introduction to financial accounting
Basic concepts and tools

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Source: Kimmel/Weygandt/Kieso "Financial Accounting"
Seventh Edition Wiley

After this lesson you should be able to:

1. Explain what is accounting
2. Identify the users and uses of accounting information.
3. Describe the content and purpose of each of the financial statements (Balance Sheet & Income Statement, Statement of Cash Flows)
4. Explain the relationship between Balance Sheet and Income Statement

If I'm not going to be an accountant why do I need to know about accounting???

KNOWING THE NUMBERS

- To be good at your business you have to know numbers

- In business, accounting and financial statements are the means for communicating the numbers

- If you don't know to read financial statements, you can't really do your business

What is Accounting?

- **Accounting** is the information system that identifies, records and communicates the economic events of an organization to interested users for decision-making.

- **Users** of accounting information can be divided broadly into two groups: internal and external users.

Accounting is useful for:

Internal users

Internal users of accounting information are managers who plan, organize and run a business. These include **marketing managers, production supervisors, finance directors, and company officers.**

Marketing

What price should Apple charge for an iPod to maximize the company's net income?

Management

Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

Finance

Is cash sufficient to pay dividends to Microsoft stockholders?

Accounting is useful for:

- **External users**

  There are several types of **external users** of accounting information.

  Investors (owners) use accounting information to make decision to buy, hold, or sell stocks.

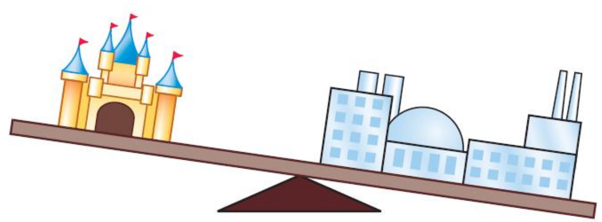
  Creditors such as suppliers and bankers use accounting information to evaluate the risk of selling on credit or lending money.

Creditors

Will United Airlines be able to pay its debts as they come due?

Investors

Is General Electric earning satisfactory income?



Investors

How does Disney compare in size and profitability with Time Warner?

Accounting is useful for

- **Individuals**
- **Managers**
- **Investors and creditors**
- **Government Regulatory Agencies** (to evaluate if the company is operating within prescribed rules)
- **Taxing Authorities** (to evaluate if the company complies with the tax laws)
- **Employees** (to evaluate the ability to pay salaries and wages)

Financial vs. Management accounting

- **Management accounting** provides mostly confidential information for internal decision makers (e.g. top executives)

- **Financial accounting** provides information mostly to external users

- Its primary objective is to provide information useful to make investment and decisions

- There are very strong links between financial and management accounting

- In order to understand the differences between financial and management accounting we can consider a firm as an Input-Output system

Financial vs. Management accounting

- A firm needs economic resources (labor force, buildings, cash,…). These are the inputs of its activity

- The inputs acquired are then processed or transformed inside the firm

- The firm's products (goods or services) represent the outputs of its activity

Financial vs. Management accounting

- When the firm buys its inputs and when it sells its products it performs **external transactions**
- When the firm transforms its inputs into outputs it performs **internal processes**
- While **external transactions** are the object of **financial accounting**, what happens inside the firm (that is its internal processes) is the main object of management accounting
- So, we'll focus our attention on external transactions while dealing with financial accounting
- You will learn about management accounting in a different course

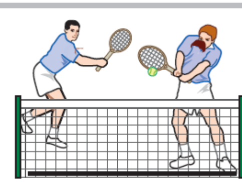
Forms of organizations

- There are three main forms of organizations:
  - Proprietorship, **which has a single owner, personally liable for the business' debts**
  - Partnership, **which has two or more owners called partners, personally liable for the business' debts**
  - Corporation, **which has many owners called stockholders or shareholders, not personally liable for the company's debts**

- For our purposes, we'll refer to a generic "company". When necessary we'll distinguish among the different forms of business

Sole Proprietorship

-Simple to establish
-Owner controlled
-Tax advantages



Partnership

-Simple to establish
-Shared control
-Broader skills and resources
-Tax advantages

Corporation

-Easier to transfer ownership
-Easier to raise funds
-No personal liability

Financial statements

- The most basic concept in accounting is the **entity concept**. An accounting entity is an organization that stands apart as a separate economic unit. From an accounting point of view, we need to sharply separate each entity in order not to confuse its affairs with those of other entities

- The key product of financial accounting is the set of **financial statements**: the documents that report financial information about a business entity to decision makers

- Financial statements tell us how well a business entity is performing in terms of profits and losses and where it stands in financial terms

Financial statements

- In other words, when we prepare a set of financial statements, we do it in relation to a specific entity, whose name is reported on the top of each statement

TOOTSIE ROLL INDUSTRIES, INC.
Income Statement
For the Year Ended December 31, 2011 (in thousands)

Revenues		$532,505
Expenses		
Cost of goods sold	$365,225	
Selling, marketing, and administrative expense and other	106,368	
Income tax expense	16,974	
Total expenses		488,567
Net income		$ 43,938

Financial statements

- Assets, Liabilities, expenses and revenues are of interest of users of accounting information. This information is arranged in the format of the following **financial statements**:
  - Balance Sheet (or Statement of financial position)
  - Income Statement (or Profit & Loss, or Statement of operations)
  - Statement of Cash Flows

- There are other statements (like, for example, the Statement of retained earnings), but they are less important for our purposes

- Each statement answers a different question about the company's performance and its financial position

The Balance Sheet

- The Balance Sheet gives a picture of the company's financial position at the end of an accounting period
- It reports three main categories of items: **Asset/Liabilities/Shareholders'Equity**

Assets: are the economic resources of a business that are expected to be of benefit in the future (e.g. cash, inventories, plant, equipment)

Liabilities are "outsider claims", that is economic obligations (debts) payable to outsiders (creditors) (e.g. a loan, bonds payable)

Shareholder's (or Owner) Equity represents the "insider claims" to the business resources. These are the assets held by the owners who invested money in the firm

TOOTSIE ROLL INDUSTRIES, INC.
Balance Sheet
December 31, 2011 (in thousands)

Assets		
Cash		$ 78,612
Investments		10,895
Accounts receivable		41,895
Inventories		71,760
Prepaid expenses		5,070
Property, plant and equipment, net		212,162
Other assets		437,462
Total assets		$857,856
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable	$ 10,683	
Dividends payable	4,603	
Accrued liabilities	43,069	
Deferred income taxes payable	43,521	
Bonds payable	7,500	
Employee benefits payable and other	82,545	$191,921
Stockholders' equity		
Common stock	551,666	
Retained earnings	114,269	665,935
Total liabilities and stockholders' equity		$857,856

The Income Statement

- The Income Statement reports the company’s revenues, expenses and net earnings (or income) for the accounting period
- In order to define revenues and expenses we need first to define net income/net earnings

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Revenues: are increases in net earnings deriving from sales of goods or services to customers or clients

Expenses: are decreases in net earnings. They are the cost of doing business, that is the cost of all the resources used to perform the business’ activity

Net income/Net earnings = revenues – expenses
If net earnings are < 0, it is called **net loss**

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The Statement of Cash Flows

- The Statement of Cash Flows answers the following question:
  - **How much cash did the company generate and spend during the period?**

TOOTSIE ROLL INDUSTRIES, INC.
Statement of Cash Flows
For the Year Ended December 31, 2011 (in thousands)

Cash flows from operating activities		
Cash receipts from operating activities	$528,004	
Cash payments for operating activities	(477,614)	
Net cash provided by operating activities		$ 50,390
Cash flows from investing activities		
Capital expenditures and acquisitions	(16,351)	
Net purchases/sales of investment securities and other	(34,806)	
Net cash used by investing activities		(51,157)
Cash flows from financing activities		
Repurchase of common stock	(18,190)	
Dividends paid in cash	(18,407)	
Net cash used by financing activities		(36,597)
Net increase (decrease) in cash		(37,364)
Cash at beginning of year		115,976
Cash at end of year		$ 78,612

- **We'll focus on Balance Sheet and Income Statement in the beginning.** Later, we'll learn about the Statement of Cash Flows too

The accounting period

- For each statement we talk about a “period”. This is the **accounting period**, that is the period of time depicted by financial statements
- Usually this period corresponds to the **calendar year** (01.01-12.31)
- When the accounting year is different from the calendar year, we talk about **fiscal year**
- The accounting year chosen by each entity is reported on the top of each statement

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Relationship between Balance Sheet and Income Statement

- The Income Statement reports net income/net earnings (or net loss) as the difference between revenues and expenses

- At the same time, net income/net earnings (or net loss) is part of the owners' equity, since it represents the remuneration for the investment they made in the firm

- We can say that Income Statement gives details about the increase (in case of net income/net earnings) or decrease (in case of net loss) in the owners' equity due to the operations performed by the company during an accounting period

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TOOTSIE ROLL INDUSTRIES, INC.
Retained Earnings Statement
For the Year Ended December 31, 2011 (in thousands)

Retained earnings, January 1, 2011	$135,866
Add: Net income	43,938
	179,804
Less: Dividends and other (net)	65,535
Retained earnings, December 31, 2011	$114,269

TOOTSIE ROLL INDUSTRIES, INC.
Balance Sheet
December 31, 2011 (in thousands)

Assets

Cash	$ 78,612
Investments	10,895
Accounts receivable	41,895
Inventories	71,760
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Review Questions

Review Question

Net income will result during a time period when:

a. assets exceed liabilities.

b. assets exceed revenues.

c. expenses exceed revenues.

d. revenues exceed expenses.

Which of the following financial statements is prepared as of a specific date?

a. Balance sheet.

b. Income statement.

c. Retained earnings statement.

d. Statement of cash flows.

Review Question

Which is not one of the three forms of business organization?

1. Sole proprietorship
2. Creditorship
3. Partnership
4. Corporation

Which statement about users of accounting information is incorrect?

1. Management is considered an internal user
2. Taxing authorities are considered external users
3. Present creditors are considered external users
4. Regulatory authorities are considered internal users