

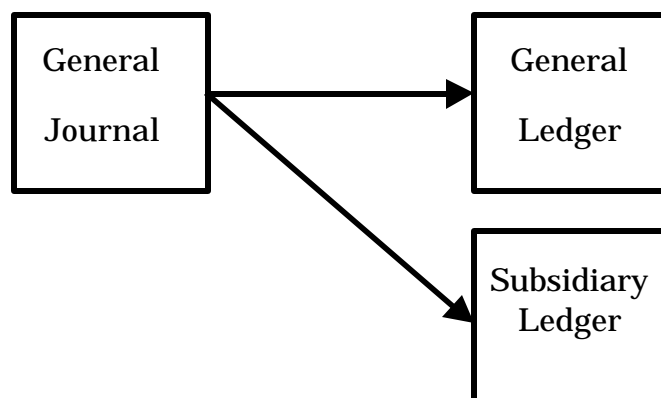
Financial Statement Preparation

Topics to be Discussed

- Review of Basic Accounting Concepts
- Basic Underlying Assumption #3 - Timeliness of Information
- Basic Objectives of Financial Accounting
- Qualitative Characteristics of Accounting Information
- Basic Financial Statements
- Balance Sheet
 - Elements of Balance Sheet
 - Asset Valuation
 - Basic Underlying Assumption #4 - Going Concern
 - Reliability
 - Historical Cost Principle
- Income Statement
 - Elements of Income Statement
- Statement of Cash Flows
- Accounting Cycle
- Adjusting Entries
 - Matching Principle
 - Materiality Concept
 - Cost-Benefit Concept
- Closing Entries
- Reversing Entries

Review of Basic Accounting Concepts

- Objectives of Financial Accounting
 - Provide information useful in credit and investment decisions
- Basic Underlying Assumptions
 - Economic Entity
 - Monetary Units
- Basic Accounting Principles
 - Revenue Principle
- Basic Recording Process



Basic Underlying Assumption #3

Timeliness of Information

Time Period Assumption

Periodicity

Users of accounting information would prefer periodic reports based upon estimates, possibly inaccurate estimates, rather than reports only at the end of the life of the accounting entity

- ☞ The accounting system should be designed to provide information on a timely basis

The one year, or 12-month, accounting period adopted by a business is called its "accounting period" or its FISCAL YEAR.

MONTH OF FISCAL YEAR END

	2001	2000	1999	1998
January	32	30	28	25
February	10	11	11	11
March	16	15	16	14
April.....	8	8	9	9
May	18	16	17	14
June	48	48	53	52
July	8	11	9	8
August	15	15	15	14
September	38	40	38	38
October	19	19	21	23
November	15	15	16	15
Subtotal	227	228	231	223
December	373	372	369	377
Total Companies	600	600	600	600

The NATURAL BUSINESS YEAR of a company begins and ends when the company's business activity is at its lowest point.

Financial statements covering periods shorter than one year (usually quarterly) are referred to as INTERIM STATEMENTS.

Basic Objectives of Financial Accounting

SFAC 1 - Objectives of Financial Reporting by Business Enterprises

Provide information

USEFUL IN INVESTMENT AND CREDIT DECISIONS

includes those advising investors and creditors

USEFUL IN ASSESSING FUTURE CASH FLOWS

help assess the amounts, timing, and uncertainty of prospective cash receipts

ABOUT ENTERPRISE RESOURCES, CLAIMS TO RESOURCES AND CHANGES IN THEM

helps users identify enterprise's financial strengths and weaknesses

provides basis to evaluate enterprises performance

provides indications of cash flow potential and cash needs

SFAC 2 - Qualitative Characteristics of Accounting Information

Primary Qualities

RELEVANCE

☞ information capable of making a difference in a decision

☞ the FASB has indicated that "relevance" is one of two qualities that distinguish "better" (more useful) information from "inferior" (less useful) information

☞ components

PREDICTIVE VALUE - helps users make predictions about the outcome of past, present, and future events

FEEDBACK VALUE - helps users to confirm or correct prior expectations

TIMELINESS - information available to decision makers before it loses its capacity to influence their decisions

Secondary Qualities

COMPARABILITY

☞ information that has been measured and reported in a similar manner for different enterprises

Basic Financial Statements

Balance Sheet

A summary of the assets, liabilities, and owners' equity of an accounting entity as of a given date

Alternative titles

Statement of Financial Condition

Statement of Financial Position

Position Statement

BALANCE SHEET TITLE

	2001	2000	1999	1998
Balance Sheet	573	571	569	569
Statement of Financial Position	25	27	28	27
Statement of Financial Condition	2	2	3	4
Total Companies	600	600	600	600

Income Statement

A summary of the revenues and expenses of an accounting entity for a given period of time

Alternative titles

A	B
Statement	Income
Report	Profit and Loss
	Earnings
	Operations

INCOME STATEMENT TITLE

	2001	2000	1999	1998
Income	259	284	296	298
Operations	230	198	186	180
Earnings	102	108	114	117
Other	9	10	4	5
Total Companies	600	600	600	600

Statement of Cash Flows

A summary of cash inflows and outflows for a period of time

Summarizes cash flows from following activities:

Operating - providing services and/or obtaining and selling inventory

Investing - primarily purchase and disposition of long-term assets

Financing - primarily issuance and repaying long-term debt or stock

Balance Sheet

Elements of Balance Sheet

Heading

Name of the company

Title of the financial statement

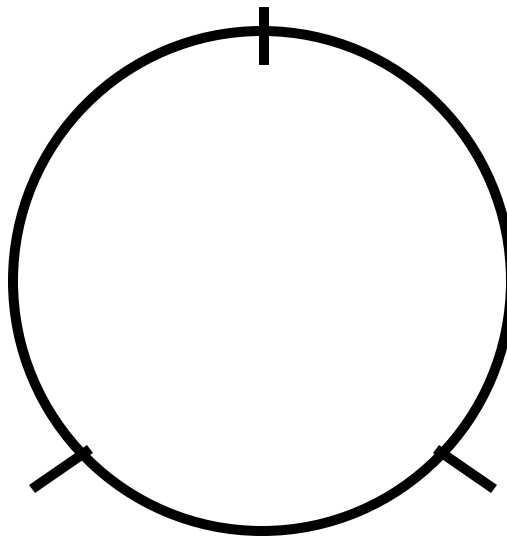
Date

ASSETS - probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events

CURRENT ASSETS

Cash and other assets reasonably expected to be realized in cash or sold or consumed during one year or the normal operating cycle, whichever is longer

NORMAL OPERATING CYCLE



Typical current assets

Cash

Temporary investments

Receivables

Inventory

Prepaid expenses

CURRENT ASSETS

LONG TERM INVESTMENTS

Represent investments (in stocks, bonds, real estate, partnerships, joint ventures, etc.) acquired for such long-term purposes as

- ☞ long-term price appreciation
- ☞ long-term steady income
- ☞ creating and insuring desirable operating relationships between companies to improve income performance

PLANT, PROPERTY AND EQUIPMENT

Represent tangible, long-term assets acquired for use in the operation of the accounting entity

- ☞ Alternative titles
 - plant and equipment
 - plant assets
 - fixed assets
- ☞ Examples
 - building
 - land
 - equipment

INTANGIBLE ASSETS

Represent long-term rights and privileges of a non-physical nature acquired for use in operation of the entity

- ☞ Examples
 - patents
 - copyrights
 - trademarks
 - goodwill

OTHER ASSETS

LIABILITIES - probable future sacrifices of economic benefits arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events

CURRENT LIABILITIES

obligations whose liquidation is expected to require the use of current assets or services or the creation of other current liabilities within one year or the normal operating cycle, whichever is longer

☞ Examples

- notes and accounts currently payable
- accrued liabilities, such as interest payable and wages payable
- current maturities of long-term debt

LONG-TERM LIABILITIES

obligations not requiring liquidation within one year or the normal operating cycle, whichever is longer

OTHER LIABILITIES

OWNERS' EQUITY - the financial interests of the owners arising from the initial, and possibly subsequent, investments and accumulated profits. May also be described as the residual interest in the assets of an entity that remains after deducting its liabilities.

Sole Proprietorship

☞ J. Doe, Capital

Partnership

☞ J. Doe, Capital

☞ M. Doe, Capital

Corporation

☞ Common Stock

☞ Retained Earnings

Alternative Titles

☞ Net Assets

☞ Stockholders' Equity

Asset Valuation

Some Alternative Valuations

- 1.
- 2.
- 3.

Basic Underlying Assumption #4

Going Concern Concept

In the absence of contrary information, an accounting entity is assumed to remain in existence for an indeterminate period of time

Liquidation valuation for assets would not be appropriate unless the accounting entity were liquidating

Review of Qualitative Characteristics of Accounting Information

Primary qualities

☞ Relevance

- predictive value
- feedback value
- timeliness

☞ Reliability

- the FASB has indicated that relevance and reliability are the two primary qualities that make accounting information useful for decision-making

VERIFIABILITY - a high degree of consensus can be secured among independent measurers using the same measurement methods

REPRESENTATIONAL FAITHFULNESS - agreement between the accounting numbers and descriptions and the resources or events that these numbers and descriptions purport to represent

NEUTRALITY - in formulating or in implementing accounting standards, the primary concern should be the relevance and reliability of the information that results, not the economic consequence of the standard or rule. A neutral choice between accounting alternatives is free from bias towards a predetermined result

Basic Accounting Principle #2 - Historical Cost Principle

initial valuation of assets and liabilities should be equal to the exchange price (purchase/sale price, historical cost). Subsequent valuations should be based on historical cost.

Income Statement

Elements of Income Statement

HEADING

NAME OF COMPANY
TITLE OF STATEMENT
TIME PERIOD

The McMenemy Corporation
Income Statement
For the Year Ended December 31, 20x1

REVENUE	REVENUES		
	Gross Sales		\$100,000
	Less: Sales Returns & Allowances	2,000	
	Sales Discounts	<u>3,000</u>	<u>5,000</u>
	Net Sales		95,000
COST OF GOODS SOLD	COST OF GOODS SOLD		
	Beginning Inventory	20,000	
	Net Purchases:		
	Gross Purchases	60,000	
	Less: Purchase Returns & Allowances	2,000	
	Purchase Discounts	<u>5,000</u>	
	Net Purchases	<u>53,000</u>	
	Cost of Goods Available for Sale	73,000	
	Ending Inventory	<u>23,000</u>	
	Cost of Goods Sold		<u>50,000</u>
GROSS MARGIN	GROSS MARGIN		45,000
OPERATING EXPENSES	OPERATING EXPENSES		
	Rent Expense	12,000	
	Wages Expense	15,000	
	Utilities Expense	<u>8,000</u>	
	Total Operating Expenses		<u>35,000</u>
NET INCOME	NET INCOME		\$ 10,000

Statement of Cash Flows

Elements of Statement of Cash Flows

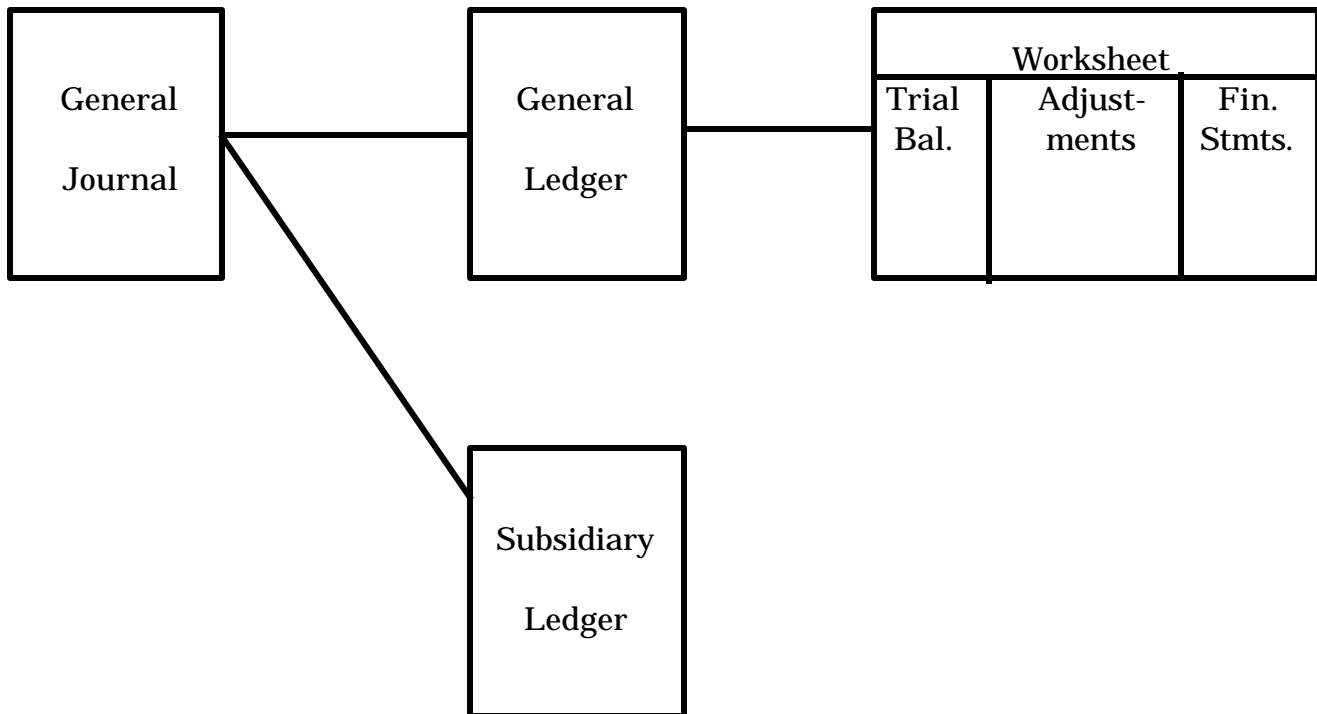
HEADING

NAME OF COMPANY
TITLE OF STATEMENT
TIME PERIOD

The McMenemy Corporation
Statement of Cash Flows
For the Year Ended December 31, 20x1

OPERATING ACTIVITIES	CASH FLOWS FROM OPERATING ACTIVITIES		
	Net Income		\$10,000
	Adjustments to reconcile net income to net cash provided by operating activities		
	Increase in accounts receivable	(3,000)	
	Increase in accounts payable	<u>4,000</u>	<u>1,000</u>
	Net cash provided by operating activities		11,000
INVESTING ACTIVITIES	CASH FLOWS FROM INVESTING ACTIVITIES		
	Purchase of equipment	(6,000)	
	Sale of Long-Term Investments	14,000	
	Purchase of patents	<u>(3,000)</u>	<u>5,000</u>
FINANCING ACTIVITIES	CASH FLOWS FROM FINANCING ACTIVITIES		
	Payment of cash dividends	(1,000)	
	Retirement of long-term debt	(15,000)	
	Issuance of common stock	<u>12,000</u>	<u>(4,000)</u>
	NET INCREASE IN CASH		12,000
	CASH AT BEGINNING OF PERIOD		<u>6,000</u>
	CASH AT END OF PERIOD		<u><u>18,000</u></u>

Accounting Cycle



Adjusting Entries

Accounting Principle #3 - Matching Principle
 against the revenues recognized during an accounting period, we should match the expenses that were incurred in order to obtain the revenues

Depreciation

Depreciation Expense	1,000,000	
Accumulated Depreciation - Building		1,000,000

Building	50,000,000	Initial Cost
Accumulated Depreciation	<u>1,000,000</u>	Accumulated Depreciation
	49,000,000	Book Value

Constraints

MATERIALITY - the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

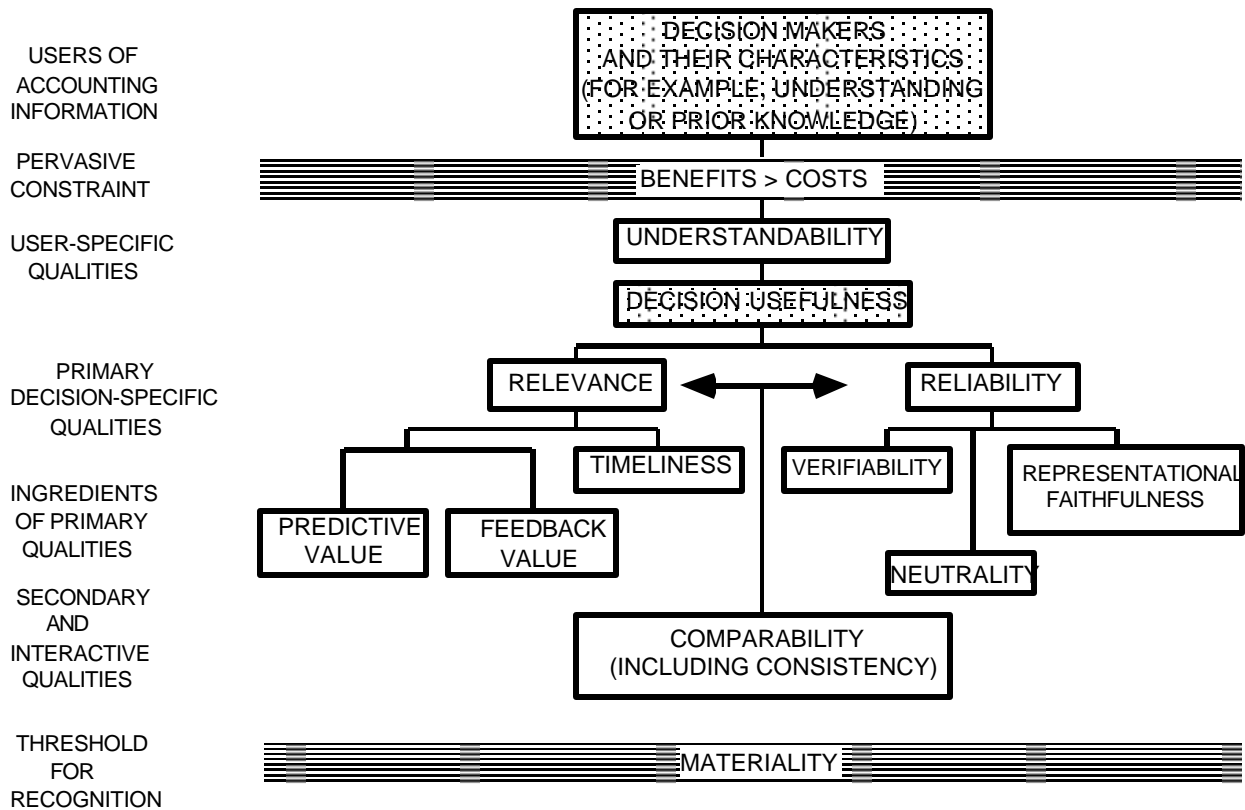
should consider

- relative and absolute size of item
- nature/importance of the item

an item is immaterial and, therefore, irrelevant if its inclusion or omission would have no impact on a decision maker

COST-BENEFIT CONSIDERATIONS - in order to justify providing accounting information the benefits that may be derived from the use of this information must exceed the costs of providing the data.

A HIERARCHY OF ACCOUNTING QUALITIES



Accrual Basis Accounting

- ☞ recognize revenues when earned rather than when cash is paid
- ☞ recognize expenses when incurred rather than paid
- ☞ accrual and deferral accounts

ACCRUED REVENUE - revenue earned, but not received (revenue receivable)

ACCRUED EXPENSE - expense incurred, but not paid (expense payable)

PREPAID (DEFERRED) REVENUE - cash is received, but revenue is not earned (prepaid income)

PREPAID (DEFERRED) EXPENSE - cash is paid, but expense is not incurred (prepaid expense)

Inventories

merchandise

supplies

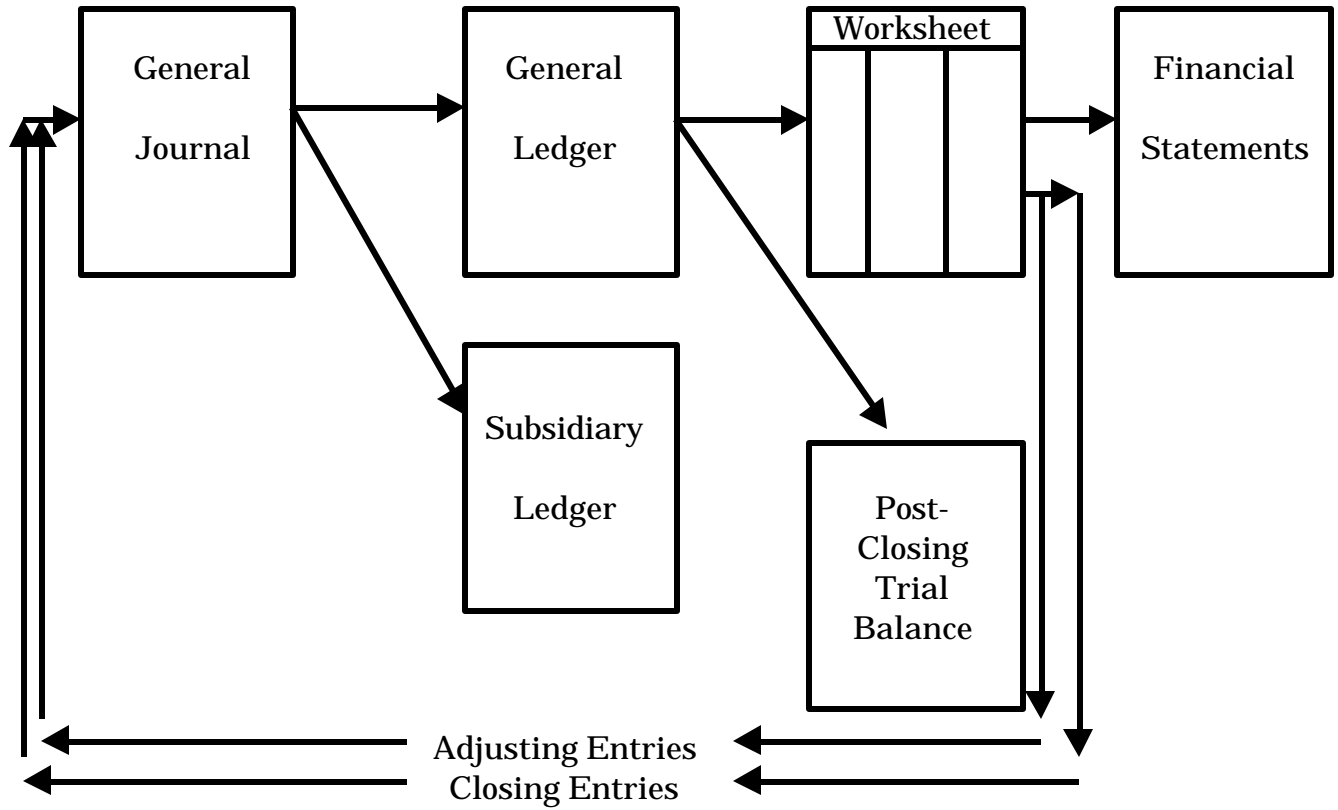
Closing Entries

Reasons for Closing Entries

NOMINAL or TEMPORARY accounts - accounts that are closed at the end of the accounting period (income statement accounts)

REAL or PERMANENT account - accounts that are not closed at the end of the accounting period (balance sheet accounts)

Review of Basic Recording Process



Reversing entries

Weekly Payroll Entry

Wages Expense	1,000	
Cash		1,000

Wednesday, December 31 (end of fiscal year) Adjusting Entry

Wages Expense	600	
Wages Payable		600

Erroneous January 2 Payroll Entry

Wages Expense	1,000	
Cash		1,000

Entry Should Have Been

Wages Expense	400	
Wages Payable	600	
Cash		1,000

Entries With Reversing Entry

December 31 Adjusting Entry

Wages Expense	600	
Wages Payable		600

Entries Without Reversing Entry

Wages Expense	600	
Wages Payable		600

January 1 Reversing Entry

Wages Payable	600	
Wages Expense		600

No entry

January 2 Payment Entry

Wages Expense	1,000	
Cash		1,000

Wages Expense	400	
Wages Payable	600	
Cash		1,000

Review of Basic Recording Process

