

Introduction to Financial Accounting (Chapter 1, Antle)

- **What is accounting?**

- Accounting is the act of gathering and reporting the financial history of an organization (company).
- This requires a continuous process of
 - Capturing financial data,
 - Organizing it,
 - Producing financial reports.

- **Framework for understanding accounting information**

- Information in accounting reports are determined by
 - *Economic concepts*. Determine what is being actually reported (measured)? Financial value, wealth, income, ...
 - *Accounting conventions*. Dictate how to report financial transactions to measure the desired economic criteria.
 - *Institutional context*. This reflects the effect of the human element in adopting accounting conventions.



- **Financial statements: Balance Sheet**

- An organization's balance sheet is a list of resources available (*assets*), resources committed (*liabilities*), and their difference (*equity*) at a point in time.

Union Plaza Hotel and Casino, Inc. and Subsidiaries			
Consolidated Balance Sheet as of December 31, 2001			
(dollars in thousands)			
ASSETS		LIABILITIES	
Cash and cash equivalents	\$ 3,552	Accounts payable	\$ 2,441
Accounts receivable, net	786	Accrued liabilities	2,353
Inventories of food, beverage, etc.	423	Other current liabilities	609
Prepaid expenses	793	Total current liabilities	<u>\$ 5,403</u>
Total current assets	<u>\$ 5,554</u>	Long-term debt	32,900
Property and equipment:		Obligations under capital leases	1,582
Land	\$ 7,012	TOTAL LIABILITIES	<u>\$39,885</u>
Buildings	48,040	STOCKHOLDERS' EQUITY	
Leasehold improvements	3,564	Common stock	\$ 750
Furniture and equipment	31,659	Additional paid-in capital	\$ 5,462
	<u>\$90,275</u>	Retained earnings	\$14,525 \$8,313
Less accumulated depreciation and amortization	(55,903)	Less treasury stock	<u>(13,897)</u>
Net property and equipment	\$34,372	TOTAL STOCKHOLDERS' EQUITY	\$ 628
Other assets	587	TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$40,513</u>
TOTAL ASSETS	<u>\$40,513</u>		

- The numbers on the balance sheet add up. Assets and liabilities and stockholders' equity must balance.

- This is the fundamental accounting identity,

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY} .$$

- Equivalently,

$$\text{ASSETS} - \text{LIABILITIES} = \text{EQUITY} .$$

- **Financial statements: Income statement**

- An organization's income statement lists the economic resources acquired (*revenues*) and consumed (*expenses*) through *operations* over a period of time.

Union Plaza Hotel and Casino, Inc. and Subsidiaries
Income Statement for the Year Ended December 31, 2001
(dollars in thousands)

REVENUES	
Casino	\$37,807
Food and beverage	10,351
Rooms	11,110
Other	2,524
GROSS REVENUES	<u>61,792</u>
Less promotional allowances	<u>(6,922)</u>
NET REVENUES	<u>54,870</u>
OPERATING EXPENSES	
Casino	\$22,865
Food and beverage	8,997
Rooms	4,294
General and administrative	5,155
Entertainment	591
Advertising and promotion	1,329
Utilities and maintenance	6,712
Depreciation and amortization	4,130
Provision for doubtful accounts	44
Other costs and expenses	1,246
TOTAL OPERATING EXPENSES	<u>\$55,363</u>
OPERATING INCOME (LOSS)	<u>\$ (493)</u>
OTHER INCOME (EXPENSE)	
Interest income	3
Loss on sale of assets	(159)
Interest expense	<u>(2,265)</u>
TOTAL OTHER INCOME (EXPENSE)	<u>(2,421)</u>
NET LOSS	<u><u>\$ (2,914)</u></u>

- The income statement reports success or failure of company's operations during the period.
- Relative to the balance sheet, the income statement explains the *change in retained earnings* between the beginning and end of the period.

- **Financial statements: Cash flow statement**

- An organization’s cash flow statement describes flow of cash into and out of organization during a period.
- The cash flows are classified as one of three types
 - *Operating activities*. Intended to generate net income.
 - *Investing activities*. Resulting from acquiring or disposing of productive company assets.
 - *Financing activities*. Payments to or receipts from suppliers of money (e.g., shareholders or debt holders).

Union Plaza Hotel and Casino, Inc. and Subsidiaries
Consolidated Statements of Cash Flows for the Year Ended December 31, 2001
 (dollars in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	\$54,761
Cash paid to suppliers and employees	(51,314)
Interest received	3
Interest paid	(2,384)
NET CASH PROVIDED BY (USED IN)	
OPERATING ACTIVITIES	\$ 1,066
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of property and equipment	\$ 42
Purchase of property and equipment	(1,173)
NET CASH USED IN INVESTING ACTIVITIES	\$ (1,131)
CASH FLOWS FROM FINANCING ACTIVITIES	
Principal payments on short-term contracts	\$ (158)
Proceeds from long-term debt	2,000
Principal payments on long-term debt	(641)
Principal payments on capital leases	(919)
NET CASH PROVIDED BY FINANCING ACTIVITIES	\$ 282
NET INCREASE (DECREASE) IN	
CASH AND CASH EQUIVALENTS	\$ 217
CASH AND CASH EQUIVALENTS, at beginning of the year	3,335
CASH AND CASH EQUIVALENTS, at end of the year	\$ 3,552

- Relative to the balance sheet, the income statement explains the *change in cash* between the beginning and end of period.

- **Annual report**

- The balance sheet, the income statement and the cash flow statement are part of a comprehensive financial report called annual report.
- The annual report contains other elements.
 - *Retained earnings statement.* Shows changes in retained earnings during the period covered by the statement.

FASTFORWARD	
Statement of Retained Earnings	
For Month Ended December 31, 2007	
Retained earnings, December 1, 2007	\$ 0
Plus: Net income	4,400
	<u>4,400</u>
Less: Dividends	200
Retained earnings, December 31, 2007	<u>\$ 4,200</u>

- *Management Discussion and Analysis.* Covers three aspects of an organization,
 - *Liquidity.* Ability to pay near-term obligations.
 - *Capital resources.* Ability to fund operations and expansions.
 - *Results of operation.* Profitability and efficiency.
- *Notes to financial statements.* Clarify and expand information included in the body of the statements.

Union Plaza Hotel and Casino
(Excerpts from footnote 1: A Summary of Significant Accounting Policies)

Property and equipment are stated at cost. Depreciation is computed using the straight-line method.

The retail value of admissions, food and beverage and other complimentary items furnished to customers without charge is included in gross revenue and then deducted as promotional allowances.

- *Auditor's report.* The Auditor (an independent accountant) gives an opinion on whether the financial statements present the financial position, the results of operations, and the cash flows in accordance with GAAP.

- **Why study accounting?**
 - To assist in decision making.
 - Such decision making includes
 - Granting credit,
 - Making investments,
 - Borrowing money,
 - Adhering to regulations,
 - Determining remuneration of executives,
 - Evaluating competition,
 - Evaluating potential litigation.

- **A word of caution**
 - Accounting produces scores of numbers with vague, often misunderstood implications.
 - When making decisions based on financial statements, it is important to look beyond the numbers and understand the economic concept, accounting convention and institutional context involved.

- **Economic concepts: Financial value**
 - Three main economic concepts are at the heart of accounting: Financial value, wealth, and economic income.
 - The financial value is the amount of money an item would bring if sold.
 - The accuracy of financial valuation depends on how well a market functions.
 - In a *well-functioning market*, goods and services will be properly valued.
 - If no well-functioning market for an item exists, then its financial value is assessed (estimated).
 - A well-functioning market have three characteristics,
 - *Competitiveness*. All items are sold at the same price (reflecting the true financial value) at a point in time.
 - *Low transaction costs*. Price paid to buy/sell a good requires few operational resources to complete transaction.
 - *Organization and regulation*. Market has standard definitions of tradable items, rules and conventions for making transactions, and procedures for policing traders.
 - Examples of a well-functioning market include the market for gold and the stock market. An example for a not-too-well functioning market is the market for real-estates.

- **Economic concepts: Wealth**

- The wealth of an organization is the sum of the financial values of the things (material and non-material) it owns.
- Things an organization owns can be classified to *assets* (if they produce future benefits) and *liabilities* (if they involve future sacrifices).
- Wealth and Equity are synonyms,

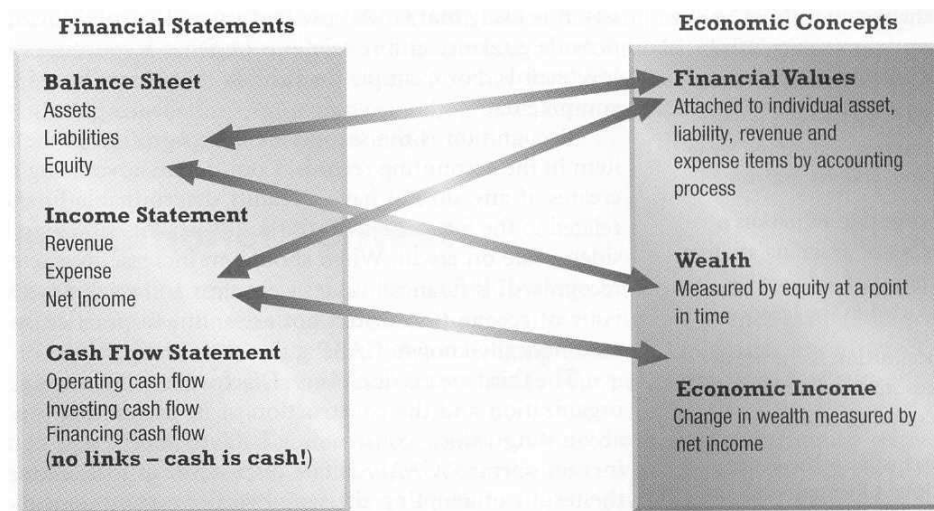
$$\text{WEALTH} \equiv \text{EQUITY} = \text{ASSETS} - \text{LIABILITIES}$$

- **Economic concepts: Income**

- Economic income is the change in an organization's wealth, excluding capital transactions with its owners (i.e. income from operations).
- It describes an organization's success in using its economic resources over a period.
- Owner investments are not counted as income because increase in wealth attributable to them is *not* generated by use of the organization's resources.

- **Financial statements and economic concepts**

- Financial statements measure, to the extent possible, the economic status of an organization.
- Financial statements and economic concepts are related as follows.



- **Generally Accepted Accounting Principles (GAAP)**
 - GAAP are the commonly understood and accepted conventions for gathering, organizing, and reporting financial history of organization.
 - GAAP apply in three main areas: *valuation*, *recognition* and *disclosure*.
 - *Accounting valuation*: GAAP help to specify value of items reported. It provides guidance and restrictions on accounting values used in financial statements.
 - E.g., Union Plaza’s “plant and equipment are carried at cost less accumulated depreciation and amortization.”
 - *Recognition*: This is the act of recording a transaction in the accounting records (i.e. creating an *account*).

- GAAP specifies how an item should be treated in accounting records. E.g., when an item is sold on credit, GAAP help determining when an asset increase and revenue realization should be recorded.
 - *Disclosure*: This is the act of providing information about the organization and the construction of its accounting reports.
 - GAAP require disclosure of measurement methods, assumptions, and, in places, results of adopting alternative sets of assumptions.
 - Securities and Exchange Commission (SEC) is the Federal agency that has authority to determine GAAP for public companies in the US.
 - In practice, SEC has delegated establishing GAAP to FASB.
 - Financial Accounting Standards Board (FASB) is a private, not-for-profit organization.
- **Factors Affecting GAAP**
 - *Market richness*. Where market for a good is well-functioning, GAAP will use market valuations to drive accounting.
 - *Complexity of transactions*. When transactions are simple, GAAP is simple and conversely.
 - An example of a simple transaction is buying lunch. A complex transaction is paying for an AUB professor in salary, social benefits, and a pension plan.

- *Type of business entity*. E.g., sole proprietor, partnership, corporation, not-for-profit, governmental. (We focus on for-profit organizations.)

- **Institutional Context**

- GAAP cannot dictate exact accounting treatments for all situations, since new transactions are constantly being constructed (e.g., derivatives).
- Therefore, we need to consider the human element in accounting.
- These include the incentives that faced the issuers of the accounting reports.
- E.g., when management compensation is based on net income, management may bias net income estimation.
- In addition, understanding the legal, business and cultural environment in which the organization operates is crucial.