

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

Review of Basic Accounting Concepts

Objectives of Financial Accounting

Provide information useful in credit and investment decisions

Basic Underlying Assumptions

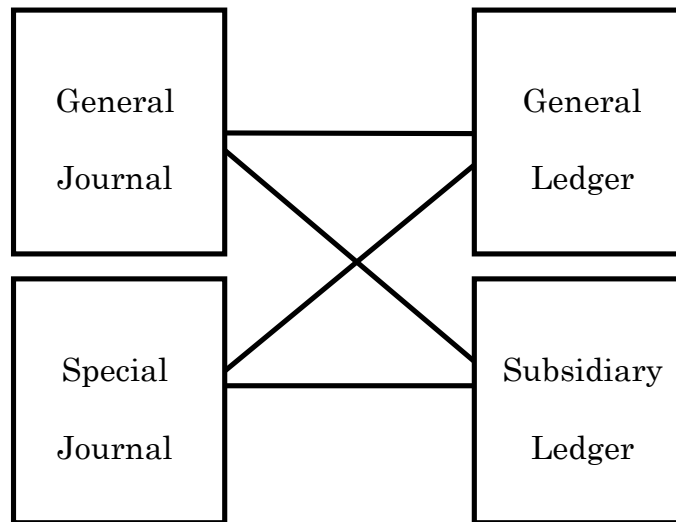
Economic Entity

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

	2006	2005	2004	2003
January	27	30	30	30
February	8	8	8	9
March	17	17	17	16
April	9	8	9	8
May	17	18	18	18
June	42	41	41	49
July	10	13	11	8
August	14	12	11	14
September	47	49	44	42
October	16	17	19	17
November	12	12	12	13
Subtotal	219	225	220	224
December	381	375	380	376
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

	2006	2005	2004	2003
Balance Sheet	578	577	576	574
Statement of Financial Position	21	22	23	24
Statement of Financial Condition	1	1	1	2
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 Report | Income Profit and Loss Earnings Operations |

INCOME STATEMENT TITLE

	2006	2005	2004	2003
Income	260	255	255	242
Operations	252	254	251	261
Earnings	87	86	86	90
Other	1	5	8	7
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

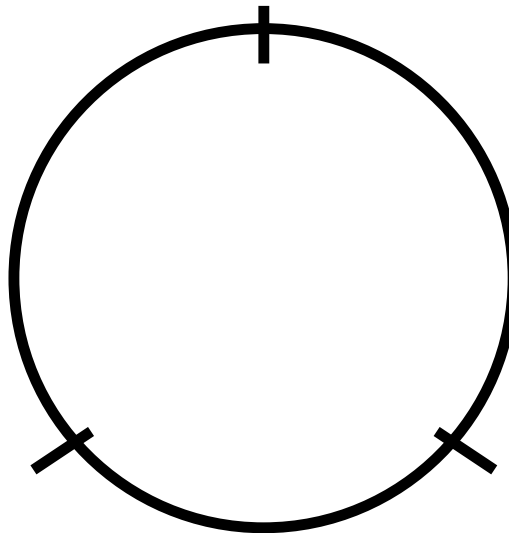
Date

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 (confirmatory) 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 pre-determined 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.

Proposed additional primary quality

UNDERSTANDABILITY – the quality of information that enables users to comprehend its meaning. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely. Comparability also can enhance understandability.

Although presenting information clearly and concisely helps users to comprehend it, the actual comprehension or understanding of financial information depends largely on the users of the financial report. Users of financial reports are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report. In making decisions, users also should review and analyze the information with reasonable diligence. However, when underlying economic phenomena are particularly complex, fewer users may understand the financial information depicting those phenomena. In these cases, some users may need to seek the aid of an advisor. Information that is relevant and faithfully represented should not be excluded from financial reports solely because it may be too complex or difficult for some users to understand without assistance.

Income Statement

Elements of Income Statement

HEADING

NAME OF COMPANY
 TITLE OF STATEMENT
 TIME PERIOD

The McMenimen 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

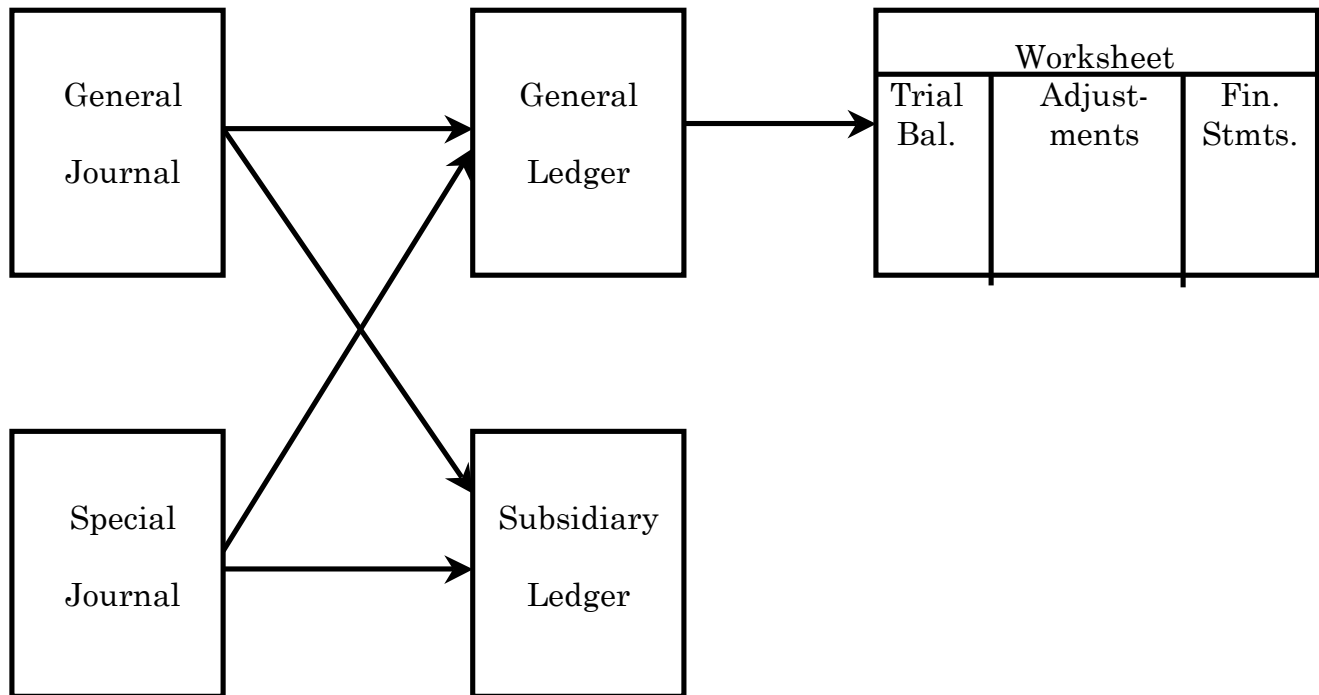
HEADING

NAME OF COMPANY
TITLE OF STATEMENT
TIME PERIOD

The McMenimen 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.

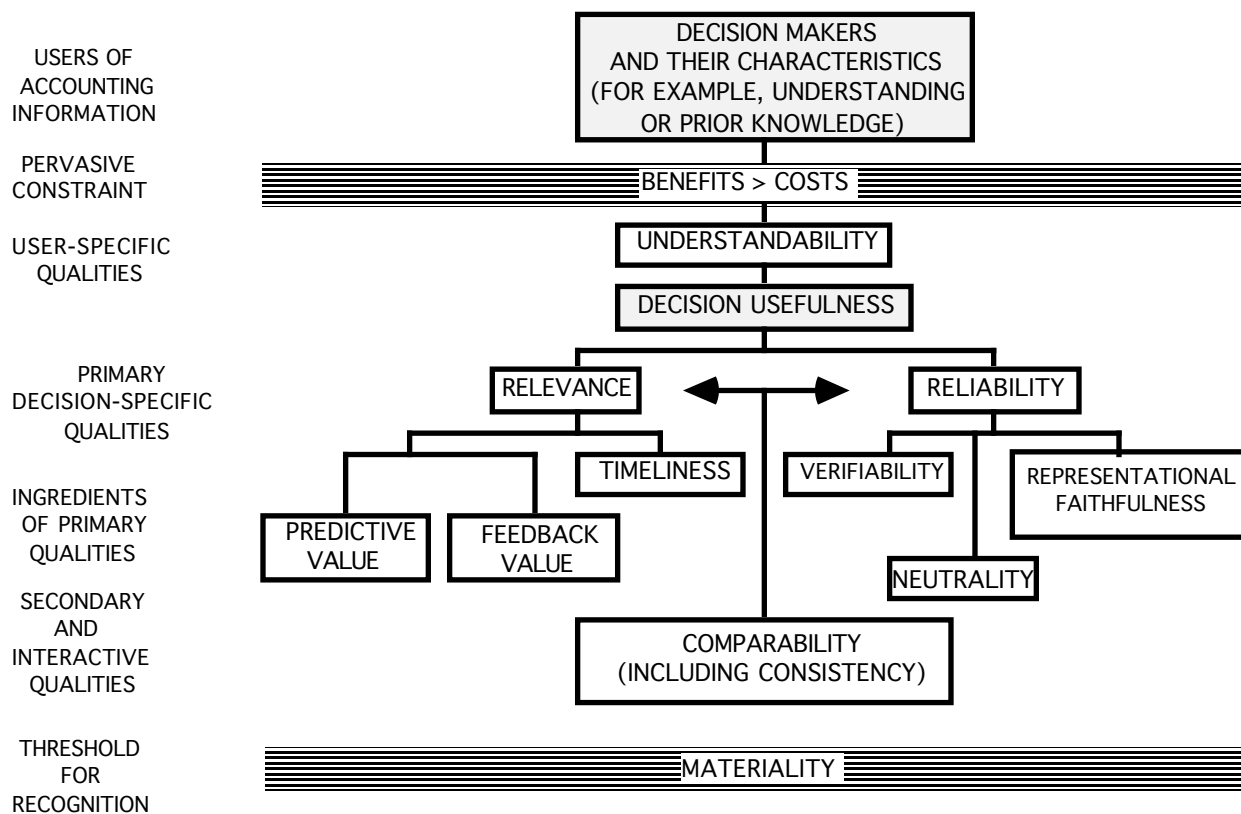
should consider

- 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

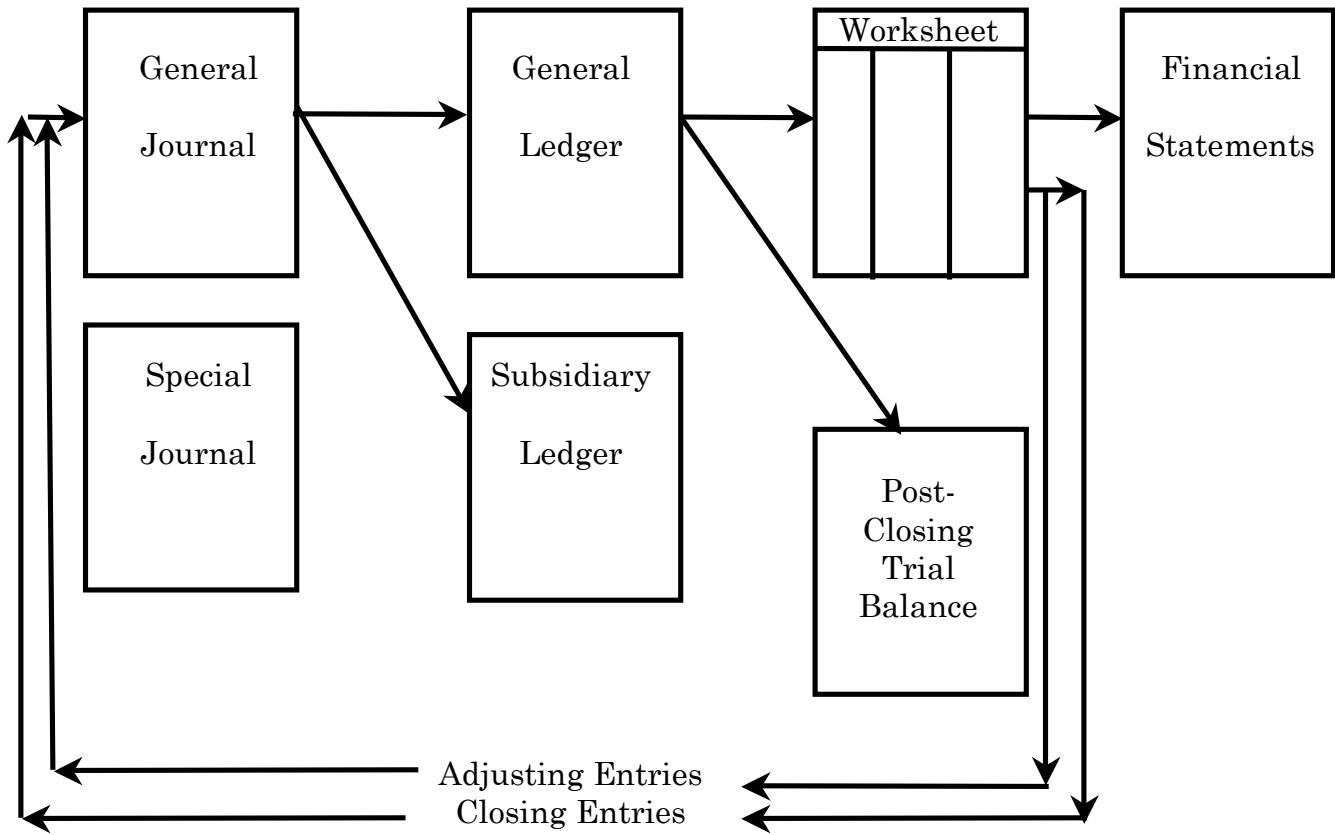
Closing Entries

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



Demonstration Problem - Part I

The following account balances have been obtained from the books of the Hirsch Parachute Company as of December 31, 20x2, the end of the company's fiscal year. The accounts shown are those having non-zero balances. You may assume that there are additional accounts in the accounting system.

Accounts Payable	.....	\$ 30,000	Prepaid Insurance	.....	\$ 300
Accounts Receivable	.....	40,000	Purchases	.....	80,000
Building	.....	56,000	Purchase Discounts	.....	6,000
A. J. Hirsch, Capital	.....	60,000	Purchase Returns & Allow.	..	4,000
Cash	.....	5,000	Sales	.....	100,000
A. J. Hirsch, Drawing	.....	3,000	Sales Discounts	.....	3,000
Equipment	.....	20,000	Sales Returns & Allow.	.....	1,000
Land	.....	5,000	Supplies	.....	3,700
Merchandise Inventory	.....	50,000	Utilities Expense	.....	20,500
Mortgage Note Payable	.....	100,000	Wages Expense	.....	12,000
Prepaid Advertising	.....	500			

Record, in general journal form, the necessary year-end adjusting entries for the Hirsch Parachute Company based on the additional information provided below.

Additional information:

- Insurance expense for the year amounted to \$100.
- Ending inventory of supplies amounted to \$1,000.
- Depreciation expense for the year was as follows;

Building	.....	\$2,200
Equipment	.....	2,000
- Mr. Hirsch bought 10 months advertising for the company, starting on May 1, 20x2, at a cost of \$500. This transaction has already been recorded.
- Accrued wages amounts to \$400.
- The mortgage note payable, issued on December 31, 20x2, is to be paid over a 10-year period, the first payment being made one year from this date. Payments will be \$10,000 plus interest at a rate of 10% per year based on the unpaid principal.

Demonstration Problem - Part II

Shown below are the adjusted account balances (after recording the previously stated adjusting entries) of the Hirsch Parachute Company as of December 31, 20x2, the end of the company's fiscal year.

Accounts Payable	\$ 30,000	Mortgage Note Payable	\$100,000
Accounts Receivable	40,000	Prepaid Advertising	100
Accum. Depr. - Building	2,200	Prepaid Insurance	200
Accum. Depr. - Equipment	2,000	Purchases	80,000
Advertising Expense	400	Purchase Discounts	6,000
Building	56,000	Purchase Returns & Allow. ..	4,000
A. J. Hirsch, Capital	60,000	Sales	100,000
Cash	5,000	Sales Discounts	3,000
Depreciation Expense	4,200	Sales Returns & Allow.	1,000
A. J. Hirsch, Drawing	3,000	Supplies	1,000
Equipment	20,000	Supplies Expense	2,700
Insurance Expense	100	Utilities Expense	20,500
Land	5,000	Wages Expense	12,400
Merchandise Inventory	50,000	Wages Payable	400

The merchandise inventory, as of December 31, 20x2, was \$75,000.

Required:

- Prepare an income statement
- Prepare a balance sheet
- Indicate which accounts would be closed out at the end of the fiscal year, December 31, 20x2.

HIRSCH PARACHUTE CO.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 20x2

Revenues		
Gross Sales		\$ 100,000
Less: Sales Returns & Allow	\$ 1,000	
Sales Discounts	<u>3,000</u>	<u>4,000</u>
Net Sales		\$ 96,000
Cost of Goods Sold		
Beginning Inventory	\$ 50,000	
Add: Net Purchases		
Gross Purchases	\$ 80,000	
Less: Purchase		
Ret. & Allow. ...	4,000	
Purch. Disc.	<u>6,000</u>	
Net Purchases		<u>70,000</u>
Goods Available for Sales		120,000
Less: Ending Inventory		<u>75,000</u>
Cost of Goods Sold		<u>\$ 45,000</u>
Gross Margin		51,000
Operating Expenses:		
Advertising Expense	\$ 400	
Wages Expense	12,400	
Utilities Expense	20,500	
Insurance Expense	100	
Supplies Expense	2,700	
Depreciation Expense	<u>4,200</u>	
Total Operating Expenses		<u>40,300</u>
Net Income		<u>\$ 10,700</u>

HIRSCH PARACHUTE CO.
BALANCE SHEET
AS OF DECEMBER 31, 20x2

Assets

Current Assets

Cash		\$ 5,000
Accounts Receivable		40,000
Merchandise Inventory		75,000
Supplies		1,000
Prepaid Insurance		100
Prepaid Advertising		<u>100</u>
Total Current Assets		\$ 121,200

Plant and Equipment

Land		\$ 5,000
Building	\$ 56,000	
Less: Accumulated Depreciation	<u>2,200</u>	53,800
Equipment	\$ 20,000	
Less: Accumulated Depreciation	<u>2,000</u>	<u>18,000</u>
Total Plant and Equipment		\$ 76,800

Other Assets

Prepaid Insurance		<u>\$ 100</u>
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TOTAL ASSETS		<u>\$ 198,100</u>
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Liabilities

Current Liabilities

Accounts Payable		\$ 30,000
Current Portion of Mortgage Note Payable		10,000
Wages Payable		<u>400</u>
Total Current Liabilities		\$ 40,400

Long-Term Liabilities

Mortgage Note Payable	\$ 100,000	
Less: Current Portion	<u>10,000</u>	90,000

Owner's Equity

A. J. Hirsch, Capital, 12/31/x1		\$ 60,000
Add: Net Income		<u>10,700</u>
		\$ 70,700
Deduct: Withdrawals		<u>3,000</u>
A. J. Hirsch, Capital, 12/31/x2		<u>\$ 67,700</u>

TOTAL LIABILITIES AND OWNER'S EQUITY		<u>\$ 198,100</u>
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