1 General

1. Accounting is a highly stylized language/information system, and the purpose of it is to convey information. It is a formal way that businesses communicate the financial performance and position of a business enterprise to its investors and creditors. It does NOT report what many of the individual assets are worth, therefore does NOT report what the whole entity is worth (its fair market value).
2. Accounting keeps track of transactions with outside parties.
3. **Accrual Accounting** – Keeps track of cash, revenues, and expenses, changes in equity, including receivables.
4. **Cash Accounting** – keep track of only cash receipts and payments
5. **Four functions of accounting**
    a. **Collect** – collect the data to be analyzed
    b. **Measure** – turn the data collected and give it a "equivalent" monetary value
    c. **Classify** – classify the measured data into one of 7 elements of accounting
    d. **Present** – Present the data on the Balance Sheet, Income Statement, and Cash Flow Statement.
6. **Seven Elements of Accounting** – assets, liabilities, equity, revenue, expense, gain, loss (See sections below).
    a. Cost and Cash are NOT elements of accounting.
7. **Accounting period** – period of time covered by one income statement
    a. **Fiscal year** – one year, but not necessarily from Jan1 – Dec 31.
8. **Statements of Financial Accounting Standards (SFAS)** – these statements make up the Generally Accepted Accounting Principles (GAAP), and there are currently 147 SFASs.
9. **Statements of Financial Accounting Concepts (SFAC)** – These are NOT the same as the SFASs.
10. The <u>FORM</u> of GAAP based reports are not consistent with the <u>ECONOMIC SUBSTANCE</u> of business activities
    a. Financial statements must be fair, in all material aspects.
11. **Securities Exchange Commission (SEC)** – Regulating organization for financial reporting. Publicly traded companies with more than 10 million in assets or more than 500 shareholders must file electronically.
    a. **Form 8k** – used to announce the occurrence of a material event or important corporate changes
    b. **Form 10k** – Formal, detailed publican of the annual report, contains 3 years of audited statements.
    c. **Form 10-Q** – A mini 10k that must be filed 45 days from the end of each fiscal quarter.
12. **Transaction –** an event that is recorded in the accounting records.
13. Debt and equity capital are always at risk, since they're uncertain. SEC requires timely and specific information.
14. **Entity** – any organization for which financial statements are prepared. Also a collection of assets/resources.
    a. **Value Proposition** – idea to add value to a product and sell it.
    b. **Business Plan** – who to sell to, how to sell, funding
    c. **Funding** – get the funds to carry out the value proposition and business plan.
    d. Since there is no "end" to a successful business, the value of a business is exclusively in its potential.
15. **Entity Concept -** The entity and the owner are NOT the same. The owner of a business can withdraw money from the business, but must record the transaction on the entity's financial statements.
16. **Materiality Principle** – Disregard trivial matters and disclose all important matters.
17. **Money Measurement Concept** – Accounting reports only those facts that can be stated in monetary amounts.
    a. Some facts cannot be measured (ie How many cars does GE own? How happy are the workers?)
18. **Going Concern Concept** – Assumes that businesses will continue to operate until proven otherwise.
    a. Accounting does not report what the assets could be sold for if the entity cased to exist.
19. **Proprietorship** – entity owned by one person. The owner assumes all liability for the entity.
20. **Corporation** – entity that has many rights and limited liability for its owners.
21. **Claim** – legal claim to cash. These are claims against ALL assets, not any particular asset.
22. **Monetary Assets** – assets that have a claim on a specified amount of money (cash, securities, bonds).
23. **Basic Growth/Discouting (Interest) Equation** – Future_Value = $(1+r)^t$ * Present_Value
    a. Future value is the value in t periods (usually years)
    b. Present Value is the value of the asset at this moment in time
    c. r is interest rate
    d. Discounting is finding the present value of an asset, assuming it loses value over time.
24. **Probability of return** – Cash has a 100% probability of benefit, but low return. Other investments have a < 100% probability of benefit, but offer higher returns.
25. **5 ways to own something** – Customer pays in advance (UnER), Vendor gives you product in advance (AP), borrow money (IBD), Investors give you money (CEC), profits (RE).
26. Can move things around to play with earnings (by capitalizing/expensing), but cannot change cash.

2 Balance Sheet – Contains the 3 Stock Elements (Assets, Liabilities, Equity)

Assets	**Capital**
Cash	Unearned Revenue (UnRev)
Accounts Receivable (AR)	Accounts Payable (AP)
Inventory (INV)	Accrued Expenses (AccEx)
Prepaid Expenses (PpdEx)	
	Interest Bearing Debt (IBD)
Long Lived Assets (LLA)	
(Accumulated Depreciation/Amortization)	Contributed Equity Capital (CEC)
	(Treasury Stock)
	Retained Earnings (RE)

27. **Balance Sheet** – snapshot of the financial position of an entity at a point in time.
    a. Left side of the BS shows assets, right side shows the sources of funds that provided the assets (capital).
    b. Right side can be the amount of funds supplied by creditors and equity investors, or as the claims of these parties against the assets.
28. **Assets** – valuable resources that are expected to deliver probable future economic benefit.
    a. Assets must have been acquired at a measurable cost. For example, if an entity buys a trademark, it is an asset. Its reputation, however, is not, even though it helps it sell its product.
    b. Employees are NOT assets, but contracts are.
29. **Current Assets** – assets that are expected to be converted to cash or used up within one year
    a. **Cash/Cash Equivalents** –cash or short term funds. **Only cash is cash. Nothing else is cash.**
    b. **Accounts Receivable (AR)** – amount that is owed to the business, usually by a customer. Electric bills are AR to the electric company – the electric company provides electricity, customer pays later.
    c. **Inventory (INV)** – goods being held for sale, supplies, raw materials, partially finished products that will be sold upon completion. Note: Must be for sale. A truck used to transport goods is not inventory.
    d. **Prepaid Expenses (PpdEx)** – assets that will be used up in the near future, but have been paid for.
        i. Insurance Policies and other protection mechanisms are intangible (but still current) assets.
    e. **Other Possible Assets** – these may or may not appear on the balance sheet of every company
        i. **Marketable Securities** – stocks/bonds that are expected to be converted into cash within a year
30. **Non-current Assets** – assets that are not used up within a year (trucks, buildings, machines)
    a. **Long Lived Assets (LLA)** – value of all capitalized costs (See Section 4, Dealing With Costs).
    b. **Accumulated Amortization (AccAm)** – Amount of LLA that's been used up. When all capitalized assets have been depreciated, AccAm = LLA.
    c. **Other Non-current Assets** – these may or may not appear on every company's balance sheet
        i. **Patents and Trademarks** – valuable, owned, and were acquired at a measurable cost (if purchased).
        ii. **Goodwill** – Occurs when a company buys another company and pays more than the net identifiable assets. Goodwill = Buying price – (Assets of company bought – liabilities of company bought).
31. **Liabilities** – obligations of the entity to outside parties who have furnished resources, brings probable future economic sacrifice.
    a. **Creditors/Lenders** – parties who have extended credit to the entity.
32. **Current Liabilities** – claims that become due within one year.
    a. **Unearned Revenue (UnRev) –** money received but the services/goods have not yet delivered.
    b. **Accounts Payable (AP)** – Amount that the company owes to its suppliers for goods/services that have been delivered but have not been paid for. Opposite of AR.
    c. **Accrued Expenses (AccEx) –** Amounts owed to employees and others for services they have provided but for which have not been paid.
    d. **Other Current Liabilities –** these may or may not appear on every company's balance sheet
        i. **Estimated Tax Liability –** amount owned to the government for taxes
        ii. **Bank Loan Payable** – Debt owned to the bank in the form of a promissory note.
33. **Non-current Liabilities –** liabilities not due to be paid in the coming year.
    a. **Interest Bearing Debt (IBD) –** Loans of cash and/or cash equivalents that bear interest.
34. **Equity – Net Assets.**
    a. **Contributed Equity Capital (CEC)** – amount provided directly by equity investors (Initial public offering)
        i. **Common Stock** – small pieces of the company, promises a claim on future profits.

        ii. **Shareholders** – people who own the common stock.
        iii. The market price of a stock does NOT affect the balance sheet or assets of an entity. However, all additional stock sales and stock buybacks occur at the current market price.
        iv. **Treasury stock** – the buyback of CEC. If a company buys back $2000 worth of stock, treasury stock shows as (2000) right beneath the original CEC value. (Original CEC does NOT change).
            1. If treasury stock is sold, the original treasury stock value is kept while the CeC is increased.
    b. **Retained Earnings** - Amount retained from profits (or earnings), aka amount of earnings that has not been paid to equity investors in the form of dividends, aka owners claim on the assets.
        i. Cumulative value since the entity began, shows the amount of capital generated by operating activities. It is NOT the same as cash.

35. **Capital** – Equity + Liabilities, same amount of assets, represented by the entire right side of the balance sheet.
    a. **Cost of Capital** – the cost to get capital. For loans, it's interest and points. For equity, it's net earnings.
36. Liabilities are a stronger claim than equity. Liabilities are a claim to cash. Equity is a claim only to the residual of the earnings. If the entity is dissolved, liabilities are paid off first, and whatever's left goes to the equity investors.
37. **Credit** – credit from vendors/credit cards source cash (creates cash for the current period), but increase AccEx
38. **T Accounts** – shorthand methods of keeping track of each of the elements on the balance sheet.
39. **Double Entry System –** whenever a transaction takes place, at least two items on the balance sheet changes.
40. **Capital Structure –** debt to equity ratio
41. **Profitable Operation** – transactions that increase profit increase retained earnings.
42. **Dual Aspect Concept** – Assets = Liabilities + Equity. Equity can be negative if necessary. This is the primary accounting equation.
43. **Asset Measurement (Cost) Concept** – If reliable information is available, an asset is measured as its cost.
    a. Monetary assets are reported at fair value, other assets are reported at a number based on cost.
    b. Fair values can be difficult to estimate, while costs are concrete
44. NOT ALL of a company's assets are recorded on its balance sheet (Internal benefits, stuff you can't quantify).

3 Income Statement (Statement of Earnings) – 4 Flow Elements (Rev, Exp, Gain, Loss)

Revenue
(Cost of Goods Sold)
Gross Profit
(Sales, General, Admin)
EBITDA
(Depreciation/Amortization)
EBIT
(Interest paid in the current period)
EBT
(Taxes paid in the current period)
Net Income

Note: ( ) signifies subtract. i.e. (Cost of Goods Sold) signifies to subtract the amount of COGS from Revenue.

45. **Net Income** – the amount by which equity increased as a result of operations during a period of time
46. **Income Statement** – explains the income of a period. Explains why an increase/decrease occurred.
    a. **Revenue** – the increase in retained earnings resulting from primary operations (Sell product)
        i. **Rental Revenue** – if the tenant pays up front, the landlord starts with all unearned revenue, then increases actual revenue (while decreasing unearned revenue) as the months go by.
    b. **Expense** – the decrease in retained earnings resulting from primary operations (buy merchandise)
        i. **Expenditure** – The decrease in an asset or increase in a liability associated with the acquisition of goods or services. Expenditures are recorded only on the balance sheet, and usually involves two or more elements (ie. When buying inventory, cash decreases, inventory increases by the same amount to keep it balanced).
            1. This is not the same as expense, which represents the USE of goods/services. It's possible to have an expenditure when AQCUIRING goods/services, and then classifying it as an expense when the goods/services are used.
        ii. **Depreciation/Amortization (DA)** – depreciation in the current period is an expense for the current period.
        iii. **Cost of Goods Sold (COGS)** – wholesale cost to manufacture/buy the product sold
        iv. **Sales/General/Admin (SGA)** – Any other expenses that cannot be classified in COGS, DA, Interest, or Taxes. Includes salaries, utilities, administrative expenses, advertising, etc.

        1. Also known as **operating expenses**
    c. **Gains –** the increase in retained earnings resulting from non-primary operations
    d. **Losses –** the decrease in retained earnings resulting from non-primary operations
    e. **Operating Income =** Revenue - Expenses
    f. **Non-Operating Income =** Gains - Losses
    g. **Net Income = Revenue - Expenses + Gains – Losses = Operating Income + Non-Operating Income**
        i. Net income connects the retained earnings between two balance sheets
        ii. New RE = old RE + Net Income – Dividends paid
        iii. **Profit, earnings, and surplus** all mean net income
    h. **Gross Margin (Gross Profit) =** Revenue – Cost of Goods Sold
    i. **EBITDA, Operating Earnings -** Earnings Before Interest, Taxes, Depreciation, and Amortization.
        i. EBITDA = Gross Margin - SGA
    j. **EBIT** = EBITDA – Depreciation/Amortization
    k. **EBT** = EBIT – Interest incurred in the current period
    l. **Net Income =** EBT – taxes.
    m. **Gross Margin Percentage -** Gross Margin / Revenue
    n. **Net Income Percentage –** Net Income / Revenue
    o. **Net Profit Margin** – Net Income / Gross Margin
47. **Realization Principle** – revenue is realized when the following conditions are met:
    a. Goods and/or services have been manufactured and delivered.
    b. Both parties understand and agree to the cost.
    c. The entity has a legal claim to cash.
48. **Matching Principle –** the costs associated with the revenues of a period are the expenses of that period.
    a. Drives expense recognition
49. **Conservatism Principle** – Increases in equity are recognized only when they are reasonably certain. Decreases in equity are recognized as soon as they are reasonably possible.
50. **Bad Debt/Aged Receivables** – accounts where people agreed to pay later but never do. Bad debt needs to be taken into account when recognizing revenue. These usually apply to AR. If AR goes down, so goes equity.
51. **Contra asset** – it's an asset, but is subtracted from another asset (Allowance for Doubtful accounts, AccAm)
52. **Day Sales Uncollected** = Accounts Receivable / (Total credit sales / 365). Indicates whether customers are paying their bills when they are due, aka **solvent**.

4 Dealing with Costs

53. If benefits are expected in the current period, **Expense** the cost (note on income statement as an expense, often in SGA)
54. If the benefits are expected over multiple periods, **Capitalize** the cost (make it a long lived asset)
    a. **Basis** – the amount you capitalize
        i. **Basis =** Actual cost - expected resale cost x periods later.
    b. Determine how much to expense every period for x periods. Each period, that amount goes to the income statement as an expense (often SGA). The cumulative amount expensed is marked on the balance sheet as a contra asset (AccAm).

5 Cash Flow Statement

55. Keeps track of operating activities, investing activities, and financing activities.
56. It links the amount of cash from one balance sheet to the next.
    a. New Cash Value = Old Cash Value + Total Cash FLow
57. **Direct Method** – parallels income statement directly. Starts at the top of the income statement, with revenue explicitly and moves down through the reported expenses, gains, and losses one by one, adjusting for omissions and commissions. Basically, it asks the following questions:
    a. What amount of cash was provided by customers during this period from sales or past receivables?
    b. What amount of cash was paid to suppliers, for direct expenses during this period or for products sold this period, for inventory held for the next period, or for inventory previously purchased but not yet paid for?
    c. What amount of cash was paid for operating expenses during this period regardless of when the resources were provided or when those expenses were utilized to generate sales?
    d. What amount of cash was source or used by non-operating (gains and losses) events?
58. **Indirect Method** – Begins where the income statement ends, at net income
    a. **Cash Flow from Operating Activities (CFOA)** = Net Income + Depreciation in the period + (Change in Receivables) + (Change in Inventory) + (Change in prepaid assets) + Change in Unearned Revenue + Change in Accounts Payable + Change in Accrued Expenses.
    b. **Cash Flow from Investment Activities** = (Change in Long Lived Assets)

c. **Cash Flow from Financing Activities** = Change in Long Term Debt + Change in CeC + (Change in Treasury Stock)

d. **Format:**

Net Income
Depreciation in the period
(Change in current assets)
Change in current liabilities
Cash Flow due to Operating Activities (CFOA)

(Change in LLA)
Cash Flow due to Investing Activities (CFIA)

Change in Interest Bearing Debt
Change in Contributed Equity Capital
Cash Flow due to Financing Activities (CFFA)

Total Cash Flow = CFOA + CFIA + CFFA

6 Booking Example

For an example that was used in my Financial Accounting class regarding a business that revolves around walking ugly puppies and selling t-shirts, download http://www.helpfulnotes.com/files/econ/uglypuppyex.zip. This file contains 6 sets of events and books (Balance sheet, income statement, cash flow statement) for 6 consecutive periods, starting from the creation of the business in period 1.

For each period, two sets of books are provided:

Conservative: This set of books makes conservative accounting choices

1. Revenue is recognized using the realization principle.
2. Inventory uses a LIFO standard (last item that comes in is the first item out. For example, if we buy 10 shirts at $5 each and then another 10 at $6 each, the first ones sold are the ones at $6.)
3. All expenses are expensed (don't capitalize unless absolutely necessary).

Liberal: This set of books makes liberal accounting choices

1. Revenue is recognized when the order is received, even if goods/services have not been delivered and/or payment has not been received.
2. Inventory uses a FIFO standard (first item that comes in is the first item out. For example, if we buy 10 shirts at $5 each and then another 10 at $6 each, the first ones sold are the ones at $5.)
3. All expenses that can be reasonably capitalized are capitalized. However, expenses cannot be capitalized if they are clearly used up in the current period.

You can see the staggering difference between these two sets of books, especially in the early periods. Remember that these two sets of books are FOR THE SAME COMPANY, they simply tell the story in two different ways, and both are completely legal. It's something to keep in mind when you look at the financial statements of real corporations.

Accounting Trivia

1. The principle focus of financial accounting is to serve the needs of outsiders, investors, creditors, vendors, and regulators.
2. A primary and indirect provider of financial capital is vendors
3. The balance sheet reports a company's financial performance at a point of time
4. GAAP is composed of approximately 149 Financial Accounting Standards.
5. The first measure of net operating performance is gross profit
6. Liabilities represent what a company owes
7. If a company reports negative earnings, it can still report positive cash flow for th same period
8. A cost must be classified as either an expense or an asset
9. The SEC is the enforcement agency and the FASB is the principal rule making authority for accounting standards in the United States
10. The matching principle guides expense valuation
11. The realization principle guides revenue recognition
12. Retained earnings represents the cumulative reported earnings of the company less distributions to shareholders
13. The balance sheet reports all of the assets created by transactions by a company
14. Assets = Liabilities + Equity is the accounting equation similarly represented by the financing equation Assets = Capital
15. Creditors have a strong (legal) claim on the company's assets while investors have a residual claim
16. Events that are not transactions are not accounted for, PERIOD.
17. Events that are transactions are accounted for as either recurring activities or non-recurring activities
18. Revenue results when a sale is earned regardless of whether or not cash is exchanged
19. expenses are expired costs
20. assets (except for cash) are unexpired costs
21. Depreciation is the accounting for the current expiration of a capitalized cost.
22. If the managers of a company are accused of alter ego abuses, it means that they are not treating the company's business separately from their own, and they have probably violated the entity assumption.
23. The accounting assumption that is most malleable regarding classification is the period assumption (classifying in which period the event occurred)
24. Deprecation/amortization methods are determined either by SFAS pronouncements or by management and may or may not mirror the physical deterioration of a company's tangible assets
25. If we decide to capitalize a cost, but it's salvage value is 0, then we amortize the entire cost.
26. Accumulated amortization is a contra asset
27. EBIT is often called operating earnings
28. EBIT will generally be equal to or less than EBITDA
29. Reported net income tells shareholders how much INCOME the cash earned during the most recent accounting period (not CASH).