Introduction to Accounting

EDWIN RENÁN MALDONADO ©

CATEDRÁTICO – UPR RIO PIEDRAS

SEG. SEM. 2017-18

Textbook: Financial Accounting, Spiceland

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Financial Accounting, 4^{th}. Ed., Spiceland which is the textbook assigned for the course CONT 3105 – “Introducción a los Fundamentos de Contabilidad” at the University of Puerto Rico, Río Piedras Campus.

Topics

Topics

Accounting and Its Environment

Accounting and Its Environment

1.1 Accounting Definition

Accounting and Its Environment

1.1 Accounting Definition

- Accounting is the language of business.
- Accounting is:
  a. a system
  b. of maintaining records
  c. of a company's operations
  d. and communication that information
  e. to decision makers.

Accounting and Its Environment

1.2 Social Function

Accounting and Its Environment

1.2 Social Function

- One of the most important social function of accounting is assisting the business community to make informed decisions about companies.
- The accounting system provide useful information to users to address financial issues in any kind of entity such as business companies, not-for-profit, government and individuals, among others.

Accounting and Its Environment

1.3 Users of Financial Information

Accounting and Its Environment

1.3 Users of Financial Information

- Accountants measure the activities of the company and communicate those measurement to others.
- Accounting information that is provided for internal users (managers) is referred to as **managerial accounting**; that provided to external users is referred to as **financial accounting**.
- The most important internal and external users follow:

Accounting and Its Environment

1.3 Users of Financial Information

USERS	PURPOSE OF INFORMATION
Investors	Decide whether to invest in a business.
Creditors	Decide whether to lend money.
Customers	Decide whether to purchase products.
Suppliers	Decide the customer's ability to pay for supplies.

Accounting and Its Environment

1.3 Users of Financial Information

USERS	PURPOSE OF INFORMATION
Managers	Decide financial strategies in every aspect of a business such as hiring employees, purchasing inventory, establishing levels of production, approving expansion of operations, among other.
Employees	Decide employment opportunities in current or future employers.

Accounting and Its Environment

1.3 Users of Financial Information

USERS	PURPOSE OF INFORMATION
Competitors	Compare market share and profitability with other companies in the same industry.
Regulators	Regulate an industry such as profit limit, service cost limit, quality of services, etc.
Tax authorities	Impose and collect taxes and establish taxation policies.
Communities	Decide on environmental issues.

Accounting and Its Environment

1.4 Types of Entities

Accounting and Its Environment

1.4 Types of Entities

BUSINESS (FOR PROFIT)

1. **Corporation**
2. **Partnership**
3. **Limited Liability Company (LLC)**
4. **Sole Proprietorship**

GOVERNMENT AND NOT-FOR-PROFIT

Accounting and Its Environment

1.4 Types of Entities

a. **Corporation**:

- *Formation*: The corporation is created and administered according to the Corporate Law enacted in the State the corporation is established. The corporation is a company that is legally separate from its owners.
  - *Owners*: Denominated as shareholders. The number of shareholders can be from one to multiple shareholders, according to the state law.

Accounting and Its Environment

1.4 Types of Entities

a. **Corporation**:

- *Advantage*: The advantage of being legally separate is that the stockholders have limited liability. The limited liability prevents stockholders from being held personally responsible for the financial obligations of the corporation.

Accounting and Its Environment

1.4 Types of Entities

a. Corporation:

- *Disadvantage*: The mayor disadvantages of a corporation are:
  1. **Corporate Law**: The compliance with all requirement of the corporate law to maintain its corporate status, and
  2. **Double Taxation**: The corporation's income is taxed twice. First, the corporation pays corporate income taxes and then the stockholders pay income taxes out of the dividends received by the corporation.

Accounting and Its Environment

1.4 Types of Entities

b. Partnership:

- *Formation*: This is a business owned by two (2) or more persons. There is not specific legal requirement to create a partnership. The partnership can be formed by either a written agreement called Partnership Agreement, or may be formed informally without a written agreement when two or more owners join together in an activity to generate profit.
  - *Owners*: Denominated as partners. The number of partners must be two or more persons.

Accounting and Its Environment

1.4 Types of Entities

b. Partnership:

- *Advantage*: The main advantage is the absent of legal requirements to maintain the partnership status.

Accounting and Its Environment

1.4 Types of Entities

b. Partnership:

- *Disadvantage*: The most important disadvantages are:
  1. **Unlimited liability**: In a partnership the owners are held personally responsible for the activities of the business.
  2. **Financial Resources**: The owners must have sufficient personal funds to finance the business in addition to the ability to borrow money.

Accounting and Its Environment

1.4 Types of Entities

b. Partnership:

- *Note*: The partnership, according to the state laws, may be classified as limited partnership and general partnership. The rules explained before apply mostly to general partnership.
- The limited partnership is a partnership with limited liability. However, providing a full detailed explanation of this type of organization is beyond the scope of this course.

Accounting and Its Environment

1.4 Types of Entities

c. Limited Liability Company (LLC):

- *Formation*: State laws also recognize LLC as legal entities separate from their owners (members).
- Business owners create limited liability companies by filing articles of organization with the state in which they are organizing the businesses.
  - *Owners*: Denominated as members. The number of members can be from one to multiple members, according to the state law.

Accounting and Its Environment

1.4 Types of Entities

c. Limited Liability Company (LLC):

- *Advantage*: As the corporation, the members of an LLC enjoy the limited liability status. Consequently, the LLCs and not their members are responsible for the liabilities of the business.
  - However, when a corporation or an LLC borrow from banks or other lenders, the shareholders or members are usually asked to personally guarantee the debt. To the extent they do this, they become personally liable to repay the loan in the event the corporation or LLC is unable to repay it.

Accounting and Its Environment

1.4 Types of Entities

c. Limited Liability Company (LLC):

- *Advantage*: As the corporation, the members of an LLC enjoy the limited liability status. Consequently, the LLCs and not their members are responsible for the liabilities of the business.
  - However, when a corporation or an LLC borrow from banks or other lenders, the shareholders or members are usually asked to personally guarantee the debt. To the extent they do this, they become personally liable to repay the loan in the event the corporation or LLC is unable to repay it.

Accounting and Its Environment

1.4 Types of Entities

c. Limited Liability Company (LLC):

- *Disadvantage*: In case the entity's intention is to become public (sell stock to the market), the LLC is not the legal form of organization. In that case, the entity must be legally organized as a corporation.

Accounting and Its Environment

1.4 Types of Entities

d. Sole Proprietorship:

- *Formation*: A sole proprietorship is a business owned by only one person. However, the most important distinction of this type of business is that it is not legally organized by any specific state law. A sole proprietorship is not a corporation, nor a partnership, nor a LLC.

Accounting and Its Environment

1.4 Types of Entities

d. Sole Proprietorship:

- *Advantage*: Two main advantages for this type of business:
    1. The owner is free to manage and operate its business without any legal requirement (*in addition to those established by the industry or specific law*), and
    2. without the restrictions that imply having another owners in the business.

Accounting and Its Environment

1.4 Types of Entities

d. Sole Proprietorship:

- *Disadvantage*: As the partnership, the disadvantages are:
  1. **Unlimited liability**: The owners is held personally responsible for the activities of the business.
  2. **Financial Resources**: The owner must have sufficient personal funds to finance the business in addition to the ability to borrow money.

Accounting and Its Environment

1.4 Types of Entities

e. Government and Not-For-Profit:

- Governments and not-for-profits differ from businesses in ways that have significant implication for financial reporting.
- For the most part, governments and not-for-profit provide services targeted at groups of constituents either advocating a political or social cause or carrying out research or other activities for the betterment of society.

Accounting and Its Environment

1.4 Types of Entities

e. Government and Not-For-Profit:

- The objectives of governments and not-for-profit cannot generally be expressed in dollars and cents, are often ambiguous, and are not easily quantifiable.
- Moreover, governments and not-for-profit have relationships with the parties providing their resources that are unlike those of businesses. For examples, a not-for-profit entity mostly earns income by donation. While governments impose taxes as a way to raise income.

Accounting and Its Environment

1.4 Types of Entities

e. Government and Not-For-Profit:

- The main objective of a typical business is to earn profit, to ensure the that over the life of the enterprise, its owners get a return greater than the amount invested.
- However, the goal of governments and similar organizations is something other than earnings profit.

Accounting and Its Environment

1.5 Relationship between Accounting and other Professions

Accounting and Its Environment

1.5 Relationship between Accounting and other Professions

- Due to the fact the accounting is the "language of business", accounting is the way to financially communicate to any external or internal user regardless of whether those users are accountants or not.
- Accounting produce information to be internally used by the entity. For example, Marketing needs the sale report to supervise salesmen and monitor sales forecast. Production needs inventory levels to determine the purchase of more inventory.

Accounting and Its Environment

1.5 Relationship between Accounting and other Professions

- On the other hand, external users are not necessarily accountants. Lawyers need to evaluate financial information of an entity to determine to file or not to file a lawsuit against a company. Financial analysts review a company financial statements to advise a client to buy or not a business. Government requires the inspection of financial data of companies of the same industry to evaluate compliance with laws and regulations governing those specific operations.

Accounting and Its Environment

1.6 Factors Affecting the Accounting as Profession

Accounting and Its Environment

1.6 Factors Affecting the Accounting as Profession

- Many in the Unites States take pride in our system of financial reporting as being the most robust and transparent in the world. But most would also comment that we can do better, particularly in light of the many accounting scandals that have occurred at companies like *AIG, WorldCom and Lehman Brothers*, and the financial crisis of 2008. [*Intermediate Accounting, Kieso, 16 Ed.*]

Accounting and Its Environment

1.6 Factors Affecting the Accounting as Profession

- Here are some possibilities on how we can enhance the existing system of financial reporting:
  1. One-size-fits-all financial report do not meet the needs of the spectrum of investors.
  2. When preparing financial reports, it is difficult to ensure compliance with the voluminous and complex requirements contained in the U.S. GAAP and SEC reporting rules.
  3. Consider a more comprehensive business reporting model, including both financial and nonfinancial key performance indicators.
  4. Deliver all of this information in a timelier manner.

Accounting and Its Environment

1.7 Historical Development of Accounting

Accounting and Its Environment

1.7 <u>Historical Development of Accounting</u>

- The earliest use of accounting (systematic recordkeeping) dates back thousand of years to ancient Mesopotamia (present-day **Irak**), where records were kept of delivered agricultural products.

Accounting and Its Environment

1.7 Historical Development of Accounting

- However, the name that looms largest in early accounting history is **Luca Pacioli**, who in 1494 first described the system of double-entry bookkeeping used by **Venetian** merchants in his "Summa de Arithmetica, Geometria, Proportioni et Proportionalita." Of course, businesses and governments had been recording business information long before the Venetians. But it was Pacioli who was the first to describe the system of debits and credits in journals and ledgers that is still the basis of today's accounting systems. [*Roger Wohlner*]

Accounting and Its Environment

1.7 Historical Development of Accounting

- The industrial revolution spurred the need for more advanced cost accounting systems, and the development of corporations created large groups who were not part of a firm's management but had a vested interest in the company's results—namely, shareowners and bondholders who provided external financing. The rising public status of accountants helped to transform accounting into a profession, first in the United Kingdom and then in the United States. In 1887, thirty-one accountants joined together to create the American Association of Public Accountants. The first standardized test for accountants was given a decade later, and the first CPAs were licensed in 1896. [*Roger Wohlner*]

Accounting and Its Environment

1.7 Historical Development of Accounting

- The Great Depression (after the stock market crash of 1929) led to the creation of the Securities and Exchange Commission (**SEC**) in 1934. All publicly-traded companies were required to file periodic reports with the Commission which had been certified by members of the accounting profession. [*Roger Wohlner*]
- During the stock market crash of 1929, the Dow Jones Industrial Average, a major stock market index in the United states, fell 40% over the period of September 3 to October 29 that year. The Down bottomed out in July 1932, after losing 89% of its value.

Accounting and Its Environment

1.7 Historical Development of Accounting

- Many blamed financial accounting for stock market crash and the ensuing Great Depression of 1930s.
- At the time of the crash, accounting practices and reporting procedures were not well established, providing the opportunity for companies to engage in inaccurate financial reporting to enhance their reported performance. This led to many stocks being valued too highly.

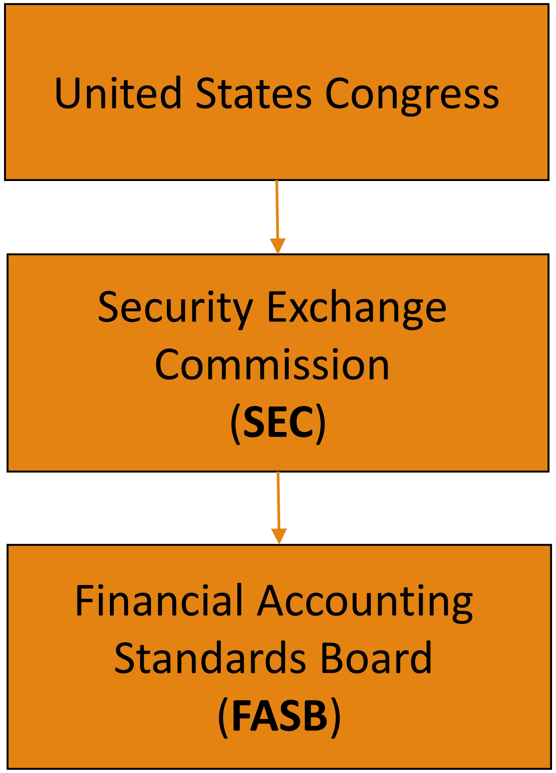
Accounting and Its Environment

1.7 Historical Development of Accounting

- While Congress has given the SEC both the power and the responsibility for setting accounting and reporting standards for publicly traded companies, the SEC has delegated the primary responsibility for setting accounting standards to the private sector, currently Financial Accounting Standards Board (**FASB**).
- The FASB was established in 1973. However, note that the SEC delegated only the responsibility, not the authority, to set these standards. The power still lies with the SEC. If the SEC does not agree with a particular standard issued by the FASB, it can force a change in the standard.

Accounting and Its Environment

1.7 Historical Development of Accounting



Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

1. **Financial Accounting Standards Board (FASB)**

- Financial accounting and reporting standards in the United States are established primarily by the Financial Accounting Standard Board (**FASB**) with the authority of the **SEC**.
- The rules of financial accounting, established by FASB, are called generally accepted accounting principles (**GAAP**).

Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

1. **Financial Accounting Standards Board (FASB)**

- The FASB is an independent, private-sector body with full-time voting members and a very large support staff.
- Members include representatives from the accounting profession, large corporations, financial analysts, accounting educators, and government agencies.

Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

Financial Accounting Standards Board (**FASB**)

↓

Generally Accepted Accounting Principles (**GAAP**)

Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

2.

International Accounting Standards Board (IASB)

- Not all countries follow the same accounting and reporting standards. For example, accounting practices differ between the United States, the United Kingdom, and Japan.

Accounting and Its Environment

1.8 Professional Organizations (Standard Setting Today)

2.

International Accounting Standards Board (IASB)

- In recent years, the accounting profession has undertaken a project whose goal is to eliminate differences in accounting standards around the world. The standard-setting body responsible for this convergence effort is the IASB.

Accounting and Its Environment

1.8 <u>Professional Organizations (Standard Setting Today)</u>

3.

American Institute of Certified Public Accountants (AICPA)

- The AICPA, which is the national professional organization of practicing Certified Public Accountants (CPAs), has been an important contributors to the development of GAAP. Various committees and boards established since the founding of the AICPA have contributed to this effort.

Accounting and Its Environment

1.9 Other Professional Organizations and Entities

Accounting and Its Environment

1.9 Other Professional Organizations and Entities

- There are other professional organizations or governmental entities which, directly or indirectly, promote, lobby or even imposed an accounting or tax rule to the public.

Accounting and Its Environment

1.9 Other Professional Organizations and Entities

1. **Internal Revenue Services (IRS):**
   - The IRS is organized to carry out the responsibilities of the secretary of the Treasury under section 7801 of the Internal Revenue Code. The secretary has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws. The IRS was created based on this legislative grant. [*www.irs.gov*]

Accounting and Its Environment

1.9 Other Professional Organizations and Entities

1. **Internal Revenue Services (IRS):**
   - Consequently, the main purpose of the IRS is to collect the proper amount of tax revenue according to the applicable federal tax law.
   - The IRS's mission is to: "Provide America's taxpayers top quality services by helping them understand and meet their tax responsibility and by applying the tax law with integrity and fairness to all." [*www.irs.gov*]

Accounting and Its Environment

1.9 Other Professional Organizations and Entities

2. Puerto Rico State Society of CPAs:

- Law 75 of May 31, 1973 signed the Law that created the Puerto Rico State Society of Certified Public Accountants as a legal entity with its own personality. This law established the compulsory licensing requirement which establishes that in order to practice public accounting in Puerto Rico, one must be a member of the Puerto Rico State Society of CPAs. [*www.colegiocpa.com*]

Accounting and Its Environment

1.9 <u>Other Professional Organizations and Entities</u>

2. Puerto Rico State Society of CPAs:

- The Vision of the PR State Society of CPAs: “To be the avant-garde institution that <u>provides the CPA with the competencies for its professional success</u>, at the same time as it <u>promotes the values of excellence</u> at a global level and promotes its participation as an <u>entity of change</u>, for the profession and the socioeconomic <u>development of Puerto Rico</u>.” [*www.colegiocpa.com*]

Accounting and Its Environment

1.10 Careers in Accounting

Accounting and Its Environment

1.10 Careers in Accounting

- One of the greatest benefits of an accounting degree is the wide variety of job opportunities it opens to an accounting degree holder. With an accounting degree you can apply for almost any position available to finance majors.

Accounting and Its Environment

1.10 Careers in Accounting

- For the past several years, accounting has ranked as one of the top majors on university campuses. Because of their importance in our society, accountants are in high demand. And because of this high demand, accounting salaries are on the rise. Starting salaries are among the highest of all major across the university.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting

1. **Public Accounting**: Public accounting firms are professional service firms that traditionally have focused on three areas:

   a. **Audit**: To help ensure that management has in fact appropriately applied GAAP, the SEC requires independent outside verification of the financial statements of publicly traded companies. Such independent examination is done by auditors, who are not employees of the company.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting

1. **Public Accounting**:

   b. **Tax Preparation/Planning**: This area in an increasingly important activity in the United States, as the complexity of tax laws related to personal and corporate taxes continues to increase.

   c. **Business Consulting**: This is perhaps the most lucrative activity of accountants. Managers who want to better understand their companies' financial strengths and weaknesses often turn to CPAs for guidance.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting

1. **Public Accounting**: If you choose a career in public accounting, the next big decision is whether to work for one of the "Big 4" public accounting firms (*Deloitte, Ernst & Young, PricewaterhouseCoopers, and KPMG*) or one of the thousands of medium and smaller-sized firms.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting

  2. **Private Accounting**: A career in private accounting means providing accounting services to the company that employs you. Every major company in the world needs employees with training and experience in financial accounting, management accounting, taxation, internal auditing, and accounting information systems.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting

2. **Private Accounting**: However, you can find others career opportunities available for accountants:

   i. FBI agent
   ii. Sports agent
   iii. Tax planners
   iv. Acquisition specialties
   v. Management advisors or IT developers
   vi. Forensic accountants
   vii. Tax lawyers

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting
  3. **Professional Certifications**: There are a myriad of options to obtain different professional certifications in the accounting professions such as:
     I. **CPA**: Most of the public accounting positions are for Certified Public Accountants (CPAs). You become a CPA by passing the four parts of the CPA exam and meeting minimum work experience requirements (in some states). Most states require that you have 150 semester hours of college credit to take the exam. Becoming a CPA can provide a big boost in salary and long-term job opportunities.

Accounting and Its Environment

1.10 Careers in Accounting

- Career Options in Accounting
  3. **Professional Certification**:
     - II. **CMA**: Certified Management Accountant
     - III. **CIA**: Certified Internal Auditor
     - IV. **CISA**: Certified Information System Auditor

Accounting and Its Environment

1.11 Ethics

Accounting and Its Environment

1.11 Ethics

- Like all structures, accounting requires a strong foundation. For accounting, part of that foundation is the ethical behavior of those who practice its rules.
- Ethics refers to a code or moral system that provides criteria for evaluating right and wrong behavior. Investors, creditors, government, and the general public rely on general ethical behavior among those who record and report the financial activates of businesses.

Accounting and Its Environment

1.11 Ethics

- Accountants themselves must have their own personal standards for ethical conduct.
- Accountants need to develop their ability to identify ethical situations and now the difference between right and wrong in the context of the accounting topics.
- One of the keys to ethical decision making is having an appreciation for how your actions affect others.

Accounting and Its Environment

1.11 Ethics

- The accounting profession, throughout the assistance with some professional organization, has established ethics codes to promote and require an ethical behavior among the accountants:
  1. AICPA: AICPA Code of Professional Conduct
  2. AICPA: AICPA's Statements on Standards for Tax Services
  3. Puerto Rico CPA Board: "Reglamento de Ética Profesional para los CPAs de P.R."

Accounting and Its Environment

1.11 Ethics

- In addition, government and its agencies have enacted laws and rules to provide regulation to the profession:
  1. **Sarbanes-Oxley Act**: This law provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators.
  2. **Circular 230, IRS**: This circular provides regulations governing tax practice and applies to all persons practicing before the IRS. Practicing means tax return preparation, representing clients before the IRS, and so on.

Financial Statements

Financial Statements

2.1 Purpose and Definition

Financial Statements

2.1 Purpose and Definition

- The primary means of communicating business activities is through financial statements. Financial statements are periodic reports published by the copay for the purpose of providing information to external users. There are four primary financial statements:
  1. **Income Statements**
  2. **Balance Sheet**
  3. **Statement of Changes in Owner's Equity**
  4. **Statement of Cash Flow**

Financial Statements

2.2 Understanding the Financial Statements

Financial Statements

2.2 Understanding the Financial Statements

- Each financial statement include a heading, sections and accounts.
  1. **Heading:** The heading includes the company's name, the title of the financial statement, and the time period covered by the financial statement. The period depends the accounting period selected by the company.
     a. **Natural Year:** This period comprises a twelve-month period ending December 31.
     b. **Fiscal Year**: This period comprises a twelve-month period ending the last day of any month that is not December. A company can establish a fiscal year from September 1, 2017 to August 31, 2018.

Financial Statements

2.2 Understanding the Financial Statements

- Each financial statement include a heading, sections and accounts.
  2. **Sections:** The financial statements present the information by topic according to the statement purpose. As an example, in the income statement, there is a section for the revenues, and there is another section for the expenses.

Financial Statements

2.2 Understanding the Financial Statements

- Each financial statement include a heading, sections and accounts.
  3. **Accounts:** Within each section are accounts and their balances. An account maintains a record of the business activities related to a particular items over a period of time. For example, the Service Revenue account balance is the summation of all service revenue activities during the period.

Financial Statements

2.3 Income Statements

Financial Statements

2.3 Income Statements

- **Definition**: The income statement is a financial statement that reports the company's revenues and expenses over an interval of time.

Financial Statements

2.3 Income Statements

- **Purpose**: It shows whether the company was able to generate enough revenue to cover expenses of running the business. If revenues exceed expenses, then the company reports net income:

Revenues – Expenses = Net Income

- If expenses exceed revenues, then the company reports a net loss.

Financial Statements

2.3 Income Statements

- **Timing**: When a company records the revenues and expenses in the accounting books depend primarily by the accounting method used by the entity. There are two main accounting methods: Accrual Basis (in conformity with GAAP) and Cash Basis (not in conformity with GAAP).

Financial Statements

2.3 Income Statements

- **Timing**:
  1. *Cash Basis*: Some small companies and the average individual taxpayers use cash basis. Under this method, companies record **revenues** only when they receive cash. They record **expenses** only when they disperse cash. Determining income on the cash basis rests upon collecting revenues and paying expenses. Consequently, cash-basis financial statements are not in conformity with GAAP.

Financial Statements

2.3 Income Statements

- **Timing**:
  2. *Accrual Basis*: Most companies use accrual-basis. This method recognizes **revenue** when the performance obligation is satisfied and the **expenses** in the period incurred, without regard to the time of receipt or payment of cash. Therefore, the accrual basis applies two principles: the revenue recognition principle and the expense recognition principle.

Financial Statements

2.3 Income Statements

- **Section and Elements:** Net income (loss) results from revenues, expenses, gains and loss transactions.
  1. *Revenues*: Inflows mostly from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.
     - Examples: Sales, Services Fees, Rent Income, etc.

Financial Statements

2.3 Income Statements

- **Section and Elements:** Net income (loss) results from revenues, expenses, gains and loss transactions.

  2. *Other income and gains*: Increases in equity (net assets) form peripheral or incidental transactions of an entity except those that result from revenues or investments by owners.
     - Examples: Sales of investments or plant assets.

Financial Statements

2.3 Income Statements

- **Section and Elements:**

  3. *Expenses*: Outflows mostly from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operation.
     - Examples: Cost of goods sold, depreciation, interest, rent, salaries, taxes.

Financial Statements

2.3 Income Statements

- **Section and Elements:**
  4. *Other expenses or losses*: Decreases in equity (net assets) form peripheral or incidental transactions of an entity except those that result from expenses or distributions to owners.
     - Example: Settlement of liabilities.

Financial Statements

2.3 Income Statements

- **Example 1**: See on next pages an example of an Income Statement of a Corporation.

Financial Statements

Corporación Panadería del Pueblo

Income Statements

Years Ended December 31, 2016 and 2015

	2016	**2015**
Sales revenue	$1,050,000	$940,000
Cost of goods sold	625,000	590,000
Gross Profit	425,000	350,000
Operating Expenses		
Selling	75,000	60,000
General and administrative	200,000	180,000
Total operating expenses	275,000	240,000
Operating Income	**$ 150,000**	**$ 110,000**

Financial Statements

Corporación Panadería del Pueblo
Income Statements
Years Ended December 31, 2016 and 2015

	2016	2015
Other income (expenses)		
Interest and dividend income	$ 5,000	$ 4,000
Gain on sale of investment	7,000	0
Interest expense	(14,000)	(16,000)
Total Other Income, net	(2,000)	(12,000)
Income before income taxes	148,000	98,000
Income **tax** expense	(29,600)	(19,600)
Net Income	**$ 118,400**	**$ 78,400**

Financial Statements

2.3 Income Statements

- **Example 2**: See on next pages an example of an Income Statement of an Sole Proprietorship using the same amounts presented on corporate example.
  - Pay attention the Income Statement of a Corporation presents an Income Tax Expense, but the Income Statement of a Sole Proprietorship does not. The reason for this difference is because the Corporation is an entity legally separated from its owners and it is considered a taxpayer. However, the Sole Proprietorship is not legally separated from its owners, and therefore, the owner, and not the entity is responsible to pay the income taxes of the business.

Financial Statements

Panadería del Pueblo

Income Statements

Years Ended December 31, 2016 and 2015

	2016	2015
Sales revenue	$1,050,000	$940,000
Cost of goods sold	625,000	590,000
Gross Profit	425,000	350,000
Operating Expenses		
Selling	75,000	60,000
General and administrative	200,000	180,000
Total operating expenses	275,000	240,000
Operating Income	**$ 150,000**	**$ 110,000**

Financial Statements

Panadería del Pueblo

Income Statements

Years Ended December 31, 2016 and 2015

	2016	**2015**
Other income (expenses)		
Interest and dividend income	$ 5,000	$ 4,000
Gain on sale of investment	7,000	0
Loss on sale of capital asset	(14,000)	(16,000)
Total Other Income, net	(2,000)	(12,000)
Net Income	**$ 148,000**	**$ 98,000**

Financial Statements

2.4 Balance Sheet

Financial Statements

2.4 Balance Sheet

- **Definition**: The Balance Sheet reports the assets, liabilities, and capital of a business enterprises at a specific date.

Financial Statements

2.4 Balance Sheet

- **Purpose**: This financial statement provides the financial position of a company at a specific date which is summarized by the accounting equation:

ASSETS = LIABILITIES + CAPITAL

Financial Statements

2.4 Balance Sheet

- **Section**:

1. *Assets*: The assets are the resources of the company. In addition, the assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
   - Examples: Cash, account receivables, inventory, supplies, equipment, building, intangible assets (copyrights, patents).

Financial Statements

2.4 <u>Balance Sheet</u>

- **Section**:

2. *Liabilities*: The liabilities are amounts owed to creditors. In addition, the liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
   - Examples: Accounts payable, salaries payable, utility payable, note payable.

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*: Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprises, the equity is the ownership interest.

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*: The presentation of the equity section in the Balance Sheet varies according the company's legal organization.
   - **Sole Proprietorship**: The capital balance represents the residual interest of the only owner of the entity. Assume John Smith is the only owner of a sole proprietorship with a capital of $100,000:

JOHN SMITH, CAPITAL	**$100,000**

Financial Statements

2.4 <u>Balance Sheet</u>

- **Section**:

  3. *Equity*:

     - **Partnership**: The capital balance represents the residual interest of the partners of the entity. Assume John Smith and Mary Stuart are the two partners (50% each) of a partnership with a capital of $100,000.

JOHN SMITH, CAPITAL	**$50,000**
MARY STUART, CAPITAL	**<u>50,000</u>**
TOTAL CAPITAL	**$100,000**

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:

   - **Limited Liability Company (LLC)**: The capital balance represents the residual interest of the member or members of the entity. In case the LLC has only one owners, the capital section looks similar as a sole proprietorship capital section. In contrast, in case the LLC has multiple members, the capital section looks similar as a partnership capital section.

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:
   - **Corporation**: The capital section of a corporation is denominated as “Stockholders’ Equity”. The Stockholders’ Equity section includes, at least, the following three accounts:
     i. Capital stock
     ii. Additional Paid-In Capital
     iii. Retained Earnings

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:
   - **Corporation**:
     i. *Capital stock*: Companies must disclose the par value and the authorized, issued, and outstanding share amounts, normally classified as common stock and preferred stock. The common stock represent the basic ownership interest with voting rights. However, the preferred stock, nonvoting, is a special class of share that possesses certain preferences or priority to claim on earnings.

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:

   - **Corporation**:

     i. *Capital stock*: In issuing stock, companies follow these procedures. First, the state must authorize the stock, generally in a certificate of incorporation or charter. Next, the corporation offer share for sale, entering into contracts to sell stock. The, after receiving amounts for the stock, the corporation issues share (after having the authorization from the state of incorporation).

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:

   - **Corporation**:

     ii. *Additional Paid-In Capital*: Represent the total amount paid in on capital stock in excess of par value.

     iii. *Retained Earnings*: Represents the undistributed earnings of a corporation. This account increases by the net income of the corporation and decreases by the net losses and dividends paid to stockholders.

Financial Statements

2.4 Balance Sheet

- **Section**:

3. *Equity*:

   - **Corporation**: Assume a new corporation with 1,000,000 authorized common stock with par value $1.00, sell 5,000 stock and collected $100,000. The stockholders' equity follows:

Common Stock, Par Value $1.00 authorized 1,000,000, issued and outstanding 5,000	$ 5,000
Additional Paid-In Capital	95,000
Retained Earnings	0
Total	$100,000

Financial Statements

2.4 Balance Sheet

- **Section**:
  3. *Equity*:
     - **Government and Not-for-Profit**: The government and not-for-profit entities capital account is mainly named as “Net Assets”.

Financial Statements

2.4 Balance Sheet

- **Example 3**: See on next pages an example of an balance sheet of a Corporation.

Financial Statements

Corporación Panadería del Pueblo
Balance Sheets
December 31, 2016 and 2015

ASSETS	**2016**	**2015**
Current Assets		
Cash	$ 50,000	$ 40,000
Account receivable	150,000	160,000
Inventory	255,000	185,000
Investment	55,000	75,000
Property, Plant & Equipment		
Machinery and equipment	215,000	200,000
Accumulated depreciation	(160,000)	(140,000)
Intangible	15,000	15,000
Other Assets	5,000	5,000
TOTAL ASSETS	**$ 585,000**	**$ 540,000**

Financial Statements

Corporación Panadería del Pueblo

Balance Sheets

December 31, 2016 and 2015

LIABILITIES	**2016**	**2015**
Current Liabilities		
Accounts payable	$ 15,000	$ 20,000
Accrued liabilities	28,000	40,000
Unearned revenues	20,000	20,000
Current maturity of long-term debt	10,000	10,000
Long-term debts	190,000	200,000
Other noncurrent liabilities	10,000	10,000
TOTAL LIABILITIES	**$ 273,000**	**$ 300,000**

Financial Statements

Corporación Panadería del Pueblo
Balance Sheets
December 31, 2016 and 2015

STOCKHOLDERS' EQUITY	**2016**	**2015**
Common stock, $1 par value, 10,000 authorized;		
5,000 issued and outstanding	$ 5,000	$ 5,000
Paid –in capital	95,000	95,000
Retained Earnings	212,000	140,000
TOTAL STOCKHOLDERS' EQUITY	**$ 312,000**	**$ 240,000**
TOTAL LIABILITIES AND		
STOCKHOLDERS' EQUITY	**$ 585,000**	**$ 540,000**

Financial Statements

2.4 Balance Sheet

- **Example 4**: See on next pages an example of an balance sheet of a Sole Proprietorship using the same amounts presented on corporate example.
  - **Pay attention to the capital section**.

Financial Statements

Panadería del Pueblo
Balance Sheets
December 31, 2016 and 2015

ASSETS	**2016**	**2015**
Current Assets		
Cash	$ 50,000	$ 40,000
Account receivable	150,000	160,000
Inventory	255,000	185,000
Investment	55,000	75,000
Property, Plant & Equipment		
Machinery and equipment	215,000	200,000
Accumulated depreciation	(160,000)	(140,000)
Intangible	15,000	15,000
Other Assets	5,000	5,000
TOTAL ASSETS	**$ 585,000**	**$ 540,000**

Financial Statements

Panadería del Pueblo
Balance Sheets
December 31, 2016 and 2015

LIABILITIES	**2016**	**2015**
Current Liabilities		
Accounts payable	$ 15,000	$ 20,000
Accrued liabilities	28,000	40,000
Unearned revenues	20,000	20,000
Current maturity of long-term debt	10,000	10,000
Long-term debts	190,000	200,000
Other noncurrent liabilities	10,000	10,000
TOTAL LIABILITIES	**$ 273,000**	**$ 300,000**
Juan del Pueblo, Capital	312,000	240,000
TOTAL LIABILITIES AND OWNER'S EQUITY	**$ 585,000**	**$ 540,000**

Financial Statements

2.5 Statement of Changes in Equity

Financial Statements

2.5 Statement of Changes in Equity

- **Definition**: The Statement of Changes in Equity is a financial statement that summarizes the changes in equity over an interval of time. The reporting period coincides with the time period covered by the income statement.

Financial Statements

2.5 Statement of Changes in Equity

- **Purpose**: The purpose of this statement is to explain the changes in balances, over an interval of time, of:
  - The capital accounts (**sole proprietorship**) or accounts (**partnership**), or
  - the two primary components of the stockholders’ equity in a **corporation**: common stock and retained earnings.

Financial Statements

2.5 Statement of Changes in Equity

- **Purpose**: Pay attention to the following two events that explain the differences found in the capital accounts:
  1. Increases in Capital Accounts:
     a. *Owner's Contributions*: Every time an owner contributes resources (money, property) to the company, the capital account increase. In case of a corporation, the entity receives cash in exchange of corporate stock. In that case, the common stock and paid-in capital accounts increase.

Financial Statements

2.5 <u>Statement of Changes in Equity</u>

- **Purpose**: Pay attention to the following two events that explain the differences found in the capital accounts:
  1. <u>Increases in Capital Accounts</u>:
     b. *Net Income*: In every period an company generates net income, the capital account (**sole proprietorship** or **partnership**) increases by the net income amount. In case of a **corporation**, the net income amount represents an addition to the balance of Retained Earnings account.

Financial Statements

2.5 <u>Statement of Changes in Equity</u>

- **Purpose**: Pay attention to the following two events that explain the differences found in the capital accounts:
  2. <u>Decreases in Capital Accounts</u>:
     a. *Owner's Distributions*: Every time a company distributes resources (money, property) to the owners, the capital account decreases. In case of a corporation, the distributions to the stockholders (pay in the form of dividends) decrease the Retained Earnings Account.

Financial Statements

2.5 Statement of Changes in Equity

- **Purpose**: Pay attention to the following two events that explain the differences found in the capital accounts:

  2. Decreases in Capital Accounts:

     b. *Net Loss:* In every period an company generates net losses, the capital account (**sole proprietorship** or **partnership**) decreases by the net loss amount. In case of a **corporation**, the net loss amount represents a reduction to the balance of Retained Earnings account.

Financial Statements

2.5 Statement of Changes in Equity

- **Example 5**: See on next pages an example of the Statement of Changes in Owner's Equity of a Corporation for the **Examples 1 and 3** of this presentation.

Financial Statements

Corporación Panadería del Pueblo
Statements of Changes in Owners' Equity
Years Ended December 31, 2016

	Total	Retained Earnings	Common Stock
Beginning Balance	$240,000	$140,000	$100,000
Net Income	118,400	118,400	
Proceed on common stock	0		0
Dividends	(46,400)	(46,400)	________
Ending Balance	**$312,000**	**$212,000**	**$100,000**

Financial Statements

2.5 Statement of Changes in Equity

- **Example 6**: See on next pages an example of the Statement of Changes in Owner's Equity of a Sole Proprietorship for the **Examples 2 and 4** of this presentation.

Financial Statements

Panadería del Pueblo

Statements of Changes in Owner's Equity

Years Ended December 31, 2016 and 2015

	2016	**2015**
Juan del Pueblo, Capital, Beginning	$240,000	$142,000
Net Income	148,000	98,000
Contributions	0	0
Distributions	(76,000)	0
Juan del Pueblo, Capital, Ending	**$312,000**	**$240,000**

Financial Statements

2.6 Statement of Cash Flows

Financial Statements

2.6 Statement of Cash Flows

- **Definition**: The Statement of Cash Flows is a financial statement that measures activities involving cash receipts and cash payments over an interval of time.

Financial Statements

2.6 Statement of Cash Flows

- **Purpose**: The main purpose of this statement is to explain to the users the change in the “cash account” over an interval of time.

Financial Statements

2.6 Statement of Cash Flows

- **Sections**: We can classify all cash transactions into three categories that correspond to the three fundamental business activities: operating, investing and financing.

Financial Statements

2.6 <u>Statement of Cash Flows</u>

- **Sections**:
  1. *Operating*: Include cash receipts and cash payments for transactions involving revenue and expenses (the main business operation) activities during the period. In other words, operating activities include the cash effects of the same activities that are reported in the income statement to calculate net income.

Financial Statements

2.6 Statement of Cash Flows

- **Sections**:

2. *Investing*: Generally include cash transactions for the purchase and sale of investment and long-term assets.
3. *Financing*: Include cash transactions with lenders, such as borrowing money and repaying debt, and with owners, such as contributing money to business, issuing stock and paying dividends.

Financial Statements

2.6 Statement of Cash Flows

- **Example 7**: See on next page an example of the Statement of Cash Flows of a Corporation for the **Examples 1, 3 and 5** of this presentation.
  - Pay attention this statement is explaining the change in the cash account from a beginning balance of $40,000 (January 1, 2016) to the ending balance of $50,000 (December 31, 2016).
  - The $10,000 increase in cash is due to different factors from operating, investing and financing activities.

Financial Statements

Corporación Panadería del Pueblo
Statement of Cash Flows
Year Ended December 31, 2016

		2016
Cash flow from operating activities		
Net Income	$118,400	
Adjustment to reconcile net income	(59,000)	
Net cash flow from operating activities		$ 59,400
Cash flow from investing activities		
Purchase of equipment	(15,000)	
Sales of investment	27,000	
Net cash flow from investing activities		7,000
Cash flow from financing activities		
Payment of long-term debt	(10,000)	
Dividends paid	(46,400)	
Net Cash flow from financing activities		(56,400)
Net increase in cash		10,000
Cash balance, January 1		40,000
Cash balance, December 31		**$ 50,000**

Concepts, Principles and Basic Assumptions

Concepts, Principles and Basic Assumptions

3.1 Generally Accepted Accounting Principles (GAAP)

Concepts, Principles and Basic Assumptions

3.1 Generally Accepted Accounting Principles (GAAP)

- **Definition**: As explained before, the rules of financial accounting are called Generally Accepted Accounting Principles, often abbreviated as GAAP, established primarily by the FASB.
- The term "generally accepted" means either:
  - that an authoritative accounting rule-making body has established a principles of reporting in a given area or
  - that over time a given practice has been accepted as appropriate because of its universal application.

Concepts, Principles and Basic Assumptions

3.1 Generally Accepted Accounting Principles (GAAP)

- **Rationale**: Preparing financial statements according to GAAP contributes to the comparability of accounting information.

Concepts, Principles and Basic Assumptions

3.2 Concepts and Basic Assumptions

Concepts, Principles and Basic Assumptions

3.2 Concepts and Basic Assumptions

1. **Economic Entity**: This assumptions states that we can identify all economic events with a particular economic entity.
   - **Examples**:
     a. The accounting books of Coca Cola only include transactions involving Coca Cola, not Pepsi.
     b. The accounting books of a corporation only include transactions involving the corporate operations, not its stockholders personal transactions.

Concepts, Principles and Basic Assumptions

3.2 <u>Concepts and Basic Assumptions</u>

2. **Going Concern**: This assumptions states that in the absence of information to the contrary, a business entity will continue to operate indefinitely.
   - **Example**: The auditors of the Government of Puerto Rico raised an issue of going concern with respect to the government financial statement of 2014 due to the uncertainty of the government to continue providing services and its ability to pay debts when they mature.

Concepts, Principles and Basic Assumptions

3.2 Concepts and Basic Assumptions

3. **Periodicity**: This assumption relates to the qualitative characteristic of timeliness. This assumptions divides the economic life of an enterprise into artificial time periods for periodic financial reporting.
   - **Example**: As explained before, the most common artificial time period is a year (natural year, fiscal year). However, most of the time the companies prepare monthly financial statement to evaluate the results and operations of an entity on a consistent manner.

Concepts, Principles and Basic Assumptions

3.2 Concepts and Basic Assumptions

4. **Monetary Unit**: According to this assumption, in order to measure financial statement elements, we need a unit or scale of measurement. The dollar in the United States is the most appropriate common denominator to express information about financial statement elements.

Concepts, Principles and Basic Assumptions

3.3 Fundamental Qualitative Characteristics

Concepts, Principles and Basic Assumptions

3.3 Fundamental Qualitative Characteristics

1. **Relevance:** To have relevance, accounting information should possess:
   i. confirmatory value and/or (ex. A company with net income is a conformation of the good management using appropriately the company's resources)
   ii. predictive value. (ex. A company that earns consistently annual net income predict the company's ability to generate future cash flows.

   Generally, useful information will possess both of these components. If information is not relevant to the decision at hand, it is useless.

Concepts, Principles and Basic Assumptions

3.3 Fundamental Qualitative Characteristics

1. **Relevance:** Other aspect of Relevance is Materiality. Unless an item is material in amount or nature, that is, sufficient in amount or nature to affect a decision, it need not be reported in accordance with GAAP.
   - **Example**: Recording a $6 wastebasket as a current expense instead of a long-term asset for a multibillion-dollar company like Nike has no impact on investors’ decisions.

Concepts, Principles and Basic Assumptions

3.3 Fundamental Qualitative Characteristics

2. **Faithful Representation:** To be a faithful representation of business activities, accounting information should be:
    I. complete (include all information necessary),
    II. neutral (unbiased), and
    III. free from error (using the best available information).

Concepts, Principles and Basic Assumptions

3.4 Enhancing Characteristics of Accounting Information

Concepts, Principles and Basic Assumptions

3.4 Enhancing Qualitative Characteristics

1. **Comparability:** Refer to the ability of users to see similarities and differences between two different business activities.
   - Example: A user can evaluate the total assets of Banco Popular and compare with total assets of Scotiabank.

Concepts, Principles and Basic Assumptions

3.4 Enhancing Qualitative Characteristics

2. **Verifiability:** Occurs when independent measurers, using the same methods, obtain similar results.
   - Example: An auditor computes the inventory value of GAP store using one method of inventory valuation. Other auditor, using the same method, must reach the same valuation amount of GAP inventory.

Concepts, Principles and Basic Assumptions

3.4 Enhancing Qualitative Characteristics

3. **Timeliness:** Refers to information being available to users early enough to allow them to use it in the decision process.
   - Example: The United States Congress claimed a lack of timeliness of the Government of Puerto Rico in preparing its financial statements when the government requested federal economic assistance during its bankruptcy petition. The US Congress was impaired to take a decision because the Government of Puerto Rico did not furnish its financial statements.

Concepts, Principles and Basic Assumptions

3.4 Enhancing Qualitative Characteristics

4. **Understandability:** Means that users must be able to understand the information within the context of the decision they are making.

Concepts, Principles and Basic Assumptions

3.5 Basic Principles of Accounting

Concepts, Principles and Basic Assumptions

3.5 Basic Principles of Accounting

1. **Measurement Principle:** The most commonly used measurements are based on historical cost and fair value.
   a. Historical cost: GAAP requires that companies account for and report many assets and liabilities on the basis of acquisition prices. This is often referred to as the historical cost principle. The most important advantage of historical cost over other valuations: it is generally thought to be verifiable.

Concepts, Principles and Basic Assumptions

3.5 Basic Principles of Accounting

1. **Measurement Principle:** The most commonly used measurements are based on historical cost and fair value.
   b. Fair Value: Fair value is a market-based measure. The use of fair value in financial reporting is increasing. Consequently, we presently have a "mixed-attribute" system that permit the use of historical and fair value. [Kieso]

Concepts, Principles and Basic Assumptions

3.5 Basic Principles of Accounting

2. **Revenue Recognition Principles:** This principles requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.
3. **Expense Recognition Principles**: "Let the expense follow the revenue". Thus, companies tie expense recognition to revenue recognition.

Concepts, Principles and Basic Assumptions

3.5 Basic Principles of Accounting

4. **Full Disclosure Principles:** It recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for
   i. sufficient detail to disclose matters that make a difference to users, yet
   ii. sufficient condensation to make the information understandable, keeping in mind costs of preparing and using it. [Kieso]

Concepts, Principles and Basic Assumptions

End