Objectives and Game Plan

- Understand some key concepts of Financial Accounting
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Key Conflict: Relevance v. Reliability

- Example: How should we value one-of-a-kind assets, like one of Intel's wafer fabrication plants?

Key Conflict: Relevance v. Reliability

- Example: How to value one-of-a-kind assets?
  - Financial accounting stresses ***Reliability***: Verifiable and objective information.
  - However, we will see that there is **ample room for managerial judgment** when applying "objective rules."

Important Financial Accounting Concepts

- Consistency: Across time
- Comparability: Across firms
- Conservatism: “anticipate no profit, but anticipate all losses”
- Materiality: Benefit/cost trade-off
- **Revenue Recognition**
- **Matching Principle**: Matching Efforts (costs) with Benefits (revenue)

Further, we will make assumptions about the Economic Entity, its ability to survive as a Going Concern, and the Fiscal Period (which need not be the calendar year)

The Balance Sheet Equation

$$\boxed{\text{Assets} \quad = \quad \text{Liabilities} \quad + \quad \text{Shareholders' Equity}}$$

Assets	-	Liabilities	=	Shareholders' Equity
"own"		"owe"		"owners' share of the business"
				(book value, residual claim)

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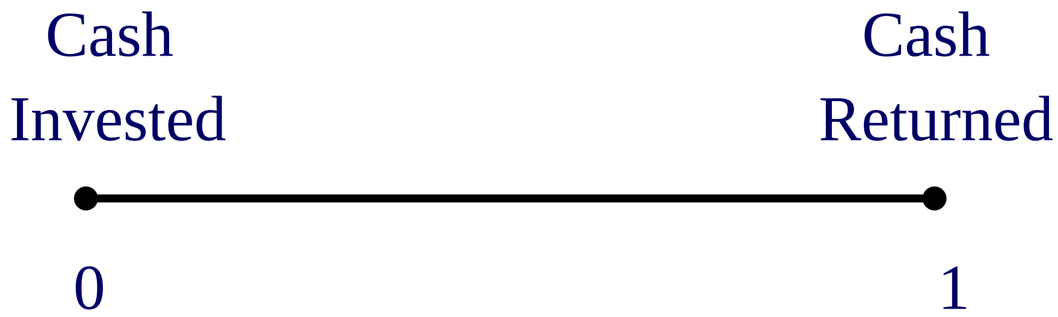
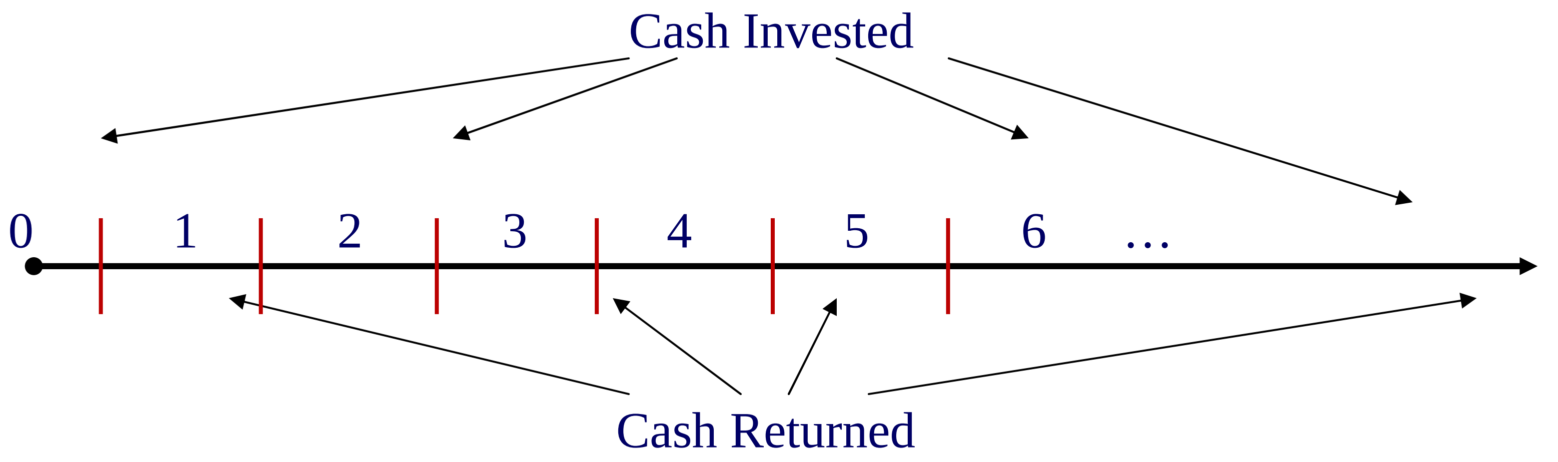
Accounting in a Single-Period World is "Easy"



- Example: Shipping Expeditions in the 15th Century
  - Ship sold at end of voyage: finite project life
  - No information available until ship returns
  - Income is simply difference between ***cash out*** and ***cash in***

Accounting in a Multiperiod World is "Difficult"



- No pre-determined end to firm's life; a firm is going concern
- Cash invested and generated at multiple points in time
- Monitoring by external investors requires them to evaluate investments and retain/reward management at particular points in time
- Therefore: Accrual accounting; the hope is that it allows performance measurement and monitoring at particular points in time, independent of when cash effects occur.

Principles of Accrual Accounting

- An attempt to measure ***firm performance*** in a particular period regardless of when cash is exchanged

- Revenue Recognition:
  - Earnings process substantially complete
  - Cash collection reasonably assured

- The Matching Principle for Expenses:
  - Match *efforts* to the benefits generated
  - Capitalize expenditures that will benefit future periods, expense as benefits are realized
  - Recognize liabilities when efforts benefiting the current period require cash payment in the future

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Cash Collection v. Revenue Recognition

	Prior Period	Current Period	Subsequent Period
Cash received concurrent with earning revenue		+ Cash (A) = + Revenue (SE) ➔ Income Statement	
Cash received before earning revenue	+ Cash (A) = + Deferred Revenue (L)	0 = - Deferred Revenue (-L) + Revenue (SE) ➔ Income Statement	
Cash received after earning revenue		+ Accounts Receivable (A) = + Revenue (SE) ➔ Income Statement	+ Cash (A) - A/R (-A) = 0

Note: Deferred Revenue can also be called Advances from Customers. Both names signify that cash has been received for a service or product that hasn't been delivered.

Cash Payment v Expense Recognition

	Prior Period	Current Period	Subsequent Period
Cash paid ***concurrent with*** using resource to generate revenue		- Cash (-A) = + Expense (-SE) ➔ Income Statement	
Cash paid ***before*** using resource to generate revenue	- Cash (-A) + Productive Asset (A) = 0	- Productive Asset (-A) = + Expense (-SE) ➔ Income Statement	
Cash paid ***after*** using resource to generate revenue		0 = + Accrued Liability (L) + Expense (-SE) ➔ Income Statement	- Cash (-A) = - Accrued Liability (-L)

Note: The "Productive Asset" could be inventory, Prepaid Insurance, PP&E, etc. In the case of PP&E, we would reduce the value of the asset through the contra-asset Accumulated Depreciation. The"Accrued Liability" could be Accounts Payable, Accrued Wage Expense, Interest Payable, etc

Temporary v Permanent Accounts

- Permanent Accounts:
  - Appear on the Balance Sheet
  - Start each period with the ending balance from the prior period

- Temporary Accounts:
  - Appear on the Income Statement
  - Start each period with a balance of $0
  - Are closed at the end of the period to the Income Summary to compute Net Income for the period

Handling Temporary Accounts in the <u>B</u>alance <u>S</u>heet <u>E</u>quation (BSE) Format

- Net Income = Revenues - Expenses + Gains - Losses
- End. Ret. Earn. = Beg. Ret. Earn. + NI - Div
- Therefore...
  - Revenues and Gains ultimately Increase Ret. Earn.
  - Expenses and Losses ultimately Decrease Ret. Earn.
  - We'll record Income Statement components directly to the Permanent Account, Retained Earnings, with a note about the reason
  - Recognize that this is a short-cut around the use of Temporary Accounts

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Exercise E4-19: Peters Company

See Example E4-19: Peters Company on pages 163-4 in the course textbook.

Exercise E4-19: Peters Company (continued)

Cash + AR + PPRent + Inv = AP + WgsPble + CC + RE

BB

1

2

3

4

4a

5

EB

Total Assets =

Liab + SE =

Exercise E4-19: Peters Company (continued)

Performance Measure	Year 1	Year 2	Total
Net Income……………			
Net Cash Flow from Operations…………….			

Key Points

- Relevance of Accounting Measures depends on the decision context
- Most relevant measures are sometimes the least reliable: a major trade-off in accounting
- Accrual Accounting attempts to measure performance, **regardless of when cash is affected**
  - Tables on ***Cash Collection v. Revenue Recognition*** slides provide a framework for thinking about the accrual process
- Balance Sheet Equation (BSE) as a tool for understanding events' impacts on the Financial Statements