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Notes – Topic 2

Financial Statements

I. Statements
  a. Requirements
    i. SEC mandates
    ii. Annual
      1. 10-K report.
      2. Filed within 60 days of year-end.
    iii. Quarterly.
      1. 10Q form.
      2. Not audited.
      3. Filed within 60 days of quarter-end.
    iv. Significant events
      1. 8-K
      2. Management or auditor change.
      3. Just a few days to report.
    v. EDGAR
      1. Electronic Data Gathering And Retrieval
      2. Available online.
      3. "Font of information."
  b. Balance Sheet
    i. Company name.
    ii. "Balance sheet" and specific date.
    iii. Indication of scale.
    iv. Assets
      1. Will generate cash or let company avoid spending cash.
      2. On left or top of Balance Sheet
    v. Liabilities & Shareholders' Equity
      1. Obligations
      2. Capital = Amount investors offered to put into corporation.
      3. Retained earnings are earnings over time to which investors have rights.
      4. Assets == Liabilities & Owners' Equity
      5. Resources == Creditors claims to owners equity.
    vi. Classified Balance Sheet
      1. Current Assets
        a. Will become cash within one-year (or within one operating cycle – the time for "cash > build > sell > cash" if longer than one year).
        b. Cash
        c. Marketable securities
        d. Accounts Receivable
        e. Notes receivable
        f. Inventory
        g. Generally shown in order of decreasing liquidity, as above.
      2. Long-Term Assets. PPE. Property, Plant, and Equipment.
      3. Current Liability.
        a. Accounts Payable.
        b. Accrued Wages (vacation time, etc)
        c. Current portion of long-term debt.
      4. Long-term Liabilities. Long-term debt.
      5. Current assets – Current liabilities = Working capital. In general, bigger is better.

        6. Current Ratio = Current Assets / Current Liabilities. Ratio should be greater than 1.
c. Income Statement
    i. Net income over time for company
    ii. Revenue / Expense Recognition
        1. Cash Basis
            a. When cash actually is received or paid it represents a revenue or expense.
            b. Vast majority of taxpayers work on cash basis.
        2. Accrual Basis
            a. Revenue is recognized when…
                i. It's earned (goods or services are delivered)
                ii. It's realized (cash or claims to cash are received).
            b. Required under GAAP.
            c. Expense recognition / matching
                i. Direct association
                    1. Eg: Cost of goods matched with revenue from goods.
                    2. Eg: Match commissions with sales.
                ii. Presumed association
                    1. Eg: Buy machinery to help increase revenue.
                    2. Allocate the cost of the machinery over the time benefits are expected from it.
                    3. Depreciation!
                iii. Speculative / indirect association
                    1. Eg: Advertising
                    2. Recognize expense immediately.
                iv. No association
                    1. Eg: Fines.
                    2. Record immediately.
    iii. Assets = Liabilities + (Paid-In Capital + (Revenues – Expenses))
d. Statement of Shareholders' Equity
    i. Balance @ A, Net Income, Issuance of Stock, Balance @ B
    ii. Common stock = par value * shares outstanding
        1. "Legal Capital"
        2. As long as the company is 'alive', the legal capital cannot be pulled by investors.
    iii. Paid-In capital is extra earnings from the sale of stock.
e. Cash Flows Statement
    i. Operating
        1. Inflows: Sales
        2. Outflows: Wages, Utilities, Taxes
    ii. Investing
        1. Inflows: Selling buildings and land
        2. Outflows: Purchasing Property Plant and Equipment
    iii. Financing
        1. Inflows: Borrowing money, equity infusion
        2. Outflows: Repaying loans, distributing cash to owners
    iv. Over a period of time ("Year ended…" or "Month ended…" et cetera)
    v. Entries on Statement
        1. Sources of cash from operating activities
        2. Uses of cash for investing activities
        3. Et cetera
        4. Net increase in cash
        5. Cash at Date A
        6. Cash at Date B

II. Footnotes to Financial Statements
   a. Summary of accounting policies
   b. Additional information on summary totals (what was netted out, et cetera)
   c. Disclosures not contained in the statements
   d. Supplementary information as required by FASB
III. Corporate Annual Report Contents
   a. Financial Statements
   b. Footnotes
   c. Letter from Management
   d. Management's Discussion and Analysis
   e. Report of Independent Auditors
   f. Management's Responsibility Statement
   g. Other
IV. Concepts / Conventions / Assumptions
   a. Separate entity concept. Firms must be considered separate entities when accounting.
   b. Going Concern Convention
      i. Assume the company will continue to operate for the foreseeable future.
      ii. Otherwise, how to value assets that outlive the company, et cetera?
   c. Materiality Convention
      i. A matter is material if someone's opinion might change depending on whether the matter is shown or not.
      ii. If perceptions won't change, it doesn't matter as much.
   d. Cost Benefit Criterion. Only make changes to systems if the benefits exceed the cost.
   e. Cost Principle
      i. Long-term assets are recorded as their purchase price.
      ii. The market value changes too much. An accurate value couldn't be assigned based on the market, and the fluxing would lead to misleading reports.
   f. Arm's Length Transactions
      i. Rational agents.
      ii. (See EC-011 discussion of "Gains from Trade")
V. Financial Ratios
   a. Statements and Earnings
      i. Current Ratio = Current Assets / Current Liabilities
      ii. Asset Turnover Ratio = Sales / Total assets
         1. Efficiency. Productivity = Output / Input
         2. Effectiveness. Is the company achieving its goals?
         3. Could be succeeding at one, but failing at other.
      iii. Debt Ratio = Total Liabilities / Total Assets
      iv. Return on Sales = Net Income / Sales
      v. Return on Equity = Net Income / Owners' Equity
   b. Investing
      i. PE Ratio = Market Price per Share / Earnings per Share
      ii. Dividend-Yield Ratio = Current Dividend per Share / Current Market Price
      iii. Dividend Payout Ratio = Common Dividend per Share / Earnings Per Share