Financial Accounting II

0. Presentation

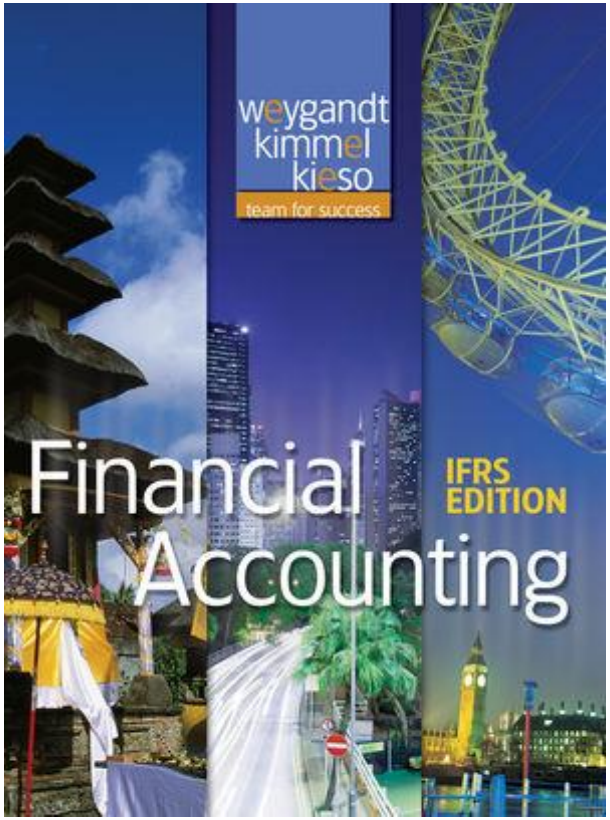
- Objectives of the course
  - Some relevant accounting topics
  - Consolidated Financial statements
  - International Accounting Standards
- Syllabus
- Evaluation
- Materials

Financial Accounting II

Evaluation

- 2 x 15% Middle term exam (multiple choice)
- 30% Final Exam

Recommended book



Financial Accounting II

I. Some relevant accounting topics

1. Presentation and discussion of the Financial Statements
2. Capital Operations
3. Subsidies
4. Leases Operations

Financial Accounting II

I. Some relevant accounting topics

1. Presentation and discussion of the Financial Statements

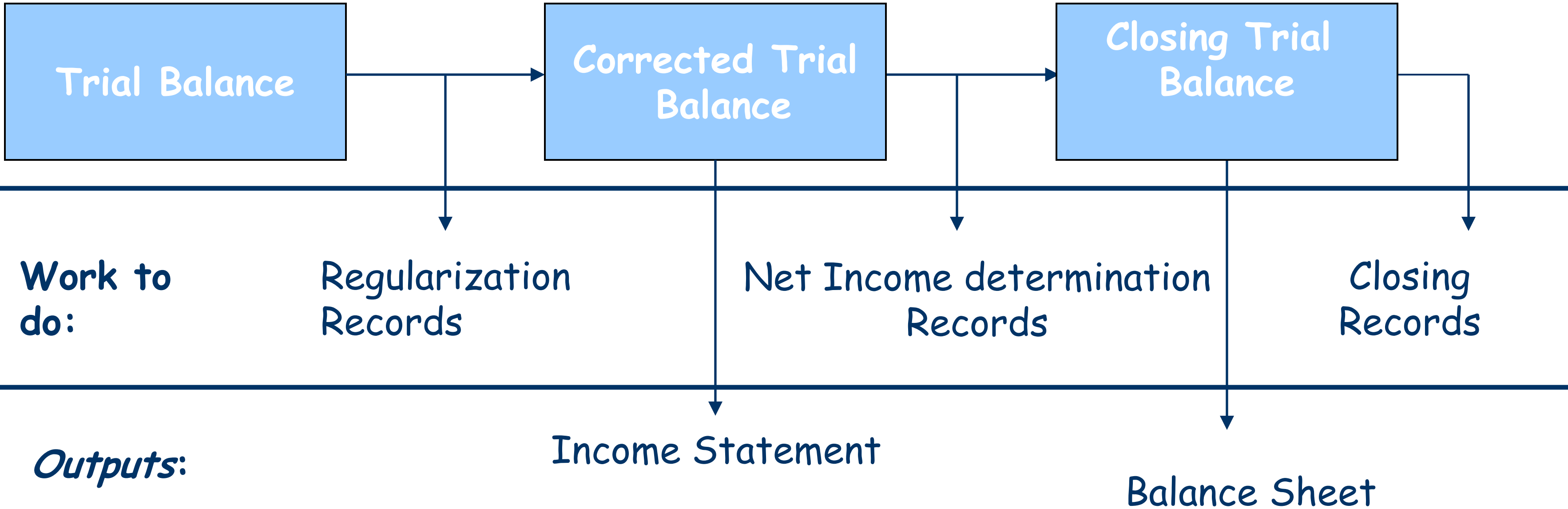
- End of the Year Operations
- Construction of the Financial Statements
  - Balance Sheet;
  - Income Statement;
  - Statement of Cash Flow (NCRF2);
  - Variation of Owners Equity Statement;
  - Annexe;

CONTABILIDADE GERAL II

I. Some relevant topics of accounting

1. Presentation of the financial statements

End of the Year Operations



Adapted from " Elementos de Contabilidade Geral, 20ª Ed, pg 708"

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

End of the Year Operations

Regularization Records

- Regularization of Cash differences, Bank deposits differences, Losses/gains in inventories, etc;
- Record/regularization of Matching and Accruals ;
- Record of Impairments and provisions;
- Record of depreciation and ammortization of the exercise;
- Record of the estimative of Income tax to pay (IRC).

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

Record of the Net Income determination

- Transference to accounts of class 8 (Results account) of the balances from the accounts of classes 6 and 7 (expenses and revenues, respectively).

Closing Records

- Closing the accounts from the balance sheet
  - The ones with creditor balance will be written a debit
  - The ones with a debtor balance will be written a credit

1. Presentation of the financial statements

Balance Sheet

Objective: The balance sheet (also called the statement of financial position) shows the financial status of a company at a particular instant in time

- Objective is to determine the value of the net investment made by the firm's owners (the shareholders) in their firm at a specific date

- The left side lists the resources of the firm
- The right side lists the claims against those resources

Assets= Liabilities + Owners' equity

I. Some relevant topics of accounting

1. Presentation of the financial statements

- Assets are economic resources that the company expects to help generate future cash inflows or reduce or prevent future cash outflows
  - Examples: Cash, inventories, equipment
- Liabilities are economic obligations of the organization to outsiders (creditors)
  - Example: A debt to a bank in the form of a note payable
- Owners' equity is the owners' claim on the organization's assets

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

- Open account – the practice of making most purchases on a credit basis instead of cash basis
- Accounts receivable are assets that result from the sale of goods or services on open account
- Accounts payable are liabilities that result from a purchase of goods or services on open account
- Inventories are assets held by the company for the purpose of sale to customers

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

- Every transaction of a company or entity affects the balance sheet equation
- An entity is an organization that stands apart from other organizations and individuals as a separate economic unit
- A transaction is any event that affects the financial position of an entity and that can reliably recorded in money terms

- An account is a summary record of the changes in a particular asset, liability, or owners' equity item
- The double-entry accounting system records each transaction in at least two accounts
- A compound entry affects more than two balance sheet accounts

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

Balance sheet

2 perspectives:

1) Patrimonial- it show the set of goods, rights and obligations in a certain firm.
2) Finance – it shows the set of applications and resources of capital

Assets = Applications of capital	Owners Equity = Shareholders Origins
	Liabilities = External Origins

Expanded Balance Sheet Equation

(1) Assets = Liabilities + Stockholders' Equity

(2) Assets = Liabilities + Paid-in Capital + Retained Earnings

(3) Assets = Liabilities + Paid-in Capital + Revenues - Expenses

EXHIBIT 2.1a:
OS Distributors' Balance Sheets.
Figures in millions of dollars

		DEC. 31, 1998		DEC. 31, 1999		DEC. 31, 2000
ASSETS						
CURRENT ASSETS		**$104.0**		**$119.0**		**$137.0**
Cash		$6.0		$12.0		$8.0
Accounts receivable		44.0		48.0		56.0
Inventories		52.0		57.0		72.0
Prepaid expenses		2.0		2.0		1.0
NONCURRENT ASSETS		**56.0**		**51.0**		**53.0**
Financial assets & intangibles		0.0		0.0		0.0
Property, plant, & equip. (net)		56.0		51.0		53.0
Gross value	$90.0		$90.0		$93.0	
Accumulated depreciation	(34.0)		(39.0)		(40.0)	
TOTAL ASSETS		**$160.0**		**$170.0**		**$190.0**

EXHIBIT 2.1b:
OS Distributors' Balance Sheets.

Figures in millions of dollars

LIABILITIES AND OWNERS' EQUITY	DEC. 31, 1998		DEC. 31, 1999		DEC. 31, 2000	
CURRENT LIABILITIES		$54.0		$66.0		$75.0
Short-term debt	$15.0		$22.0		$23.0	
Owed to banks	$7.0		$14.0		$15.0	
Current portion of long-term debt	8.0		8.0		8.0	
Accounts payable	37.0		40.0		48.0	
Accrued expenses	2.0		4.0		4.0	
NONCURRENT LIABILITIES		42.0		34.0		38.0
Long-term debt	42.0		34.0		38.0	
Owners' equity	64.0	64.0	70.0	70.0	77.0	77.0
TOTAL LIABILITIES AND OWNERS' EQUITY		$160.0		$170.0		$190.0

Income statement

Objective is to measure the net profit (or loss) generated by the firm's activities during a period of time

- Net profit (or loss) is a measure of the change in the value of the owners' investment during that period

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

Purpose of the income statement

- To present a summary of the operating and financial transactions that contributed to the net change in the firm's owners' equity during the accounting period

Revenues (Expenses) increase (decrease) owners' equity

- Revenues and expenses related to the firm's operating activities are shown on the income statement first
  - Those related to nonoperating activities follow

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

- Revenues and expenses are the key inflows and outflows of assets that occur during a business's operating cycle
- Revenues are the amount of assets received in exchange for the delivery of goods or services to customers
- Expenses are measures of the assets that a company gives up or consumes in order to deliver goods or services to a customer

Financial Accounting II

I. Some relevant topics of accounting

1. Presentation of the financial statements

- Income is the excess of revenues over expenses
- Profits or earnings are common synonyms for income
- Retained earnings is the total cumulative equity generated by income

Expanded Balance Sheet Equation

- The income statement collects all the changes in owners' equity for the accounting period and combines them in one place
- Revenue and expense accounts are nothing more than subdivisions of stockholders' equity – temporary stockholders' equity accounts

The Income Statement

- Accrual accounting is built on two basic principles:
  - Realization principle
    - Revenue is recognized at the time of the transaction generating the revenue, not when the cash from the transaction is received
  - Matching principle
    - Expenses are recognized when the product is sold, not when the expense is actually paid
      - As a consequence, in accrual accounting expenses increase during the period when the product is sold, and a firm's earnings after tax are not equal to its net cash flow

Accrual Basis and Cash Basis

- The **accrual basis** recognizes the impact of transactions in the financial statements for the time periods when revenues and expenses occur
- Accountants record revenue as a company earns it, and they record expenses as the company incurs them

Accrual Basis and Cash Basis

- The **cash basis** recognizes the impact of transactions in the financial statements only when a company receives or pays cash
- The accrual basis is the best basis for measuring economic performance

Recognition of Revenues

- Revenues are recognized when they
  - Are **earned**
    - A company earns revenues when it delivers goods or services to customers
  - And are **realized**
    - A company realizes revenues when it receives cash or claims to cash in exchange for goods or services

Matching

- There are two kinds of expenses in every accounting period:
  - **Product costs** are those linked with the revenues earned that period
  - **Period costs** are those linked with the time period itself
- Matching occurs when the expenses incurred in a period are matched to the revenues generated in the same period

Applying Matching

- **Depreciation** is the systematic allocation of the acquisition cost of long-lived assets to the periods that benefit from the use of the assets

- Land is not subject to depreciation because it does not deteriorate over time

Revenues and Expenses

- **Net Sales**
  - Represents the revenues net of any discounts and allowances for defective merchandise
- **Cost of goods sold (COGS)**
  - Often includes depreciation expenses, which are sometimes a separate account in the statement

The Income Statement

- **Gross profit**
  - Net Sales – COGS
    - First and broadest measure of the firm's profit
- **Selling, general, and administrative expenses (SG&A)**
  - Represents overhead expenses
- **Depreciation expenses**
  - Since a fixed asset generates benefits beyond the year in which it is purchased
    - The cost of the asset is "expensed" over the asset's useful life to avoid a mismatch between expenses and revenues for a number of years

The Income Statement

- **Operating profit**
  - Measures the profit generated by the firm's normal and recurrent activities before interest expenses and taxes
- **Extraordinary items**
  - Represent the balance of gains and losses resulting from infrequent transactions that are not directly related to the firm's recurrent activities

The Income Statement

- **EBIT** is the operating profit less any extraordinary losses plus any extraordinary gains
  - EBIT is shared among three claimants
    - Lenders
    - Tax authority
    - Owners
- **Net interest expenses**
  - Difference between the interest expenses incurred by the firm and any income received from its financial investments

The Income Statement

- **Income tax expense**
  - This tax provision frequently differs from the actual income tax to be paid
    - The difference being reflected in the deferred tax account in the balance sheet
- **Earnings after tax (EAT)**
  - Measure of the net change in owners' equity, when there is no cash dividend paid

EXHIBIT 2.2a:
OS Distributors' Income Statements.

Figures in millions of dollars

	1998		1999		2000	
Net sales	$390.0	*% of Sales*	$420.0	*% of Sales*	$480.0	*% of Sales*
Cost of goods sold	($328.0)		($353.0)		($400.0)	
Gross profit	62.0	*15.9%*	67.0	*15.9%*	80.0	*16.7%*
Selling, general, & administrative expenses	(39.8)		(43.7)		(48.0)	
Depreciation expenses	(5.0)		(5.0)		(8.0)	
Operating profit	17.2	*4.4%*	18.3	*4.4%*	24.0	*5.0%*
Extraordinary items	0		0		0	
Earnings before interest & tax (EBIT)	17.2	*4.4%*	18.3	*4.4%*	24.0	*5.0%*
Net interest expenses[1]	(5.5)		(5.0)		(7.0)	

[1] There is no interest income, so net interest expenses are equal to interest expenses.

EXHIBIT 2.2b:
OS Distributors' Income Statements.

Figures in millions of dollars

	1998		1999		2000	
Earnings before tax (EBT)	11.7	*3.0%*	13.3	*3.2%*	17.0	*3.5%*
Income tax expense	(4.7)		(5.3)		(6.8)	
Earnings after tax (EAT)	$7.0	*1.8%*	$8.0	*1.9%*	$10.2	*2.1%*
Dividends	$2.0		$2.0		$3.2	
Retained earnings	$5.0		$6.0		$7.0	

Reconciling Balance Sheets And Income Statements

- When a cash dividend is declared, the net increase in owners' equity (called retained earnings) is the difference between earnings after tax and the dividend
- By the same logic, when the firm repurchases its shares, the owners' equity is also decreased
- Conversely, when the firm sells its shares, the owners' equity increases

Relationship Between Income Statement and Balance Sheet

- A **balance sheet** shows the financial position of the company at a discrete point in time
- An ***income statement*** explains the changes that take place between those points in time

I. Some relevant topics of accounting

1. Statements of cash flow

Statements of cash flow (NCRF2)

Objective – to present, in detail, the variations in cash and equivalents during the period.
- show the capacity of the firm to generate and use funds.

Cash – money in cash and in deposits in banks

Equivalents to cash – Financial instruments (short term), with liquidity and convertible to money, and subject to minor risk of variations of value.

Statement of Cash Flows

- Because of accrual accounting, not everything on the income statement represents a cash flow—the statement of cash flows corrects for this.
- 3 parts:
  - Cash flow from operating activities
  - Cash flow from investing activities
  - Cash flow from financing activities
- Net cash flow

Cash flow from operating activities

- Sources of cash flow:
  - Net income
  - Depreciation, because it was deducted from net income, but it really wasn’t a cash expense, so it is added back in.
  - If liabilities go up, it is like borrowing more, so it is a source of cash—so increases in accounts payable and increases in accruals are sources of cash.

Cash flow from operating activities

- Uses of cash flow
  - If assets go up, that represents an expenditure (in order to pay for the asset), and so cash goes down. So if inventory increases, it required a use of cash flow to pay for it, so increases in inventory and accounts receivable are subtracted.

The Sources and Uses of Corporate Cash

Sources

- Decrease in any asset
- Increase in any liability
- Net profits after taxes
- Depreciation and other non-cash charges
- Sale of stock

Uses

- Increase in any asset
- Decrease in any liability
- Net loss
- Dividends paid
- Repurchase or retirement of stock

IAS 7 Format – Indirect method

- Cash flow from operating activities
- Cash generated from operations
- Cash flows from investing activities
- Cash flows from financing activities
- Net increase in cash and cash equivalents.

IAS 7: Cash generated from operations

The IAS 7 format is as follows:

Cash flows from operating activities	€	€
Net profit before tax	x	
Adjustments for:		
Depreciation	x	
Investment income	(x)	
Interest Expense	x	
Operating profit before working capital changes	x	
Increase in trade and other receivables	(x)	
Decrease in inventories	x	
Decrease in trade payables	(x)	

IAS 7: Net cash from operating activities

	€	€
Cash generated from operations	**x**	
Interest paid*	(x)	
Income taxes paid	(x)	
Cash flow before extraordinary item	x	
Proceeds from earthquake disaster settlement	x	
Net cash from operating activities		x

IAS 7: Net cash from investing activities

	€	€
Cash flows from investing activities		
Acquisition of subsidiary net of cash acquired (note a)	(x)	
Purchase of property, plant and equipment	(x)	
Proceeds from sale of equipment	x	
Interest received*	x	
Dividends received*	x	
Net cash used in investing activities		(x)

IAS 7: Cash flows from financing activities

	€	€
Cash flows from financing activities		
Proceeds from issuance of share capital	x	
Proceeds from long term borrowings	x	
Payment of finance lease liabilities	(x)	
Dividends paid*	(x)	
Net cash used in financing activities		(x)

IAS 7 - Permitted methods

1. Indirect method

2. Direct method.

Direct method

- Starts with gross cash receipts and payments
- Provides more information about sources /uses of cash
- Shows operating cash receipts and payments
- Possibly more useful in assessing future cash flows
- Useful in failure prediction models.

The Structure Of The Owners' Equity Account

- The owners' equity account represents the accumulated contribution of the changes in owners' equity since the firm's inception
  - Common stock
    - Par value
  - Paid-in capital in excess of par
  - Accumulated retained earnings
  - Treasury stock

EXHIBIT 2.5:
OS Distributors Owners' Equity on December 31, 2000.

Figures in millions of dollars

		DECEMBER 31, 2000
Owners' equity		**$77**
Common stock	**$10**	
10,000,000 shares at par value of $1		
Paid-in capital in excess of par	**20**	
Accumulated retained earnings	**47**	
(Treasury stocks)	**(0)**	