

Introduction

15.511 Corporate Accounting
Summer 2004

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June 7, 2004



Session 1:

Agenda

- Administrative matters
- Discussion of Accounting
 - Why is accounting interesting?
 - Why do we need accounting?
- Course objective
 - Sophisticated financial statement user
- An overview of information in financial statements

The required materials are:

- 10th Edition of Stickney and Weil
 - Financial Accounting: An Introduction to Concepts, Methods, and Uses
- Case Packet
- Class web server
 - Syllabus
 - Schedule
 - Homework assignments
 - Sample exams

Course Grading

- Written Problem Sets 25%
- Midterm 30%
- Final 45%

Accounting Introduction

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What is Accounting trying to do?

Demand for Information

■ Financial Accounting

- Provides information primarily to people **outside** the company
- Provides information that would be helpful in attracting capital
 - Equity and debt (useful in debt contracts)
 - Credit from suppliers
 - Customers
 - Employees
- Provides information helpful in monitoring and evaluating management performance

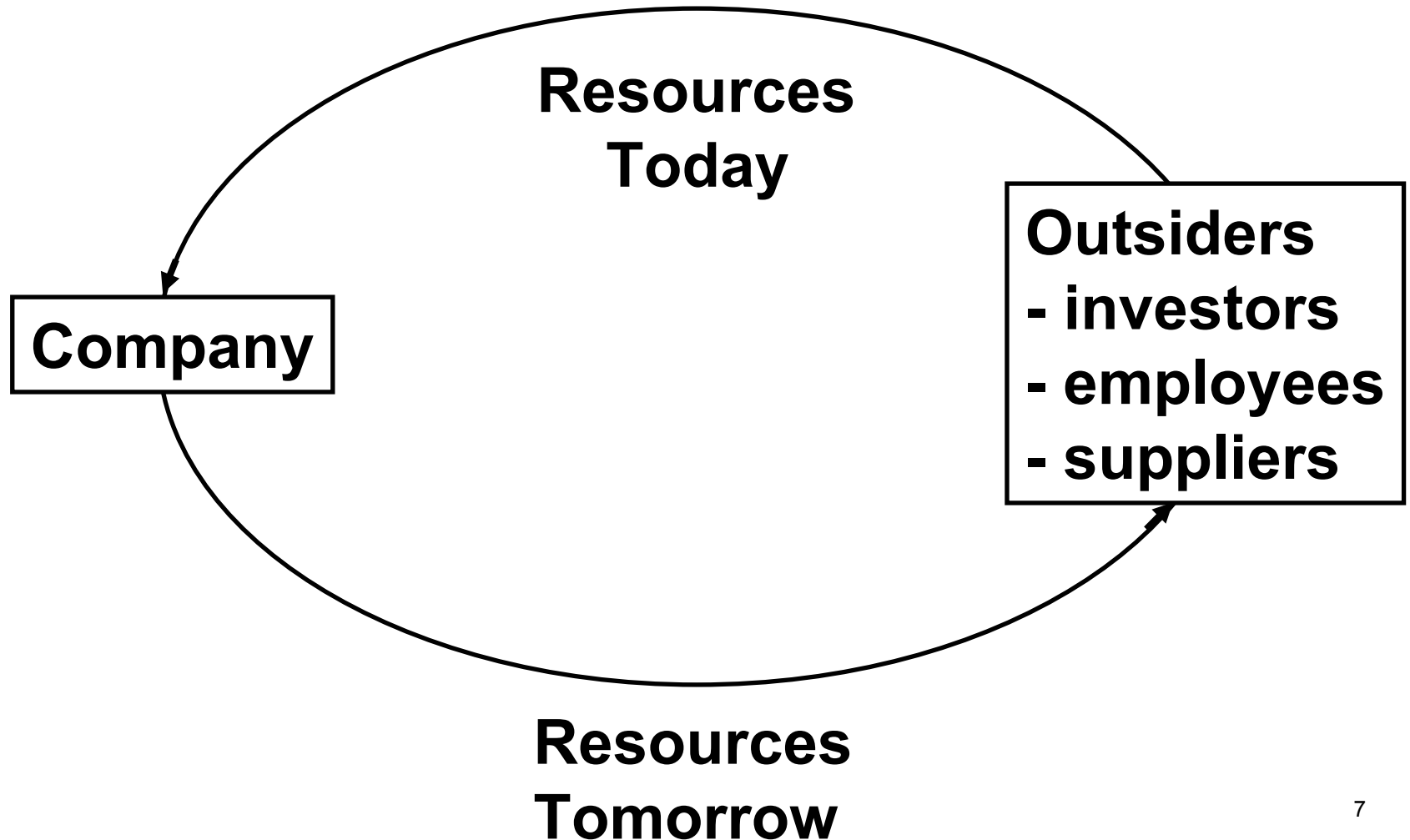
■ Managerial Accounting

- Provides information to people **inside** the company
 - Internal investment decisions
 - Performance evaluation

■ Tax Accounting

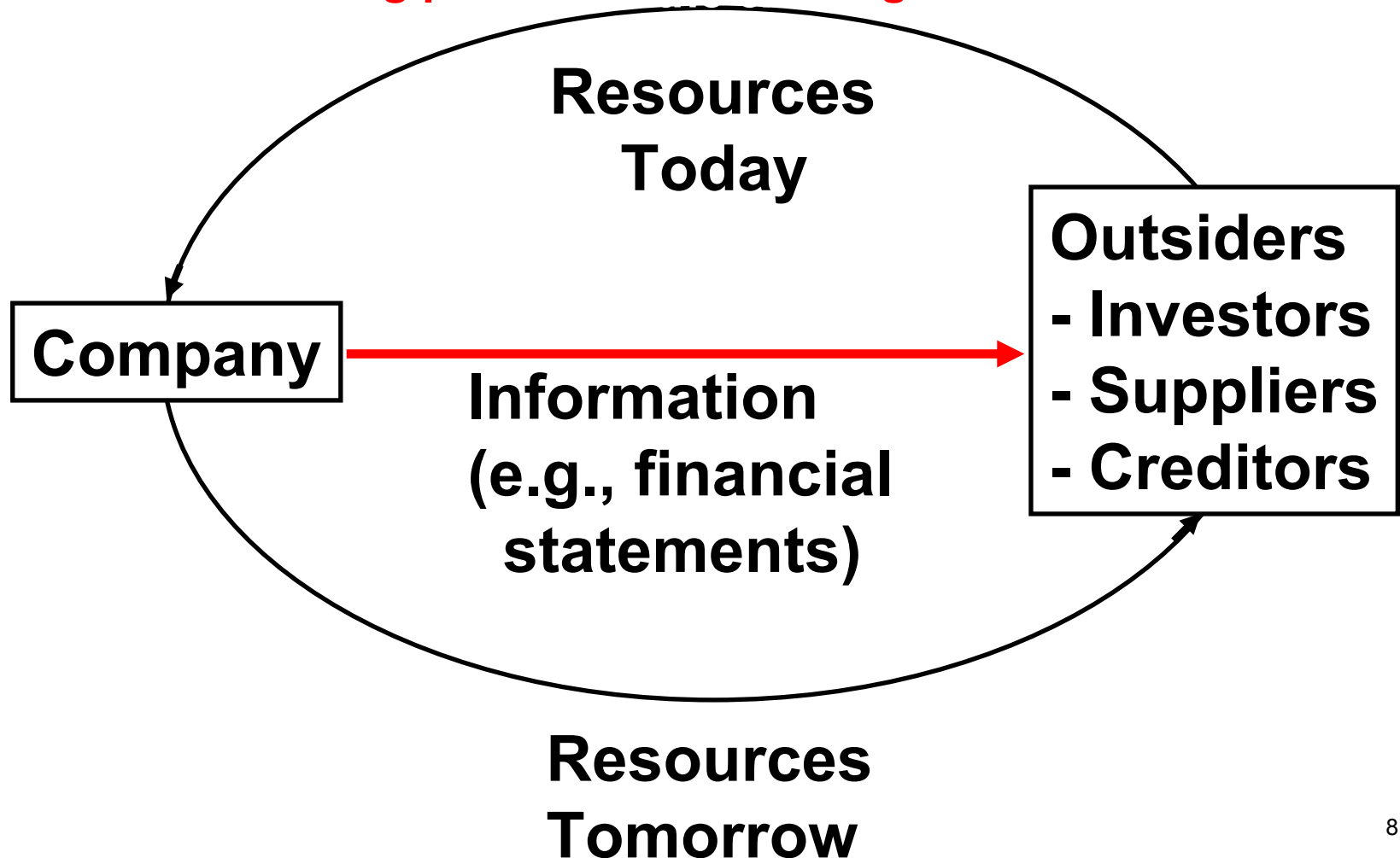
- Provides information to the tax authorities
- Legal to prepare separate books for tax and financial purposes

Why do We Need Financial Accounting?



Why do We Need Financial Accounting?

Financial accounting promotes the exchange of resources

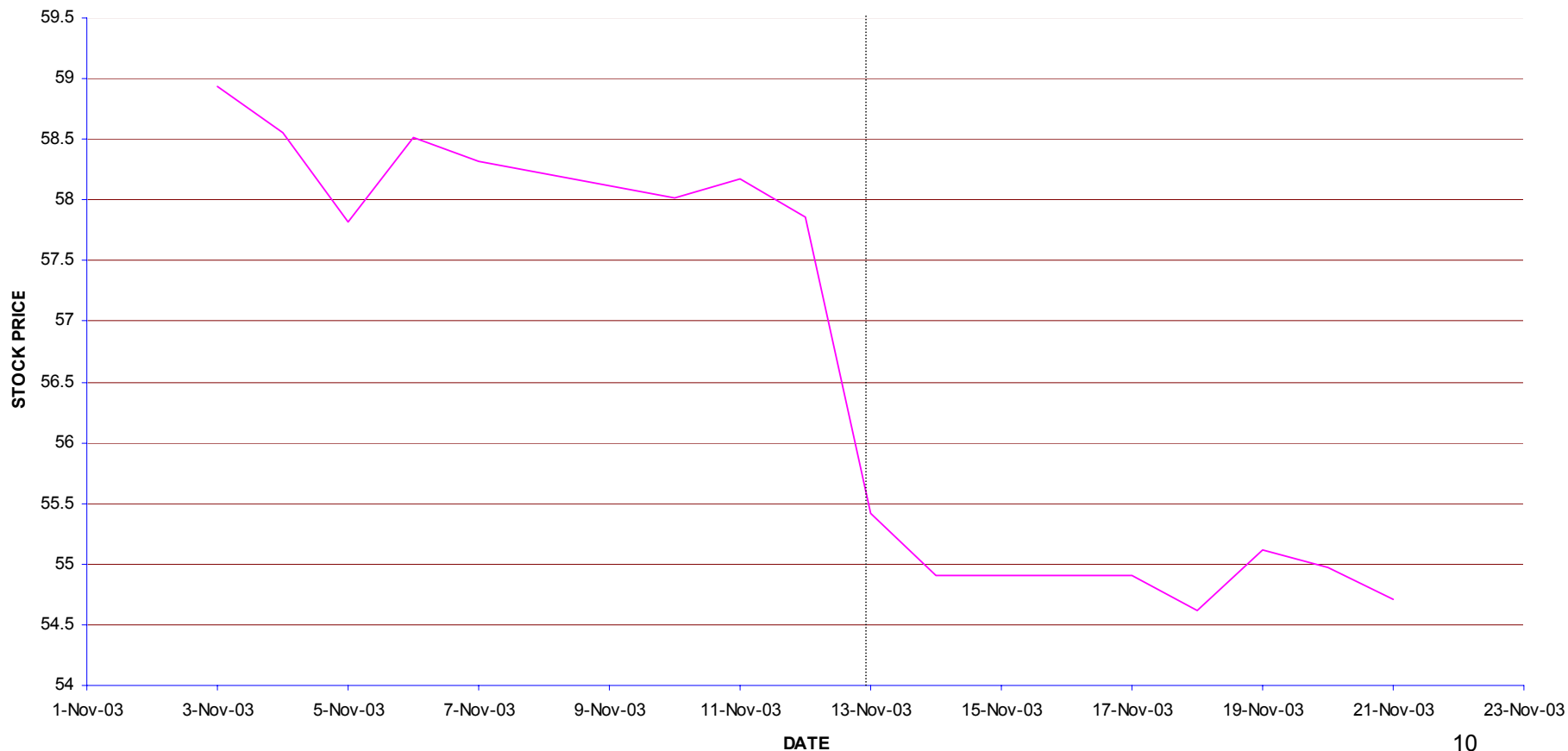


Nature of Financial Accounting Information

- Useful to those making investment and credit decisions, who have a reasonable understanding of business and economic activities.
- Helpful to
 - present and potential investors
 - creditors
 - other users
 - *in assessing the amount, timing, and uncertainty of future cash flows.*
- Provides information about economic resources, the claims to those resources, and the changes in them.

How important is this information?

The Reaction of Wal-Mart Stock to Announcement of 3rd Quarter Earnings



Financial Accounting

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WHAT IS OUR COURSE OBJECTIVE?

- To become intelligent users of accounting information. Examples:
 - Managers use accounting information in making investment decisions
 - Investors use accounting information in valuing stocks
 - Bankers rely on accounting information in deciding whether to lend money to a business and in assessing the risk of the loan
 - Accounting information is crucial in evaluating the performance of employees at various levels in an organization

WHAT IS OUR COURSE OBJECTIVE?

- To become intelligent users of accounting information
- Be comfortable looking through an annual report
 - Learn the language and techniques
- Begin to develop the ability to use financial statements to assess a company's performance

- Have a sense of the limitations of financial statement data

- What are not our objectives
 - to train you to be an accountant or bookkeeper
 - Financial Statement Analysis - take 15.535

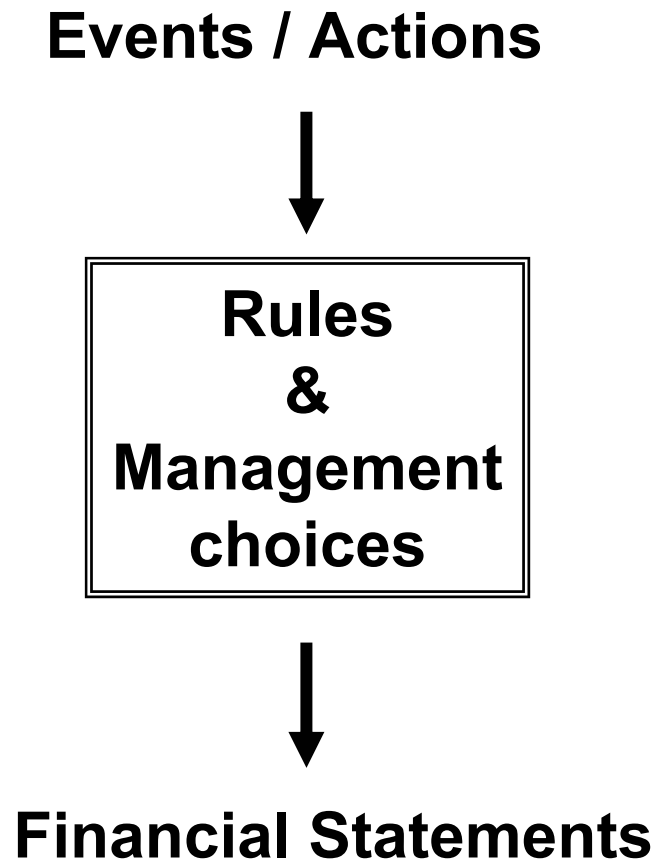
World of a Sophisticated Financial Statement User

Events are occurrences that affect the firm.

Examples include:

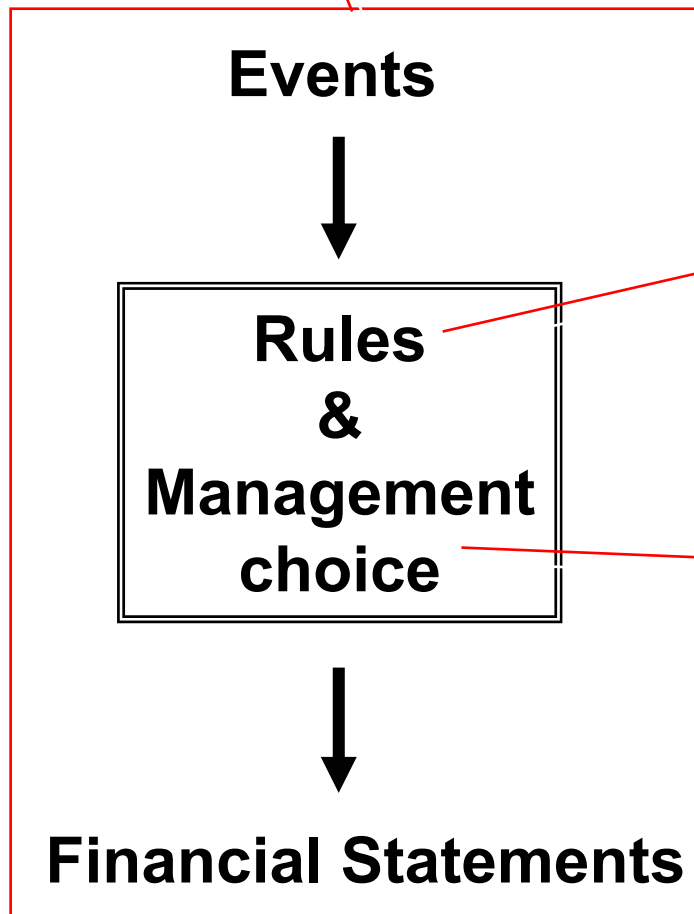
- 1) Microsoft sued by the Justice Department**
- 2) McDonald's sells hamburgers**
- 3) United Airlines workers go on strike**
- 4) The Gap announces a new marketing strategy for its Old Navy Clothing stores**

World of a Sophisticated Financial Statement User



World of a Sophisticated Financial Statement User

Financial Accounting = translates events into financial statements



**Generally
Accepted
Accounting
Principles (GAAP)**

Management selects from alternative rules and from allowable estimates under GAAP

Three keys to becoming a sophisticated financial statement user

- Understand the rules and management's discretion
- Understand what explains the rules and the type of management discretion
 - Incentives
- Understand how events affect firm value

Understanding the genesis of the rules

- Demand for independence: Accounting enters objective, verifiable information into accounting records
 - Information produced by managers alone is not believable. Outside investors demand independently audited financial information
 - In the process, accounting misses out on forward-looking information that might be valuable, but lacks objective evidence (e.g., research in progress)

Understanding the genesis of the rules

- Asymmetry
 - Asymmetric treatment of good and bad news
 - Faced with uncertain bad news, accounting tends to enter it into the records
 - Faced with uncertain good news, tendency to ignore it
 - Why?
 - Demand for bad news
 - Creditors with no upside, but all the downside
 - Investors believe bad news disclosed by management, but skeptical of good news unless supported by objective evidence
 - Management incentives affect believability of their disclosures

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Accounting is complex and interesting because.....

- Diversity of businesses and events
- Many different players
- Diverse incentives
 - Economic
 - Other
- Uncertainty
- Many regulations

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Financial Reporting Requirements

- **Audited Annual Report (10-K)**
- Unaudited Quarterly Reports (10-Q)
- Current Reports (8-K)
 - within 10 days of the end of a month containing a significant event (e.g., major asset sales, changes in ownership, bankruptcy, changing the auditor)
- Foreign Companies (20-F)

Focus: The Annual Report

- The Management Letter
 - Management discussion on developments during the year and current state of the company
- The Financial Statements
- The Auditors' Report

Financial Reports: The Auditors' Report

- GAAS (Generally Accepted Auditing Standards)
 - Reasonable assurance that financial statements are free of material misstatement
 - Assess the accounting principles used and significant estimates made by management
- Actual opinion
 - financial statements present fairly, in all material respects, the financial position, the results of operations, etc.
 - are in conformity with GAAP (Generally Accepted Accounting Principles).

Financial Reports: The Auditors' Report

- Management responsible for
 - the preparation and integrity of the financial statements, etc.
 - Statements prepared in accordance with GAAP.
 - Estimated amounts based on management's best estimates and judgments.
 - Maintenance of an internal control system to ensure that assets are safeguarded and transactions are properly authorized, recorded and reported.

- The Board has an Audit Committee composed entirely of outside directors
 - This committee appoints the auditor who has direct access to the Audit Committee.

Financial Statements

- Contain primarily historical Information
- Balance Sheet
 - Assets, liabilities & owners' equity
- Income Statement
 - Revenue (-) Expenses = Net Income
- Statement of retained earnings
 - Cumulative sum of undistributed profits
- Statement of cash flows
 - Operating, Investing and Financing activities
- Footnotes
 - Significant accounting policies, estimates, etc.

Financial Statements: Balance Sheet

- Balance sheet
 - Statement of the financial position of a business **as of a certain date**.
- Assets
 - Resources owned by a corporation, e.g., cash, accounts receivable, equipment, land
- Liabilities
 - amounts/services owed by the company, e.g., loans payable, accounts payable, customer advances, etc.
- Stockholders' equity
 - initial investment by the owners (capital stock -- common and preferred stocks)
 - Plus the cumulative sum of undistributed profits (retained earnings)

Financial Statements: Income Statement

- Income statement measures the “performance” of a company **over a period of time**
- Revenues -- a measure of economic benefits generated by the sale of products or providing of services **over a period of time**
- Expenses -- a measure of economic sacrifices incurred to “earn” the revenues of a **given period**
- Examples of expenses -- cost of inventory sold, salaries to employees, rent and lighting, advertising,
- Net income = revenues (-) expenses

Dividends

- Are dividends paid to owners considered an expense?
 - Owners are residual claimants
 - Dividends are **distributions** to the owners **out of the profits** earned by the business
 - In determining accounting profits to the “residual” owners, we only **subtract the costs of all factors of production**, e.g., physical capital (depreciation), human capital (salaries), debt capital (interest cost), etc.
 - Dividends are not a factor of production

Financial Statements: Retained Earnings & Shareholders' Equity

- Retained earnings
 - A measure of undistributed profits of a business
 - Do not include capital contributed by owners
- Retained earnings = Cumulative sum of profits earned from the inception of business (-)
Cumulative sum of all “dividends” distributed to the owners from the inception of business
- Statement of shareholders' equity describes the change in retained earnings **over a period of time** (e.g., a year)
 - Beginning balance in retained earnings
 - **Add** Net income earned during the period
 - **Subtract** Dividends distributed during the period
 - Ending balance in retained earnings

Summary

- Accounting is a complex field contrary to common perceptions.
- Financial accounting information facilitates the exchange of resources.
- To become a sophisticated financial statement user, you need to understand how the information in financial statements is recorded.