Introduction

15.511 Corporate Accounting
Summer 2004

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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**?

- **Outsiders**
  - investors
  - employees
  - suppliers

**Company**

**Resources Today**

**Resources Tomorrow**
Why do We Need Financial Accounting?

Financial accounting promotes the exchange of resources

Resources Today

Company

Information (e.g., financial statements)

Outsiders
- Investors
- Suppliers
- Creditors

Resources Tomorrow
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

Events / Actions

Rules & Management choices

Financial Statements
World of a Sophisticated Financial Statement User

Financial Accounting = translates events into financial statements

Events

Rules & Management choice

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
Financial Accounting
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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
Financial Accounting

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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.