



Intro to Financial Reporting

Day 1: Learning the “Language of Business”

Jane Kennedy

September 20, 2011

Jump Start Goals?

- Introduce Accounting, “the language of business,” and its strange new jargon
- Learn framework and basic concepts
- Learn to build financial statements
- Introduce real world financial data
- Level the playing field
- Set expectations for the quarter

Objective of Financial Reporting

Financial reporting provides **useful information** to interested parties so that they can make **better decisions**.

Interested parties include:

Investors

Customers

Creditors

Employees

Suppliers

Government

3

Our Agenda -- Day 1

1. Unveil the framework
2. Introduce two major financial statements
 - a. Balance Sheet
 - b. Income Statement
 - c. Relation between B/S and I/S
3. Building financial statements -- an example
4. Summarize five transactions & prepare financial statements
5. Introduce the 3rd major financial statement (if time)
 - Statement of Cash Flows

4

1. Balance Sheet Equation “the framework”

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

- What are **Assets**?
 - What the firm **owns** or has the right to use
- What are **Liabilities**?
 - What the firm **owes in dollars or goods or services**
- What is **Owners' Equity**?
 - The **residual** difference, i.e., Assets - Liabilities
 - Contributed capital and earned capital

5

Balance Sheet Equation: *Four views*

- **Assets** = **Liabilities** + **Owners' Equity**
- **Own** = **Owe** + **Owners' Residual**
- **Investments** = **Sources of Financing**
- **Resources** = **Claims** on the Resources

6



2a. Balance Sheet



$$A = L + OE$$

	December 31,	
	2010	2009
ASSETS		
Current assets		
Cash and cash equivalents	\$203,870	\$187,297
Accounts receivable, net	102,034	79,356
Inventories	215,355	148,488
Prepaid expenses and other current assets	34,591	32,859
Total current assets	555,850	448,000
Property and equipment, net	76,127	72,926
Intangible assets, net	3,914	5,681
Other non-current assets	39,487	18,981
Total assets	\$675,378	\$545,588
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	84,679	68,710
Accrued expenses	55,138	40,885
Current maturities of long-term debt	6,865	9,178
Current maturities of lease obligations	--	97
Other current liabilities	2,465	1,292
Total current liabilities	149,147	120,162
Long-term debt, net of current maturities	9,077	10,948
Other non-current liabilities	20,188	14,481
Total liabilities	\$178,412	\$145,591
Stockholders' equity		
Common stock	\$224,904	\$197,359
Retained earnings	270,021	202,188
Other	2,041	450
Total stockholders' equity	496,966	399,997
Total liabilities & stockholders' equity	\$675,378	\$545,588

?

Balance Sheet: Assets

- **Asset recognition criteria**
 - Ownership or rights to use
 - Future economic benefits
 - Benefits can be measured
- Some assets are not easily measured and do not appear on the Balance Sheet
- Most assets are measured at cost (at least initially)

9

A closer look at assets



	December 31,	
	2010	2009
ASSETS		
Current assets		
Cash and cash equivalents	\$203,870	\$187,297
Accounts receivable, net	102,034	79,356
Inventories	215,355	148,488
Prepaid expenses and other current assets	34,591	32,859
Total current assets	555,850	448,000
Property and equipment, net	76,127	72,926
Intangible assets, net	3,914	5,681
Other non-current assets	39,487	18,981
Total assets	\$675,378	\$545,588

10

Balance Sheet: Liabilities

- **Liability recognition criteria**
 - An obligation exists
 - Amount and timing of obligation can be measured



	December 31,	
	2010	2009
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	84,679	68,710
Accrued expenses	55,138	40,885
Current maturities of long-term debt	6,865	9,178
Current maturities of lease obligations	--	97
Other current liabilities	2,465	1,292
Total current liabilities	149,147	120,162
Long-term debt, net of current maturities	9,077	10,948
Other non-current liabilities	20,188	14,481
Total liabilities	\$178,412	\$145,591

11

Balance Sheet: Owners' Equity

- **Who are the owners?**
- **Classification**
 - Contributed capital
 - Stock (often at "par")
 - Additional paid-in capital
 - Earned capital (retained earnings)
 - Beginning bal. + net income - dividends = ending bal.
 - Cumulative earnings - cumulative dividends
 - Other

12

A closer look at owners' equity



	December 31,	
	2010	2009
Stockholders' equity		
Common stock	\$224,904	\$197,359
Retained earnings	270,021	202,188
Other	2,041	450
Total stockholders' equity	496,966	399,997
Total liabilities & stockholders' equity	\$675,378	\$545,588

13

Balance Sheet: Equity

Owners' Equity = Assets – Liabilities

- **Terms you might encounter:**

- Net worth or net assets
- Equity
- Shareholders' equity
- Stockholders' equity
- Owners' equity
- Book value

**These all mean
the same thing!**

14

Balance Sheet Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Accounts payable	\$50,000	Accounts receivable	\$11,000
Common stock	\$78,000	Unearned revenue	\$55,000
Cash	\$36,000	Prepaid rent	\$20,000
Land	\$30,000	Retained earnings	\$82,000
Inventory	\$110,000	Equipment, net	\$145,000
Taxes payable	\$10,000	Wages payable	\$10,000
		Notes payable	\$67,000

★What are Ullrich's total assets? **\$352,000**

15

Balance Sheet Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Accounts payable	\$50,000	Accounts receivable	\$11,000
Common stock	\$78,000	Unearned revenue	\$55,000
Cash	\$36,000	Prepaid rent	\$20,000
Land	\$30,000	Retained earnings	\$82,000
Inventory	\$110,000	Equipment, net	\$145,000
Taxes payable	\$10,000	Wages payable	\$10,000
		Notes payable	\$67,000

★What are Ullrich's total liabilities? **\$192,000**

16

Balance Sheet Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Accounts payable	\$50,000	Accounts receivable	\$11,000
Common stock	\$78,000	Unearned revenue	\$55,000
Cash	\$36,000	Prepaid rent	\$20,000
Land	\$30,000	Retained earnings	\$82,000
Inventory	\$110,000	Equipment, net	\$145,000
Taxes payable	\$10,000	Wages payable	\$10,000
		Notes payable	\$67,000

★ Does $A = L + OE$? $\$352,000 = \$192,000 + \$160,000$

17

Starbucks Balance Sheets -- Assets

	Oct 3, 2010	Sep 27, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$1,164.0	\$ 599.8
Short-term investments — available-for-sale securities	236.5	21.5
Short-term investments — trading securities	49.2	44.8
Accounts receivable, net	302.7	271.0
Inventories	543.3	664.9
Prepaid expenses and other current assets	156.5	147.2
Deferred income taxes, net	304.2	286.6
Total current assets	2,756.4	2,035.8
Long-term investments — available-for-sale securities	191.8	71.2
Equity and cost investments	341.5	352.3
Property, plant and equipment, net	2,416.5	2,536.4
Other assets	346.5	253.8
Other intangible assets	70.8	68.2
Goodwill	262.4	259.1
TOTAL ASSETS	<u>\$6,385.9</u>	<u>\$5,576.8</u>

18

Starbucks Balance Sheets -- Liab. & OE

	<u>Oct 3,</u> <u>2010</u>	<u>Sep 27,</u> <u>2009</u>
Current liabilities:		
Accounts payable	282.6	267.1
Accrued compensation and related costs	400.0	307.5
Accrued occupancy costs	173.2	188.1
Accrued taxes	100.2	127.8
Insurance reserves	146.2	154.3
Other accrued liabilities	262.8	147.5
Deferred revenue	414.1	388.7
Total current liabilities	1,779.1	1,581.0
Long-term debt	549.4	549.3
Other long-term liabilities	375.1	389.6
Total liabilities	2,703.6	2,519.9
Shareholders' equity:		
Common stock (\$0.001 par value) — authorized, 1,200.0 shares; issued and outstanding, 742.6 and 742.9 shares, respectively (includes 3.4 common stock units in both periods)	0.7	0.7
Additional paid-in capital	106.2	147.0
Other additional paid-in-capital	39.4	39.4
Retained earnings	3,471.2	2,793.2
Accumulated other comprehensive income	57.2	65.4
Total shareholders' equity	3,674.7	3,045.7
Noncontrolling interests	7.6	11.2
Total equity	3,682.3	3,056.9
TOTAL LIABILITIES AND EQUITY	\$6,385.9	\$5,576.8

19

Balance Sheet summary

- $A - L = OE$...What you “own” less what you “owe” defines your net worth (in an accounting sense).
- The balance sheet is a snapshot of assets, liabilities, and owners' equity at a **point** in time.
- The balance sheet **does not** contain all assets and liabilities.
- In valuing assets and liabilities, measurement plays a key role...and measuring items often involves judgments and/or assumptions.

20

2b. Income Statement

- What is it?
 - Captures firm's performance during a period
 - Lists **Revenues** earned and **Expenses** incurred
 - Net Income = **Revenues** minus **Expenses**
 - Net Income explains some of the changes in Owners' Equity due to operations for the period
 - Other words for Net Income: profit, earnings, “bottom line”
 - Other names for the income statement include the statement of operations, earnings statement, P&L

21

Key Income Statement definitions

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

- **Revenues** reflect *increases* in net Assets due to operating, e.g., selling a product or service
 - often called “sales”
- **Expenses** reflect *decreases* in net Assets in an attempt to produce revenue, e.g., the cost of merchandise sold, salaries & wages
 - may be referred to as “charges”
- Can net income be negative?
 - Yes, if expenses exceed revenues, we have a net **loss**

22

Income Statement Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Rent expense	\$24,000	Accounts receivable	\$11,000
Accounts payable	\$50,000	Unearned revenue	\$55,000
Common stock	\$78,000	Depreciation expense	\$7,000
Cost of goods sold	\$231,000	Prepaid rent	\$20,000
Cash	\$36,000	Bike sales	\$712,000
Land	\$30,000	Interest expense	\$5,000
Inventory	\$110,000	Retained earnings	\$82,000
Service revenue	\$293,000	Equipment, net	\$145,000
Wage expense	\$195,000	Wages payable	\$10,000
Taxes payable	\$10,000	Notes payable	\$67,000

★What are Ullrich's total **revenues**? **\$1,005,000**

23

Income Statement Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Rent expense	\$24,000	Accounts receivable	\$11,000
Accounts payable	\$50,000	Unearned revenue	\$55,000
Common stock	\$78,000	Depreciation expense	\$7,000
Cost of goods sold	\$231,000	Prepaid rent	\$20,000
Cash	\$36,000	Bike sales	\$712,000
Land	\$30,000	Interest expense	\$5,000
Inventory	\$110,000	Retained earnings	\$82,000
Service revenue	\$293,000	Equipment, net	\$145,000
Wage expense	\$195,000	Wages payable	\$10,000
Taxes payable	\$10,000	Notes payable	\$67,000

★What are Ullrich's total **expenses**? **\$462,000**

24

Income Statement Quiz

Ullrich Company sells bicycles. Ullrich's financial records contain the following accounts and balances (as of 12/31/10). The accounts are randomly listed.

Rent expense	\$24,000	Accounts receivable	\$11,000
Accounts payable	\$50,000	Unearned revenue	\$55,000
Common stock	\$78,000	Depreciation expense	\$7,000
Cost of goods sold	\$231,000	Prepaid rent	\$20,000
Cash	\$36,000	Bike sales	\$712,000
Land	\$30,000	Interest expense	\$5,000
Inventory	\$110,000	Retained earnings	\$82,000
Service revenue	\$293,000	Equipment, net	\$145,000
Wage expense	\$195,000	Wages payable	\$10,000
Interest payable	\$10,000	Notes payable	\$67,000

- ★What are Ullrich's total revenues? **\$1,005,000**
- ★What are Ullrich's total expenses? **\$462,000**
- ★What is Ullrich's net income? **\$543,000**

25

Income Statement

- Common format

	Revenues (or sales)
-	<u>Cost of goods sold (or cost of sales)</u>
=	Gross profit
-	<u>Operating expenses</u>
=	Operating income
+/-	<u>Other revenues/gains and expenses/losses</u>
=	Income before taxes
-	<u>Tax expense</u>
=	Income after taxes
-	<u>Other (special items)</u>
=	Net income (or earnings or profits)

26



Under Armour

Income Statement (in thousands)

	Year Ended December 31,		
	2010	2009	2008
Net revenues	\$1,063,927	\$856,411	\$725,244
Cost of goods sold	533,420	446,286	372,203
Gross profit	530,507	410,125	353,041
Operating expenses			
Selling, general and administrative expenses	418,152	324,852	276,116
Income from operations	112,355	85,273	76,925
Other income (expenses), net	(3,436)	(2,855)	(7,025)
Income before income taxes	108,919	82,418	69,900
Provision for income taxes	40,442	35,633	31,671
Net income	\$68,477	\$46,785	\$38,229

27

Starbucks Income Statements

Fiscal Year Ended	Oct 3,	Sep 27,	Sep 28,
	2010	2009	2008
Net revenues:			
Company-operated retail	\$ 8,963.5	\$ 8,180.1	\$ 8,771.9
Specialty:			
Licensing	1,340.9	1,222.3	1,171.6
Foodservice and other	403.0	372.2	439.5
Total specialty	1,743.9	1,594.5	1,611.1
Total net revenues	10,707.4	9,774.6	10,383.0
Cost of sales including occupancy costs	4,458.6	4,324.9	4,645.3
Store operating expenses	3,551.4	3,425.1	3,745.1
Other operating expenses	293.2	264.4	330.1
Depreciation and amortization expenses	510.4	534.7	549.3
General and administrative expenses	569.5	453.0	456.0
Restructuring charges	53.0	332.4	266.9
Total operating expenses	9,436.1	9,334.5	9,992.7
Income from equity investees	148.1	121.9	113.6
Operating income	1,419.4	562.0	503.9
Interest income and other, net	50.3	37.0	5.2
Interest expense	(32.7)	(39.1)	(53.4)
Earnings before income taxes	1,437.0	559.9	455.7
Income taxes	488.7	168.4	144.0
Net earnings including noncontrolling interests	948.3	391.5	311.7
Net earnings (loss) attributable to noncontrolling interests	2.7	0.7	(3.8)
Net earnings attributable to Starbucks	\$ 945.6	\$ 390.8	\$ 315.5

28

2c. Relation between Income Statement & Balance Sheet

- Income Statement explains *changes* in Owners' Equity over a period *due to operations*
- For corporations, this link occurs through a specific Owners' Equity account called Retained Earnings
 - Retained earnings = $\sum(\text{Net Income} - \text{Dividends})$
 - Beginning RE + Net Income - Dividends = Ending RE
- For single proprietorships & partnerships, earnings are combined with contributed capital in owners' capital account(s)

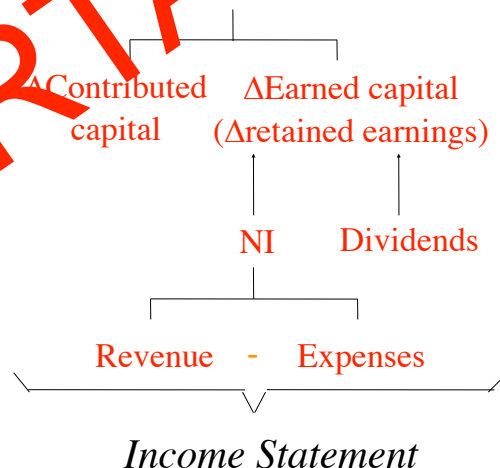
29

Relation between B/S and I/S

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

$$\Delta \text{Assets} = \Delta \text{Liabilities} + \Delta \text{Owners' Equity}$$

$$\Delta \text{Assets} - \Delta \text{Liabilities} = \Delta \text{Owners' Equity}$$



30



Under Armour

Income Statement (in thousands)

	Year Ended December 31,		
	2010	2009	2008
Net revenues	\$1,063,927	\$856,411	\$725,244
Cost of goods sold	533,420	446,286	372,203
Gross profit	530,507	410,125	353,041
Operating expenses			
Selling, general and administrative expenses	418,152	324,852	276,116
Income from operations	112,355	85,273	76,925
Other income (expenses), net	(3,436)	(2,855)	(7,025)
Income before income taxes	108,919	82,418	69,900
Provision for income taxes	40,442	35,633	31,671
Net income	\$68,477	\$46,785	\$38,229

31



Under Armour

	December 31,	
	2010	2009
Stockholders' equity		
Common stock	\$224,904	\$197,359
Retained earnings	270,021	202,188
Other	2,041	450
Total stockholders' equity	496,966	399,997
Total liabilities & stockholders' equity	\$675,378	\$545,588

Chg RE = 67833
NI = 68477

Chg RE = \$67,833

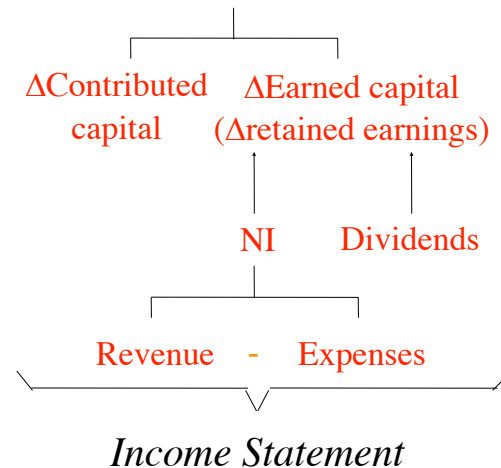
NI = \$68,477

diff = \$644 = ?

32

Relation between B/S and I/S

$$\Delta \text{Assets} - \Delta \text{Liabilities} = \Delta \text{Owners' Equity}$$



33

Starbucks' Owners' Equity section

	Oct 3, 2010	Sep 27, 2009
Shareholders' equity:		
Common stock (\$0.001 par value) — authorized, 1,200.0 shares; issued and outstanding, 742.6 and 742.9 shares, respectively (includes 3.4 common stock units in both periods)	0.7	0.7
Additional paid-in capital	106.2	147.0
Other additional paid-in-capital	39.4	39.4
Retained earnings	3,471.2	2,793.2
Accumulated other comprehensive income	57.2	65.4
Total shareholders' equity	3,674.7	3,045.7
Noncontrolling interests	7.6	11.2
Total equity	3,682.3	3,056.9
TOTAL LIABILITIES AND EQUITY	<u>\$6,385.9</u>	<u>\$5,576.8</u>

$$\Delta \text{RE} = 3471.2 - 2793.2 = 678$$

What is Net Income?

34

Starbucks Income Statements

	Oct 3,	Sep 27,	Sep 28,
Fiscal Year Ended	2010	2009	2008
Net revenues:			
Company-operated retail	\$ 8,963.5	\$ 8,180.1	\$ 8,771.9
Specialty:			
Licensing	1,340.9	1,222.3	1,171.6
Foodservice and other	403.0	372.2	439.5
Total specialty	1,743.9	1,594.5	1,611.1
Total net revenues	10,707.4	9,774.6	10,383.0
Cost of sales including occupancy costs	4,458.6	4,324.9	4,645.3
Store operating expenses	3,551.4	3,425.1	3,745.1
Other operating expenses	293.2	264.4	330.1
Depreciation and amortization expenses	510.4	534.7	549.3
General and administrative expenses	569.5	453.0	456.0
Restructuring charges	53.0	332.4	266.9
Total operating expenses	9,436.1	9,334.5	9,992.7
Income from equity investees	148.1	121.9	113.6
Operating income	1,419.4	562.0	503.9
Interest income and other, net	50.3	37.0	5.2
Interest expense	(32.7)	(39.1)	(53.4)
Earnings before income taxes	1,437.0	559.9	455.7
Income taxes	488.7	168.4	144.0
Net earnings including noncontrolling interests	948.3	391.5	311.7
Net earnings (loss) attributable to noncontrolling interests	2.7	0.7	(3.8)
Net earnings attributable to Starbucks	\$ 945.6	\$ 390.8	\$ 315.5

35

Starbucks' Owners' Equity section

	Oct 3,	Sep 27,
	2010	2009
Shareholders' equity:		
Common stock (\$0.001 par value) — authorized, 1,200.0 shares; issued and outstanding, 742.6 and 742.9 shares, respectively (includes 3.4 common stock units in both periods)	0.7	0.7
Additional paid-in capital	106.2	147.0
Other additional paid-in-capital	39.4	39.4
Retained earnings	3,471.2	2,793.2
Accumulated other comprehensive income	57.2	65.4
Total shareholders' equity	3,674.7	3,045.7
Noncontrolling interests	7.6	11.2
Total equity	3,682.3	3,056.9
TOTAL LIABILITIES AND EQUITY	<u>\$6,385.9</u>	<u>\$5,576.8</u>

$$\Delta RE = 3471.2 - 2793.2 = 678$$

$$\text{What is Net Income? } 945.6$$

$$NI - Div = \Delta RE$$

$$945.6 - Div = 678$$

$$Div = 267.6$$

36

Starbucks' Statement of Owners' Equity

	Common Stock		Additional Paid-in Capital	Other Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Shareholders' Equity	Noncontrolling Interest	Total
	Shares	Amount							
Balance, September 27, 2009	742.9	\$ 0.7	\$ 147.0	\$ 39.4	\$ 2,793.2	\$ 65.4	\$ 3,045.7	\$ 11.2	\$3,056.9
Net earnings	0.0	0.0	0.0	0.0	945.6	0.0	945.6	2.7	948.3
Unrealized holding loss, net	0.0	0.0	0.0	0.0	0.0	(17.0)	(17.0)	0.0	(17.0)
Translation adjustment, net of tax	0.0	0.0	0.0	0.0	0.0	8.8	8.8	0.0	8.8
Comprehensive income							937.4	2.7	940.1
Stock-based compensation expense	0.0	0.0	115.6	0.0	0.0	0.0	115.6	0.0	115.6
Exercise of stock options, including tax benefit of \$27.7	10.1	0.0	137.5	0.0	0.0	0.0	137.5	0.0	137.5
Sale of common stock, including tax benefit of \$0.1	0.8	0.0	18.5	0.0	0.0	0.0	18.5	0.0	18.5
Repurchase of common stock	(11.2)	0.0	(285.6)	0.0	0.0	0.0	(285.6)	0.0	(285.6)
Net distributions to noncontrolling interests	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.8)	(0.8)
Cash dividend	0.0	0.0	0.0	0.0	(267.6)	0.0	(267.6)	0.0	(267.6)
Purchase of noncontrolling interests	0.0	0.0	(26.8)	0.0	0.0	0.0	(26.8)	(5.5)	(32.3)
Balance, October 3, 2010	<u>742.6</u>	<u>\$ 0.7</u>	<u>\$ 106.2</u>	<u>\$ 39.4</u>	<u>\$ 3,471.2</u>	<u>\$ 57.2</u>	<u>\$ 3,674.7</u>	<u>\$ 7.6</u>	<u>\$3,682.3</u>

$$NI - Div = \Delta RE$$

$$945.6 - 276.6 = 678$$

37

3. Building Financial Statements

- We are ready to create financial statements from the underlying transactions
- Transactions are the building blocks for financial statements
- Again, the purpose of these statements is to help users assess the firm's:
 - financial condition **Balance Sheet**
 - performance **Income Statement**
 - cash flows **Statement of CF**

38

Dawg Company

- Dawg Co. was conceived by two UW Foster School alums
- Dawg Co.'s mission: provide 'sustainable warmth' during Seattle's long winters
- Strategy: leverage Seattle's coffee culture
- First product: insulated mugs with the UW Foster School logo



39

Dawg Co. Business Model?

Buy & resell Foster School mugs at a profit

- **Transaction #1:** Dawg Co. issues 5,000 shares at \$10 per share.
- How is the balance sheet affected?

Assets = Liabilities + Owners' Equity

(Cash) \$50,000 = 0 (Stock) \$50,000

40

Transaction #2

- Dawg Co. buys office equipment for \$15,000 in cash.
- How is the Balance Sheet affected?

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

(Equip.) \$15,000		
	\$0	\$0
(Cash) - \$15,000		
<u> </u>	<u> </u>	<u> </u>
\$0	\$0	\$0

41

Transaction #3

- Dawg Co. buys 5,000 mugs from ThermoServ at \$5 each, using credit.
- How is the Balance Sheet affected?

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

(Inventory) \$25,000	=	(AP) \$25,000		\$0
----------------------	---	---------------	--	-----

42

Transaction #4

- Dawg Co. sells 3,000 mugs to the University Bookstore for \$8 each. As is typical, the bookstore will pay later.
- How is the Balance Sheet affected?

Assets = Liabilities + Owners' Equity

(Acct. Rec.) \$24,000	=	\$0	(Revenue) \$24,000
(Inventory) -\$15,000	=	\$0	(Expense) -\$15,000
			<u>\$9,000</u>

Gross Profit on sales?

43

How did Dawg Co. 'perform' on the sale to the Bookstore?

Recap of Transaction #4

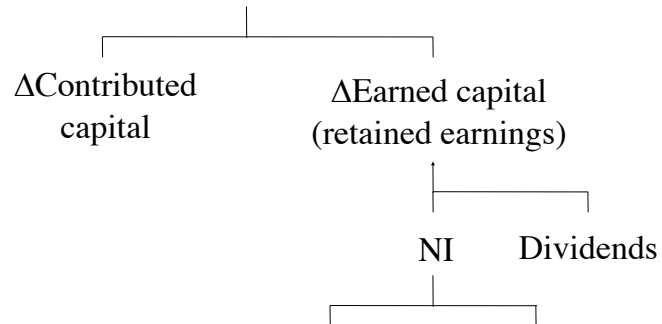
- Sold 3,000 insulated mugs to the U-Bookstore.
 - Sold for \$8 each
 - Sales (revenue) = \$24,000
- Cost of mugs sold?
 - Cost was \$5 each
 - Cost of Goods Sold (expense) = \$15,000
- Gross Profit on sale?
 - Sales minus CGS

$$\$24,000 - \$15,000 = \$9,000$$

44

Another recap... Relation between B/S and I/S

$$\Delta \text{Assets} = \Delta \text{Liabilities} + \Delta \text{Owners' Equity}$$



$$\begin{aligned} \Delta \text{Accounts receivable} + \Delta \text{Inventory} &= \Delta \text{Liab} + \Delta \text{Contrib capital} + \text{Revenue} - \text{Expenses} \\ \$24,000 + -\$15,000 &= \$0 + \$0 + \$24,000 - \$15,000 \end{aligned}$$

Net asset inflow
= \$9,000

Gross Profit
= \$9,000

45

Aside: What inventory remains on the Balance Sheet?

- How many mugs are left in Inventory?
 - Started with 5,000 (from transaction #3)
 - Sold 3,000 mugs to the U-Bookstore.
 - Must be 2,000 left
- Cost of remaining mugs?
 - Cost was \$5 each
 - Cost of current inventory = \$10,000 (2,000 mugs @ \$5 each)
- Another summary view
 - Transaction 3: Purchased mugs costing \$25,000
 - Transaction 4: Sold \$15,000 of these mugs to U-Bookstore
 - Current balance = \$10,000 (\$25,000 - \$15,000), same as above

46

Transaction #5

- Dawg Co. pays \$6,000 in wages to its dedicated part-time employees.
- How is the Balance Sheet affected?

$$\textit{Assets} = \textit{Liabilities} + \textit{Owners' Equity}$$

$$\text{(Cash) } -\$6,000 = \quad \quad \quad 0 \quad \quad \text{(Wage exp) } -\$6,000$$

47

4. Summary of Transactions

- Introduce a spreadsheet to summarize the five transactions we just discussed
- From this spreadsheet, we can prepare the three major financial statements

48

Dawg Co. Financial Summary

Events	Assets				Liab.	Owners' Equity	
	Cash	Account Rec.	Inventory	Equipmt.	Account Payable	Contrib. Capital	Retained Earnings
1. Issue stock	50,000					50,000	
2. Buy equipmt.	-15,000			15,000			
3. Buy mugs			25,000		25,000		
4. Sell mugs		(a) 24,000	(b)-15,000				(a) 24,000 (b)-15,000
5. Pay wages	-6,000						-6,000
totals	29,000	24,000	10,000	15,000	25,000	50,000	3,000

49

Dawg Co. Balance Sheet

DAWG COMPANY

**June 30,
200x**

Balance Sheet as of:

ASSETS:

Current assets:

Cash	\$ 29,000
Accounts receivable	24,000
Inventories	10,000
<i>Total current assets</i>	<u>\$ 63,000</u>

Non-current assets:

Equipment	15,000
<i>Total non-current assets</i>	<u>\$ 15,000</u>
TOTAL ASSETS	<u>\$ 78,000</u>

LIABILITIES:

Current liabilities:

Accounts payable	\$ 25,000
TOTAL LIABILITIES	<u>\$ 25,000</u>

OWNER'S EQUITY

Common stock	\$ 50,000
Retained earnings	3,000
<i>Total owners' equity</i>	<u>53,000</u>
TOTAL EQUITIES	<u>\$ 78,000</u>

50

Dawg Co. Income Statement

DAWG COMPANY

	June 30, 200x
Income Statement for 3 months ended:	
Sales revenue:	\$ 24,000
Cost of goods sold	<u>15,000</u>
Gross Profit	\$ 9,000
Other expenses:	
Wages	\$ <u>6,000</u>
Total other expenses	\$ 6,000
NET INCOME	\$ 3,000

Reconciliation to Ending Owners' Equity

Beginning Owners' Equity	0
Net Income (Loss)	3,000
Dividends	<u>0</u>
Ending Owners' Equity	3,000

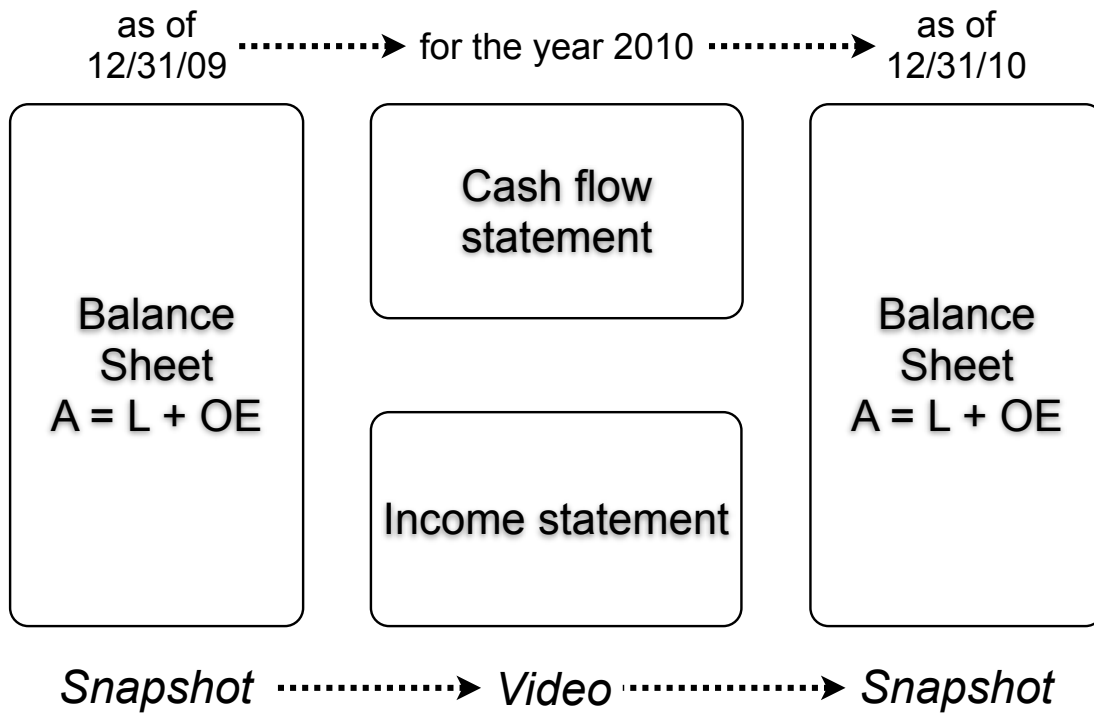
51

5. Statement of Cash Flows

- The 3rd major financial statement
 - Statement of Cash Flow: assessing cash flows (liquidity) during a period
- What is it (in its most simple form)?
 - Cash inflows and cash outflows
 - Categorized by operating, investing and financing

52

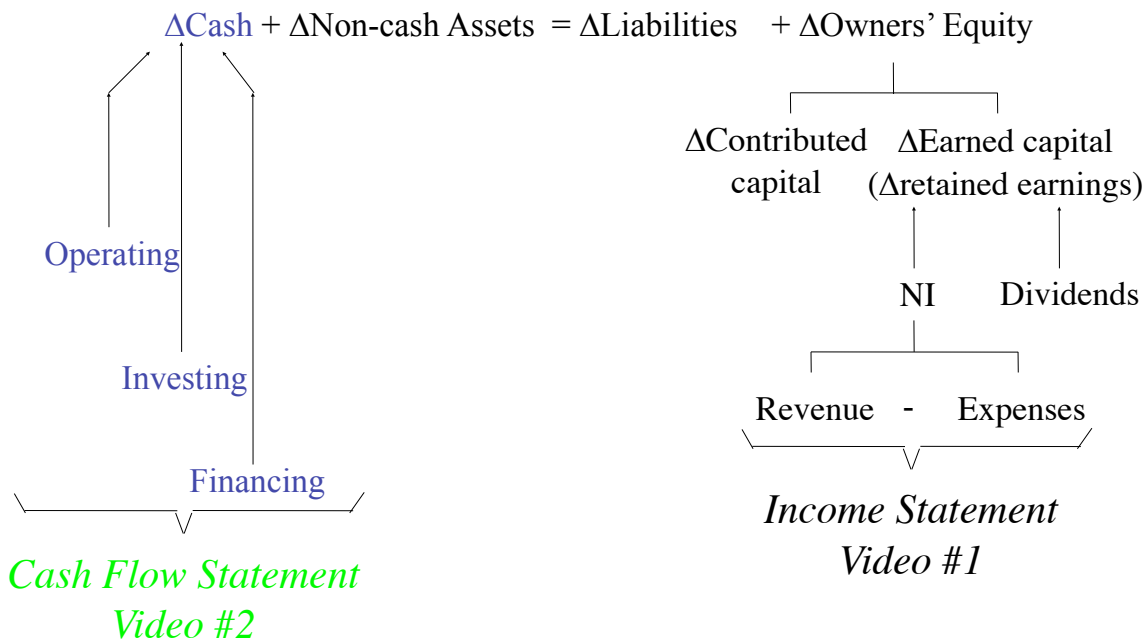
3 Major Financial Statements



53

Amazon

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$



54

Activities Generating or Using Cash Flows

- *Operating activities*: the normal business activities (producing, buying, selling goods and services, and operating facilities).
- *Investing activities*: buying and selling of longterm productive assets and investment assets
- *Financing activities*: borrowing & repaying debt, issuing and repurchasing stock, paying dividends.

55

CVS Caremark Statement of Cash Flows: Operating Activities

<i>in millions</i>	Year Ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Cash receipts from revenues	\$ 94,503	\$ 93,568	\$ 82,250
Cash paid for inventory and prescriptions dispensed by retail network pharmacies	(73,143)	(73,536)	(64,131)
Cash paid to other suppliers and employees	(13,778)	(13,121)	(11,832)
Interest and dividends received	4	5	20
Interest paid	(583)	(542)	(574)
Income taxes paid	(2,224)	(2,339)	(1,786)
Net cash provided by operating activities	4,779	4,035	3,947

56

CVS Caremark Statement of Cash Flows: Investing Activities

<i>in millions</i>	Year Ended December 31,		
	2010	2009	2008
Cash flows from investing activities:			
Additions to property and equipment	(2,005)	(2,548)	(2,180)
Proceeds from sale-leaseback transactions	507	1,562	204
Acquisitions (net of cash acquired) and other investments	(177)	(101)	(2,651)
Purchase of short-term investments	–	(5)	–
Proceeds from sale or maturity of short-term investments	1	–	28
Proceeds from sale or disposal of assets	34	23	19
Net cash used in investing activities	(1,640)	(1,069)	(4,580)

57

CVS Caremark Statement of Cash Flows: Financing Activities

<i>in millions</i>	Year Ended December 31,		
	2010	2009	2008
Cash flows from financing activities:			
Increase (decrease) in short-term debt	(15)	(2,729)	959
Repayment of debt assumed in acquisition	–	–	(353)
Issuance of long-term debt	991	2,800	350
Repayments of long-term debt	(2,103)	(653)	(2)
Dividends paid	(479)	(439)	(383)
Derivative settlements	(5)	(3)	–
Proceeds from exercise of stock options	285	250	328
Excess tax benefits from stock-based compensation	28	19	53
Repurchase of common stock	(1,500)	(2,477)	(23)
Net cash provided by (used in) financing activities	(2,798)	(3,232)	929

58

Important to Know!

Operating cash flow and net income (earnings) are *different* concepts!

- Sales revenue \neq cash collected
- Expenses \neq cash paid
- Net income \neq Cash from Operations

59

CVS Caremark: Cash Flow and Net Income are Different

<i>in millions</i>	Year Ended December 31,		
	2010	2009	2008
Reconciliation of net income to net cash provided by operating activities:			
Net income	\$ 3,424	\$ 3,696	\$ 3,212
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,469	1,389	1,274
Stock-based compensation	150	165	92
Deferred income taxes and other noncash items	30	48	(3)
Change in operating assets and liabilities, net of effects from acquisitions:			
Accounts receivable, net	532	(86)	(291)
Inventories	(352)	(1,199)	(488)
Other current assets	(4)	48	12
Other assets	(210)	(2)	19
Accounts payable	(40)	4	(64)
Accrued expenses	(176)	(66)	183
Other long-term liabilities	(44)	38	1
Net cash provided by operating activities	\$ 4,779	\$ 4,035	\$ 3,947

Difference = \$1,355 million!

60

Preparing the Statement of CF

- Consider Dawg Co.
- Look at the Cash account
- Categorize cash flows into:
 - Operating
 - Investing
 - Financing

61

Dawg Co. - Stmt of Cash Flows

Events	Cash	Operating	Investing	Financing
1. Issue stock	+50,000			+50,000
2. Buy equipmt.	-15,000		-15,000	
3. Buy mugs	--			
4. Sell mugs	--			
5. Pay wages	-6,000	-6,000		
totals	29,000	-6,000	-15,000	+50,000

62

Dawg Co. - Stmt of Cash Flows

DAWG COMPANY

Cash Flow Statement for the period ended	June 30, 200x
OPERATING ACTIVITIES	
Cash collected from customers:	\$ 0
Cash outflows for operations:	
Wages	(6,000)
Total operating cash outflows	\$ (6,000)
Cash from operating activities	\$ (6,000)
INVESTING ACTIVITIES	
Purchase equipment	(15,000)
Cash from investing activities	\$ (15,000)
FINANCING ACTIVITIES	
Original contribution	\$ 50,000
Cash from financing activities	\$ 50,000
Change in Cash	\$ 29,000

63

6. Summary look at Dawg Co. (B/S)

- Balance sheet
 - Assets: Converted initial cash into equipment and inventory. Generated accounts receivable from sale.
 - Liabilities: Owe our supplier, ThermoServ
 - OE: Small profit & no dividends => increase
- Our *financial position* has changed as would be expected given a new business

64

Summary look at Dawg Co. (I/S)

- Income Statement
 - Revenues exceeded CGS on first sale - a crucial step toward profitability
 - Other expenses are minimal so far (wages)
 - Squeaked out a small profit
- A profit in the first period reflects good *performance* -- but is it sustainable?

65

Summary look at Dawg Co. (Stmt of CF)

- Statement of Cash Flows
 - Operations: \$ -6,000
 - Investing: \$ -15,000
 - Financing: \$ 50,000
- Summary:
 - Negative operating cash flow at the beginning of a business might be typical...
 - but cash needs to be monitored carefully to avoid immediate financial distress.

66

Haystack Bookstore



67

Summary of events

- Arthur King negotiates to buy Mary Becker's bookstore in Cannon Beach, Oregon.
- Arthur King puts personal funds into the business and borrows \$80,000 to complete the purchase. He prepares to (re)open the business.
- April 1, King opens his store and greets his first customers.
- Case provides information about events for the last 9 months of the year.

68

Case Questions

1. Prepare a statement of financial position (also called a “balance sheet”) for the Haystack Bookstore as of the end of the day March 31.
2. Prepare a balance sheet as of December 31.
3. Prepare an income statement for the 9 months ended December 31. Did Haystack Bookstore earn a profit?
4. Prepare a cash flow statement from the inception of the business through December 31.

69

Haystack Balance Sheet Spreadsheet

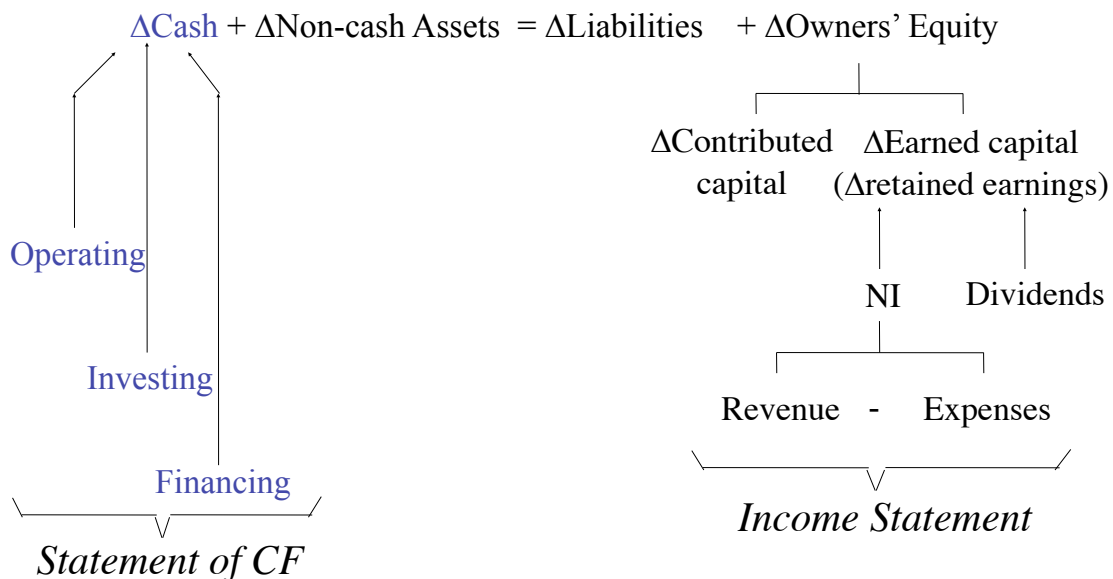
	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
1							ASSETS					LIAB.			OE
2	Ref														
3	#	Event Descript.	Cash												
4		beg. bal.													
5	1	orig contribution													
6	2a	borrow \$80k													
7	2b	acquire business													
8	3	legal fees for land & bldg													
9	a	fire insurance													
10	b	purchase fixtures													
11	c	purch merch on acct													
12		BALANCE at 3/31													
13	d	summary of sales													
14	e	purch merch on acct													
15	f	payments on acct													
16	g	utilities													
17	h	wages													
18	i	King's "salary"													
19	j	adjmt-see below													
20	k	adjmt-see below													
21		PRE-ADJ. TRIAL BAL at 12/31													
22	j	cost of goods sold													
23	k	deprec exp													
24	l	insurance exp													
25	m	interest exp													
26		PRE-CLOSING BALANCE													
27	o	to close													
28		ENDING BALANCE at 12/31													

70

Q3. Did Haystack Bookstore earn a profit?

71

Q4. Prepare a cash flow statement from the inception of the business through December 31.



72

Haystack Cash Flow Statement worksheet (direct method)

◇	A	B	C	D	E	F
1	Ref			from	from	from
2	#	Event Descript.	Cash	operations	investment	financing
3		<i>beg. bal.</i>				
4	1	orig contibution	60,000			
5	2a	borrow & ...	80,000			
6	2b	acquire business	-125,000			
7	3	closing costs	-5,000			
8	a	fire insurance	-600			
9	b	purchase fixtures	-1,300			
10	c	purchase merch on acct				
11		BALANCE at 3/31	8,100			
12	d	summary of sales	62,300			
13	e	purch merch on acct				
14	f	payments on acct	-42,100			
15	g	utilities	-1,900			
16	h	wages	-2,800			
17	i	King's "salary"	-9,000			
18	j	adjmt for CGS				
19	k	adjmt for depreciation				
20		PRE-ADJ. TRIAL BAL	14,600			
21						
22		Cash from operating activities				
23		Cash from investment activities				
24		Cash from financing activities				
25		net change in cash				

73

Cash Flow versus Earnings
How are they different?

74

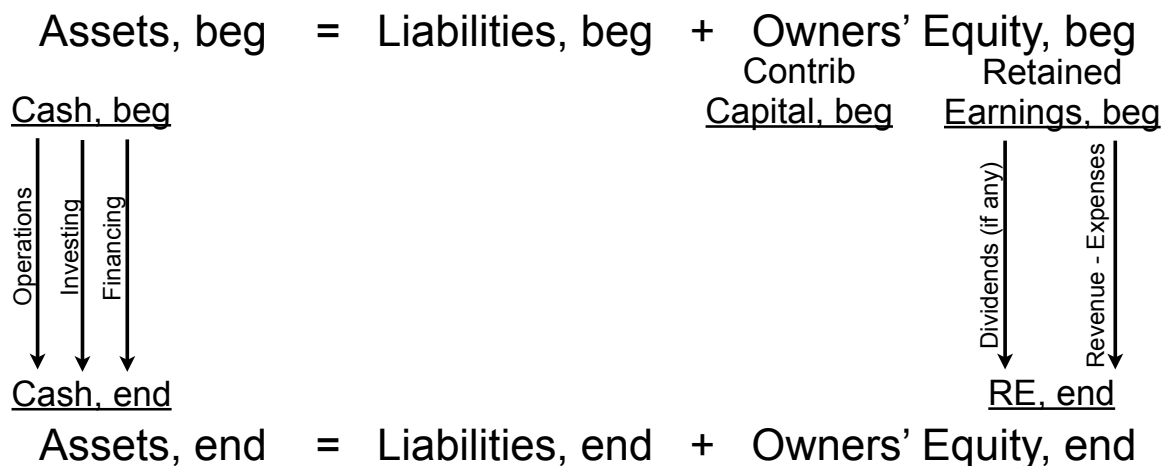
Haystack takeaways, page 1 of 3

- Accountants generally record events at their historical cost – and only those they can measure.
- The Balance Sheet is a snapshot of the Assets, Liabilities and Owners' Equity at a point in time, i.e., $A = L + OE$
- Our two videos are about Cash Flow and Net Income. These are *different* concepts.
- The *change* in RE = Net Income - Dividends

75

Haystack takeaways, page 2 of 3

- The 3 major financial statements articulate (fit together) to provide data about the economics of the firm.



76

Haystack takeaways, page 3 of 3

- Product costs are 'matched' (expensed) with sales; period costs are expensed with time.
- Personal and business transactions should not be comingled.
- Judgment is required to prepare financial statements as well as to use them.
- We will evaluate firms not just on their performance and financial condition but also on the judgments managers make.