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INTRODUCTION TO FINANCIAL ACCOUNTING

This presentation contains information, in addition to the material prepared and provided by the professor, from:

1. Financial Accounting, David Spiceland, 6th Ed., McGraw-Hill
2. Intermediate Accounting, David Spiceland, 11th Ed., McGraw-Hill
3. Intermediate Accounting, Donald Kieso, 18th Ed., Wiley
4. Other: Official Websites

I. Accounting and its Environment

A. Definition

- It is a service activity that provides financial information of an entity to the users (stakeholders), so that they can make their decisions.
- It is an information system.
- It is a financial language.

B. FINANCIAL AND ECONOMIC ENVIROMENT



B. Social function of accounting



FINANCIAL ACCOUNTING

Provides information to external users.

Functions

- Measure business transactions
- Disclose the information

Usefulness

- Useful for decision making (investors and creditors)
- Useful to predict cash flows
- Provide information of entity resources, claims and changes on these

C. Users of financial information

STAKEHOLDERS

INTERNAL

- Company Management

EXTERNAL

- Investors (shares & credit)
- Investment Analysts
- Creditors (e.g. banks, suppliers, bondholders)
- Rating Agencies: (Bond credit rating – e.g. Moody's)
- Stock Market Index (Standard and Poor's 500 - S&P 500)
- Customers
- Government (e.g. IRS)
- Competitors
- Academia
- Press

C. Users of financial information

USERS: DECISIONS

Determine risk and return before providing capital

INVESTMENT DECISIONS

Investors: Buy shares?

CREDIT DECISIONS

Creditors: Lend Money?

OTHER DECISIONS

Customers: Purchases the products?

Suppliers: Sell on credit?

Management: Short- and long-term decisions? (e.g. market expansion)

Company Personnel: More benefits?

Competitors: Change strategy?

Government: Society welfare? (e.g. environment laws, more taxes)

D. Types of organizations (for-profit and non-profit)

TYPES OF BUSINESSES AND THEIR ACTIVITIES

1. CORPORATION:

It is a business authorized by the state and legally incorporated.

Advantages:

- Legally separated from their owners
- Limited liability
- Continuity of operations
- Capital from two sources (debt and shares)

Disadvantages:

- High Costs: incorporation, operation & compliance
- Double taxation (company and shareholders)
- Greater government regulations

2. *PARTNERSHIP:

It is an agreement between two or more people to carry out activities to generate income.

Advantages:

- Single taxation
- Fewer regulation (documents)
- Easy to dissolve

Disadvantages:

- Unlimited liability (personal assets)
- Responsibility for actions of each partner
- Limited life (death or retirement of a partner)
- Distribution of profits according to original agreement
- Limited funding sources (only debts)

*There are Partnership with Limited Liability

3. SOLE PROPRIETORSHIP:

- One owner

BUSINESSES AND THEIR ACTIVITIES

ACTIVITIES

- **OPERATING** (MAIN OPERATIONS)
 - Sell and buy products
 - Provide services

- **INVESTING** (buy or sell resources for a return)
 - Buy and sell shares (other companies)
 - Loan to others & collection of loans
 - Buy and sell non current assets (e.g. vacant land)

- **FINANCING** (money from: creditor/debt and investors/shares)
 - Buy and sell shares (own)
 - Make and paid loans (e.g. bank)

FINANCIAL STATEMENTS

Reports to the external users

- INCOME STATEMENT (results of operations)
- BALANCE SHEET (financial position)
- CASH FLOWS (uses and sources of cash)
- STATEMENT OF STOCKHOLDERS' EQUITY (changes in equity)
- NOTES (more detail: assumptions, methods, other)

FINANCIAL STATEMENTS

Reports to the external users

Annual Report:

Important components:

*10K (Financial Information)

*Notes to the Financial Statements

*Management discussion and analysis (MD&A):

-management's views on significant events pertaining to the company.

Other Information

FINANCIAL STATEMENTS

ELEMENTS/ACCOUNTS

- Revenues- inputs from the sale of products or services provided
- Expenses- cost “sacrifice” of sale products or services
- Net Income- Revenues less expenses
- Dividends- distribution to stockholders
- Assets- resources
- Liabilities- claims to the resources
- Stockholders' Equity- residual interest (owners, claims)

FINANCIAL STATEMENTS

FORMAT: INCOME STATEMENT

*Reports the result of the main operation of the company.

*Financial Statement that reports the company's revenues and expenses over an interval of time.

*Informs if the company is agile generating income to cover expenses.

MULTIPLE STEP

ABC CORP
Income Statement
For the period ended 12/31/xxxx

SINGLE STEP

Revenues	
Service revenue	\$20,000
Expenses	
Rent expense	1,000
Salaries expense	1,000
Advertising Expense	1,000
Utilities expense	1,000
Interest expense	1,000
Total expenses	<u>5,000</u>
Net income	\$15,000

Revenues	
Sales Revenue	\$20,000
Cost of Goods Sold	(1,000)
Gross Profit	\$19,000
Less: Operating Expenses	
Rent expense	500
Salaries expense	500
Advertising Expense	500
Utilities expense	500
Operating Income	\$17,000
Less/Plus: Other Revenues & Expenses	
Interest expense	<u>1,000</u>
Income before Tax	\$16,000
Less: Income tax expenses	<u>1,000</u>
Net income	\$15,000

EPS: \$1.25

FINANCIAL STATEMENTS

FORMAT: BALANCE SHEET

ABC CORP
Balance Sheet
12/31/xxxx

*Disclose: Assets,
liabilities and capital
structure.

Current Assets

Cash	\$20,000
Account Receivable	10,000
Inventory	20,000

Non-Current Assets

Land	<u>50,000</u>
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Total Assets **\$100,000**

Current Liabilities

Account Payable	5,000
Salaries Payable	5,000

Non-Current Liabilities

Notes Payable	<u>30,000</u>
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Total Liabilities **\$40,000**

Stockholder's Equity

Capital Stock	45,000
Retained Earnings	<u>15,000</u>

Total Stockholder's Equity **\$60,000**

$$A = L + C$$

FINANCIAL STATEMENTS

FORMAT: CASH FLOWS

*Inform: cash inflows and outflows

ABC CORP
Cash Flows
For the period ended 12/31/xxxx

Operating Activities

Cash inflows (e.g. from clients)	\$10,000
Cash outflows (e.g. paid expenses)	<u>(5,000)</u>
Net Cash Flows	15,000

Investing Activities

Cash inflows (e.g. sale investment)	2,000
Cash outflows (e.g. purchases land)	<u>(1,000)</u>
Net Cash Flows	1,000

Financing Activities

Cash inflows (e.g. sale own shares)	20,000
Cash outflows (e.g. paid loan)	<u>(16,000)</u>
Net Cash Flows	4,000

<u>Plus: Cash at the beginning of the period</u>	<u>\$0</u>
Cash at end of the period	\$20,000

FINANCIAL STATEMENTS

Income Statement

Revenues	
Service revenue	\$20,000
Expenses	
Rent expense	1,000
Salaries expense	1,000
Advertising Expense	1,000
Utilities expense	1,000
Interest expense	1,000
Total expenses	<u>5,000</u>
Net income	\$15,000

Cash Flows

Operating Activities	
Cash inflows	\$10,000
Cash outflows	<u>5,000</u>
Net Cash Flows	15,000
Investing Activities	
Cash inflows	2,000
Cash outflows	<u>1,000</u>
Net Cash Flows	1,000
Financing Activities	
Cash inflows	20,000
Cash outflows	<u>16,000</u>
Net Cash Flows	4,000
Cash at end of the period	\$20,000

Balance Sheet

Current Assets	
Cash	\$20,000
Account Receivable	10,000
Inventory	20,000
Non-Current Assets	
Land	<u>50,000</u>
Total Assets	\$100,000
Current Liabilities	
Account Payable	5,000
Salaries Payable	5,000
Non-Current Liabilities	
Notes Payable	<u>30,000</u>
Total Liabilities	\$40,000
Stockholder's Equity	
Capital Stock	45,000
Retained Earnings	15,000
Total Stockholder's Equity	\$60,000

FINANCIAL STATEMENTS

ABC CORP
Changes in Equity
For the period ended 12/31/xxxx

CHANGES IN STOCKHOLDER'S EQUITY

	Capital Stock	Retained Earnings	Total Stockholder's Equity
Beginning Balance	\$0	\$0	\$0
Issuance of Stock	\$45,000		\$45,000
Add: Net Income		\$15,000	\$15,000
Less: Dividends		(\$0)	(\$0)
Ending Balance	\$45,000	\$15,000	\$60,000

Statement of Stockholders' Equity

Common Stock (external capital)

+

Retained Earnings (internal capital)

Stockholder's Equity

Capital Stock	\$45,000
Retained Earnings (From Net Income)	15,000
	\$60,000

ROLE OF AN EXTERNAL AUDITOR

- Express an opinion on the veracity of the Financial Information and the compliance with US GAAP.

Types of Opinions

- Unqualified opinion (meets everything)
- Qualified opinion (meets everything, except for...)
- Adverse opinion (does not comply)
- Disclaimer of opinion (no opinion)

“Our responsibility is to express an opinion on these financial statements based on our audits”.

Certified Public Accountants (CPA)

- State License
- Independent professional

Accounting Scandals

e.g. Enron

e.g. WorldCom

e.g. Xerox

Sarbanes-Oxley Act (SOX 2002)

- U.S. law: set new requirements for all U.S. public company boards, management and public accounting firms.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

- Supervise the audits of public companies to protect the interests of stakeholders.

E. Relationship of accounting with other disciplines

Provides financial information for decision making in the different departments of a company.

- Human Resources: (e.g. salary increase, hire new staff)
- Operations (e.g. logistic, new equipment)
- Marketing (e.g. increase in promotion budget)

F. Factors that affect accounting as a profession and discipline

F. Factors that affect accounting as a profession and discipline

CHANGES TO ACCOUNTING STANDARDS (FASB)

TECHNOLOGICAL ADVANCES AND AUTOMATION

➤ **Big Data:**

Large data sets, when analyzed reveals patterns and trends.

➤ **Data Analytics:**

Is a process of inspecting, cleansing, transforming and modelling data with the goal of discovering useful information, informing conclusions, and supporting decision-making.

➤ **Artificial Intelligence**

WHAT SHOULD ACCOUNTANTS KNOW ABOUT DATA ANALYTICS?

1. Accountants should implement controls over the storage and use of data.
2. Accountants should develop the skill set necessary to extract value from data through advanced analytics.

G. Historical development of accounting

Accounting History: Literature Review

- Long before the first CPA license was granted in the U.S., accountants were responsible for the administration and finances of a business.
- Records from 4000 B.C. have been found in Mesopotamia temples (King, Case and Senecker, 2017).
- However, there are records on the double entry, “Massari Ledgers” for 1340 in Genoa. By the 15th century the double entry had already spread from Italy to Germany.
- Also, it is speculated that Benetto Cotrugli's book in 1463 included a section on bookkeeping, his work being published several decades later.
- Also, some cost-keeping records were found in post medieval periods.
- In the U.S., information from 1620 has evidenced the audit functions that were performed for the government. Likewise, accounting education is introduced in 1635.
- By 1680 the colonies in Massachusetts developed processes for making budgets and systems for collecting taxes for different cities. (Previts & Merino, 1998: 27-30).

Accounting History: Literature Review

- **Luca Pacioli** “father of accounting”, made history in 1494, with his Summa, many pages have been written, reviewing the accounting profession. His creation "debitore" (debtor/**debit/Dr.**) and "creditore" (**credit/Cr.**), have been one of the greatest contributions throughout history for the development of accounting.
- The first account books using the double entry are from 1546-52.
- The Dr. and Cr. today are the backbone of accounting.
- Other critics argue that Dr. and Cr. allowed to create the concept of economic entity and that it helped to create venture capitalism, later mercantile, financial, managerial, and investment fund capitalism.
- James Bennett the so-called "teacher of bookkeeping" James Bennett and his book published in 1814.
- The basic equation, as well as the accounting language, arises from the work of Charles Ezra Sprague in the 1900s, he proposed the constructed language, which was originated with a specific purpose (Previts & Merino, 1998: 4-15).
- The international accounting era was strengthened in 1967, with the named “Father of International Accounting Education” Gerhard G. Mueller and the publication of the first book on International Accounting.

H. Accounting career opportunities

CAREERS

Public Accountant: (provides auditing, tax, consulting, and accounting services)

Tax Accountant: (taxes for individuals and companies: local, state, and federal)

Forensic Accountant: (legal cases, investigating fraud.)

Financial Accountant: (reports, bookkeeping for companies uses for external users)

Managerial Accountant: (reports, bookkeeping for companies uses for internal users)

Consultant: (finances, budgeting, to taxes, to investment)

Internal Auditor: (ensures the proper use of resources and compliance with regulation)

External Auditor: (audit and review the financial information of a company and reports on findings)

Government Accountant: (management of funds for local, state, or federal government)

I. Professional certifications

CPA

- Certified Public Accountant
- In the United States, the CPA is a license to provide accounting services to the public.
- Approve exam: Auditing (AUD), Business Environment and Concepts (BEC), Financial Accounting and Reporting (FAR), and Regulation (REG).

CISA

Certified Information Systems Auditor

- audit, control, monitor and assess an organization's information technology and business systems.
- Approve exam

CMA

- Certified Management Accountant
- Professional credential: Institute of Management Accountants (IMA)
- Areas: management accounting and corporate finance.
- Approve exam

CFE

- Certified Fraud Examiner
- Offered by the Association of Certified Fraud Examiners
- Approve exam

J. Professional organizations

AICPA

The American Institute of Certified Public Accountants (AICPA) organization of Certified Public Accountants (CPAs) in the United States

- Founded in 1887, later in 1957 named AICPA
- 418,000 members in 143 countries
- Mission: "power the success of global business, CPAs, CGMAs and specialty credentials by providing the most relevant knowledge, resources and advocacy, and protecting the evolving public interest"

CCPAPR

Colegio de Contadores Públicos Autorizados de Puerto Rico

- Created: Law 75 of May 31, 1973
- Compulsory membership requirement, which establishes that to practice public accounting in PR
- Continuing Education Law requirement to renew the CPA license

IASB

The International Accounting Standards Board (IASB)

- Develops the International Financial Reporting Standards (IFRS Standards), before: International Accounting Standards (IAS).
- Founded on April 1, 2001 (before: International Accounting Standards Committee (IASC)).

HIERARCHY OF STANDARD-SETTING

Congress of United States

Securities and Exchange Commission (SEC)

- Government agency of the United States (US).
- Created by the US Congress after Wall Street Crash of 1929.
- Protect the market and their users and prevent manipulation.
- Establish reporting requirements, for companies whose securities are publicly traded.
- 1933 Securities Act: Initial offering.
- 1934 Securities Exchange Act: Secondary market transactions.

Private Sector

- Industries, Companies, Stakeholders, etc.

Committee on Accounting Procedure (CAP) (1938 to 1959)

- First private sector standard-setting body
- Committee of the American Institute of Accountants (AIA) Later: (AICPA: 1957)
- AIA: National professional organization for certified professional public accountants
- Issued 51 Accounting Research Bulletins (ARBs)

Accounting Principles Board (APB) (1959 to 1973)

- Issued 31 Accounting Principles Board Opinions (APBOs), various Interpretations, and four Statements

FASB (1973-Present)

- Marshall Armstrong, president of the AICPA appointed a group of seven men (the Wheat Committee: Headed by Francis Wheat) in the early 1970s
- The purpose was to examine the organization and operation of the APB, to determine what adjustments were needed to facilitate more accurate and timely results.
- Private organization standard-setting to establish and improve U.S. accounting standards (US GAAP)
- Seven members

Rules of Financial Accounting: USA

FASB Accounting Standards Codification

- Generally Accepted Accounting Principles (GAAP)
- Includes 90 topics
- Includes SEC guidance

Accounting Standards Update (ASU)

- New standard issued by FASB

Rules of Financial Accounting: GLOBAL

- International Financial Reporting Standards (IFRS Standards),
- International Accounting Standards (IAS).

Rules of Financial Accounting

The *FASB Accounting Standards Codification*® (FASB Codification)

1. Is the sole source of authoritative GAAP other than SEC issued rules that apply only to SEC registrants.
2. The FASB issues an Accounting Standards Update (Update or ASU) to communicate changes to the FASB Codification, including changes to non-authoritative SEC content.

<https://www.fasb.org/page/PageContent?pageId=/standards/accounting-standards-updates-issued.html>

Accounting Standards Update (ASU)

Each ASU explains:

1. How the FASB has changed US GAAP, including each specific amendment to the FASB Codification
2. Why the FASB decided to change US GAAP and background information related to the change
3. When the changes will be effective and the transition method.

Others: Professional organizations

FAF

- The Financial Accounting Foundation (FAF) is in Norwalk, Connecticut.
- It was organized in 1972 is an private and independent organization.
- The goal is to ensuring objectivity and integrity in financial reporting standards.
- Establishing and improving financial accounting and reporting standards;
- Educating constituents about those standards;
- The oversight, administration, and finances of its standard-setting Boards, the (FASB) and the Governmental Accounting Standards Board (GASB), and their Advisory Councils.
- Selecting the members of the standard-setting Boards and Advisory Councils
- Protecting the independence and integrity of the standard-setting process.

GASB

The Governmental Accounting Standards Board

- Creates the generally accepted accounting principles (GAAP) used by state and local governments in the US.

Others: Professional organizations

IMA

Institute of Management Accountants

- Focused exclusively on advancing the management accounting profession.
- Worldwide association of accountants and financial professionals in business.
- Founded in 1919.

IRS

The Internal Revenue Service

- Responsible for collecting taxes and administering the Internal Revenue Code.
- It is part of the Department of the Treasury .
- The duties of the IRS: providing tax assistance; pursuing and resolving instances of erroneous or fraudulent tax filings; overseeing various benefits programs.

SEC

Securities and Exchange Commission

- Is an government agency of the United States.
- Oversees securities exchanges.
- Protects the investor from being provided with false information.
- Founded in 1929.

K. Ethics and values

***AICPA Code of Professional Conduct:**

- codified statements that outline a CPA's ethical and professional responsibilities.
- Standards for auditor independence, integrity and objectivity, responsibilities to clients and colleagues and acts discreditable to the accounting profession.

*Full version: <https://www.aicpa.org/research/standards/codeofconduct.html>

***IMA Code of Professional Conduct:**

COMPETENCE

- Maintain an appropriate level of professional leadership and expertise by enhancing knowledge and skills.

CONFIDENTIALITY

- Keep information confidential except when disclosure is authorized or legally required.

INTEGRITY

- Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts of interest.

CREDIBILITY

- Communicate information fairly and objectively.

*Full version: <http://www.imanet.org/>

Ethical Decisions

- Determine the facts of the situation.
- Identify the facts and ethical issue.
- Identify the values related to the situation.
- Evaluate the alternative course of action.
- Identify risk and consequences.
- Make your decision.
- Take any indicated action.