Understanding Financial Statements & Reporting
- Lecture 1 -

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Course Content

• The financial reporting environment & its complexities
• The Balance Sheet
• The Income Statement
• The Statement of Stockholders’ Equity
• The Statement of Cash Flows
• Analysis of financial statements & reporting

Assignments

• Reminder:
  – Reading assignments are found on the course home page
  – You should always read the assigned material before watching a lecture
  – You should always work the assigned problems after watching a lecture
**Today’s Content**

- The accounting model
- The four basic financial statements
- The footnotes
- The auditor’s report

**Financial Reporting**

- What is financial reporting?
  - Reporting on the financial condition of a business … “external reporting”

**The Accounting Foundation**

- Assets = Liabilities + Equity
  - Buying a new car!
    - Price: $33,000
    - Down payment: $10,000
    - Financing from bank: $23,000
  - Assets = Liabilities + Equity
  - $33,000 = $23,000 + $10,000
The Accounting Model

- The $33,000 new car!
  - Assets = Liabilities + Equity
  - $33,000 = $23,000 + $10,000
  - (the value of your new car) (what you owe the bank) (what you have already invested)

The Accounting Elements

- How would you define the accounting elements in the accounting model?
  - Asset is something of value … something that has future use
  - Liability is a claim against an asset
  - Equity is what is already invested in an asset

The Foundation

- The accounting model is the foundation for all financial reporting
  - Simple formula but innumerable complexities
  - The discipline of accounting involves the details, complexities, regulations, nuances, etc.
Understanding Financial Reporting

Our focus is understanding financial statements & financial reporting

- Management’s creation
- Management’s responsibility
- Required of all publicly traded companies:
  - An annual report to shareholders
  - A 10K report to the Securities & Exchange Commission (SEC)

The Four Basic Financial Statements

- The Balance Sheet
  - Statement of position
- The Income Statement
  - Earning statement
- The Statement of Stockholder’s Equity
  - A reconciliation of stockholder’s equity
- The Statement of Cash Flows
  - Sources & uses of funds

The Balance Sheet

- Assets = Liabilities + Stockholder’s Equity
  - Presents a company’s financial condition as of a specific date… usually the end of the company’s fiscal year
  - Current assets … current liabilities … retained earnings … etc.
  - Assets = “Claims against assets”
Income Statement

- Presents the results of operations for the entire fiscal year (the accounting period)
  - Revenues - Expenses = Income
    - Operating income … operating expenses …
    - Investment income … income before taxes … etc.

Statement of Stockholder’s Equity

- Reconciles the beginning and ending balances of all of the accounts in the stockholder’s equity section of the balance sheet
  - Some companies do a “Statement of Retained Earnings” which reconciles the retained earnings account

Statement of Cash Flows

- Provides details about cash inflows and outflows from operating, financing, and investing activities during the fiscal year (accounting period)
  - Statement of sources & uses of funds
The Notes to the Financial Statements

- Notes (footnotes) are an integral part of the financial statements
  - The notes help explain the impact of a variety of occurrences:
    - The accounting policies & any changes in policies
    - Details of specific, complex accounts
    - Information about major significant events

The Auditor’s Report

- A report by an independent auditor is required for all publicly traded companies
  - An auditor is responsible for issuing an opinion on the “fairness” of the presentation of management’s financial statements
The Standard Auditor’s Report

• Divided into 3 separate sections:
  – The “introductory paragraph” identifies the specific financial statements that were audited
  – The “scope paragraph” states that the audit was conducted in accordance with GAAS
  – The “opinion paragraph” which states the auditor’s opinion about their presentation

The Auditor’s Report

• Where financial analysis begins!
  – What type of report did the auditor issue?
    – 1) Clean (“unqualified”) opinion … meaning without any qualifications
    – 2) Unqualified opinion with an explanatory paragraph
    – 3) Qualified opinion
    – 4) Adverse opinion
    – 5) A “disclaimer of opinion”
Unqualified Reports

- Clean or unqualified report … all fair
- Unqualified opinion “with explanatory paragraph” to explain an uncertainty or a concern about the company as a “going concern”
  – The auditor feels it necessary to explain an item of concern

Qualified Reports

- Qualified for a departure from GAAP
- Qualified for an unjustified change in accounting policy
- Qualified for a scope impairment
  – The auditor includes an “except for” item in the opinion paragraph

Adverse Opinion & A Disclaimer

- Adverse opinion is issued in serious situations … such as when the departure from GAAP has highly material effects on the fairness of the financial statements
- A disclaimer of opinion is issued in serious situations in which the auditor experiences a material limitation of scope or is no longer independent
The 8K Form

• SEC Form 8K must be filed by a company to explain the reasons for a change of auditor
  – Can be a warning sign to financial analysts

Summary

• Financial statements are management’s responsibility
  – And company’s need clean audit opinions
• Audit reports are the auditor’s responsibility
  – And auditors need good clients
  – Auditors live and die by their reputations & the market for good clients is very competitive