

Accounting Principles

Prepared by Dr. Hoda Metwally

Lecture 10

جامعة الجميع الذكية

تسعى لتكون الكيان الأول الذي يتبنى مبدأ المجتمع التعليمي
التعاوني ويقدم العلم مقابل العمل لتنمية وبناء المجتمعات.

ACCOUNTING PRINCIPLES



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EVERYONE'S SMART UNIVERSITY

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ACCOUNTING PRINCIPLES

Plant Assets

Tangible in Nature



Actively Used in Operations



Expected to Benefit Future Periods



Called Property, Plant, & Equipment

What are assets?

Items owned/controlled by the entity that have value



- Resources controlled by entity
- Result of a past transaction (ie not a future transaction)
- Future economic benefits will flow to the entity

Coffee machine used in a coffee shop

1. The owner exclusively controls the machine – using it every day to make coffee to sell to customers. No-one outside the business has that control
2. The machine was purchased last year and was the result of a past event (it is not something that is going to be purchased in the future)
3. The coffee machine will be used to make coffee to sell to customers, earn revenue and make a profit – so it will provide future economic benefit to the owner

Any examples of Assets that you can think of?

Types of Assets:

1. Current Assets

Items that meet the definition of an asset but are either cash or items that will be turned into cash within 12 months:

Examples:

Cash

Inventory (Goods for resale)

Accounts Receivable



2. Non-Current Assets

Items that meet the definition of an asset but will be held and used in the business over a number of years and usually for more than 12 months:

Examples:

- Land; buildings (eg factory)
- Plant and equipment or machinery,
- Motor vehicles, Office fixtures and fittings; computer equipment
- Investments



Definition of a liability:

Money the business owes to others

- Present obligation
- to make a future economic sacrifice
- as a result of a past event



The Coffee Shop buys Coffee from a coffee supplier

The arrangement with the Coffee supplier allows the Coffee Shop owner to pay for the coffee within 14 days of delivery.

Until the Coffee shop owner pays for the coffee purchased – he has

- a present obligation to the supplier (he OWES them for the coffee)
- It was the result of a past event (when the owner took delivery of the coffee)
- It will result in an outflow (Cash) when the Coffee shop owner pays for the coffee

Two main types of Liabilities:

1. Current Liability

Money you owe another entity that will be payable within the next 12 months:

Examples:

- Accounts Payable (For inventory supplied for resale); wages payable; interest owing to the bank
- Current Portion of a loan (Amount of repayments due within the next 12 months)

2. Non-Current Liability

Money you owe another entity that will be payable after the next 12 months: Example:

- Non-Current Portion of a loan (Amount of repayments due after 12 months – Total Due \$36,000; repayments \$1,000 per month – Current liability would be \$12,000; Non-Current Liability would be \$24,000)

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Definition of Equity:

If the business sold all its assets and paid off all its liabilities, what's left is called the 'Owner's Equity' $E = A - L$

Equity is the residual interest in the assets (A) of the entity after deducting all its liabilities (L)

- Assets – Liabilities = Equity
- Otherwise known as Net Assets
- **Accounting equation!**

CONTROL/OWN

minus

OWE

=

**OWNERS'
WORTH
(Equity)**



Equity (Types)

- **Capital (+)** = amounts contributed by owners
 - ☐ sole trader or partnership: **Owner's Capital**
 - ☐ company: **Share Capital**
- **Retained Profits (+)** = profits kept in the business not returned to the owners
- **Distributions to owners (money taken out of the business) (-)**
 - sole trader or partnership:
called ***drawings***
 - company:
called ***dividends***

The Income Statement or Statement of profit and loss

- Purpose is to report the success or failure, thus performance (Profit or Loss) of the entity's operations for a period of time
- Managers are interested in the profit because they allocate resources based on their beliefs about an entity's future performance
- The income statement reflects the accounting return for an entity over a specified time period
- Profit is the difference between the income and expenses for a reporting period
- **Profit = Income (or Revenue) - Expenses**

The income statement

Financial Statement Elements

- **Income (amounts earned)**
 - Sales income
 - Service income (eg Legal fees for a law firm)
 - Rent income
 - Interest income (eg on a term deposit)



Definition of Income (from last week)?

1. An increase in equity
2. that results in ▲assets or ▼liabilities
3. other than a capital contribution by owners

• Expenses

Cost of assets consumed:

- Office supplies used; depreciation (assets used); cost of goods (inventory) sold

or Cost of services used:

- Wages; insurance; telephone; rent; motor vehicle expenses

-in the process of generating revenues

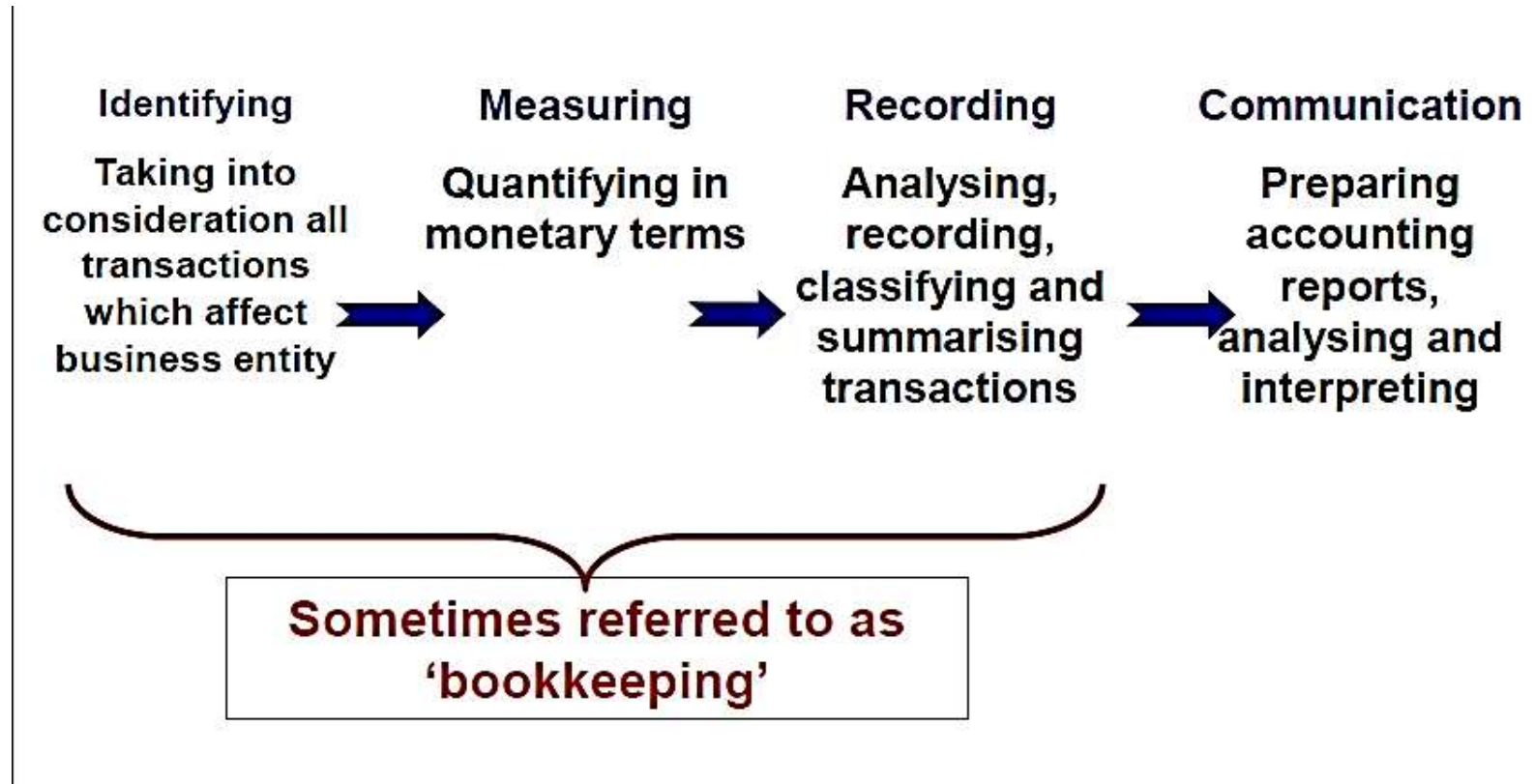


Definition of Expense (from last week)?

1. A decrease in equity
2. that results in ▼ assets or ▲ liabilities
3. other than a distribution to the owners, i.e. drawings or dividends

Also referred to as 'expired costs'

The Accounting Process:



CHAPTER 10

ACCOUNTING PRINCIPLES

STUDY OBJECTIVES

After studying this chapter, you should understand:

GAAP & the conceptual framework	Basic accounting principles
Objectives of financial reporting	Accounting constraints
Qualitative characteristics & financial statement elements	How to analyze classified financial statements
Basic accounting assumptions	Accounting principles used in international operations

STUDY OBJECTIVE 1

GAAP & CONCEPTUAL FRAMEWORK

GAAP is a set of standards and rules recognized as a general guide for financial reporting supported by:

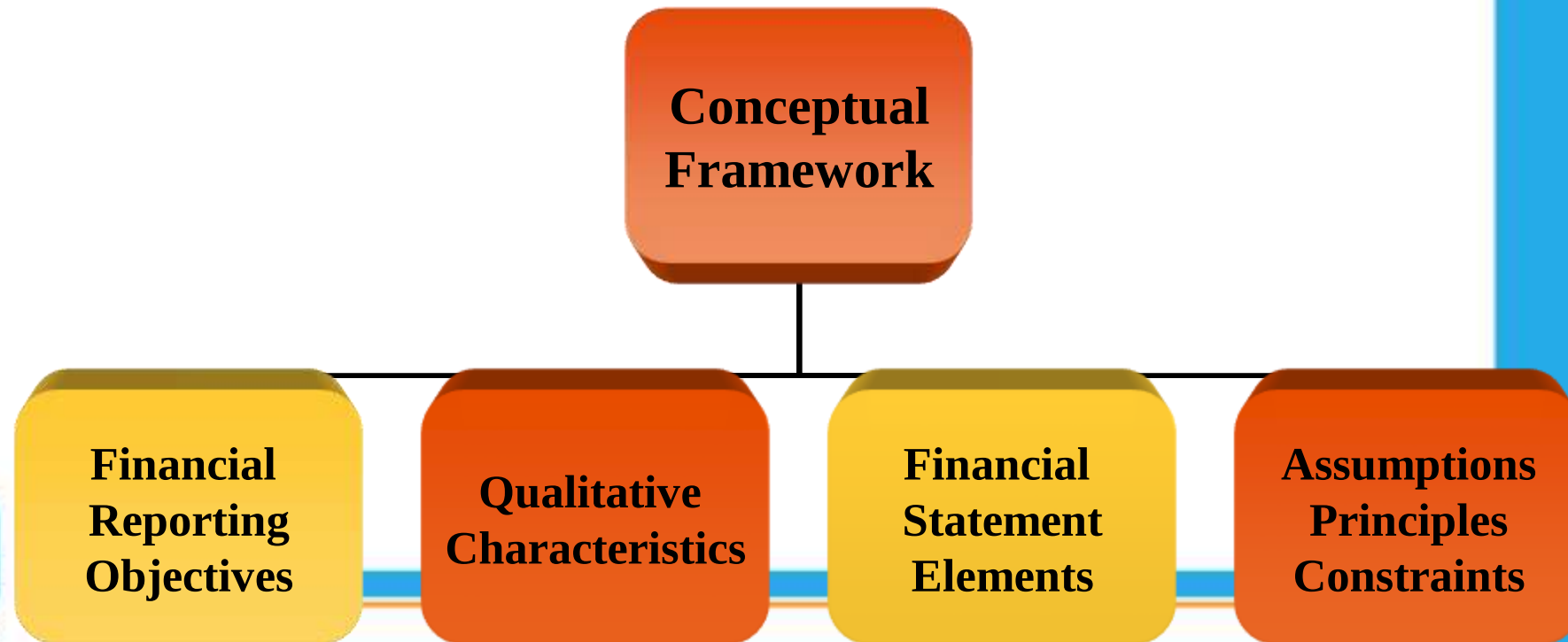
SEC
Mandates GAAP

FASB
Develops GAAP

Collaborate

GAAP & CONCEPTUAL FRAMEWORK

The FASB developed a
CONCEPTUAL FRAMEWORK
to resolve accounting and reporting problems.



STUDY OBJECTIVE 2

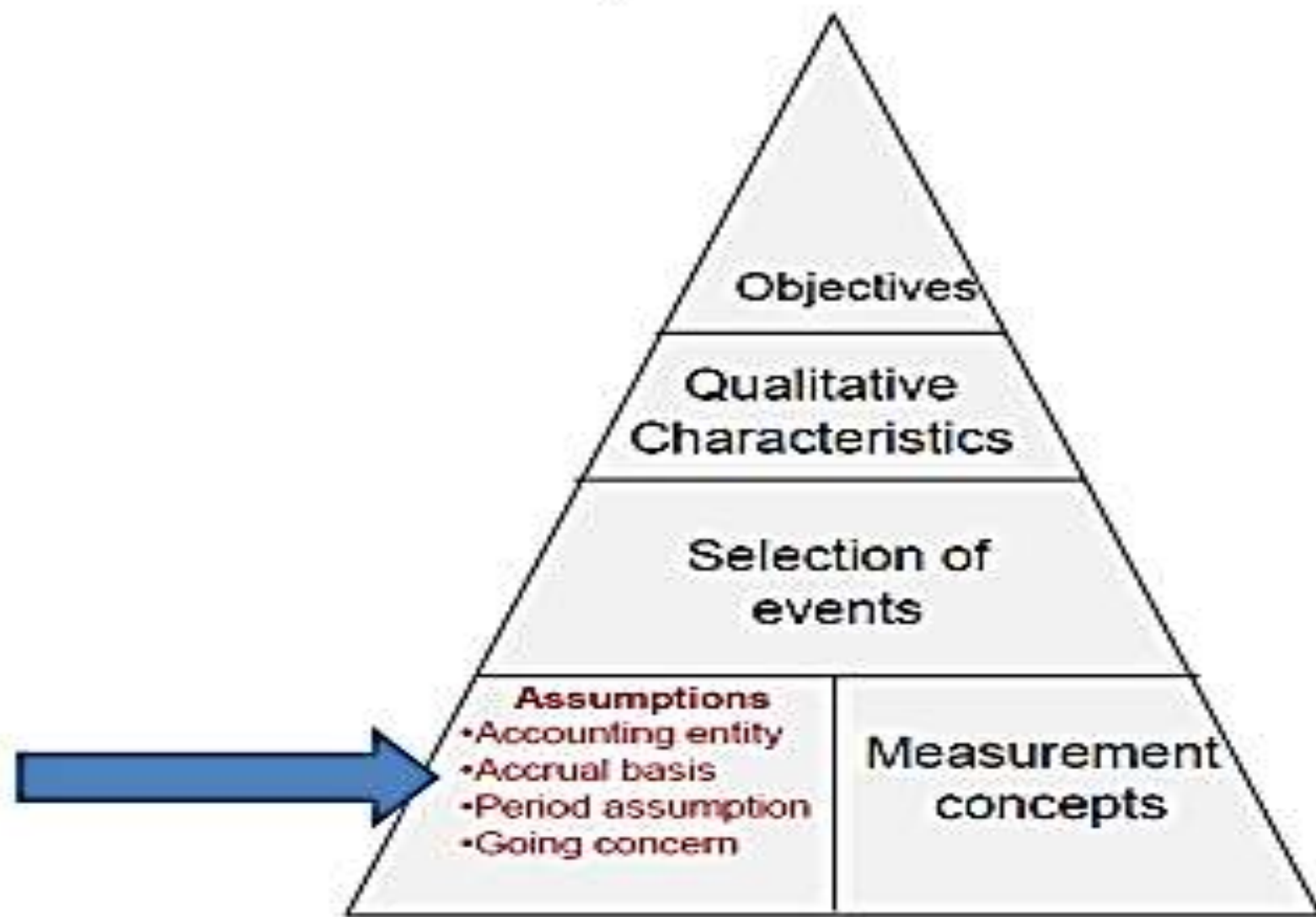
FINANCIAL REPORTING OBJECTIVES

To provide information:

- | | |
|---|---|
| 1 | Useful to those making investment and credit decisions. |
| 2 | Helpful in assessing future cash flows. |
| 3 | That identifies the economic resources, the claims to those resources, and the changes in those resources and claims. |

Assets – Liabilities = Stockholders' Equity

Conceptual framework



Some assumptions in preparing financial statements:

Accounting Entity Concept

Every entity can be separately identified and accounted for. Personal transactions must be kept separate from business transactions

Accrual basis

Transactions recorded when they occur and not when cash is received or paid (Income recorded when earned; expenses recorded when incurred)

Period Concept

The economic life of an entity can be divided into artificial time periods. Most common = the 'financial year'

Going concern

The assumption that, in the absence of evidence to the contrary, a business will continue in the future and use its assets in operations rather than sell them.

STUDY OBJECTIVE 3

QUALITATIVE CHARACTERISTICS

Useful information is:

RELEVANT

RELIABLE

COMPARABLE

CONSISTENT



RELEVANCE

RELEVANT INFORMATION:

- Makes a difference in a decision.
- Has predictive value and feedback value.
- Is timely.



RELIABILITY

RELIABLE INFORMATION

- Is dependable and verifiable.
- Is free of error and bias.
- Is a faithful representation.
- Is factual.

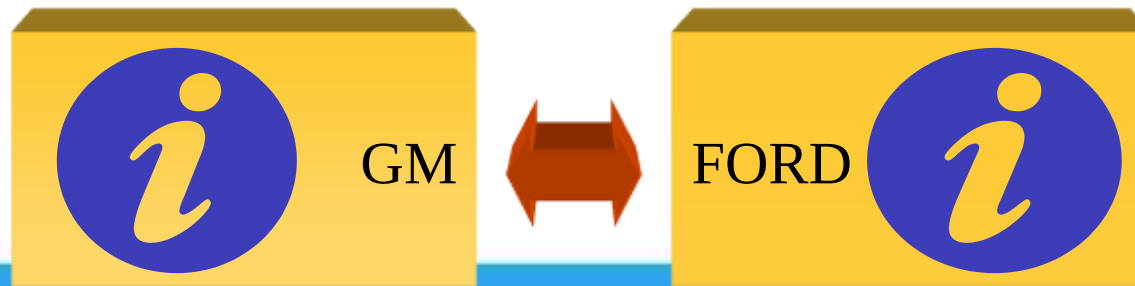


**NEWS
FLASH!**

COMPARABILITY

COMPARABLE INFORMATION

- Accounting information from two similar companies should be comparable.
- Different companies in similar industries should use the same accounting principles.



CONSISTENCY

CONSISTENT INFORMATION

- Companies should use the same accounting principles from year to year.
- Changes in accounting principles must be justifiable.



STUDY OBJECTIVE 4

BASIC ACCOUNTING ASSUMPTIONS

Monetary unit

Economic entity

Time period

Going concern

MONETARY UNIT ASSUMPTION

Only transaction data that can be expressed in terms of money be included in the accounting records.

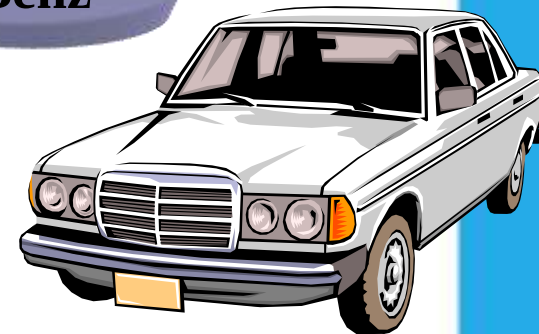


ECONOMIC ENTITY ASSUMPTION

The activities of the entity are to be kept separate and distinct from the activities of the owner and all other economic entities.



BMW



Benz

Economic events can be identified with a particular unit of accountability

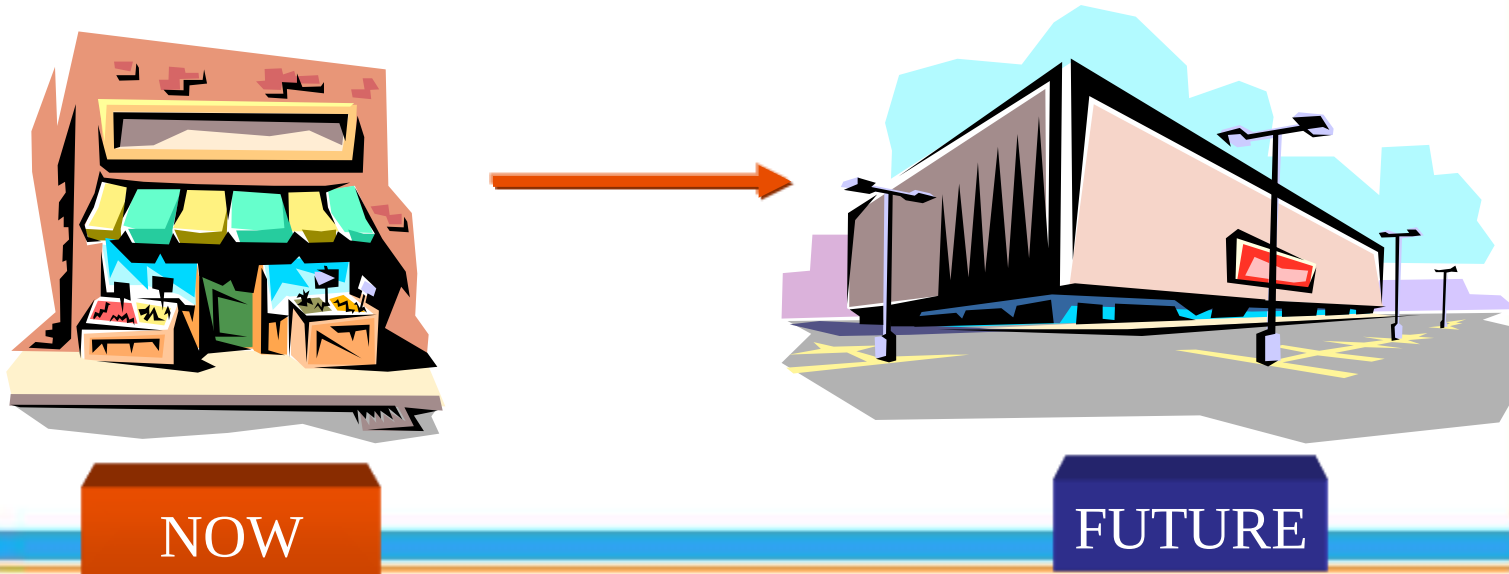
TIME PERIOD ASSUMPTION

The economic life of a business can be divided into artificial time periods

	2003	2005	2007
QTR 1	JAN	FEB	MAR
QTR 2	APR	MAY	JUN
QTR 3	JUL	AUG	SEPT
QTR 4	OCT	NOV	DEC

GOING CONCERN ASSUMPTION

The enterprise will continue in operation long enough to carry out its existing objectives.



STUDY OBJECTIVE 5

BASIC ACCOUNTING PRINCIPLES

1. REVENUE RECOGNITION
2. MATCHING
3. FULL DISCLOSURE
4. COST

Assets – Liabilities = Stockholders' Equity

REVENUE RECOGNITION PRINCIPLE

Revenue should be recognized in the accounting period in which it is earned.

When a sale is involved, revenue is recognized at the point of sale.



MATCHING PRINCIPLE

**Expenses are matched with revenues
in the period in which efforts
are made to generate revenues.**

Types of costs

Expired Costs

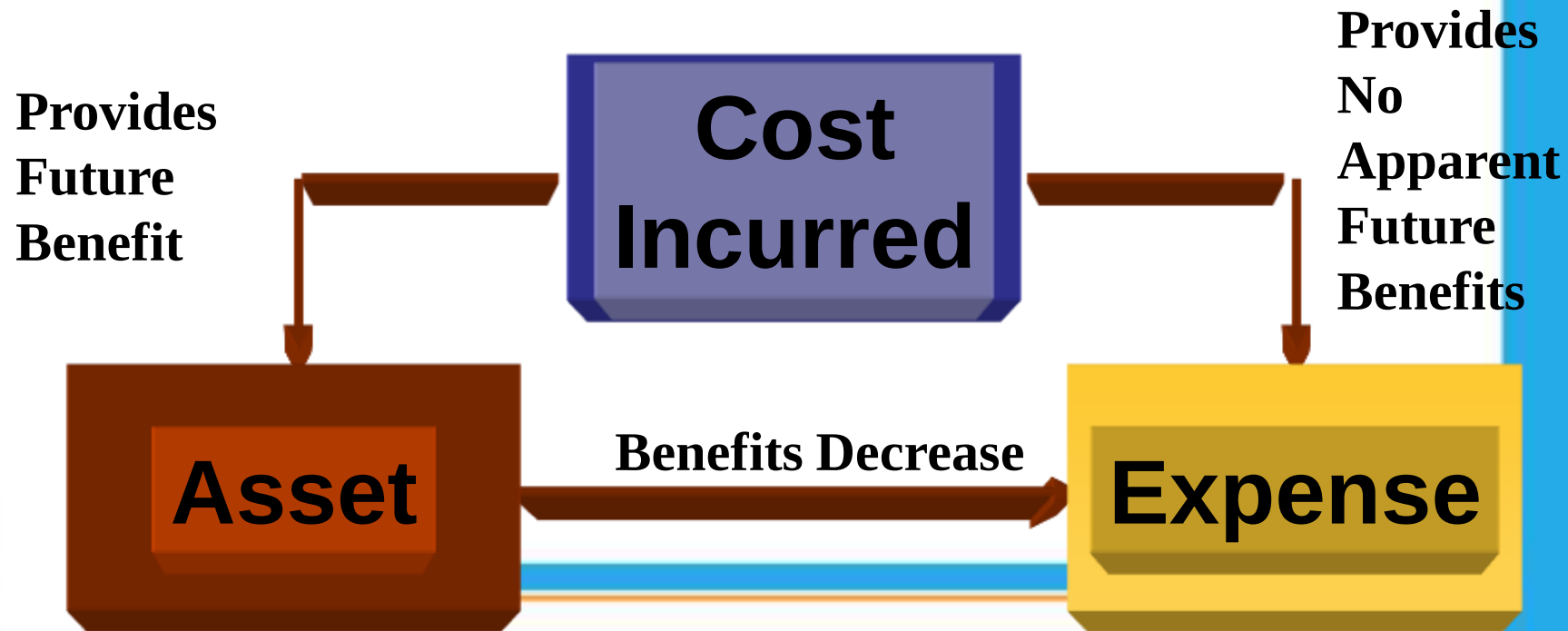
**Generate revenues
only in the current
accounting period.**

Unexpired Costs

**Generate revenues
in future accounting
periods.**

EXPENSE RECOGNITION PATTERN

Operating expenses contribute to the revenues of the period but their association with revenues is less direct than for cost of goods sold.



FULL DISCLOSURE PRINCIPLE

Requires that circumstances and events that make a difference to financial statement users are to be disclosed in one of two places.

Body/Data

Notes

**SUMMARY OF SIGNIFICANT
ACCOUNTING POLICIES USUALLY
THE FIRST FOOTNOTE**

COST PRINCIPLE

Requires assets to be recorded at cost.

COST

is relevant because it represents:

PRICE PAID

or

ASSETS SACRIFICED

or

COMMITMENT MADE

COST

is reliable because it is:

**OBJECTIVELY
MEASURABLE**

and

FACTUAL

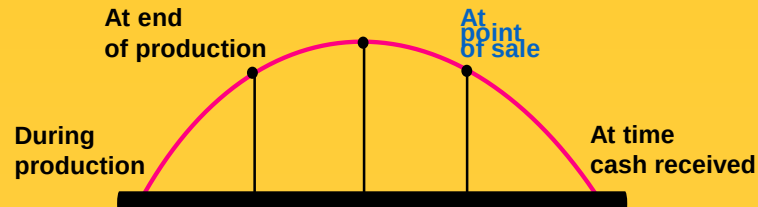
and

VERIFIABLE



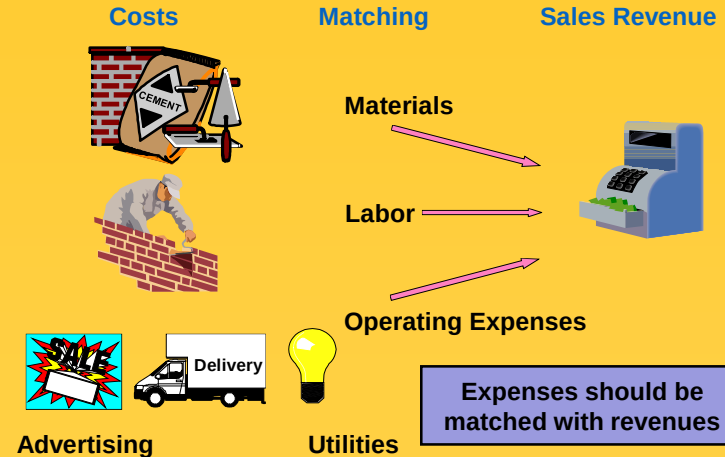
BASIC ACCOUNTING PRINCIPLES

Revenue Recognition

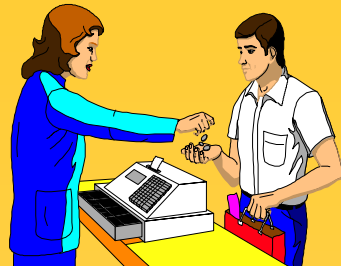


Revenue should be recognized in the accounting period in which it is earned (generally at point of sale).

Matching

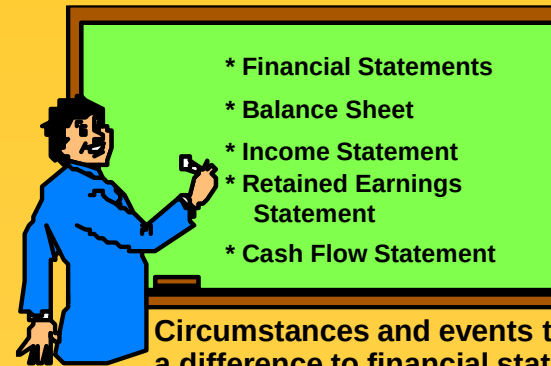


Cost



Assets should be recorded at cost.

Full Disclosure



Circumstances and events that make a difference to financial statement users should be disclosed.

BASIC ACCOUNTING CONSTRAINTS

Study Objective 6

Materiality



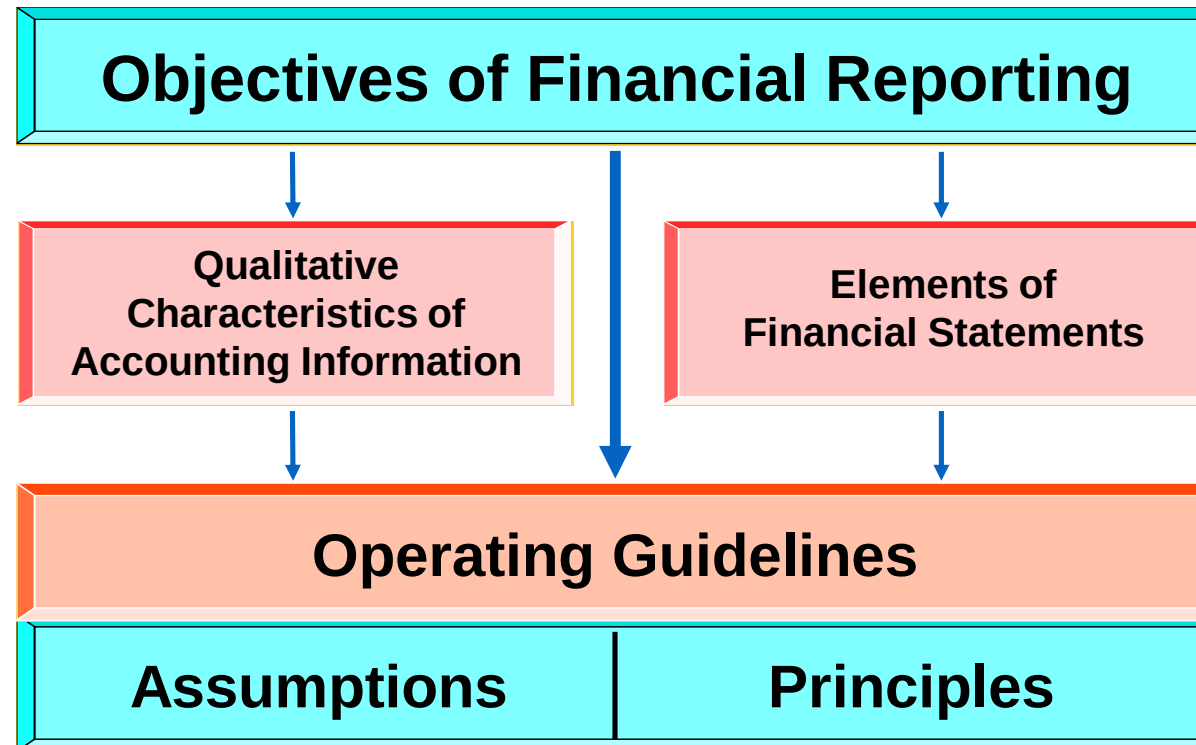
For small amounts, GAAP does not have to be followed.

Conservatism



When in doubt, choose the solution that will be least likely to overstate assets and income.

SUMMARY OF CONCEPTUAL FRAMEWORK



REVIEW QUESTION

Valuing assets at their liquidation value rather than their cost is inconsistent with which of the following:

- a. Time period assumption
- b. Matching principle
- c. Going concern assumption
- d. Materiality constraint

Answer:

Going concern assumption

Liquidation values would suggest the company is going out of business.

STUDY OBJECTIVE 7

ANALYZING CLASSIFIED FINANCIAL STATEMENTS

Classified Balance Sheet

<u>Assets</u>	<u>Liabilities and Stockholders Equity</u>
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant & equipment	Stockholders' equity
Intangible assets	

ANALYZING CLASSIFIED FINANCIAL STATEMENTS

Classified Income Statement

Category	Includes:
Revenue sections	Sales, discounts, allowances
Cost of goods sold	Cost of items sold to produce sales
Operating expenses	Selling & administrative expense information
Other revenues & gains	Revenues or gains from non-operating transactions
Other expenses & losses	Expenses or losses from non-operating transactions

Also included are tax expense and EPS

INCOME STATEMENT WITH TAX EXPENSE

Leads, Inc
Income Statement
For the Year Ended December 31, 2006

Sales	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>50,000</u>
Income from operations	150,000
Other revenues and gains	10,000
Other expenses and losses	<u>4,000</u>
Income before income taxes	156,000
Income tax expense (30%)	<u>46,800</u>
Net income	\$109,200

EARNINGS PER SHARE

$$\frac{\text{Net income}}{\text{Common shares outstanding}} = \text{EPS}$$

Assuming Leads, Inc. had 54,600 shares of common stock outstanding, EPS would be:

$$\frac{109,200}{54,600} = \$2.00$$

FINANCIAL STATEMENTS

GENLYTE , INC.

Genlyte, Inc.
Balance Sheet
December 31, 2006

Assets		Liabilities & Equity	
Current Assets	\$156,000	Current liabilities	\$70,000
Plant & equipment	74,000	Long-term liabilities	114,000
Intangible assets	<u>14,000</u>	Stockholders' Equity	<u>60,000</u>
Total assets	\$244,000	Total liabilities & equity	\$244,000

The following ratio analysis uses Genlyte data.

FINANCIAL STATEMENTS

GENLYTE , INC.

Genlyte, Inc. Income Statement For the Year Ended December 31, 2006

Sales	\$430,000
Cost of goods sold	<u>295,000</u>
Gross profit	135,000
Selling and administrative expenses	<u>109,000</u>
Income from operations	26,000
Other expenses & losses	5,000
Income before income taxes	<u>21,000</u>
Income tax expense (33.3%)	7,000
Net income	<u>14,000</u>
Earnings per share (40,000 shares outstanding)	0.35

ANALYZING FINANCIAL STATEMENTS

Three major characteristics are evaluated

LIQUIDITY

PROFITABILITY

SOLVENCY

Each can be evaluated by financial statement ratios

LIQUIDITY RATIOS measure a company's Ability to pay its maturing obligations and meet unexpected needs for cash.

Current Ratio

Current assets/Current liabilities

$$156,000/70,000 = 2.23 \text{ to } 1$$

Working capital

Current assets – Current liabilities

$$156,000 - \$70,000 = \$86,000$$

PROFITABILITY

PROFITABILITY RATIOS measure the operating success of a company for a given period of time.

ROA

(return on assets)

Net Income / Total Assets

$$\$14,000 / \$244,000 = 5.7\%$$

ROE

(return on equity)

Net Income / Common Equity

$$\$14,000 / \$60,000 = 23.3\%$$

SOLVENCY

SOLVENCY RATIOS measure the ability of a company to survive over the long term.

DTA

(debt to total assets)

Total Debt / Total Assets

$$\$184,000 / \$244,000 = 75.4\%$$

DTE

(debt to equity)

Total Debt / Total Equity

$$\$184,000 / \$60,000 = 3.06 \text{ to } 1$$

STUDY OBJECTIVE 8

INTERNATIONAL OPERATIONS

- **World markets are becoming increasingly intertwined.**
- **Firms that conduct operations in more than one country through subsidiaries, divisions, or branches in abroad are referred to as multinational corporations.**
- **International transactions must be translated into U.S. dollars.**

