

# Accounting Principles

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## Lecture 2

### Reading & Understanding Basic Financial Statements



جامعة الجميع الذكية  
EVERYONE'S SMART UNIVERSITY

## Agenda

- Purpose of financial statements
- The Balance Sheet
- The Income Statement
- Statement of Retained Earnings
- Statement of Cash Flows
- Notes to the financial statements
- Fundamental concepts and assumptions
- Accrual vs. cash-basis accounting
- Standards for comparison
- Tools of analysis

## Primary Financial Statements

### Basic financial statements:

- ❶ Balance Sheet
- ❷ Income Statement
- ❸ Statement of Retained Earnings
- ❹ Statement of Cash Flows

## Primary Financial Statements

- Primary financial statements answer basic questions including:
  - What is the company's current financial status?
  - What was the company's operating results for the period?
  - How did the company obtain and use cash during the period?

# The Balance Sheet

- Summary of the financial position of a company at a particular date
- Assets: cash, accounts receivable, inventory, land, buildings, equipment and intangible items
- Liabilities: accounts payable, notes payable and mortgages payable
- Owners' Equity: net assets after all obligations have been satisfied

# The Balance Sheet

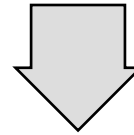
- What are the resources of the company?
- What are the company's existing obligations?
- What are the company's net assets?

## Accounting Equation

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

Resources

Sources of Funding



Resources  
to use to  
generate  
revenues

=

Creditors'  
claims  
against  
resources

+

Owners'  
claims  
against  
resources

# Reading & Understanding Basic Financial Statements

## Sample Balance Sheet

### Assets

|                     |            |
|---------------------|------------|
| Cash                | \$ 40      |
| Accounts receivable | 100        |
| Land                | <u>200</u> |

Total assets **\$340**

### Liabilities

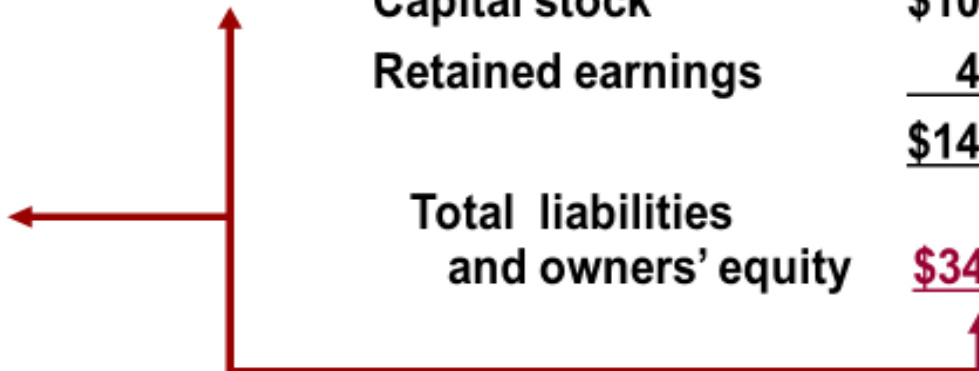
|                  |              |
|------------------|--------------|
| Accounts payable | \$ 50        |
| Notes payable    | <u>150</u>   |
|                  | <u>\$200</u> |

### Owners' Equity

|                   |              |
|-------------------|--------------|
| Capital stock     | \$100        |
| Retained earnings | <u>40</u>    |
|                   | <u>\$140</u> |

Total liabilities  
and owners' equity **\$340**

**Must  
Equal**



# Classified and Comparative Balance Sheets

- They distinguish between:
  - Current and long-term assets
  - Current and long-term liabilities
- Listed in decreasing order of liquidity
- Comparative so financial statement users can identify significant changes over time. They have more than one year on the Balance Sheet.

# Balance Sheet Limitations

- ❶ Assets recorded at historical value
- ❷ Only recognizes assets that can be expressed in monetary terms
- ❸ Owners' equity is usually less than the company's market value

# The Income Statement

- Shows the results of a company's operations over a period of time.
- What goods were sold or services performed that provided revenue for the company?
- What costs were incurred in normal operations to generate these revenues?
- What are the earnings or company profit?

# The Income Statement

## Revenues

- Assets (cash or AR) created through business operations

## Expenses

- Assets (cash or AP) consumed through business operations

## Net Income or (Net Loss)

- Revenues - Expenses

## Lecture 2

# Reading & Understanding Basic Financial Statements

### The Example Company Income Statement For the Years Ended December 31, 2010 and 2011

|                    | 2011         | 2010         |
|--------------------|--------------|--------------|
| <b>Revenues:</b>   |              |              |
| Sales              | \$100        | \$ 85        |
| Other revenue      | <u>30</u>    | <u>15</u>    |
| Total revenues     | \$130        | \$100        |
| <b>Expenses:</b>   |              |              |
| Cost of goods sold | \$ 62        | \$ 58        |
| Operating & admin. | 16           | 12           |
| Income tax         | <u>20</u>    | <u>18</u>    |
| Total expenses     | <u>\$ 98</u> | <u>\$ 88</u> |
| Net Income         | \$ 32        | \$ 12        |

## Statement of Retained Earnings

**Beginning retained earnings**

**+ Net income**

**– Dividends paid**

**= Ending retained earnings**

An additional financial statement that identifies changes in retained earnings from one accounting period to the next.

**Net income results in:**

Increase in net assets  
Increase in retained earnings  
Increase in owners' equity

**Dividends result in:**

Decrease in net assets  
Decrease in retained earnings  
Decrease in owners' equity

# Statement of Cash Flows

- Reports the amount of cash collected and paid out by a company in operating, investing and financing activities for a period of time.
- How did the company receive cash?
- How did the company use its cash?
- Complementary to the income statement.
- Indicates ability of a company to generate income in the future.

## Statement of Cash Flows

### Cash inflows

- Sell goods or services
- Sell other assets or by borrowing
- Receive cash from investments by owners

### Cash outflows

- Pay operating expenses
- Expand operations, repay loans
- Pay owners a return on investment

## Match Classification of Cash Flows

- **Operating activities** – Transactions and events that enter into the determination of net income.
- **Investing activities** – Transactions and events that involve the purchase and sale of securities, property, plant, equipment, and other assets not generally held for resale, and the making and collecting of loans.
- **Financing activities** – Transactions and events whereby resources are obtained from, or repaid to, owners and creditors.

## Operating Activities

### Cash Inflow

- Sale of goods or services
- Sale of investments in trading securities
- Interest revenue
- Dividend revenue

### Cash Outflow

- Inventory payments
- Interest payments
- Wages
- Utilities, rent
- Taxes

## Investing Activities

### Cash Inflow

- Sale of plant assets
- Sale of securities, other than trading securities
- Collection of principal on loans

### Cash Outflow

- Purchase of plant assets
- Purchase of securities, other than trading securities
- Making of loans to other entities

## Financing Activities

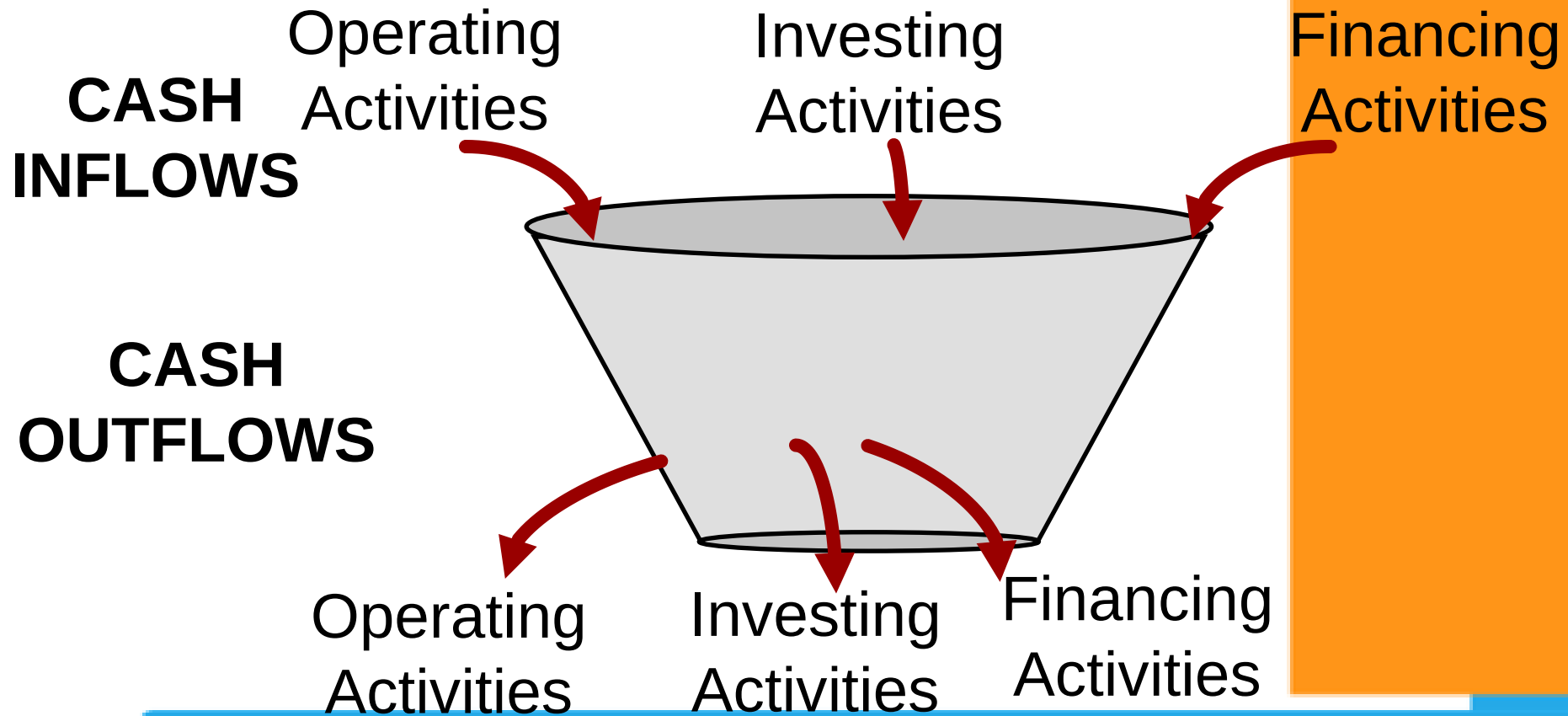
### Cash Inflow

- Issuance of own stock
- Borrowing

### Cash Outflow

- Dividend payments
- Repaying principal on borrowing
- Treasury stock purchase

## Statement of Cash Flows



# Statement of Cash Flows Analysis

|    | Operating | Investing | Financing | General Explanation                                                          |
|----|-----------|-----------|-----------|------------------------------------------------------------------------------|
| 1. | +         | +         | +         | Building up pile of cash,<br>Possibly looking for<br>Acquisition             |
| 2. | +         | —         | —         | Operating cash flow being<br>Used to buy fixed assets<br>And pay down debt   |
| 3. | +         | +         | —         | Operating cash flow and sale of fixed assets<br>being used to pay down debt. |
| 4. | +         | —         | +         | Operating cash flow and borrowed<br>money being used<br>to expand            |

# Statement of Cash Flows Analysis

|    | Operating | Investing | Financing | General Explanation                                                                              |
|----|-----------|-----------|-----------|--------------------------------------------------------------------------------------------------|
| 5. | —         | +         | +         | Operating cash flow problems covered by sale of fixed assets, borrowing and owner contributions. |
| 6. | —         | —         | +         | Rapid growth, short falls in operating cash flow; purchase of fixed assets.                      |
| 7. | —         | +         | —         | Sale of fixed assets is financing operating cash flow shortages.                                 |
| 8. | —         | —         | —         | Company is using reserves to finance cash flow short falls.                                      |

## Lecture 2

# Reading & Understanding Basic Financial Statements

### The Example Company Statement of Cash Flows December 31, 2011

#### Cash Flows From Operating Activities:

|          |             |   |
|----------|-------------|---|
| Receipts | 48          |   |
| Payments | <u>(43)</u> | 5 |

#### Cash Flows From Investing Activities:

|          |            |     |
|----------|------------|-----|
| Receipts | 0          |     |
| Payments | <u>(4)</u> | (4) |

#### Cash Flows Used By Financing Activities:

|          |            |          |
|----------|------------|----------|
| Receipts | 10         |          |
| Payments | <u>(6)</u> | <u>4</u> |

|               |  |   |
|---------------|--|---|
| Net Cash Flow |  | 5 |
|---------------|--|---|

# Notes to the Financial Statements

- Notes are used to convey information required by GAAP or to provide further explanation.

# Notes to the Financial Statements

## Four general types of notes:

- ❶ Summary of significant accounting policies: assumptions and estimates.
- ❷ Additional information about the summary totals.
- ❸ Disclosure of important information that is not recognized in the financial statements.
- ❹ Supplementary information required by the FASB or the SEC.

# What Are The Fundamental Concepts and Assumptions?

- Separate Entity Concept
- Arm's-Length Transactions
- Cost Principle
- Monetary Measurement Concept
- Going Concern Assumption

## Separate Entity Concept

**Entity** — The organizational unit for which accounting records are maintained.

**Separate entity concept** — The activities of an entity are to be separate from those of its individual owners.

- Proprietorship
- Partnership
- Corporation

# The Cost Principle

- All transactions are recorded at historical cost.
- Historical cost is assumed to represent the fair market value of the item at the date of the transaction because it reflects the actual use of resources by independent parties.

# The Monetary Measurement Concept

- Accountants measure only those economic activities that can be measured in monetary terms.
- Listed values may not be the same as actual market values:
  - Inflation
  - Measurement issues

# The Going Concern Assumption

- An entity will have a continuing existence for the foreseeable future.

# Why Use Accrual Accounting?

- GAAP – Generally Accepted Accounting Principles
- Business requires periodic, timely reporting
- Accrual-basis accounting better measures a firm's performance than does cash flow data.

## The Time Period Concept

The life of a business is divided into distinct and relatively short time periods so the accounting information can be timely, generally 12 months or less.

### Define Accrual Accounting

- A system of accounting in which revenues and expenses are recorded as they are earned and incurred, not necessarily when cash is received or paid.
- Provides a more accurate picture of a company's profitability.
- Statement users can make more informed judgments concerning the company's earnings potential.

# Revenue Recognition

Revenues are recorded when two main criteria are met:

1 →

The earning process is substantially complete

2 →

Cash has either been collected or collection is reasonably assured.

## The Matching Principle

### costs and expenses

- All costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.
- This process of matching expenses with recognized revenues determines the amount of net income reported on the income statement.

### related revenues

### Cash-Basis Accounting

- Revenues and expenses are recognized only when cash is received or payments are made.
- Mainly used by small businesses.
- Not an accurate picture of true profitability.

## Accrual vs. Cash-Basis Accounting

During 2010, Crown Consulting billed its client for \$48,000. On December 31, 2010, it had received \$41,000, with the remaining \$7,000 to be received in 2011. Total expenses during 2010 were \$31,000 with \$3,000 of these costs not yet paid at December 31. Determine net income under both methods.

### Cash-Basis Accounting

|                   |               |
|-------------------|---------------|
| Cash receipts     | \$41,000      |
| Cash disbursement | <u>28,000</u> |
| Income            | \$13,000      |

### Accrual-Basis Accounting

|                   |                 |
|-------------------|-----------------|
| Revenues earned   | \$48,000        |
| Expenses incurred | <u>\$31,000</u> |
| Income            | \$17,000        |

## Purpose of Analysis

**Financial statement analysis helps users make better decisions.**

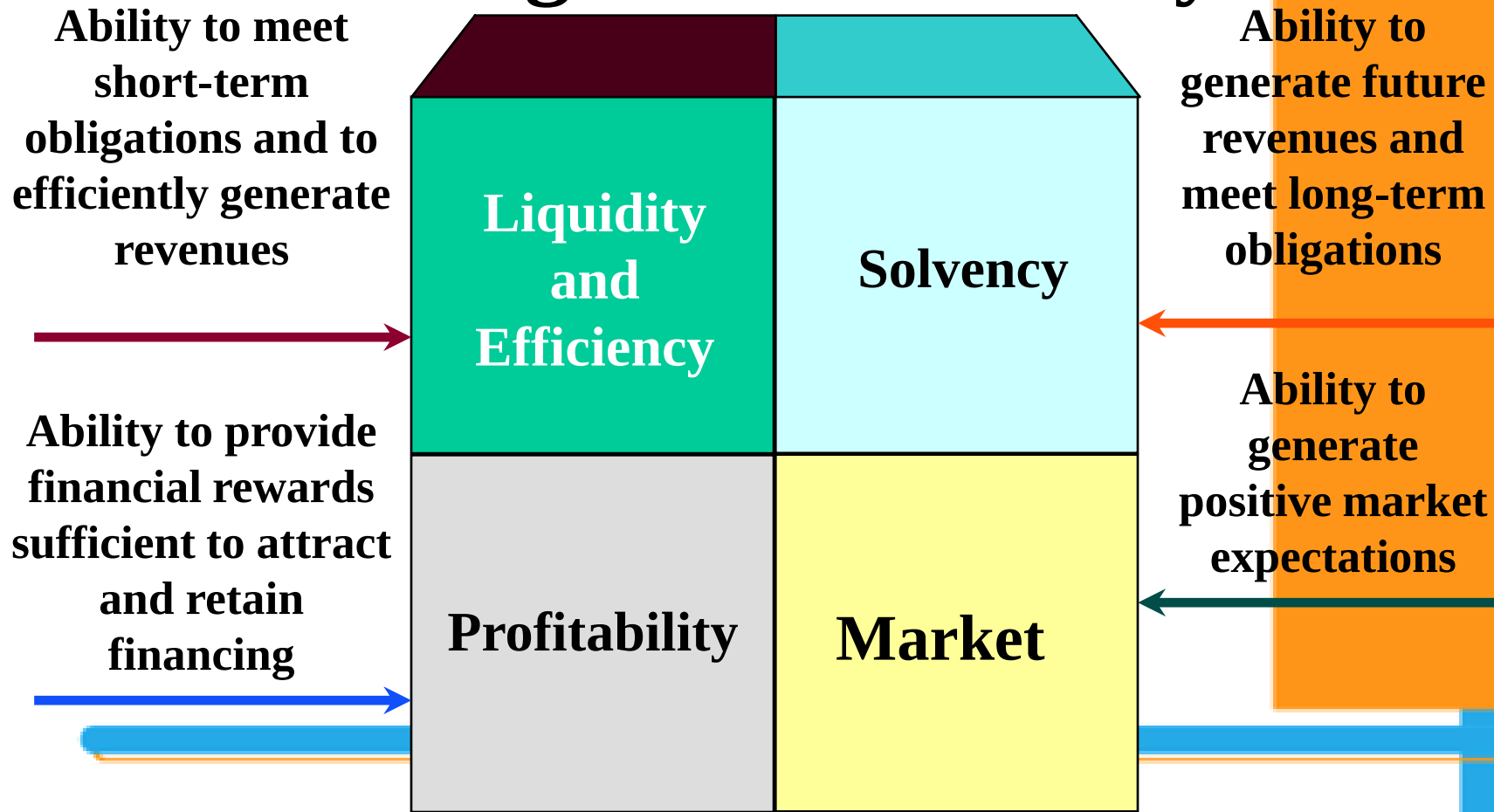
### Internal Users

- Managers
- Officers
- Internal Auditors

### External Users

- Shareholders
- Lenders
- Customers

## Building Blocks of Analysis



## Standards for Comparison

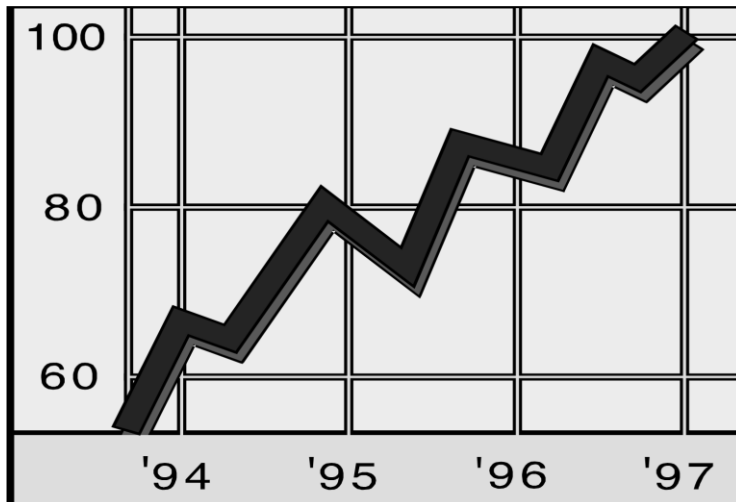
- 1 Intra-company
- 2 Competitor
- 3 Industry
- 4 Guidelines



## Tools of Analysis

### Horizontal Analysis

- Comparing a company's financial condition and performance across time.



## Tools of Analysis

### Vertical Analysis

- Comparing a company's financial condition and performance to a base amount.

