

# 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

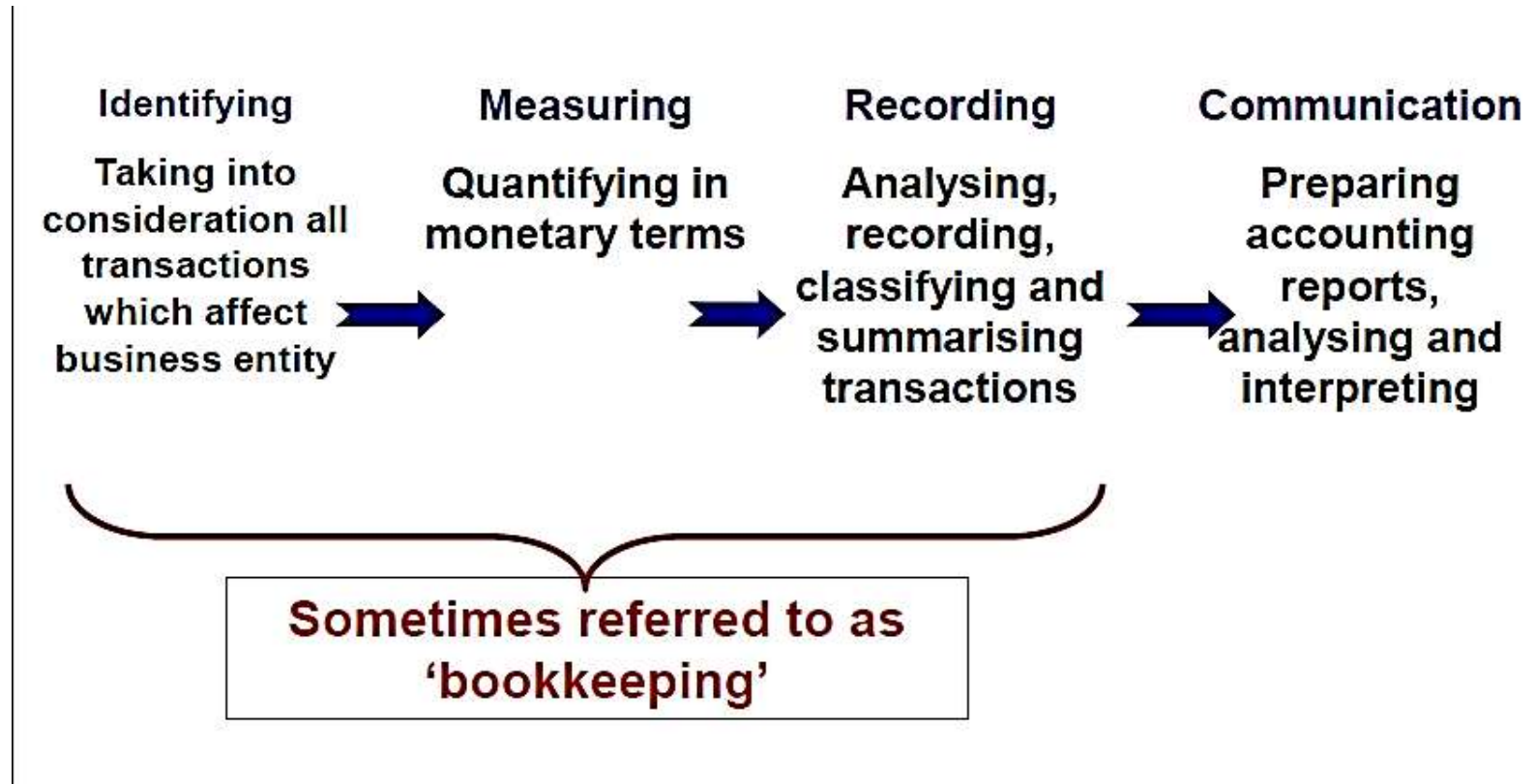


Definition of Expense (from last week)?

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:**

|                                                                       |                                                               |
|-----------------------------------------------------------------------|---------------------------------------------------------------|
| <b>GAAP &amp; the conceptual framework</b>                            | <b>Basic accounting principles</b>                            |
| <b>Objectives of financial reporting</b>                              | <b>Accounting constraints</b>                                 |
| <b>Qualitative characteristics &amp; financial statement elements</b> | <b>How to analyze classified financial statements</b>         |
| <b>Basic accounting assumptions</b>                                   | <b>Accounting principles used in international operations</b> |

## STUDY OBJECTIVE 1

# GAAP & CONCEPTUAL FRAMEWORK

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

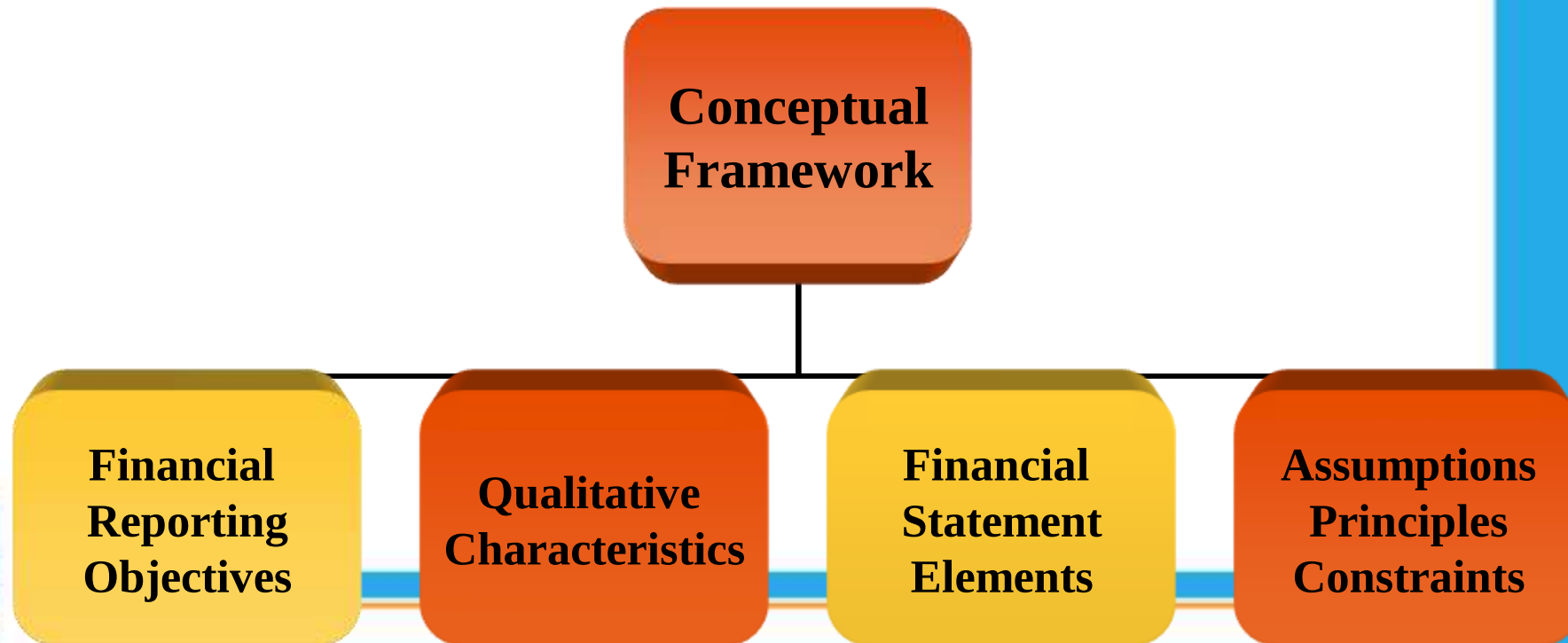
**SEC**  
Mandates GAAP

**FASB**  
Develops GAAP

Collaborate

# GAAP & CONCEPTUAL FRAMEWORK

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



## STUDY OBJECTIVE 2

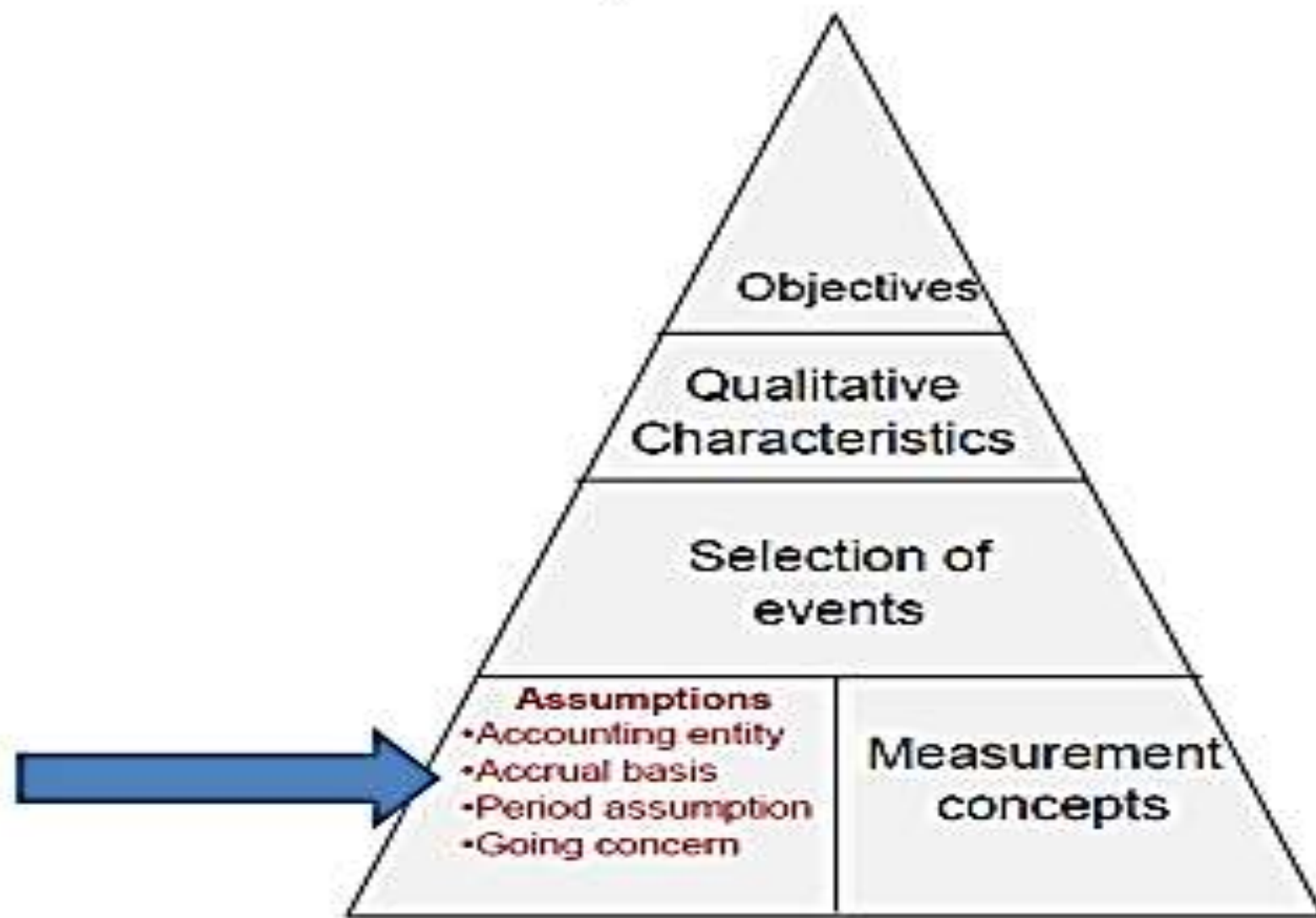
# FINANCIAL REPORTING OBJECTIVES

**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.

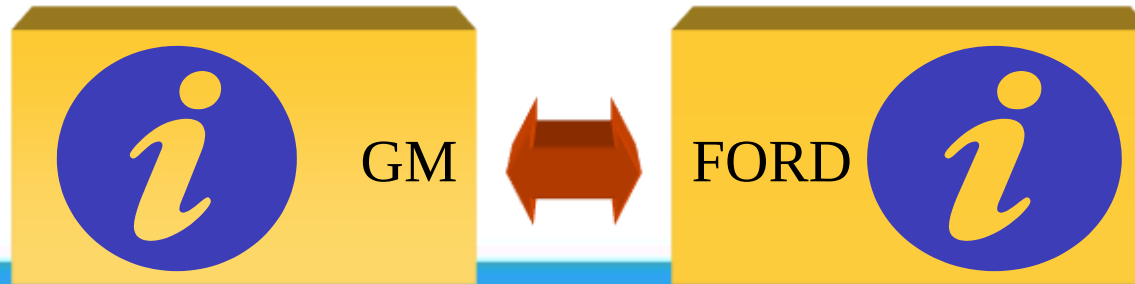


**NEWS**  
**FLASH!**

# 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.**

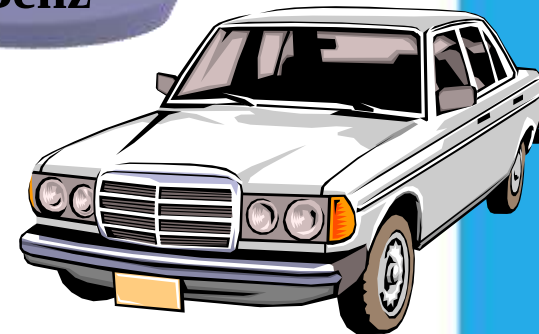


# ECONOMIC ENTITY ASSUMPTION

**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**

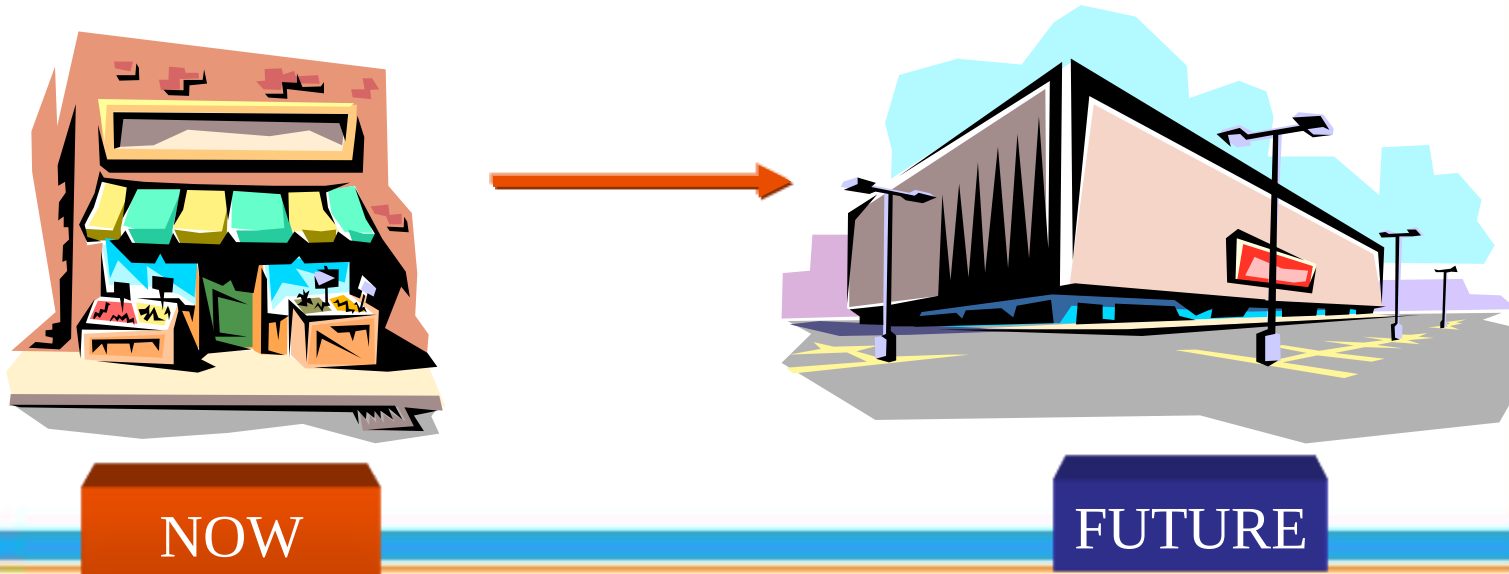
## TIME PERIOD ASSUMPTION

**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

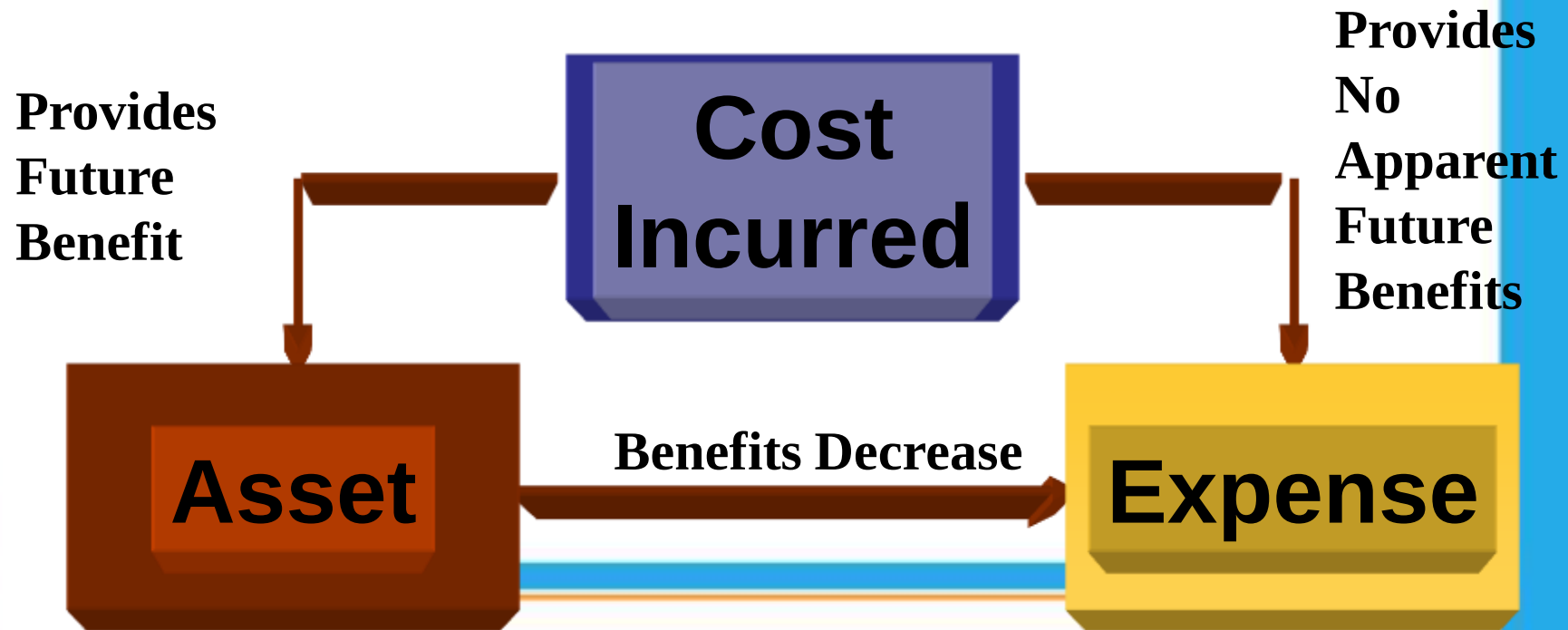
**Generate revenues  
only in the current  
accounting period.**

#### 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**

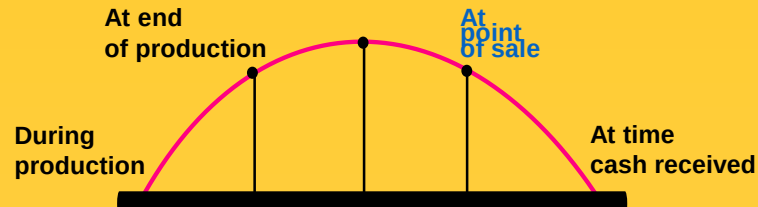
and

**VERIFIABLE**



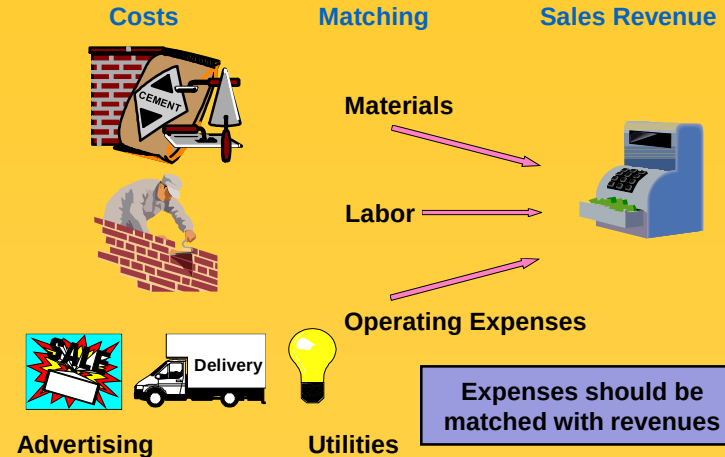
# BASIC ACCOUNTING PRINCIPLES

## Revenue Recognition

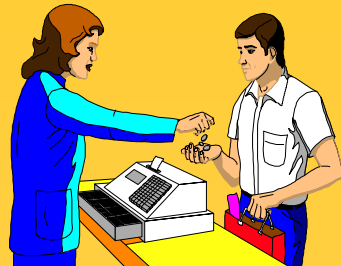


Revenue should be recognized in the accounting period in which it is earned (generally at point of sale).

## Matching

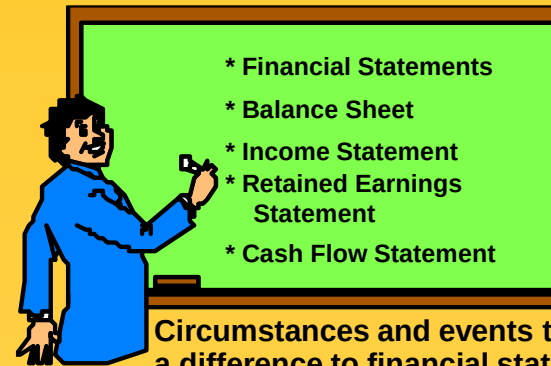


## Cost



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



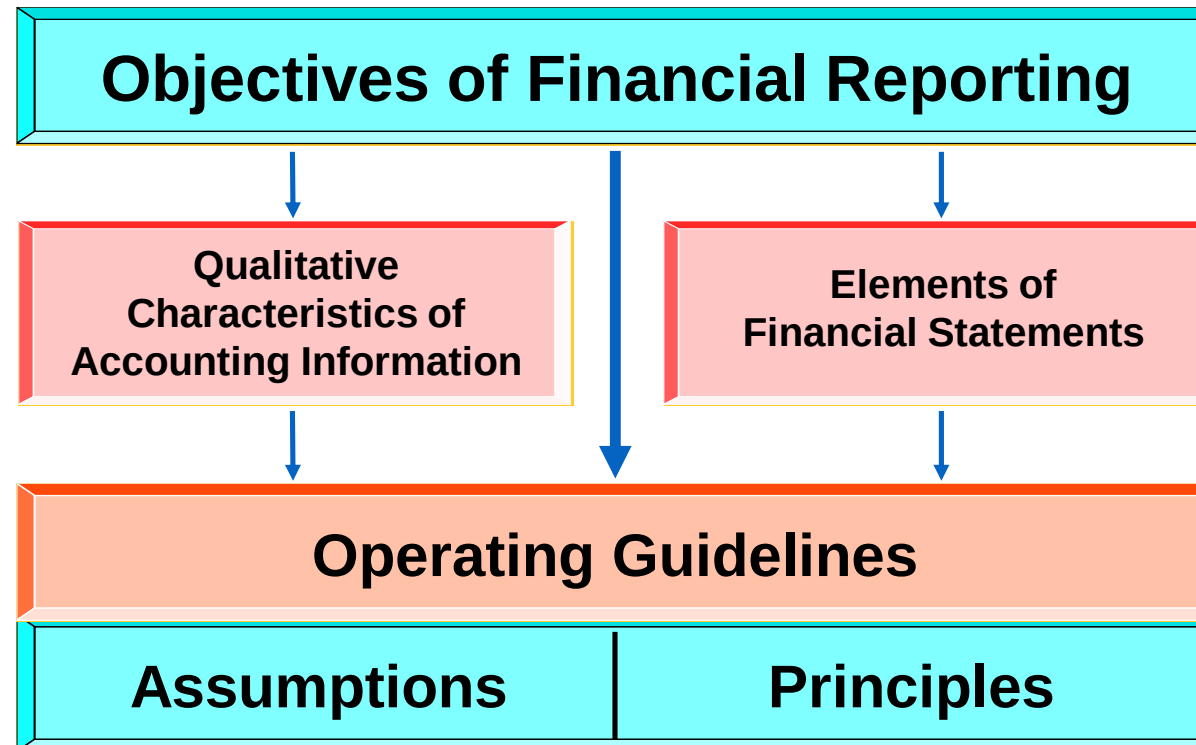
For small amounts, GAAP  
does not have to be followed.

### 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<br/>Stockholders Equity</u> |
|--------------------------------|------------------------------------------------|
| Current assets                 | Current liabilities                            |
| Long-term investments          | Long-term liabilities                          |
| Property, plant &<br>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**

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

## 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

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

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.**

