

Financial Accounting

Prepared by Dr. Mohamed Hamouda

Lecture 10



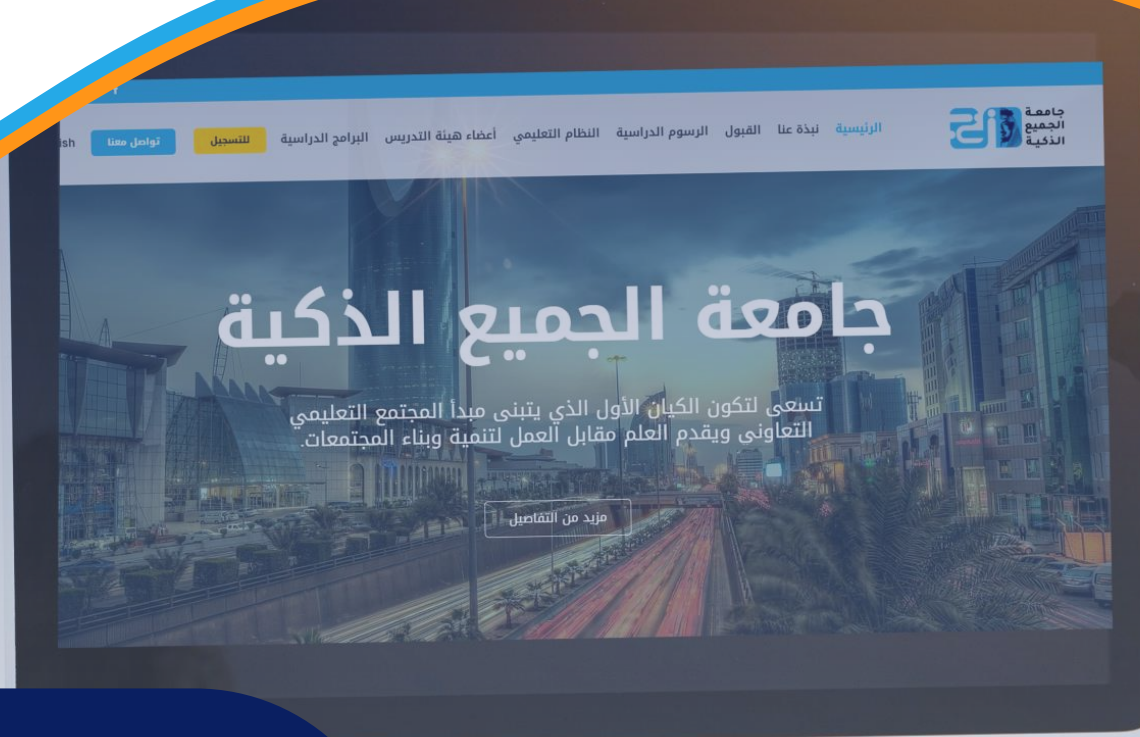
ACCOUNTING PRINCIPLES



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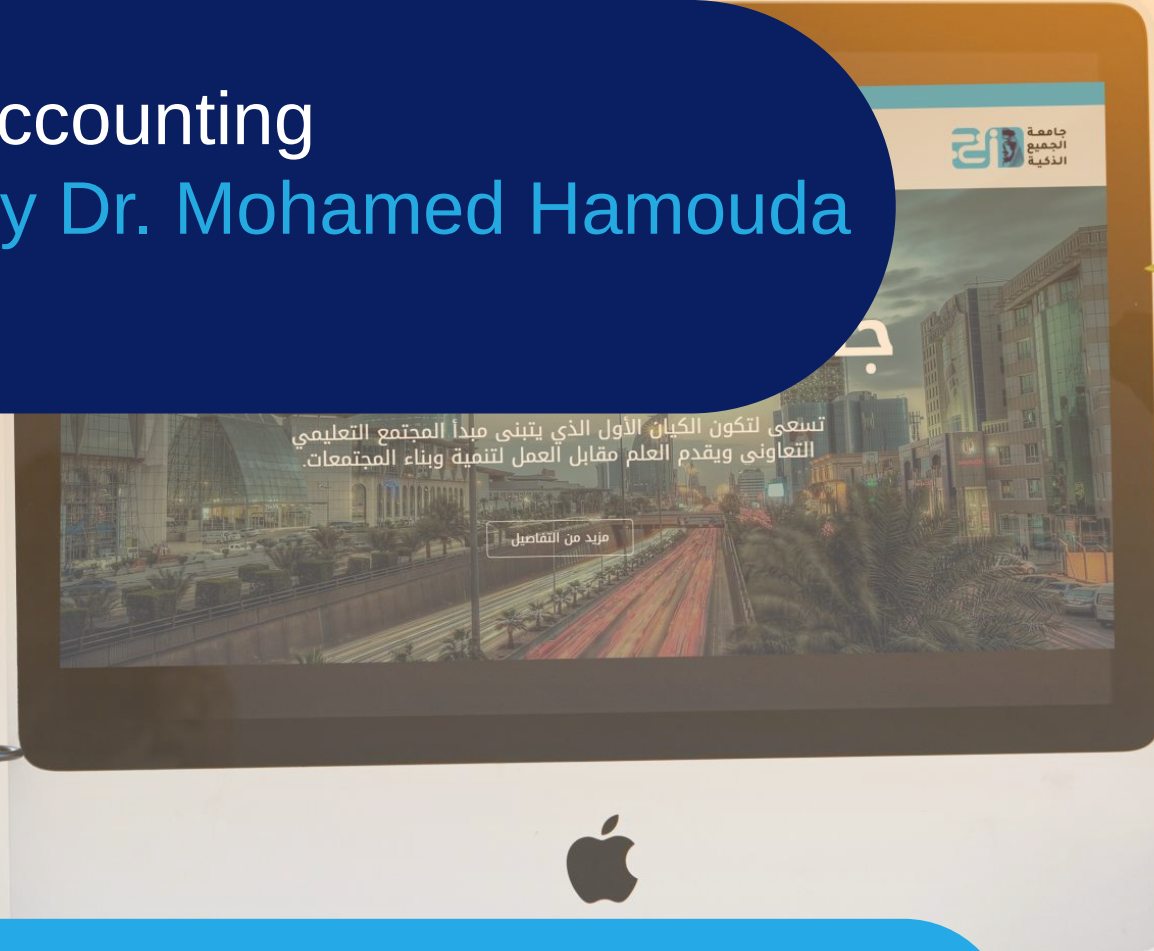
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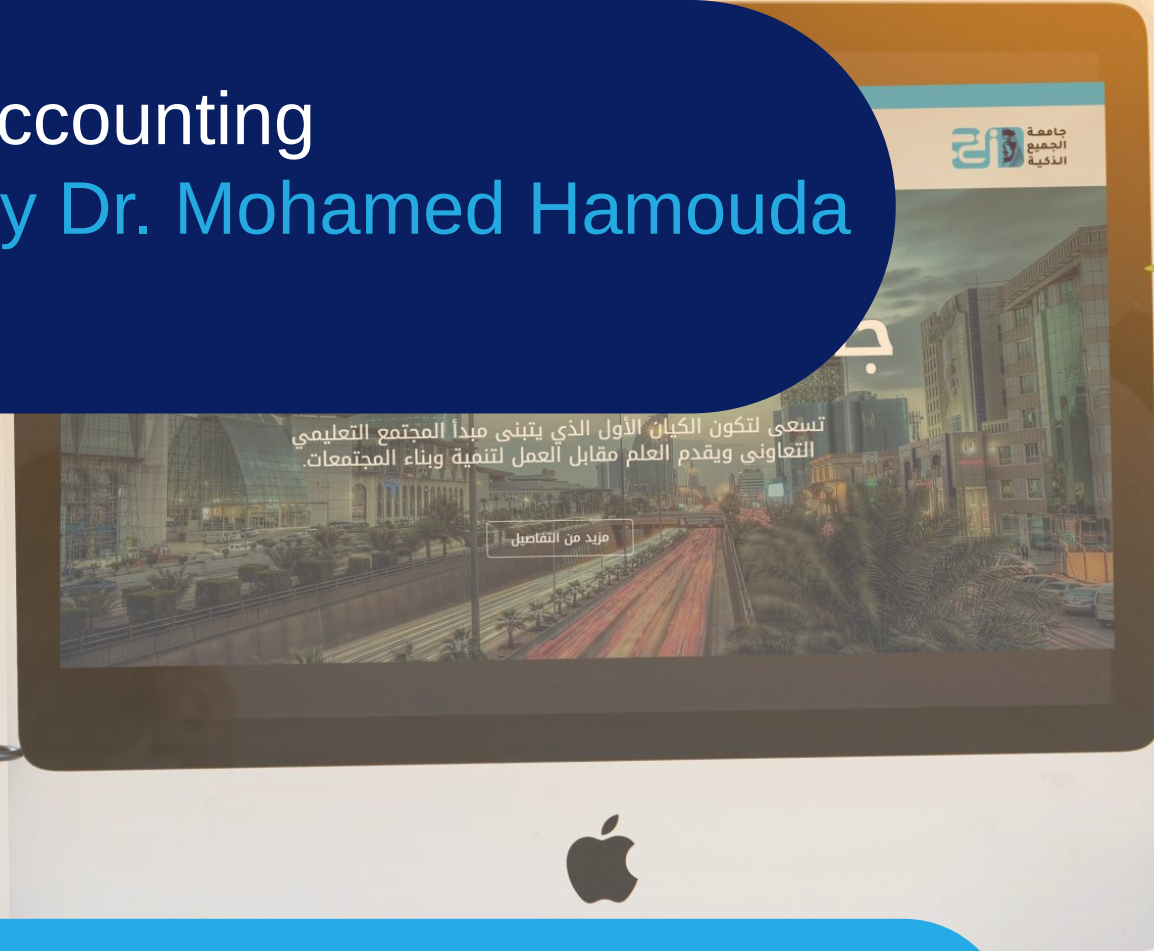
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RECAP

Building Blocks of Analysis

Ability to meet
short-term
obligations and
to efficiently
generate
revenues

**Liquidity
and
Efficiency**

Ability to
generate future
revenues and
meet long-term
obligations

Solvency

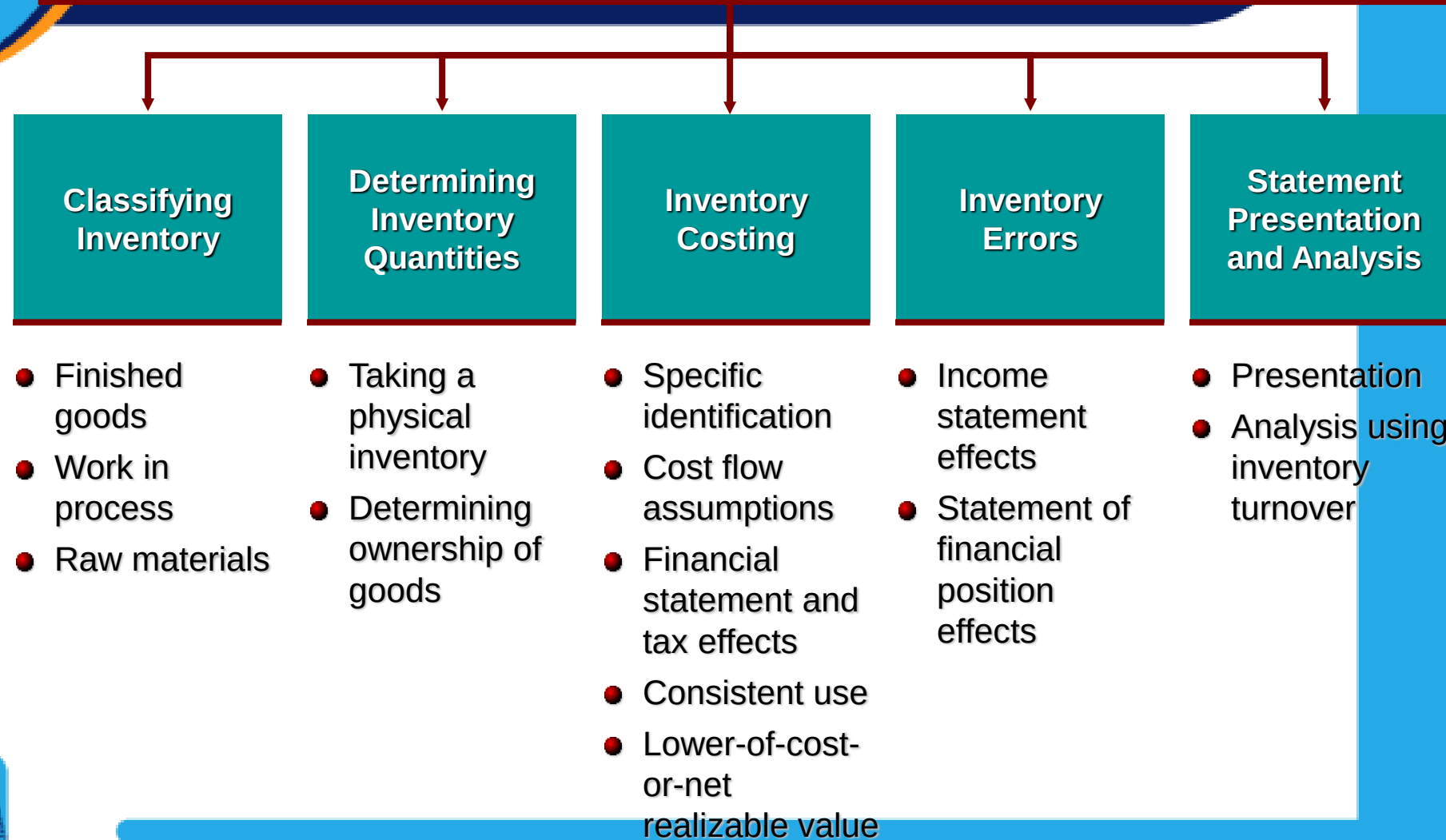
Ability to provide
financial rewards
sufficient to
attract and retain
financing

Profitability

Ability to
generate
positive
market
expectations

Market

Inventories



Allowance Method

At the end of each period, **estimate** total bad debts expected to be realized from that period's sales.



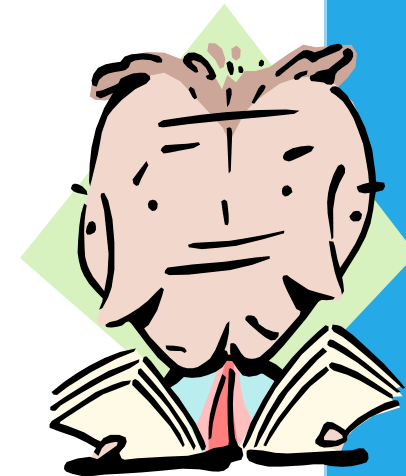
Two advantages to the allowance method:

1. It records estimated bad debts expense in the period when the related sales are recorded.
2. It reports accounts receivable on the balance sheet at the estimated amount of cash to be collected.

Estimating Bad Debts Expense

Two Methods

1. Percent of Sales Method
2. Accounts Receivable Methods
 - Percent of Accounts Receivable
 - Aging of Accounts Receivable



Plant Assets

Tangible in Nature



Actively Used in Operations



Expected to Benefit Future Periods



Called Property, Plant, & Equipment

Statement of Cash Flows

The Statement of Cash Flows: Usefulness and Format

- Usefulness
- Classifications
- Significant noncash activities
- Format
- Corporate life cycle
- Preparation
- Indirect and direct methods

Preparing the Statement of Cash Flows—Indirect Method

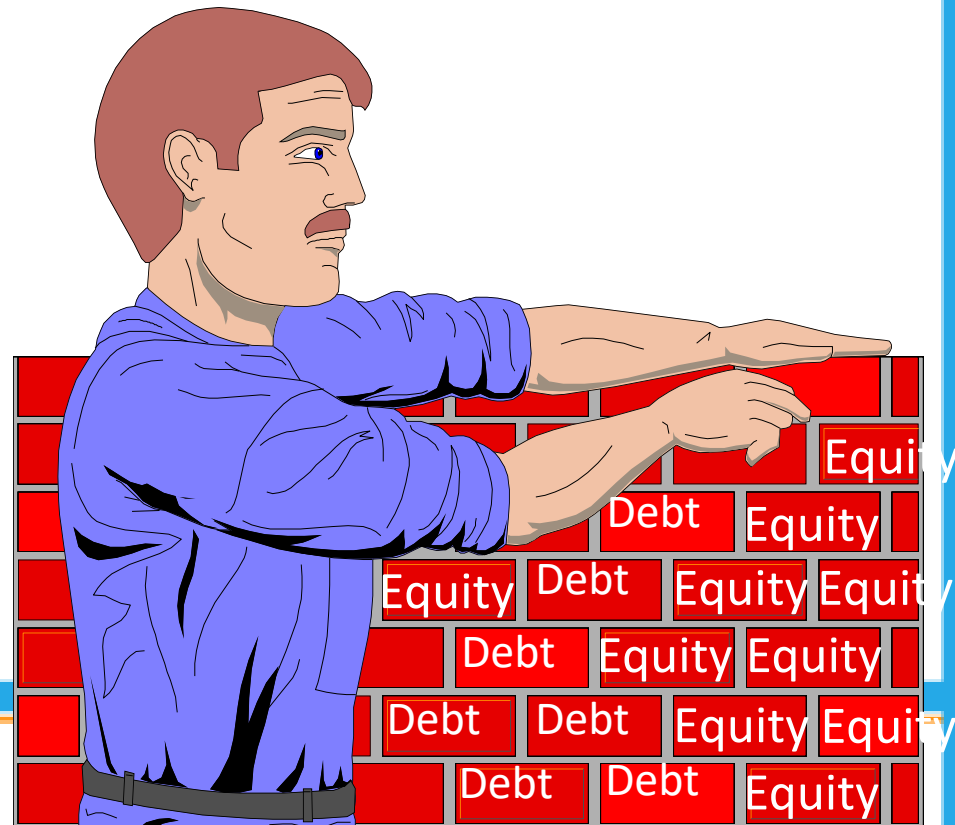
- Step 1: Operating activities
- Step 2: Investing and financing activities
- Step 3: Net change in cash

Using Cash Flows to Evaluate a Company

- Free cash flow
- Assessing liquidity and solvency

Capital Structure and Dividend Policy Decisions

- The combination of debt and equity used to finance a firm

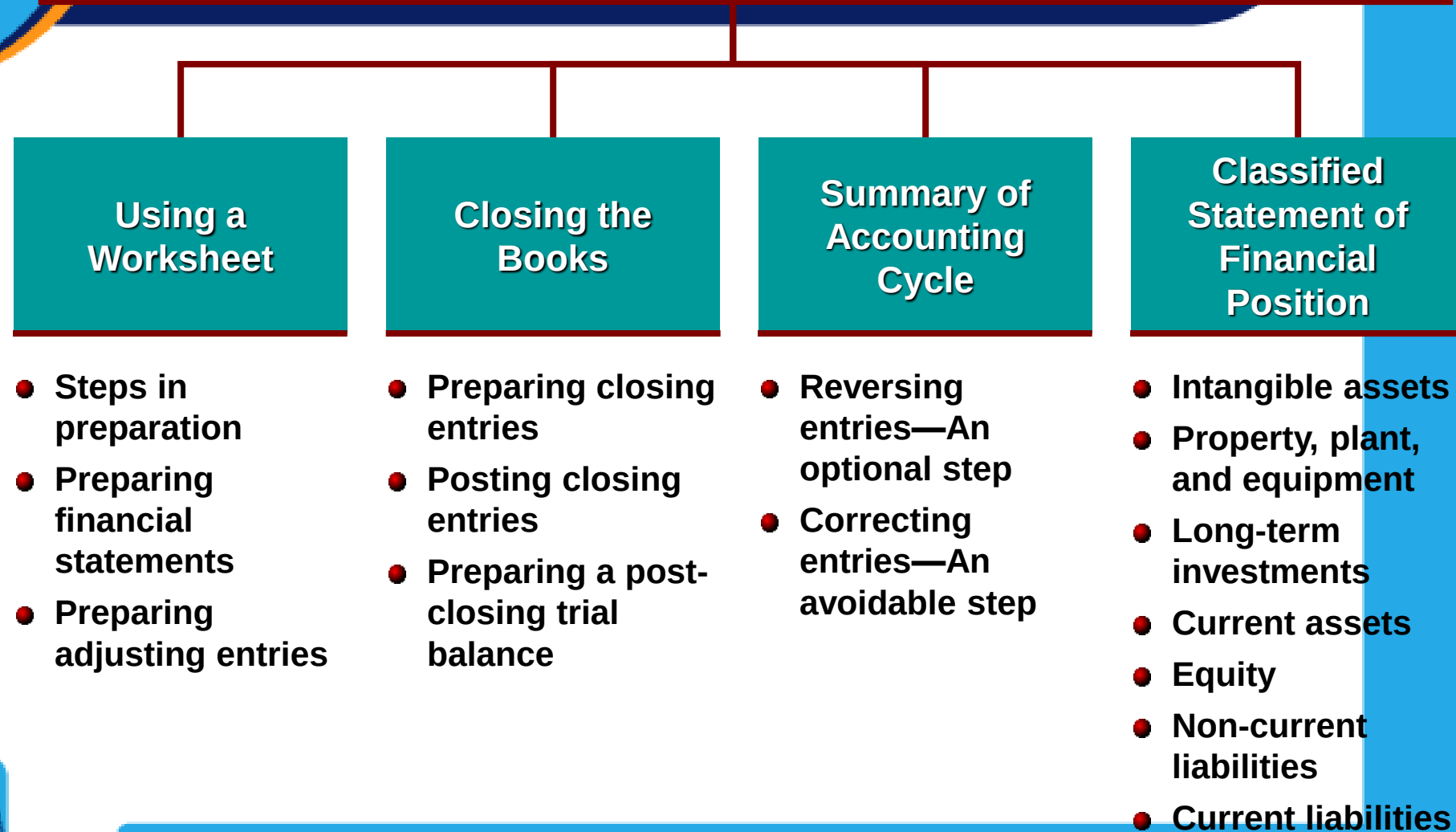


- The optimal mix of debt, preferred stock, and common equity with which the firm plans to finance its investments May change over time
- Trade-off between risk and return to achieve goal of maximizing the price of the stock



- 1. Firm's business risk
- 2. Firm's tax position
- 3. Financial flexibility
- 4. Managerial attitude

Completing the Accounting Cycle



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:

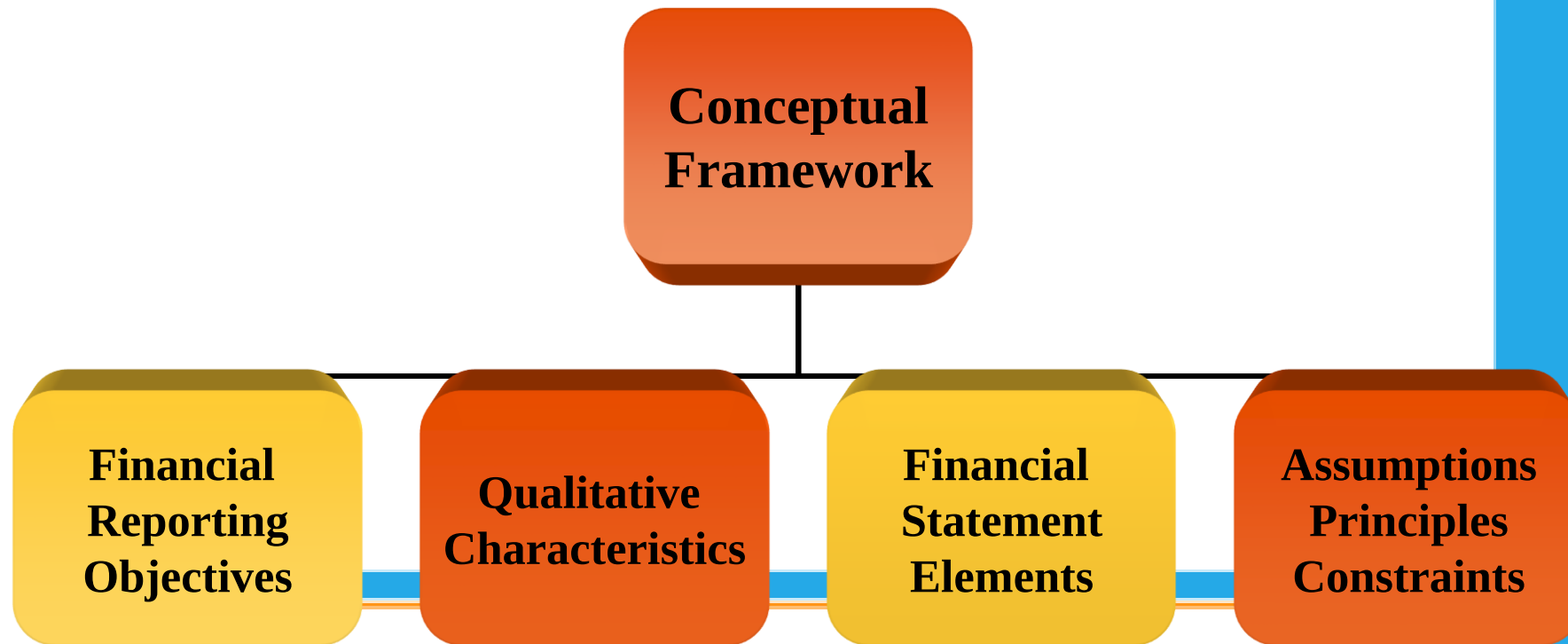
SEC
Mandates GAAP

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. |

$$\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$$

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

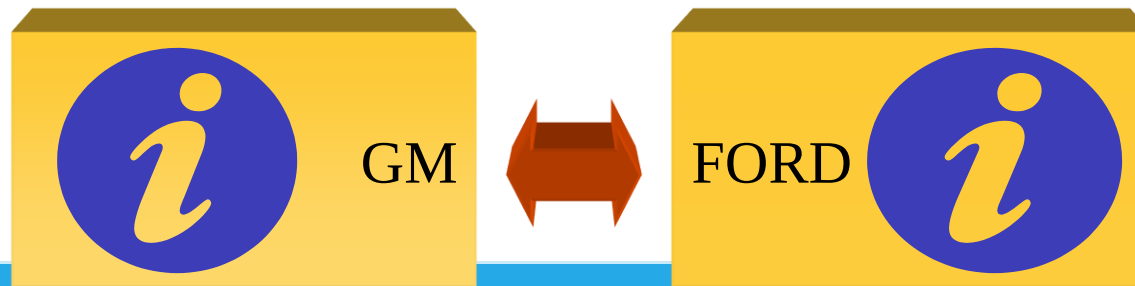
- Is dependable and verifiable.
- Is free of error and bias.
- Is a faithful representation.
- Is factual.



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.

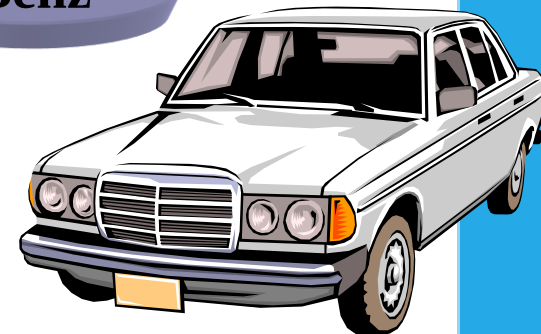


ECONOMIC ENTITY ASSUMPTION

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

TIME PERIOD ASSUMPTION

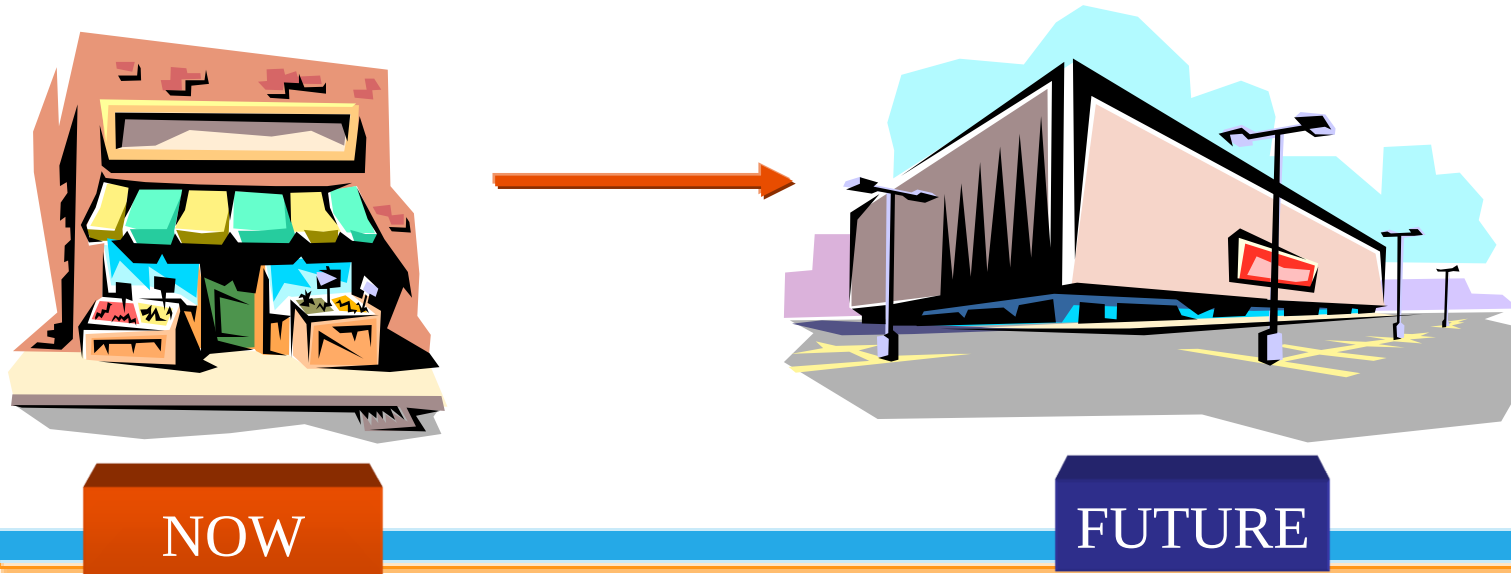
The economic life of a business can be divided into artificial time periods

	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

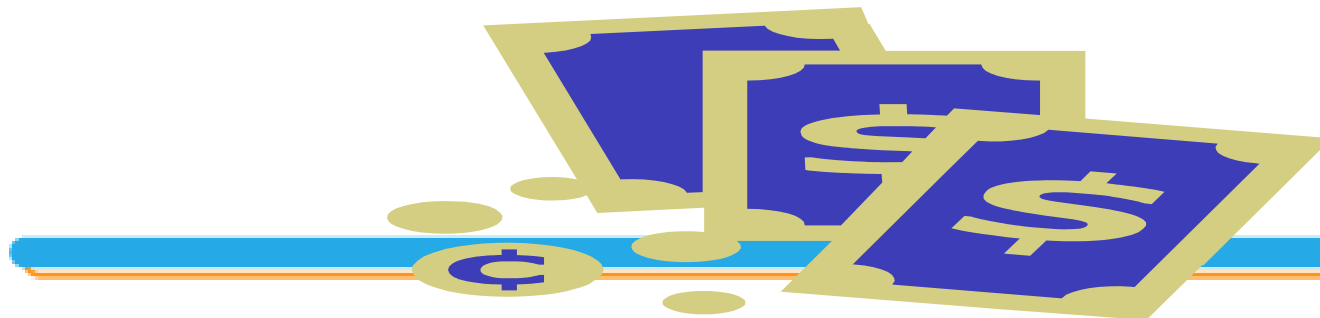
1. REVENUE RECOGNITION
2. MATCHING
3. FULL DISCLOSURE
4. COST

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

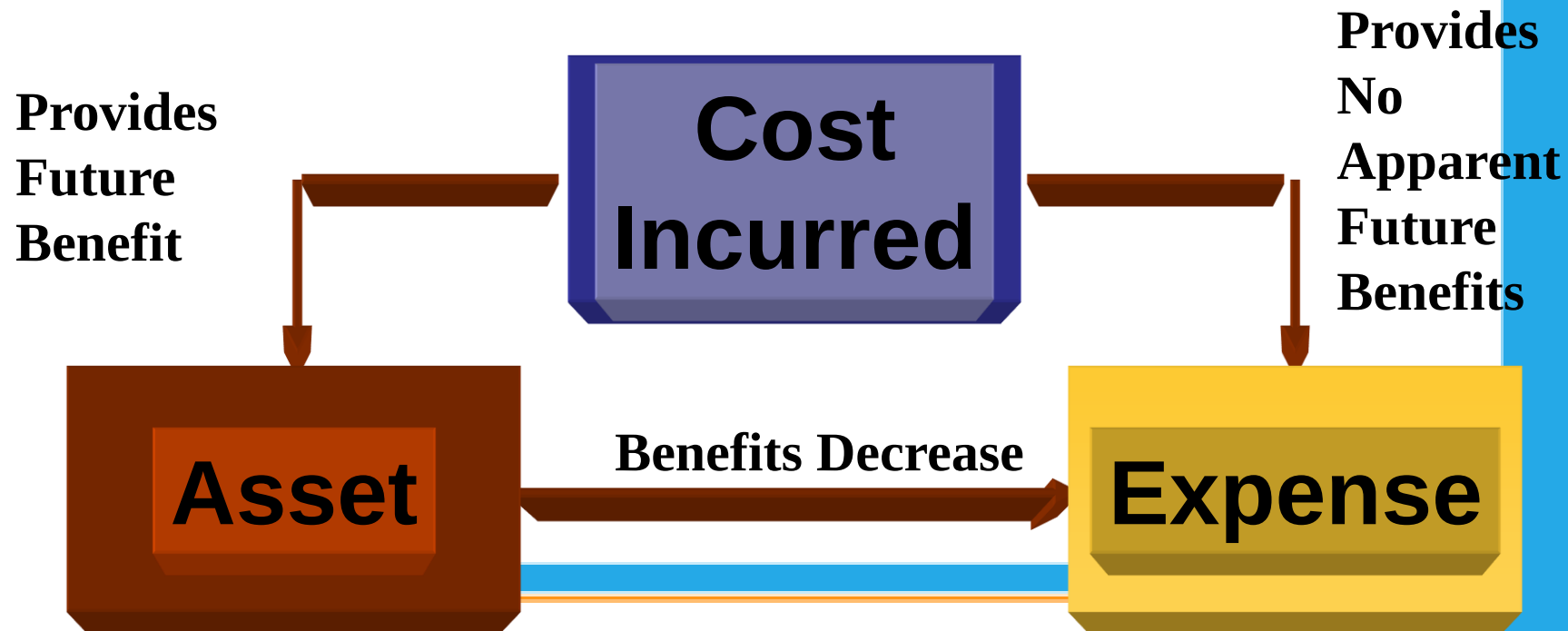
**Generate revenues
only in the current
accounting period.**

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

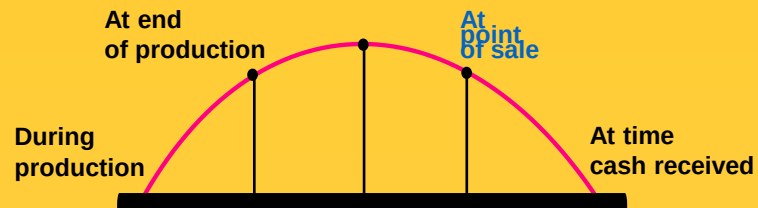
and

VERIFIABLE



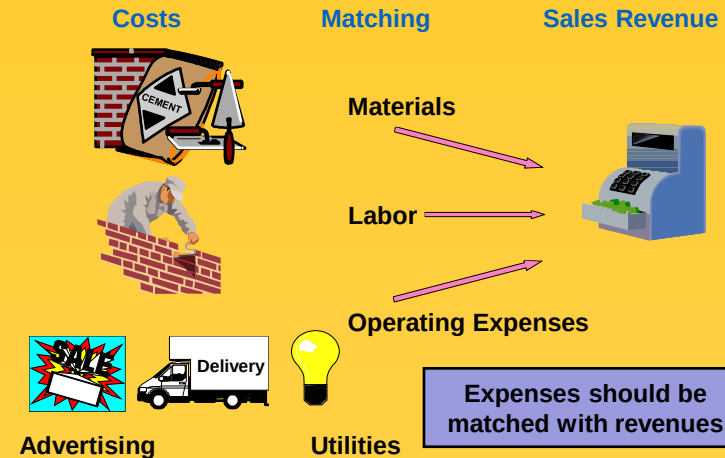
BASIC ACCOUNTING PRINCIPLES

Revenue Recognition

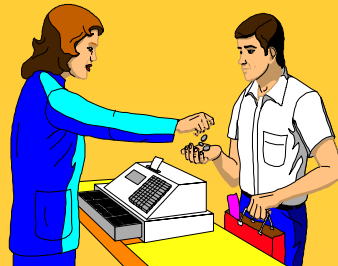


Revenue should be recognized in the accounting period in which it is earned (generally at point of sale).

Matching

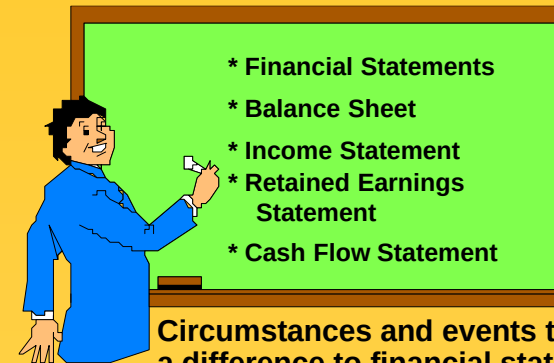


Cost



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



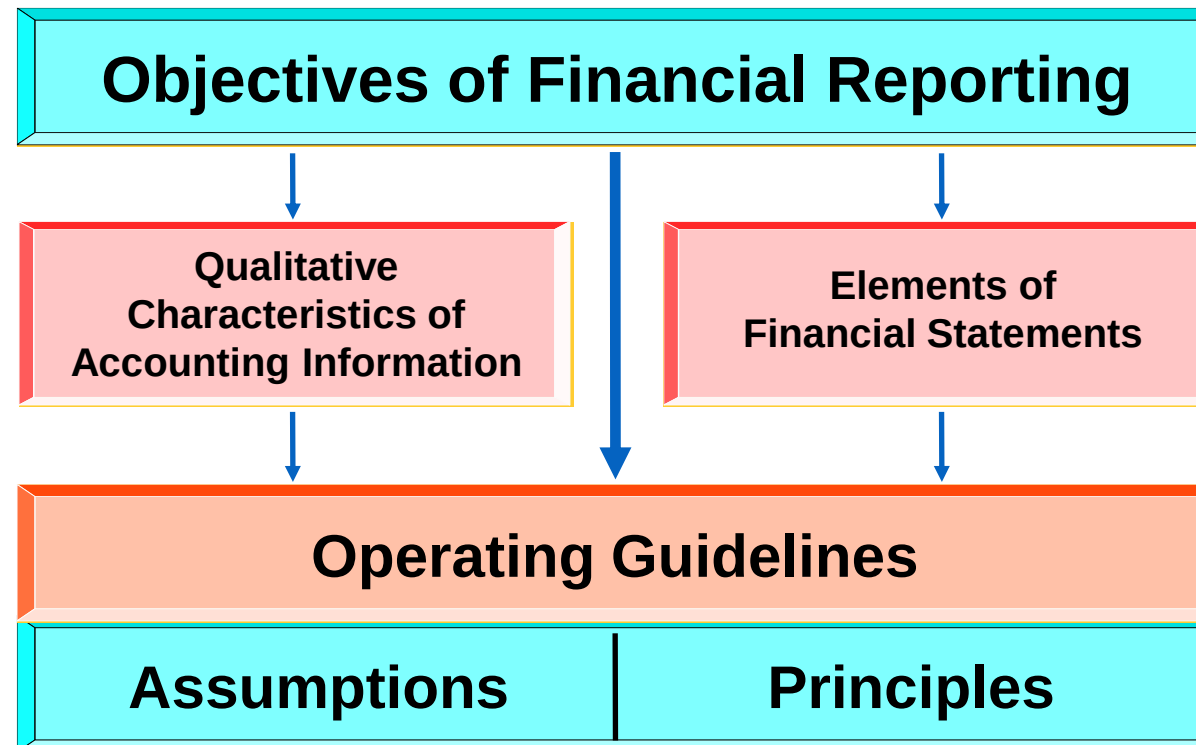
Conservatism



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

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	

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.

Chapter 10

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

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 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.**

