

# Principles of Accounting

**Prepared by  
Dr. Hoda Metwally**

MGM 227

## Lecture 2



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## Lecture 2

Reading & Understanding    Basic Financial Statements

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# 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

## **Basic financial statements:**

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

## 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, loan.
- Owners' Equity: net assets after all obligations have been satisfied

Balance Sheet answers these questions:

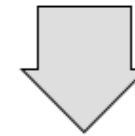
- What are the resources of the company?
- What are the company's existing obligations?
- What are the company's net assets?

# 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**

## Sample Balance Sheet

### Assets

|                     |              |
|---------------------|--------------|
| Cash                | \$ 40        |
| Accounts receivable | 100          |
| Land                | <u>200</u>   |
| Total assets        | <u>\$340</u> |

### Liabilities

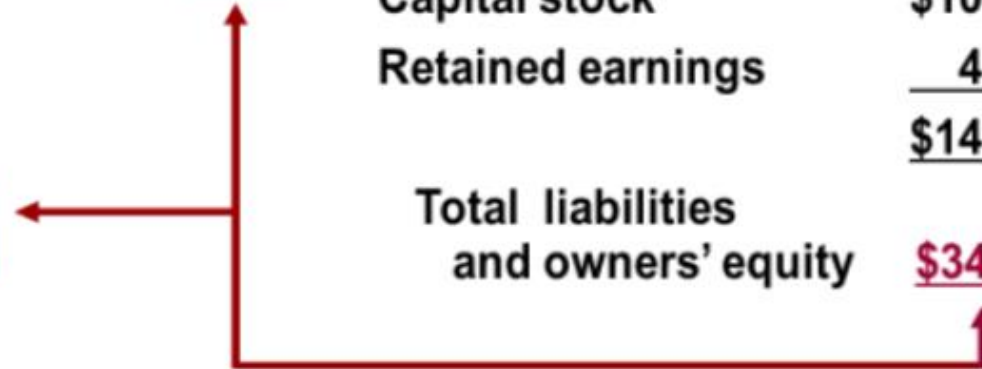
|                  |              |
|------------------|--------------|
| Accounts payable | \$ 50        |
| Notes payable    | <u>150</u>   |
|                  | <u>\$200</u> |

### 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?

## **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

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

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

# 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

# Investing Activities

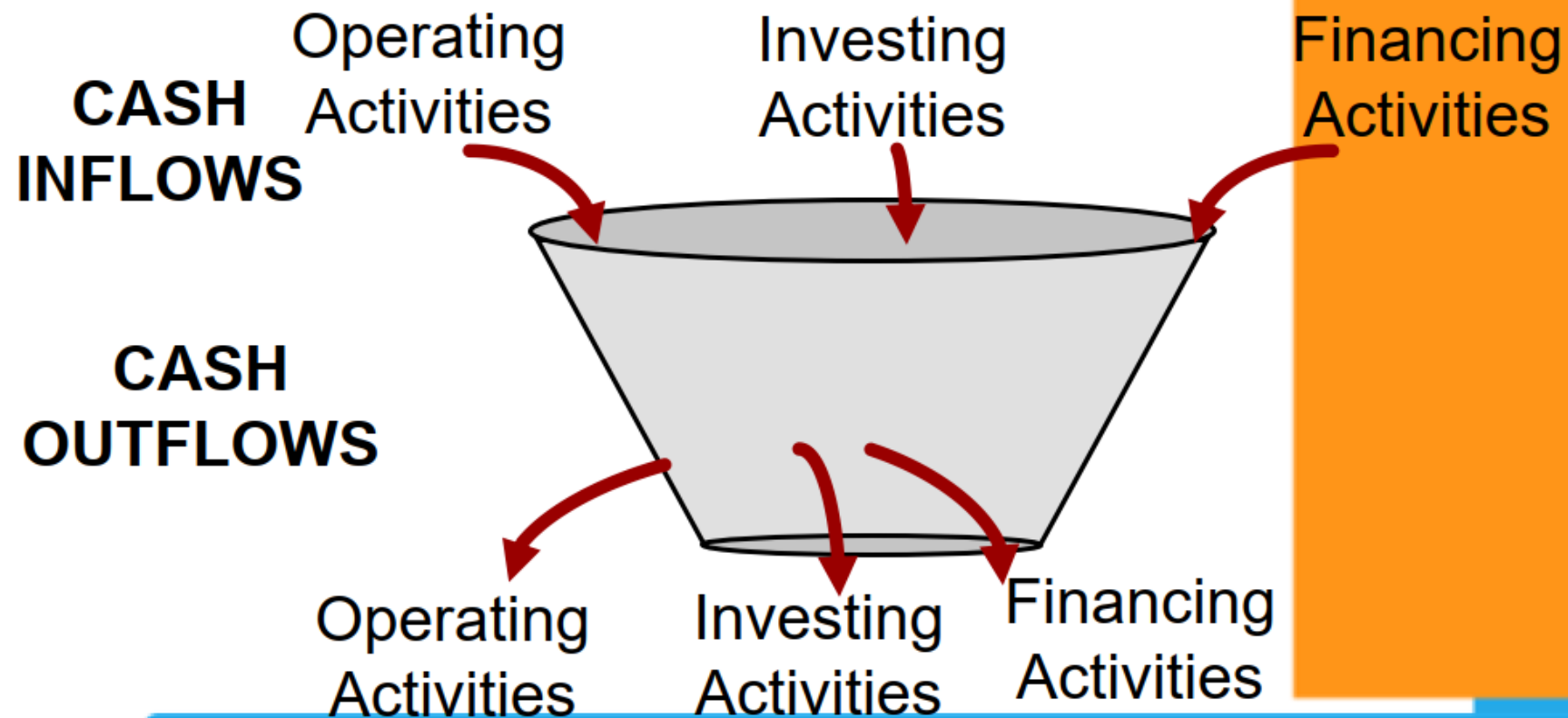
## Cash Inflow

- 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

# Statement of Cash Flows



## Statement of Cash Flows December 31, 2011

|                                                 |             |          |
|-------------------------------------------------|-------------|----------|
| <b>Cash Flows From Operating Activities:</b>    |             |          |
| Receipts                                        | 48          |          |
| Payments                                        | <u>(43)</u> | 5        |
| <b>Cash Flows From Investing Activities:</b>    |             |          |
| Receipts                                        | 0           |          |
| Payments                                        | <u>(4)</u>  | (4)      |
| <b>Cash Flows Used By Financing Activities:</b> |             |          |
| Receipts                                        | 10          |          |
| Payments                                        | <u>(6)</u>  | <u>4</u> |
| <b>Net Cash Flow</b>                            |             | <b>5</b> |

# 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        |

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

Internal Users

- Managers
- Officers
- Internal Auditors

External Users

- Shareholders
- Lenders
- Customers



Thank You