

Principles of Accounting

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MGM 227

Lecture 2



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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:

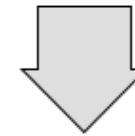
- What are the resources of the company?
- What are the company's existing obligations?
- What are the company's net assets?

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

<u>Assets</u>			<u>Liabilities</u>	
Cash	\$ 40		Accounts payable	\$ 50
Accounts receivable	100		Notes payable	<u>150</u>
Land	<u>200</u>			<u>\$200</u>
Total assets	<u>\$340</u>			
			<u>Owners' Equity</u>	
			Capital stock	\$100
			Retained earnings	<u>40</u>
				<u>\$140</u>
			Total liabilities and owners' equity	<u>\$340</u>

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?

What is the difference between Revenue and Income?

Net income or net profit (or loss)=

Sales revenue (revenue) - Expenses

Income Statement:

Revenues

- Assets (cash or Accounts Receivable) created through business operations

Expenses

- Assets (cash or Accounts Payable) 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**

	2011	2010
Revenues:		
Sales	\$100	\$ 85
Other revenue	<u>30</u>	<u>15</u>
Total revenues	\$130	\$100
Expenses:		
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

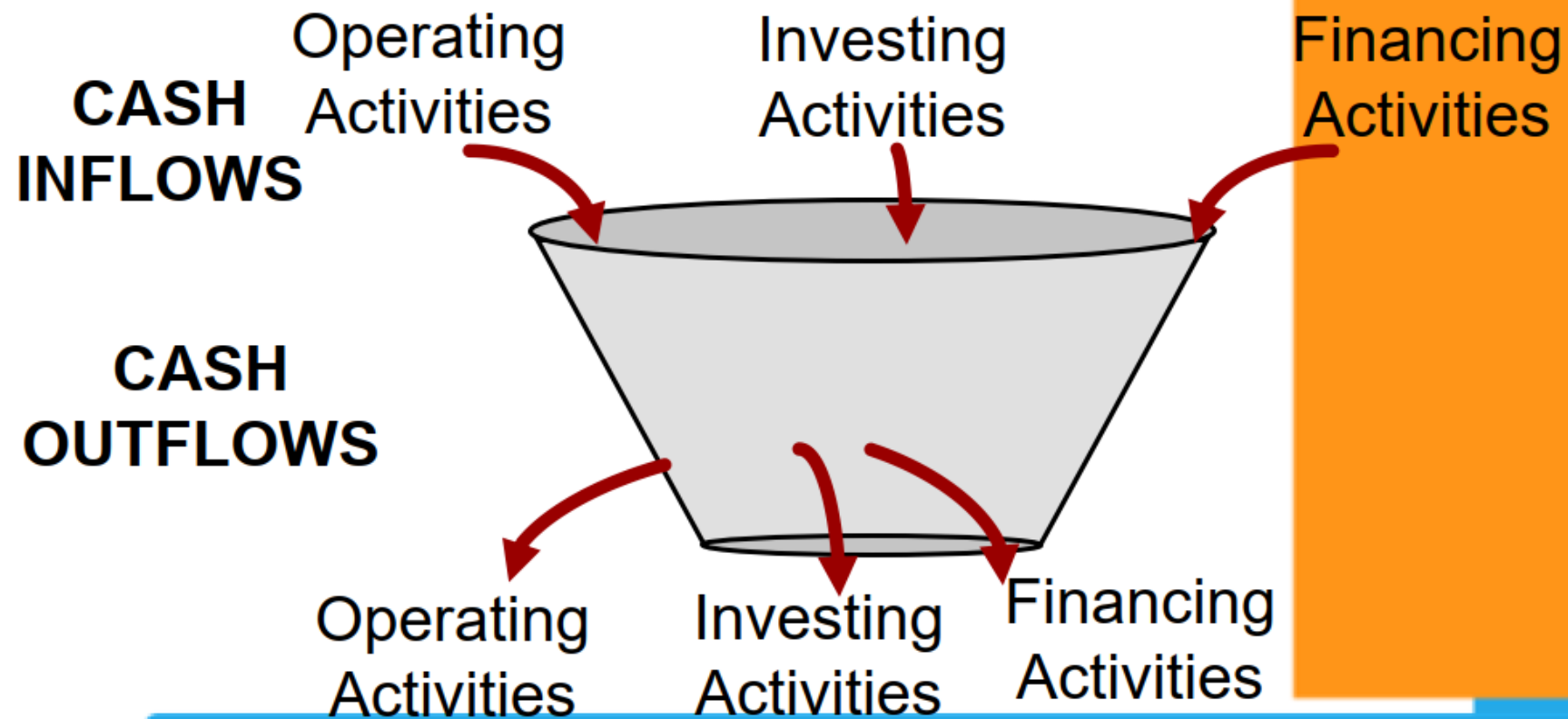
Cash Inflow

- Issuance of own stock
- Borrowing

Cash Outflow

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

Statement of Cash Flows



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

Financial statement analysis helps users make better decisions.

Internal Users

- Managers
- Officers
- Internal Auditors

External Users

- Shareholders
- Lenders
- Customers



Thank You