HELLENIC REPUBLIC
National and Kapodistrian University of Athens
EST. 1837

FINANCIAL ACCOUNTING

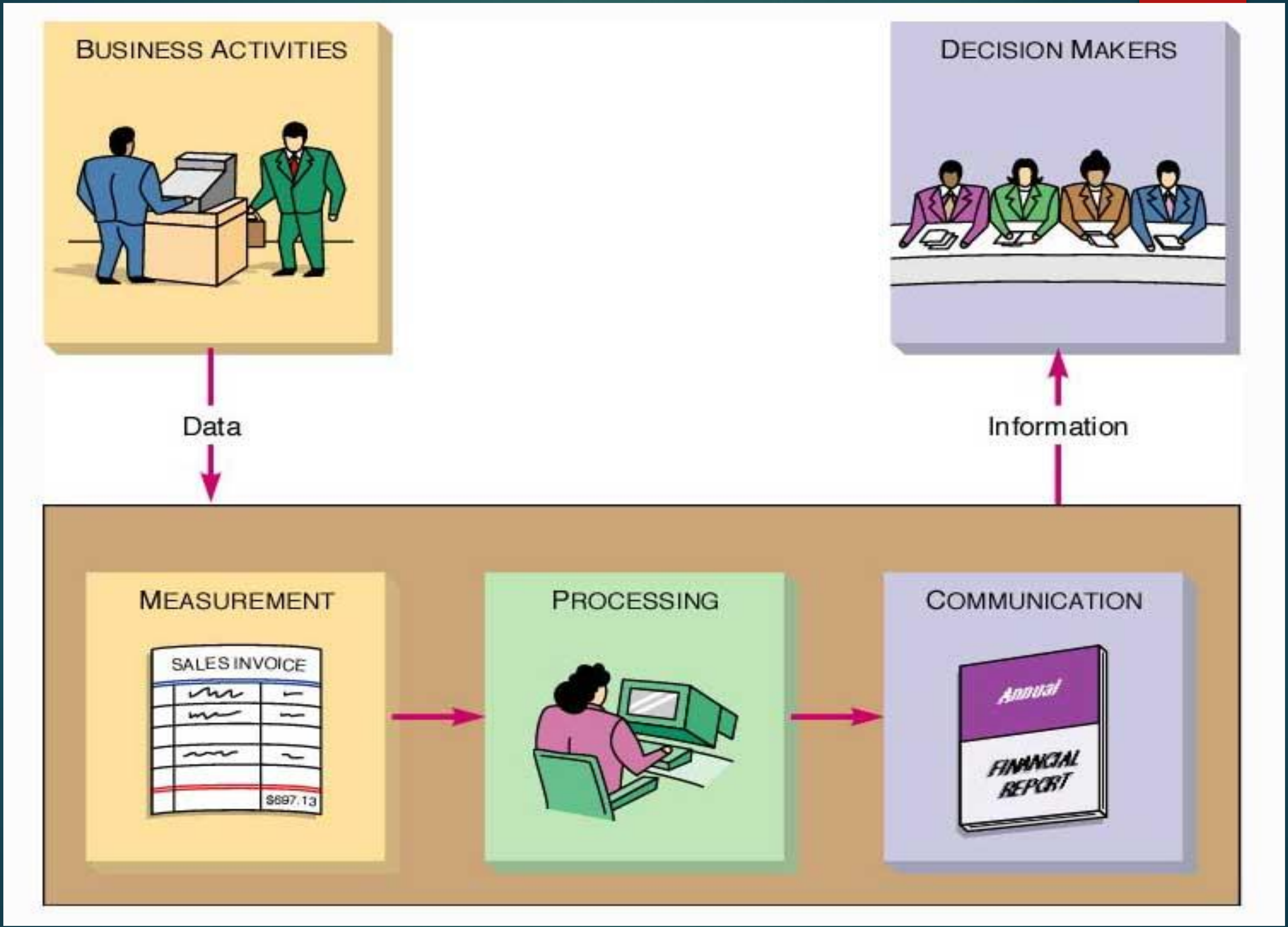
A Business Accounting System

- Accounting system records all activities regarding cash inflows, revenues, cash outflows and expenses that are related to the operation of a business organization.

- Furthermore, it provides financial information to evaluate the effectiveness of current and past operations, the financial condition at a specific point of time

- It also maintains data showing the status of resources, creditors and ownership equities of the business entity.

Accounting as an Information System



Financial and Management Accounting

- Accounting's role of assisting decision makers by measuring, processing, and communicating information is usually divided into two categories:

  1. Management accounting.
  2. Financial accounting.

- The two may be distinguished by the principal users of their information.

Management Accounting

- Is oriented toward the needs of internal decision makers.

- Provides managers and employees with information regarding how they have done in the past and what they can expect in the future.

Financial Accounting

- Is oriented toward the needs of external decision makers.
- Provides information in the form of financial statements to evaluate how well the business has achieved its goals.
- Financial statements report directly on the goals of profitability and liquidity.
- Financial statements are used extensively both inside and outside a business to evaluate the business's success.

CASH versus ACCRUAL ACCOUNTING

- The difference between the two methods is how and when sales revenue & expenses are recognized.
- Small businesses use the cash basis; no requirement to prepare & report their financial position to external users.
- Medium & large business org/tions use the accrual basis of accounting.

ACCOUNTING PRINCIPLES

1. Business Entity Concept

- The assets, liabilities, ownership equity and other transactions of the business entity only are entered in the org/tions accounting records and not the owner's personals.

2. Going Concern Concept

- Assumption that the business entity will remain in operation indefinitely.
- Especially for long-lived assets- since there is no intention to sell such assets (buildings, equipment).

ACCOUNTING PRINCIPLES

3. Money Concept

- The primary national monetary unit is used for recording numerical values.

4. Cost Principle

- It requires the value of business transactions to be recorded at their actual or equivalent historical cost.
- Usually, no adjustments are required to be made for inflation, appreciation or depreciation of some business assets.

ACCOUNTING PRINCIPLES

5. Periodicity/Time period concept

- Requires a business entity to complete an analysis to financial condition & profitability over a specific time period (weekly, monthly, quarterly, semiannually, annually).

6. Full Disclosure Principle

- Any future events that will have an economic impact on the financial position of the business should be disclosed acquisition, liquidation, lawsuits, etc.

ACCOUNTING PRINCIPLES

7. Consistency principle

- Cash or accrual basis over different financial periods.
- Inventory control methods over different financial periods.
- Different depreciation methods.

8. Conservatism Concept

- Never overstate assets.
- Never understate liabilities.

E.g. conservatism increases Cost of Goods Sold, decreases Gross Margin, report lower Operating Income

ACCOUNTING PRINCIPLES

9. Materiality Concept

- Base on accrual accounting we systematically depreciate assets over the duration of their lives.
- However, if the amount is small we can fully depreciate a fixed asset in the 1st year and not over its entire economic life.

10. Objectivity Concept

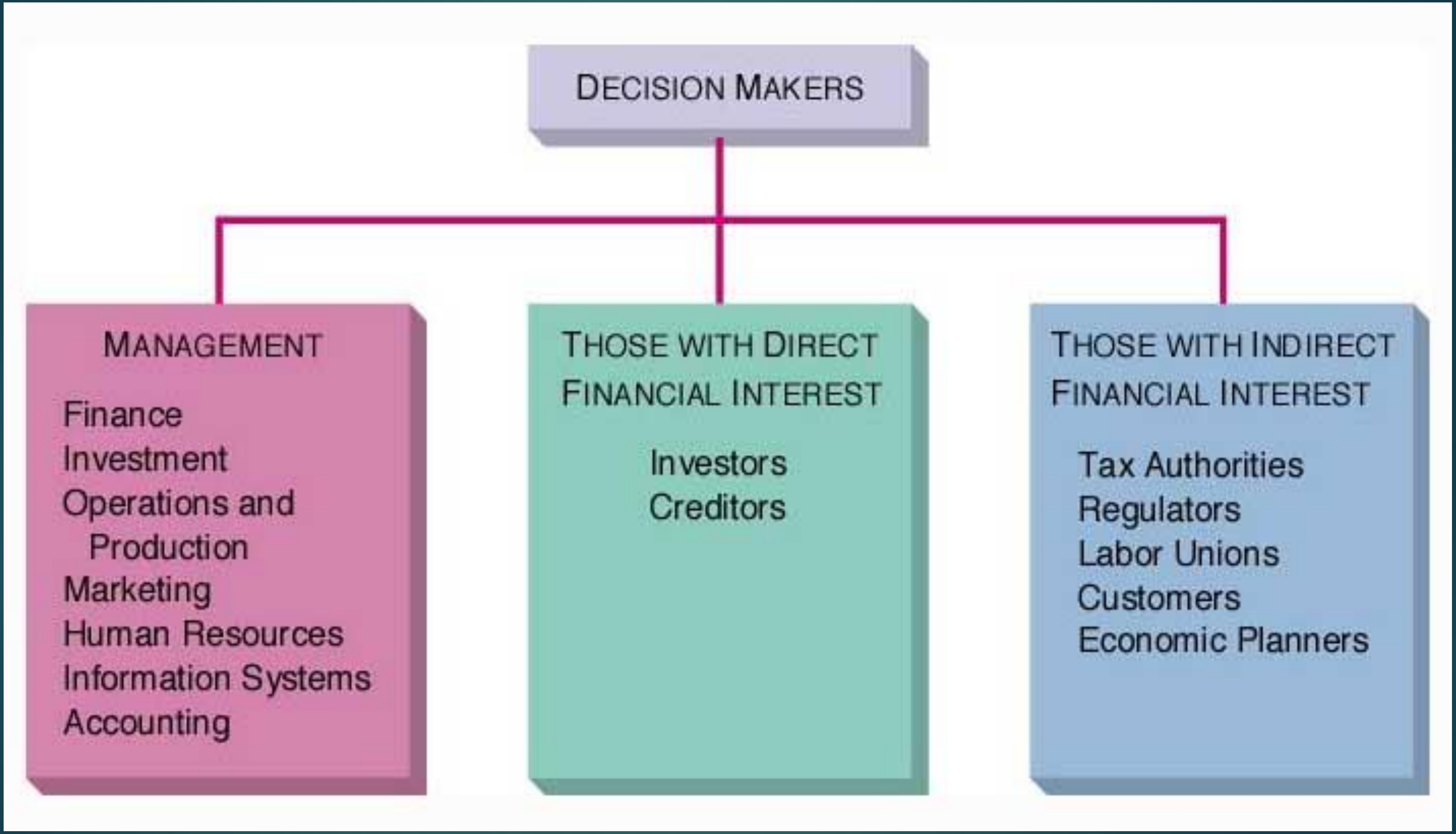
- Some form of documentation must exist to support a transaction before entered into the accounting system.

ACCOUNTING PRINCIPLES

11. Matching Principle

- It reinforces the accrual basis of accounting.
- It mandates the recognition of all sales revenues earned or expenses incurred whether payment is received or made or not.

The Users of Accounting Information



Basic Financial Reports/Statements

1. Balance Sheet

It reveals the financial condition of a business on a specific ending date of an operating period and it shows the status of its assets, liabilities, owners' equity.

- Assets: resources used by a business to create revenue, which in turn increase assets
- Liabilities: creditors' equity or claim against the assets of the business
- Owners' equity: entity/business financing

Basic Financial Reports/Statements

2. <u>Income Statement</u> (Profit & Loss account)

- It reports the economic results of the business and it shows sales revenue and expenses. Furthermore it indicates operating results, operating effectiveness.

Basic Financial Reports/Statements

- *Sales Revenue (R):* Revenue produced form the sale of goods
- *Cost of Sales (CS):* Cost of inventories/goods bought & sold
- *Expenses (E):* Cost of assets consumed during operations to produce sales revenue
- *Breakeven (BE):* Total Revenue=Total Expenses
- Net Income (NI): Total revenue>Total expenses after taxes
- Net Loss (NL): Total revenue<Total expenses after taxes

Innovative Products, Inc.
Income Statement
For Year Ending December 31, 2012

Sales		$50,00,000
Cost of Goods Sold		
Materials	8,00,000	
Labor	11,00,000	
Overhead	6,00,000	25,00,000
Gross Margin		**$25,00,000**
Operating Expenses		
Selling Expenses	9,00,000	
Administrative Expenses	6,00,000	
Depreciation and Amortization	5,00,000	2000000
Operating Income		**$5,00,000**
Other Income & Expenses		
Interest Revenue	50000	
Interest Expense	-1,00,000	
Extraordinary items	2,00,000	1,50,000
Income Before Tax		$6,50,000
Income Tax (at 35%)		$2,27,500
Net Income		***$4,22,500***

Income Statement – Cost of Goods sold

Cost of sales = Beginning/opening inventory
+ Purchases
- Ending/closing inventory
- Internally used items*

* Internally used items are those items that have been used but not for sale, such as expired, lost, broken, spoiled, given for free, etc.

- The value of the closing inventory in one period becomes the opening inventory of the next period.

The Balance Sheet

Balance Sheet Vs P+L Acc

- **P+L Acc is prepared by each department**
- **B/S is normally prepared for an overall operation**

Link Between B/S and P+L Acc

- **The account called “Retained Earnings”**

Balance Sheet Vs P+L Acc

- The Profit & Loss Account (P&L) shows the operating results of a business over a period of time.
- The Balance Sheet gives a picture/snapshot of the financial position of a business at a particular point in time.

The Balance Sheet

Format of B/S:

Can be presented in a horizontal account format or in a vertical account format.

- The Balance Sheet is based on the following equation:

  Assets = Liabilities + Equity

Asset characteristics:

- It is expected to provide future economic benefits to the firm.
- It is owned or controlled by the firm.

Liability characteristics:

- A liability is an obligation of one entity to deliver money, goods or services to another.
- To settle the obligation the firm must give up assets.

The Balance Sheet

- Assets are anything of value owned by a business, including resources and future economic rights (e.g. money or services owned to the business by customers or suppliers respectively)

The Balance Sheet

The Asset accounts are usually divided into two sections:

- current assets; and
- fixed (or long-term) assets

Current assets are cash or items that can be converted into cash within a short period of time (usually within one year).

The Balance Sheet

Current assets can include:

- cash on hand
- cash in bank
- marketable securities
- accounts receivable
- inventories (e.g. food, beverages)
- pre-paid expenses

The Balance Sheet

Fixed assets (capital assets) are those assets of a more permanent nature, used for operating rather than trading purposes, and can include:

- land, building, furniture, and equipment
- accumulated depreciation
- china, glass, linen, uniforms, etc.

The Balance Sheet

Liabilities are financial obligations to outside parties repayable at some future time (e.g. loans received from the bank).

The Liabilities accounts are also broken into two sections:

- current liabilities; and
- long term liabilities.

The Balance Sheet

Current liabilities are debts that must be paid within one year, and can include:

- accounts payable (e.g. suppliers)
- accrued expenses (e.g. unpaid wages)
- income tax payable
- deposits and credit balances (e.g. deposits for reservations)
- current position of long-term mortgage (just the balance for the next year)

The Balance Sheet

Long term liabilities are those debts due beyond one year, and can include:

- mortgage; and
- long-term loans.

The Balance Sheet

- Capital (owner'/stockholders' equity) is the sum (of money) invested in the business by its owners, and represents the rights of the owners to the assets after the prior liabilities have been satisfied if the business closes. It is, therefore, the difference between total assets and total liability and represents the equity (or interest) of the owner(s) in the business.

The Balance Sheet

It usually comprises of two items:

- capital stock; and
- retained earnings.

Capital stock usually used for incorporated (stockmarket traded) companies. It is calculated by multiplying the total number of shares by the share value.

The Balance Sheet and the P&L Account

- Retained earnings are the accumulated profits of the business, less any losses, sustained by the business since it began, (less any dividends paid to stockholders). Retained earnings are not always represented by cash, because they might have been used for necessary purpose (e.g. expansion of the business)

Importance of Balance Sheet

Provides information about:

- A business ability to pay its debts
- How much of the operation's profits have been retained for expansion?
- The breakdown of assets
- The business's debt (liabilities) relative to owner's equity. (if debt/equity high then it may indicate high financial risk)

Balance Sheet Limitation

- The true value of some assets on the balance sheet may not be apparent. (e.g. value of land)
- Goodwill is normally recorded at the time business is transferred from seller to buyer. (start from scratch in a good location compared to others)
- B/S does not show investments in employees.

Balance Sheet Limitation

- Many items recorded in B/S are matter of judgment or estimate. (depreciation methods, allowances for bad debts, etc.)
- Reflects the financial position of a business at only on moment in time. (e.g 31/12/2018)

Paul's Guitar Shop, Inc.
Balance Sheet
December 31, 2015

Assets		
Current Assets		
Cash		32,800
Accounts Receivable		300
Prepaid Rent		1,000
Inventory		39,800
Total Current Assets		73,900
Long-term Assets		
Leasehold Improvements	100,000	
Accumulated Depreciation	(2,000)	98,000
Total Long-term Assets		98,000
Total Assets:		171,900
Liabilities		
Current Liabilities		
Accounts Payable		49,000
Accrued Expenses		450
Unearned Revenue		1,000
Total Current Liabilities		50,450
Long-term Liabilities		99,500
Total Liabilities		149,950
Owner's Equity		
Owner's Equity		
Retained Earnings		11,950
Common Stock		10,000
Total Owner's Equity		21,950
Total Liabilities and Owner's Equity		171,900

Accounts and the Chart of Accounts

Accounts

- Businesspeople need to be able to retrieve transaction data quickly and in usable form.
- A filing system consisting of accounts is used to sort out or classify all the transactions that occur in a business.
- Accounts are the basic storage unit for accounting data and are used to accumulate amounts from similar transactions.

- An accounting system has a separate account for each asset, liability, and each component of stockholders' equity, including revenues and expenses.

- A small organization may have only a few dozen accounts; a multinational corporation may require thousands of accounts.

- The group of company accounts is known as the *general ledger* or simply *ledger*.

- The general ledger may be manual or computer-based.

The Chart of Accounts

- Accounts are numbered to make them easy to find.
- The list of all account numbers and names is known as the *chart of accounts*.
- Accounts are numbered for processing and reference purposes.

Equity Accounts

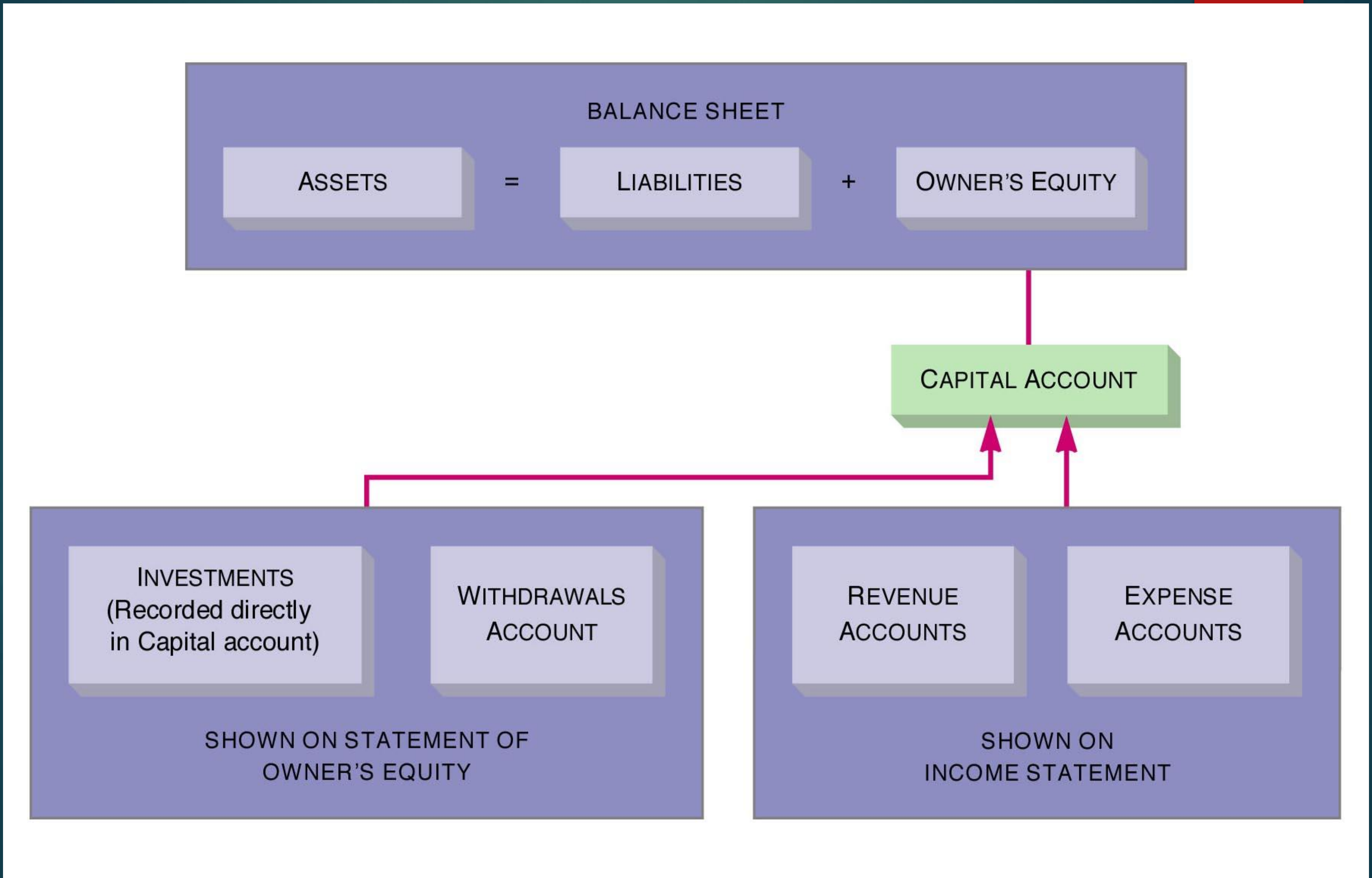
- Revenue and expense accounts are separated from other owner’s equity accounts.

- The law requires that capital investments and withdrawals be separated from revenues and expenses for income tax reporting, financial reporting, and other purposes.

- Management needs a detailed breakdown of revenues and expenses for budgeting and operating purposes.

- Accounting gives management information about whether it has achieved its primary goal of earning a net income.

Relationships of Owner's Equity Accounts



Account Titles

- The title should describe what is recorded in the account.

- If an account title is not recognizable, examine the context of the name.
  - Determine if it is an asset, liability, stockholders' equity, revenue, or expense.
  - Look for the kind of transaction that gave rise to the account.

The Double-Entry System: The Basic Method of Accounting

Features of the Double-Entry System

- Principle of duality.

- Each transaction must be recorded with at least one debit and one credit so that monetary value of debits and credits are equal.

- The whole system is always in balance.

- All accounting systems are based on the principle of duality.

The T Account

Title of Account

Debit	**Credit**
left side	**right side**

The T Account Illustrated

Cash

(1)	**50,000**	**(2)**	**35,000**
(5)	**1,500**	**(4)**	**200**
(7)	**1,000**	**(8)**	**1,000**
		(9)	**400**
		(11)	**600**
	52,500		**37,200**
Bal.	**15,300**		

- *Footings*, the total of each side are computed.
- The difference between the debit side and the credit side is the account *balance*, either debit or credit.

Analyzing and Processing Transactions

- **Every transaction affects at least two accounts.**
- **Total debits must equal total credits.**
- **Assets = Liabilities + Owner’s Equity.**

Assets		=	Liabilities		+	OE	
Debit for increases (+)	Credit for decreases (-)		Debit for decreases (-)	Credit for increases (+)		Debit for decreases (-)	Credit for increases (+)

Application of Debit/Credit Rules to OE

- **Assets = Liabilities**
  - **+ Capital, investments**
  - **- Capital, withdrawals**
  - **+ Revenues**
  - **- Expenses**

- Debit is commonly abbreviated Dr.
- Credit is commonly abbreviated Cr.

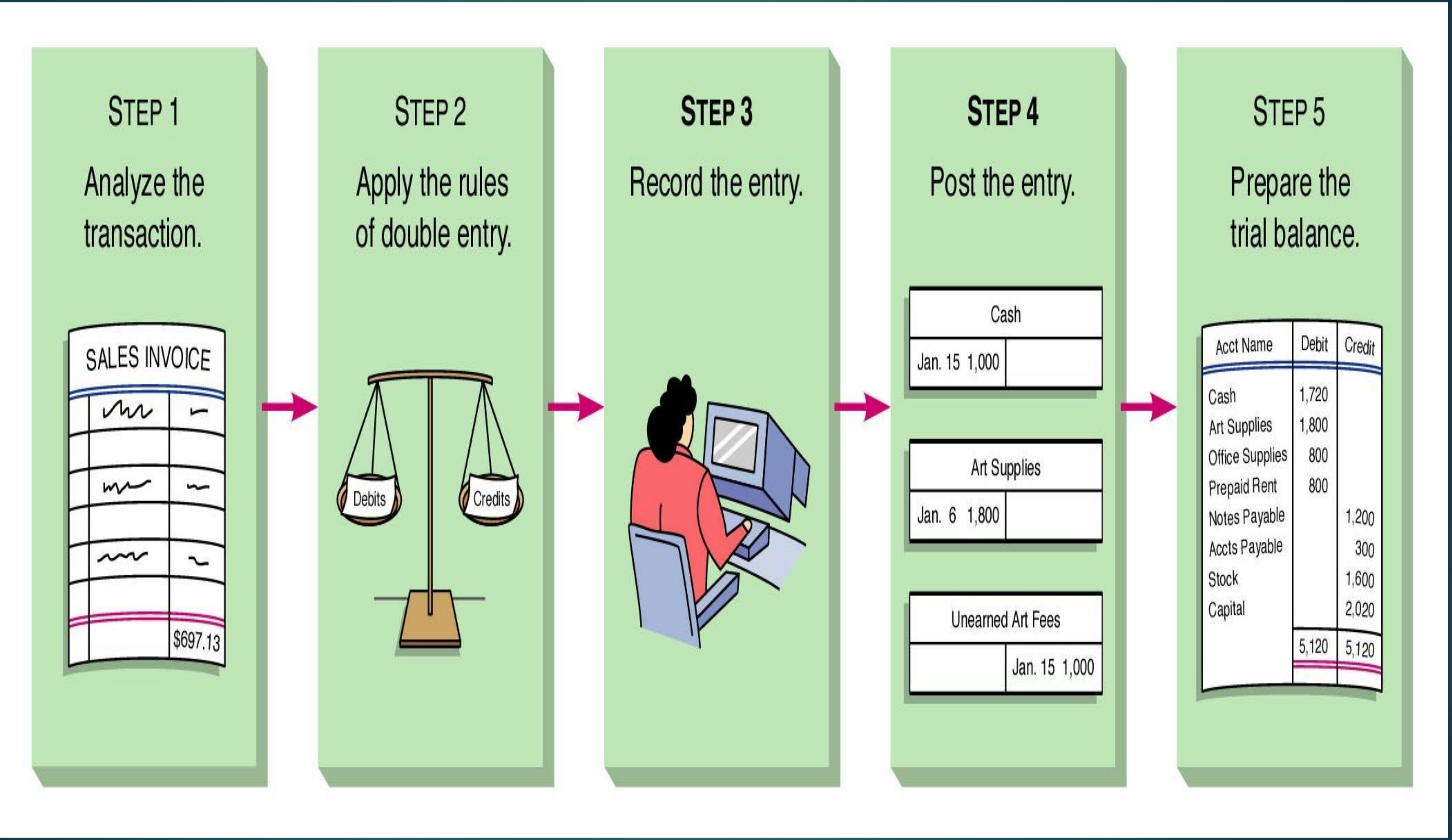
Arrangement of the Accounting Equation

- The accounting equation can be rearranged to shift withdrawals and expenses to the left side.

Assets + Withdrawals + Expenses=

Liabilities + Capital + Revenues

Analyzing and Processing Transactions



Steps in Analyzing and Processing Transactions

1. Analyze the transaction to determine its effect on assets, liabilities, and OE.
   - ✓ Supported by a source document.
2. Apply the rules of double entry.
   - ✓ Dr. increases an asset.
   - ✓ Cr. increases a liability.
   - ✓ Etc.

Steps in Analyzing and Processing Transactions (continued)

3. Record the entry.
   - Enter in chronological order in a journal.
   - Enter the date/debit account/debit amount on one line.
   - Enter the credit account/credit amount indented on the next line.

		Dr.	Cr.
June 1	Cash	**100,000**	
	Notes Payable		**100,000**

- This form is called *journal form* and is followed by an explanation.

Steps in Analyzing and Processing Transactions (continued)

4. Post the entry.
   - Post the entry to the general ledger by transferring the date and amount to the proper account.
5. Prepare the trial balance to confirm the balance of the accounts.
   - Confirm that the accounts are still in balance after recording and posting transactions.

Transaction Analysis Illustrated

Joan Miller begins business.

		Dr.	Cr.
Jan. 1	Cash	10,000	
	Joan Miller, Capital		10,000

Cash

Jan. 1 10,000	

Joan Miller, Capital

	Jan. 1 10,000

- Transaction
- Analysis
- Rules
- Entry

Rents an office, pays $800 rent in advance.

	Dr.	Cr.
Jan. 2 Prepaid Rent	800	
Cash		800

Cash

Jan. 1	10,000	Jan 2.	800

Prepaid Rent

Jan. 2	800		

- Transaction
- Analysis
- Rules
- Entry

Purchases art equipment, $4,200, with cash.

		Dr.	Cr.
Jan. 4	Art Equipment	4,200	
	Cash		4,200

Cash

Jan. 1	10,000	Jan. 2	800
		4	4,200

Art Equipment

Jan. 4	4,200		

- Transaction
- Analysis
- Rules
- Entry

Purchases office equipment, $3,000, pays $1,500 in cash and agrees to pay the rest next month.

		Dr.	Cr.
Jan. 5	Office Equipment	3,000	
	Cash		1,500
	Accounts Payable		1,500

Cash

Jan. 1	10,000	Jan. 2	800
		4	4,200
		5	1,500

Office Equipment

Jan. 5	3,000		

Accounts Payable

		Jan. 5	1,500

- Transaction
- Analysis
- Rules
- Entry

Purchases art supplies, $1,800, and office supplies, $800, on credit.

		Dr.	Cr.
Jan. 6	Art Supplies	1,800	
	Office Supplies	800	
	Accounts Payable		2,600

Art Supplies

Jan. 6	1,800		

Office Supplies

Jan. 6	800		

Accounts Payable

		Jan. 5	1,500
		6	2,600

- Transaction
- Analysis
- Rules
- Entry

Pays for a one-year insurance policy with cash.

		Dr.	Cr.
Jan. 8	Prepaid Insurance	480	
	Cash		480

Cash

Jan. 1	10,000	Jan. 2	800
		4	4,200
		5	1,500
		8	480

Prepaid Insurance

Jan. 8	480		

- Transaction
- Analysis
- Rules
- Entry

Pays $1,000 of amount owed to Taylor Supply Co.

		Dr.	Cr.
Jan. 9	Accounts Payable	1,000	
	Cash		1,000

Cash

Jan. 1	10,000	Jan. 2	800
		4	4,200
		5	1,500
		8	480
		9	1,000

Accounts Payable

Jan. 9	1,000	Jan. 5	1,500
		6	2,600

- Transaction
- Analysis
- Rules
- Entry

Collects a fee of $1,400 for placing advertisements.

		Dr.	Cr.
Jan. 10	Cash	1,400	
	Advertising Fees Earned		1,400

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
		5	1,500
		8	480
		9	1,000

Advertising Fees Earned

		Jan. 10	1,400

- Transaction
- Analysis
- Rules
- Entry

Pays the secretary two weeks' wages, $600.

		Dr.	Cr.
Jan. 12	Wages Expense	600	
	Cash		600

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
		5	1,500
		8	480
		9	1,000
		12	600

Wages Expense

Jan. 12	600		

- Transaction
- Analysis
- Rules
- Entry

Accepts $1,000 for art work to be done for another agency.

		Dr.	Cr.
Jan. 15	Cash	1,000	
	Unearned Art Fees		1,000

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
15	1,000	5	1,500
		8	480
		9	1,000
		12	600

Unearned Art Fees

		Jan. 15	1,000

- Transaction
- Analysis
- Rules
- Entry

Performs a service for $2,800. Fee to be collected next month.

		Dr.	Cr.
Jan. 19	Accounts Receivable	2,800	
	Advertising Fees Earned		2,800

Accounts Receivable

Jan. 19	2,800		

Advertising Fees Earned

		Jan. 10	1,400
		19	2,800

- Transaction
- Analysis
- Rules
- Entry

Pays the secretary two more weeks' wages, $600.

		Dr.	Cr.
Jan. 26	Wages Expense	600	
	Cash		600

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
15	1,000	5	1,500
		8	480
		9	1,000
		12	600
		26	600

- Transaction
- Analysis
- Rules
- Entry

Wages Expense

Jan. 12	600		
26	600		

Receives and pays the utility bill, $100.

		Dr.	Cr.
Jan. 29	Utilities Expense	100	
	Cash		100

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
15	1,000	5	1,500
		8	480
		9	1,000
		12	600
		26	600
		29	100

Utilities Expense

Jan. 29	100		

- Transaction
- Analysis
- Rules
- Entry

Receives (but does not pay) telephone bill, $70.

		Dr.	Cr.
Jan. 30	Telephone Expense	70	
	Accounts Payable		70

Telephone Expense

Jan. 30	70		

Accounts Payable

Jan. 9	1,000	Jan. 5	1,500
		6	2,600
		30	70

- Transaction
- Analysis
- Rules
- Entry

Withdraws $1,400 for personal expenses.

		Dr.	Cr.
Jan. 31	Withdrawals/Dividends	1,400	
	Cash		1,400

Cash

Jan. 1	10,000	Jan. 2	800
10	1,400	4	4,200
15	1,000	5	1,500
		8	480
		9	1,000
		12	600
		26	600
		29	100
		31	1,400

J.M., Withdrawals

Jan. 31	1,400		

- **Transaction**
- **Analysis**
- **Rules**
- **Entry**

Discussion

Q. Why is the expense and the liability for the telephone bill recognized at this point?

A. An expense has been incurred because telephone services have been used. The obligation to pay exists.

The Trial Balance

The Trial Balance

- The total of debits and credits in the accounts must be equal.
- A trial balance is prepared periodically (usually on the last day of the month) to test this equality.
- Steps in preparing a trial balance:
  1. List each ledger account that has a balance, debit balances in the left column, credit balances in the right column.
  2. Add (foot) each column.
  3. Compare the totals of the two columns.

- An account may have a balance other than its normal balance.
  - An asset account may have a credit balance.
  - A liability account may have a debit balance.
- The trial balance proves whether or not the total of all debits recorded equals the total of all credits recorded.
- It does not prove that the transactions were analyzed correctly or recorded for the correct amounts or in the proper accounts.
- It cannot identify transactions that were completely omitted.

If the Trial Balance does not Balance?

Possible Reasons

1. A DEBIT WAS ENTERED AS A CREDIT, OR VICE VERSA.
2. THE BALANCE OF AN ACCOUNT WAS COMPUTED INCORRECTLY.
3. AN ERROR WAS MADE IN CARRYING THE ACCOUNT BALANCE TO THE TRIAL BALANCE.
4. THE TRIAL BALANCE WAS ADDED/FOOTED INCORRECTLY.

Recording and Posting Transactions

- TRANSACTIONS ARE RECORDED IN THE GENERAL JOURNAL AND POSTED TO THE GENERAL LEDGER.

Procedure for Recording a Journal Entry

1. Record the date
   - For subsequent entries, only show date changes.
2. Write the accounts to be debited and credited, followed by an explanation.
   - Use exact account names.
   - Start debit accounts on the left.
   - Indent credit accounts.
   - Explanation should be brief, but sufficient.

Note: a transaction can have more than one debit or credit entry (a compound entry).

Procedure for Recording a Journal Entry (continued)

3. Write the debit amounts in the debit column and the credit amounts in the credit column.
4. Nothing in the Post. Ref. Column (until you post to the general ledger).
5. Skip a line after each entry.

The General Journal

- Also called “the book of original entry.”
- Journal entries are made in chronological order.
- A separate journal entry is made for each transaction (journalizing).
- Later, the debit and credit portions of the entry are transferred to the general ledger.

Posting to the Ledger

- Posting – transferring information from the journal to the ledger.

- Performed on a daily basis, or less frequently if there are few transactions.
  1. Locate the debit account named in journal transaction.
  2. Enter date, and PR to show Journal page.
  3. Enter debit amount in Debit column.
  4. Calculate and enter balance.
  5. Enter the account number in PR column of Journal.
  6. Repeat 1-5 for credit side of journal entry.7

ABC Hospitality Services		
Trial Balance		
Dec. 31, 2009		
	Debit	**Credit**
Cash	27050	
Accounts receivable	650	
Prepaid insurance	265	
Office supplies	950	
Office equipment	4000	
Accumulated depreciation, office equipment		200
Copier	3000	
Accumulated depreciation, copier		300
Accounts payable		955
Unearned revenue		2890
ABC, capital		50000
ABC, withdrawals	11250	
Revenue		16380
Salaries expense	18500	
Advertising expense	2360	
Rent expense	2700	
TOTAL	**70725**	**70725**

The Adjustment Process

The Adjustment Process

- Adjusting entries are used to apply accrual accounting to transactions that span more than one accounting period.

- Adjusting entries involve at least one balance sheet account and at least one income statement account.

- Adjusting entries never involve the Cash account.

Four Types of Adjusting Entries

1. Costs have been recorded that must be allocated between two or more accounting periods.
2. Expenses have been incurred but are not yet recorded.
3. Unearned Revenues have been recorded that must be allocated between two or more accounting periods.
4. Revenues have been earned but not yet recorded.

Deferrals

A *deferral* is the postponement of:

- The recognition of an expense already paid (Type 1 adjustment), or
- A revenue received in advance (Type 3 adjustment).

Accruals

An *accrual* is the recognition of:

- A revenue (Type 4 adjustment) or

- An expense (Type 2 adjustment)

that has arisen but has not yet been recorded.

Discussion

Q. What do plant and equipment, office supplies, and prepaid insurance have in common?

A. They are all assets that must be allocated to expenses over time; this means they all require adjusting entries at the end of the accounting period.

Allocating Recorded Costs Between Two or More Accounting Periods

Prepare typical adjusting entries.

Type 1: Allocating Deferred Expenses
Prepaid Expenses: Rent Expense

		Dr.	Cr.
Jan. 31	Rent Expense	400	
	Prepaid Rent		400

Prepaid Rent

Jan. 2	800	Jan. 31	400

Rent Expense

Jan. 31	400		

Type 1: Allocating Deferred Expenses Prepaid Expenses: Insurance Expense

		Dr.	Cr.
Jan. 31	Insurance Expense	40	
	Prepaid Insurance		40

Prepaid Insurance

Jan. 8	480	Jan. 31	40

Insurance Expense

Jan. 31	40		

Type 1: Allocating Deferred Expenses Prepaid Expenses: Art Supplies Expense

		Dr.	Cr.
Jan. 31	Art Supplies Expense	500	
	Art Supplies		500

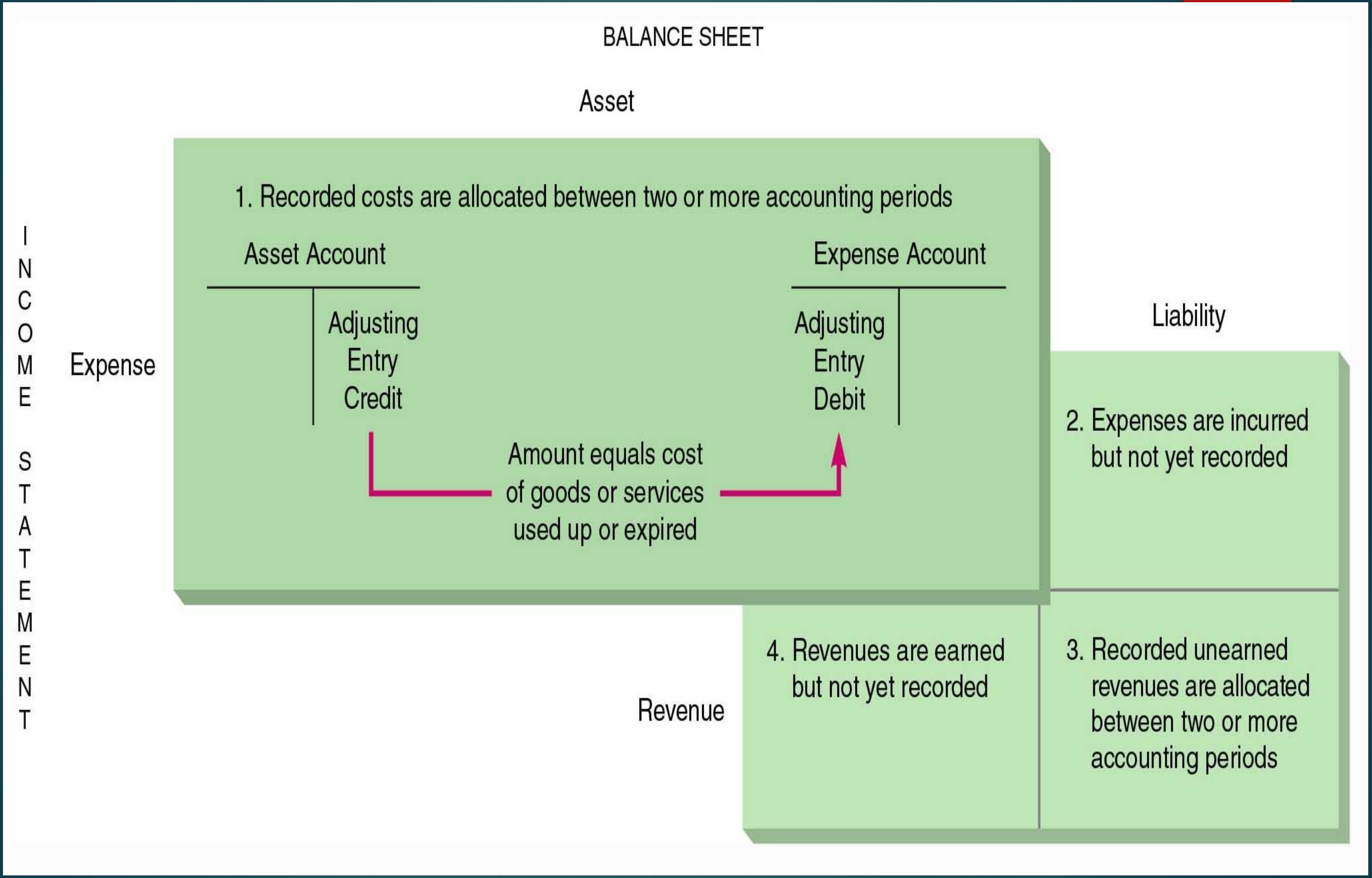
Art Supplies

Jan. 6	1,800	Jan. 31	500

Art Supplies Expense

Jan. 31	500		

Adjustment for Prepaid (Deferred) Expenses



Type 1: Allocating Deferred Expenses Prepaid Expenses: Office Supplies

		Dr.	Cr.
Jan. 31	Office Supplies Expense	200	
	Office Supplies		200

Office Supplies

Jan. 6	800	Jan. 31	200

Office Supplies Expense

Jan. 31	200		

Type 1: Allocating Deferred Expenses Depreciation of PP&E: Art and Office Equipment

Date	Account	Dr.	Cr.
Jan. 31	Depreciation Expense, PC Eqpt.	70	
	Accumulated Depreciation, PC Eqpt.		70
Jan. 31	Depreciation Expense, Office Eqpt.	50	
	Accumulated Depreciation, Office Eqpt.		50

Accumulated Depreciation, PC Equipment

	Jan. 31 70

Accumulated Depreciation, Office Equipment

	Jan. 31 50

Depreciation Expense, PC Equipment

Jan. 31 70	

Depreciation Expense, Office Equipment

Jan. 31 50	

Type 1: Allocating Deferred Expenses Depreciation of PP&E: Office Equipment

		Dr.	Cr.
Jan. 31	Depreciation Expense, Office Equipment	50	
	Accumulated Depreciation, Office Equipment		50

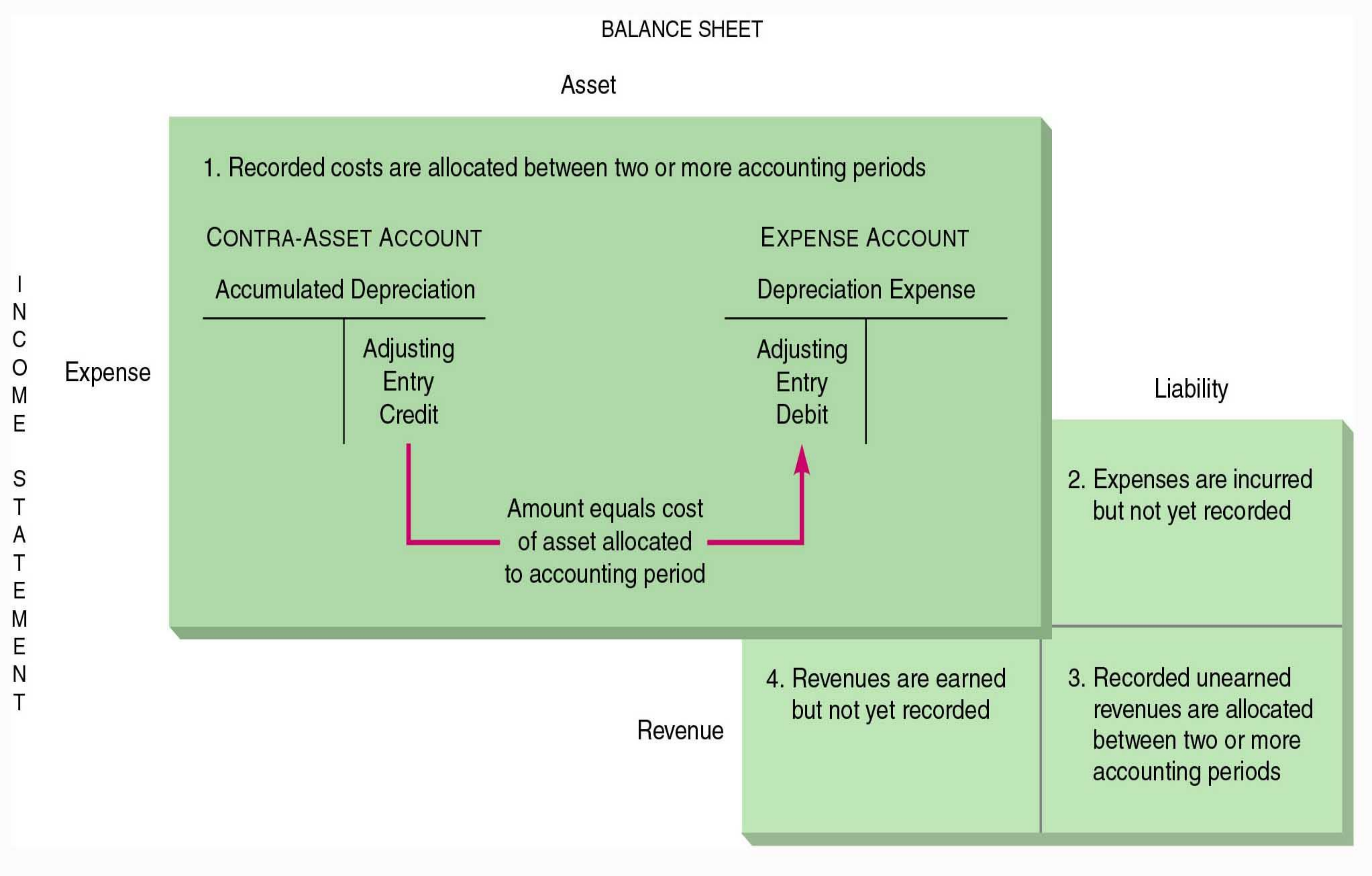
Accumulated Deprn, Office Equipment

		Jan. 31	50

Depreciation Expense, Office Equipment

Jan. 31	50		

Adjustment for Depreciation



Accumulated Depreciation – A Contra Account

- Contra Accounts: A separate account paired with a related account.

- The Contra Account balance is deducted from the related account. The result is known as the *Book Value* or *Carrying Value*.

Accumulated Depreciation – A Contra Account

- Accumulated depreciation is a contra account used to
  - Recognize that depreciation is an estimate.
  - Show the original cost of the asset, how much of that cost has been allocated as expense, the balance left to be depreciated.

Type 2: Recognizing Unrecorded Expenses
Accrued Expenses: Accrued Wages

		Dr.	Cr.
Jan. 31	Wages Expense	180	
	Wages Payable (Accrued)		180

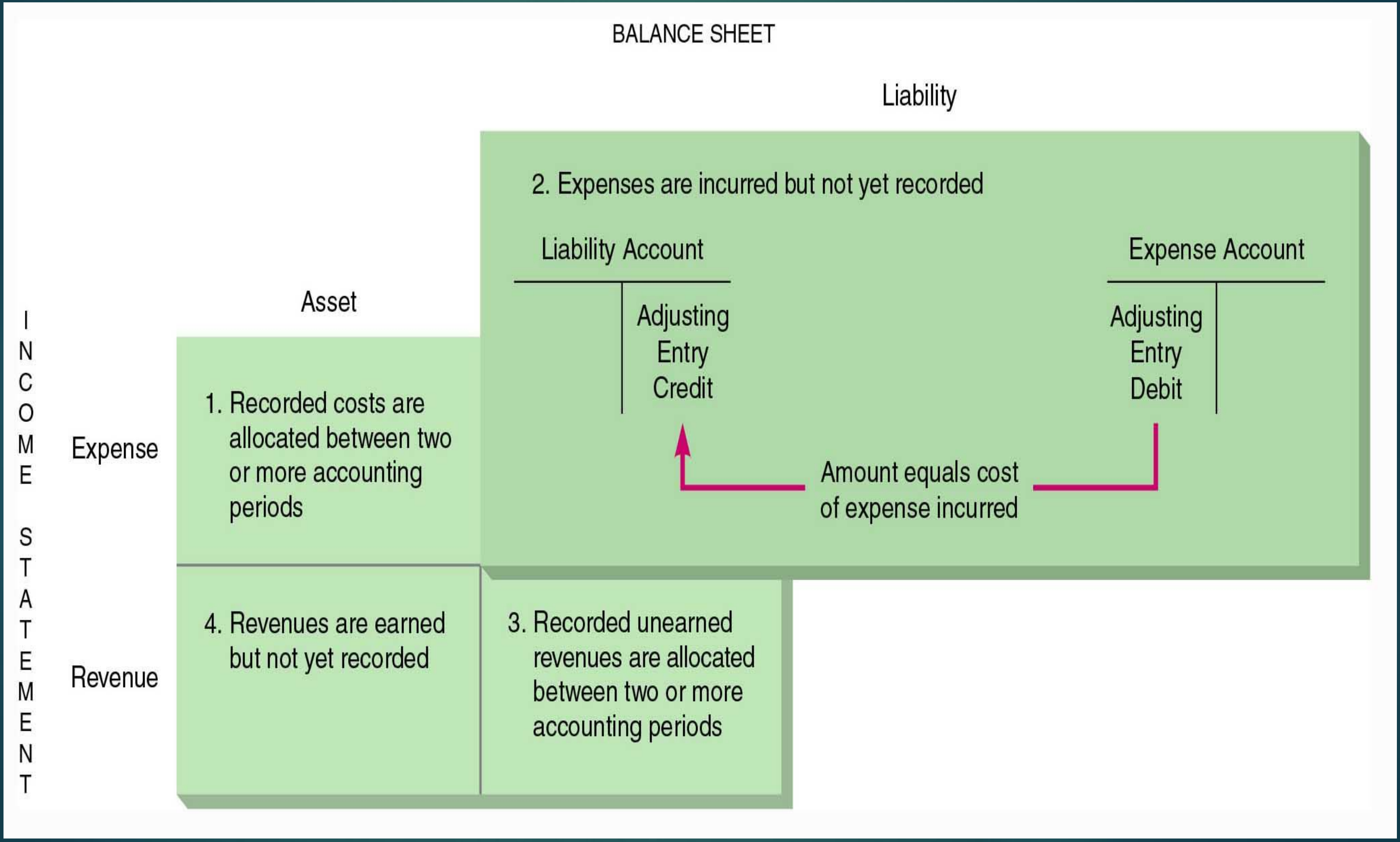
Wages Payable/Accrued

	Jan. 31 180

Wages Expense

Jan. 12 600	
Jan. 26 600	
Jan. 31 180	

Adjustment for Unrecorded (Accrued) Expenses



Type 3: Allocating Deferred Revenues Deferred Revenues: Unearned Revenue

	Dr.	Cr.
Jan. 31 Unearned Revenue	400	
Revenue		400

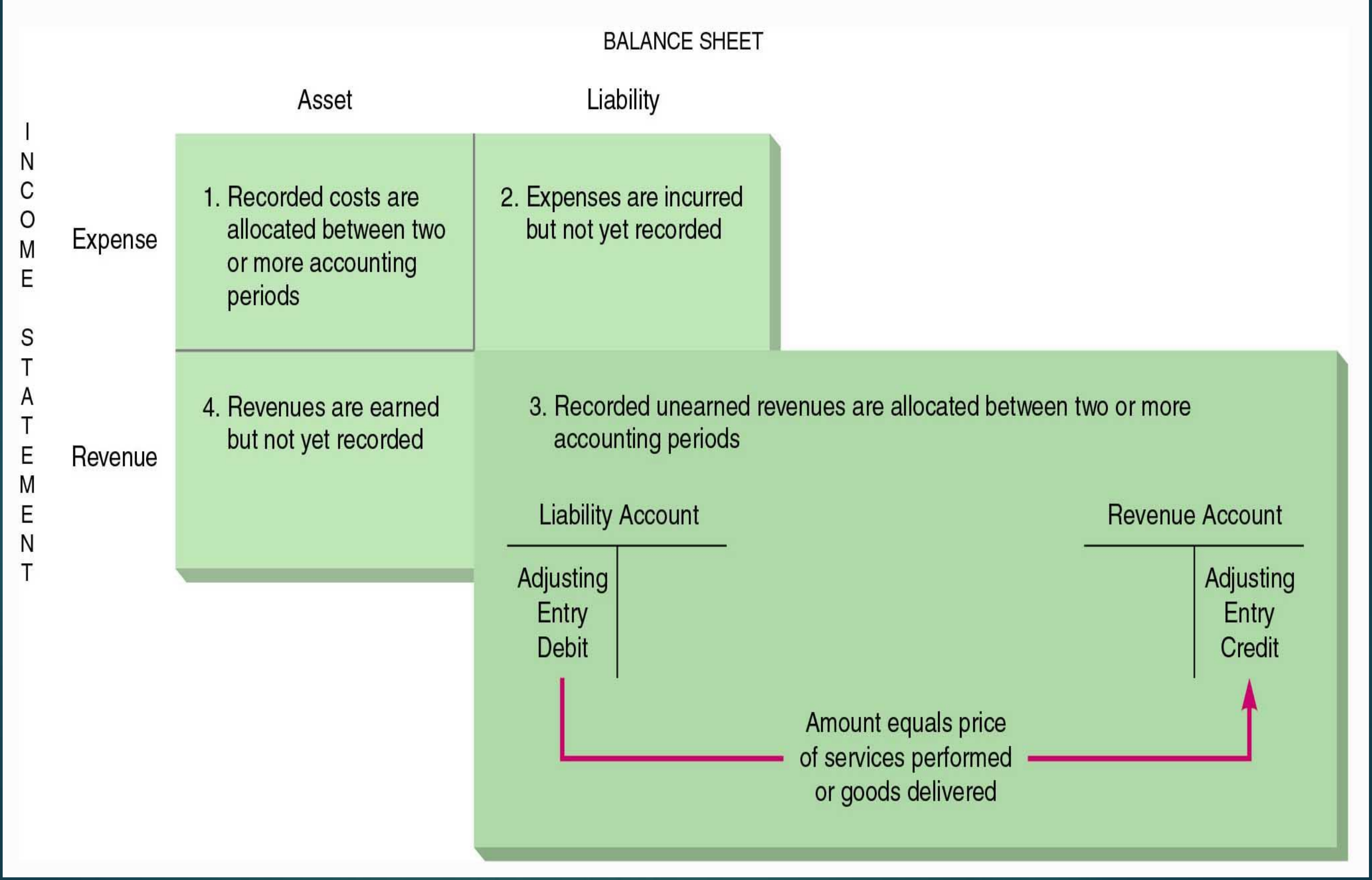
Unearned Revenue

Jan. 31	400	Jan. 15	1,000

Revenue

		Jan. 31	400

Adjustment for Unearned (Deferred) Revenues



Type 4: Recognizing Unrecorded Revenues
Accrued Revenues

		Dr.	Cr.
Jan. 31	Accounts Receivable	200	
	Revenues		200

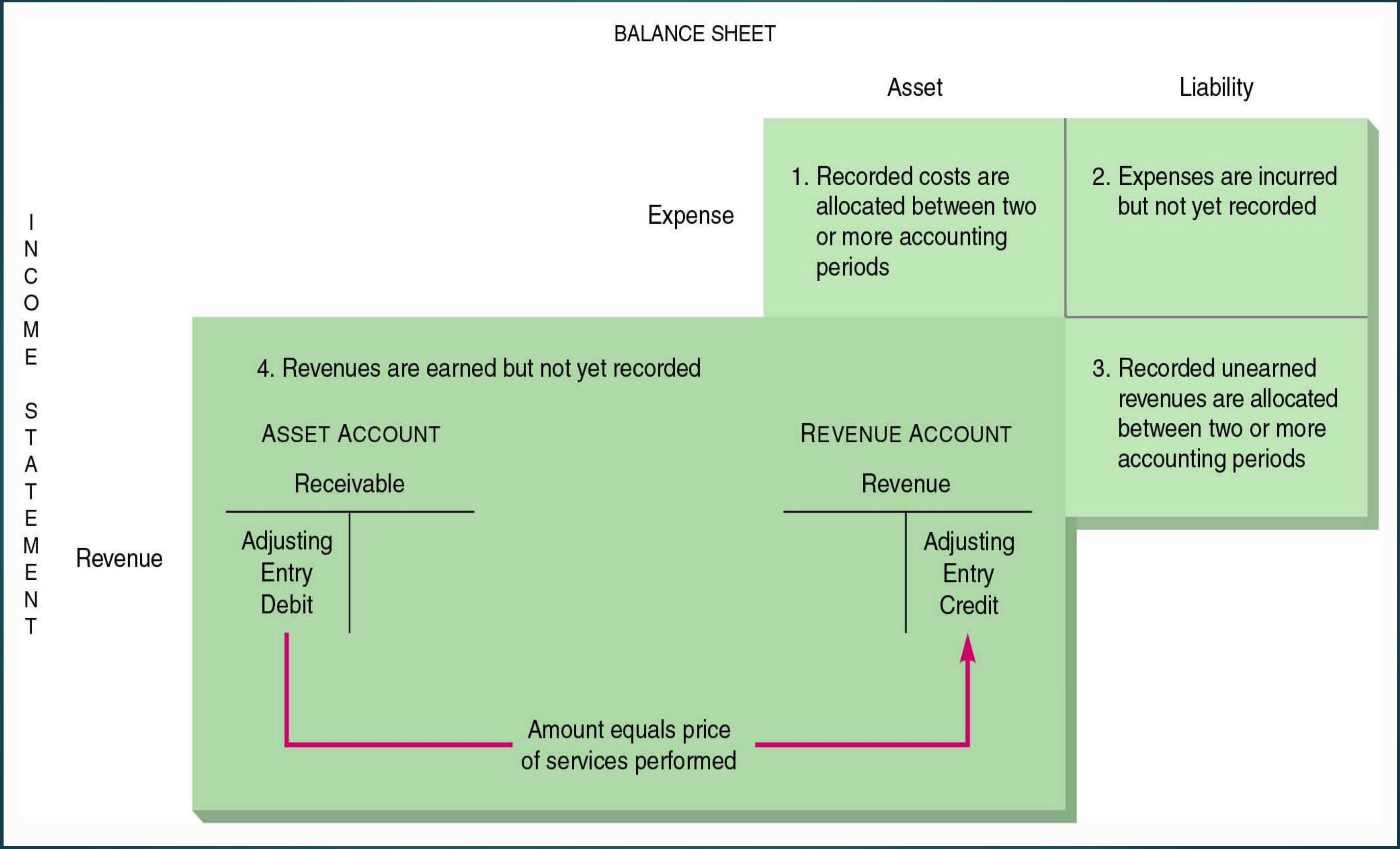
Accounts Receivable

Jan. 31	200		

Revenues

		Jan. 12	600
		Jan. 26	600
		Jan. 31	200

Adjustment for Unrecorded (Accrued) Revenues



ABC Hospitality Services Adjusted Trial Balance Dec. 31, 2009		
	Debit	Credit
Cash	27050	
Accounts receivable	650	
Prepaid insurance	115	
Office supplies	250	
Office equipment	4000	
Accumulated depreciation, office equipment		400
Copier	3000	
Accumulated depreciation, copier		450
Accounts payable		1205
Unearned revenue		1140
ABC, capital		50000
ABC, withdrawals	11250	
Revenue		18130
Salaries expense	18500	
Advertising expense	2360	
Rent expense	2700	
Telephone expense	250	
Office supplies expense	700	
Insurance expense	150	
Depreciation expense-office equipment	200	
Depreciation expense-copier	150	
TOTAL	**71325**	**71325**

Discussion

Q. Where does unearned revenue appear on the balance sheet?

A. Unearned revenue appears as a liability on the balance sheet.

STATEMENT OF CASH FLOWS (SCF)

STATEMENT OF CASH FLOWS (SCF)

The B/S & the P&L statements cannot answer cash related questions regarding cash inflows & outflows.

Purpose of the SCF:

- Report & identify the effects of cash receipts & disbursements regarding three areas of business activities:

-Operations

-Investing

-Financing

STATEMENT OF CASH FLOWS (SCF)

It's a foundation to predict future cash flows essential for the development of the operating budgets related to:

- Purchase of capital needs
- Repayment of short-term debt
- Repayment of other short-term assets

STATEMENT OF CASH FLOWS (SCF)

- SCF can also serve as a basis for the evaluation of a firm's cash management
- Methods of determining cash flows
  - <u>Direct</u>
  - <u>Indirect</u> (The easiest & most commonly used in hospitality operations)
- The SCF begins with the reported actual Net Income or Loss that will be converted from an accrual to a cash basis
  - By evaluating all B/S accounts

STATEMENT OF CASH FLOWS (SCF)

SEGMENTATION OF CASH FLOWS ANALYSIS

1. <u>Operating Activities</u>

- Includes changes in: depreciation & amortisation, all current assets (excluding only marketable securities-short-term investments), and all current liabilities

<u>Produce revenue</u>

- e.g. exchange of goods & services create sales revenue inflows for cash or on credit
- e.g. credit card & accounts receivable create revenue inflows on credit
- e.g. inventory for resale & prepaid expenses are created & consumed to support revenue generating activities

STATEMENT OF CASH FLOWS (SCF)

Operating Activities (cont.)

The generation of sales revenues creates expense outflows

- e.g. Accounts payable when paid reflect expense outflows
- e.g. payments current liabilities (inventory, employee costs, insurance costs, interest, taxes, etc.) reflect cash outflows

STATEMENT OF CASH FLOWS (SCF)

2. **Investing Activities**

- Includes changes in: all fixed assets, marketable securities (S-T investments), other assets
- e.g. sale of a long-term asset creates cash inflows
- e.g. purchase of a long-term asset creates cash outflows

STATEMENT OF CASH FLOWS (SCF)

3. <u>Financing Activities</u>

- Includes changes in L-T liabilities, equity capital and dividends paid that year
- e.g. in a partnership or proprietorship investment or withdrawal of equity capital & operating returns of income affect financing activities
- e.g. in a corporation financing activities are affected by the issuance of capital stock (cash inflow)
- e.g. the assumption of long-term debt creates cash inflow & repayment of it cash outflow

STATEMENT OF CASH FLOWS (SCF)

NEEDED STATEMENTS FOR THE SCF

- P&L for the current period
- B/S for the current period
- Statement of Retained Earnings for the current period
- Prior period’s B/S & Statement of Retained Earnings

Account	*Action*
Current Asset increase	**Increase is deducted from Net Income**
Current Asset decrease	**Decrease is added to Net Income**
Current liability increase	**Increase is added to Net Income**
Current liability decrease	**Decrease is deducted from Net Income**
Long-term liability increase	**Increase is added to Net Income**
Long-term liability decrease	**Decrease is deducted from Net Income**
Depreciation (non-cash item)	**Increase is added to Net Income**
Amortisation (non-cash item)	**Increase is added to Net Income**
Fixed & other assets increase	**Increase is deducted from Net Income**
Fixed & other assets decrease	**Decrease is added to Net Income**
Capital increase	**Increase is added to Net Income**
Capital decrease	**Decrease is deducted from Net Income**
Long-term asset disposal (gain) (non-cash item)	**Gain is deducted from Net Income**
Long-term asset disposal (loss) (non-cash item)	**Loss is added to Net Income**
Dividends paid	**Is deducted from Net Income**

STATEMENT OF CASH FLOWS 2010		
Net Income from Operations(accrual basis)		94600
adjustments to reconcile Net Income to net cash flow from operating activities		
Depreciation expense	54900	
credit card receivables(increased)	-340	
accounts receivables(increased)	-400	
inventory(decreased)	520	
prepaid expenses(decreased)	150	
accounts payable(decreased)	-2350	
accrued payroll payable(decreased)	-600	
taxes payable(decreased)	-900	
current mortgage payable(decreased)	-1000	
Net cash flow adjustment		49980
Net cash flow from operating activities		144580
Cash flow adjustments, investing activities		
Building(increased)	-120990	
Equipment(increased)	-131350	
Long-term investment(decreased)	140000	
Net cash flow from investing activities		-112340
Cash flow adjustments, financing activities		
Reduction of long-term mortgage	-11900	
Cash dividends paid	-50000	
Capital stock (increase)	30000	
Net cash flow from financing activities		-31900
Net increase in cash from 2009 to 2010		340
Cash balance, Jan. 1, 2010		5670
Cash balance, Dec. 31, 2010		6010

Ratio Analysis

Ratio Analysis

- Ratios are guides or shortcuts that are useful in:
  - Evaluating a company's financial position and operations.
  - Making comparisons with results in previous years or with other companies.
- The primary purpose of ratios is to point out areas needing further investigation.

Evaluating Liquidity

- Liquidity is a company's ability to pay bills when they are due and to meet unexpected needs for cash.
- All ratios that relate to liquidity involve working capital or some part of it.
  - Current ratio: measures short-term debt-paying ability.
  - Quick ratio: measures short-term debt-paying ability.
  - Receivable turnover: measures relative size of receivables and effectiveness of credit policies.
  - Average days' sales uncollected: measures average days to collect receivables.
  - Inventory turnover: measures relative size of inventory.
  - Average days' inventory on hand: measures average days to sell inventory.
  - Average days' payable: measures average days to pay payables.

Liquidity Ratios

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Cash + Marketable Securities + Receivables}}{\text{Current Liabilities}}$$

$$\text{Receivable Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Liquidity

Average Day's Inventory on hand = $\dfrac{\text{Days in Year}}{\text{Inventory Turnover}}$

Payable Turnover =

$\dfrac{\text{Cost of Goods Sold +/- Change in Inventory}}{\text{Average Accounts Payable}}$

Average Day's Payable = $\dfrac{\text{Days in Year}}{\text{Payables Turnover}}$

Evaluating Profitability

- Profitability reflects a company's ability to earn a satisfactory income.
- A company's profitability is closely linked to its liquidity because earnings ultimately produce cash flow.
- Profitability ratios include:
  - Profit margin: measures net income produced by each sales dollar.
  - Asset turnover: measures how efficiently assets produce sales.
  - Return on assets: measures overall earning power.
  - Return on equity: measures profitability of stockholder investments.

Profitability

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

$$\text{Asset Turnover} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$$

Evaluating Long-Term Solvency

- Long-term solvency has to do with a company's ability to survive for many years. The aim of long-term solvency analysis is to detect early signs that a company is headed for financial difficulty.
- Early signs that a company is on the road to bankruptcy include:
  - Declining profitability and liquidity ratios.
  - Unfavorable debt to equity ratio.
  - Unfavorable interest coverage ratio.

Long-Term Solvency

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Stockholders' Equity}}$$

- Measures capital structure and leverage.
- Failure to honor debt can result in bankruptcy, so debt is risky.
- BUT debt provides flexible financing:
  - It can be temporary.
  - Interest is tax deductible.
  - It leverages stockholders' investments if the company earns a return on assets greater than the cost of interest.

Long-Term Solvency
(continued…)

Interest Coverage Ratio =

$$\frac{\text{Income Before Income Taxes + Interest Expense}}{\text{Interest Expense}}$$

- Measures creditors' protection from default on interest payments.

Evaluating Cash Flow Adequacy

- Because cash flows are needed to pay debts when they are due, cash flow measures are closely related to the objectives of liquidity and long-term solvency.
- Net cash flows from operating activities.
  - Cash flow yield: measures overall operating liability to generate cash flows in relation to net income.
  - Cash flows to sales: measures ability of sales to generate cash.
  - Cash flows to assets: measures ability of assets to generate cash.
  - Free cash flow: measures cash generated after providing for commitments.

Cash Flow Adequacy

Cash Flow Yield =

$$\frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Income}}$$

Cash Flows to Sales =

$$\frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Sales}}$$

Cash Flows to Assets =

$$\frac{\text{Net Cash Flows from Operating Activities}}{\text{Average Total Assets}}$$

Free Cash Flow = N.C.F. from O.A. – Dividends – Net Capital Expenditures