



MSc in

**Financial
Management**

ATHENS UNIVERSITY OF
ECONOMICS & BUSINESS

Introduction to Accounting

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Dept. of Accounting and Finance

Learning Objectives



Upon completion of this course, students will be able:

1. To prepare Financial Statements.
2. To recognize and record accounting events.
3. To prepare trial balances and general ledger accounts.

Accounting

- An information system that **measures**, **processes**, and **communicates** financial information about a business or other economic entity.

**Measures
business
activities**



**Processes
data into
reports**



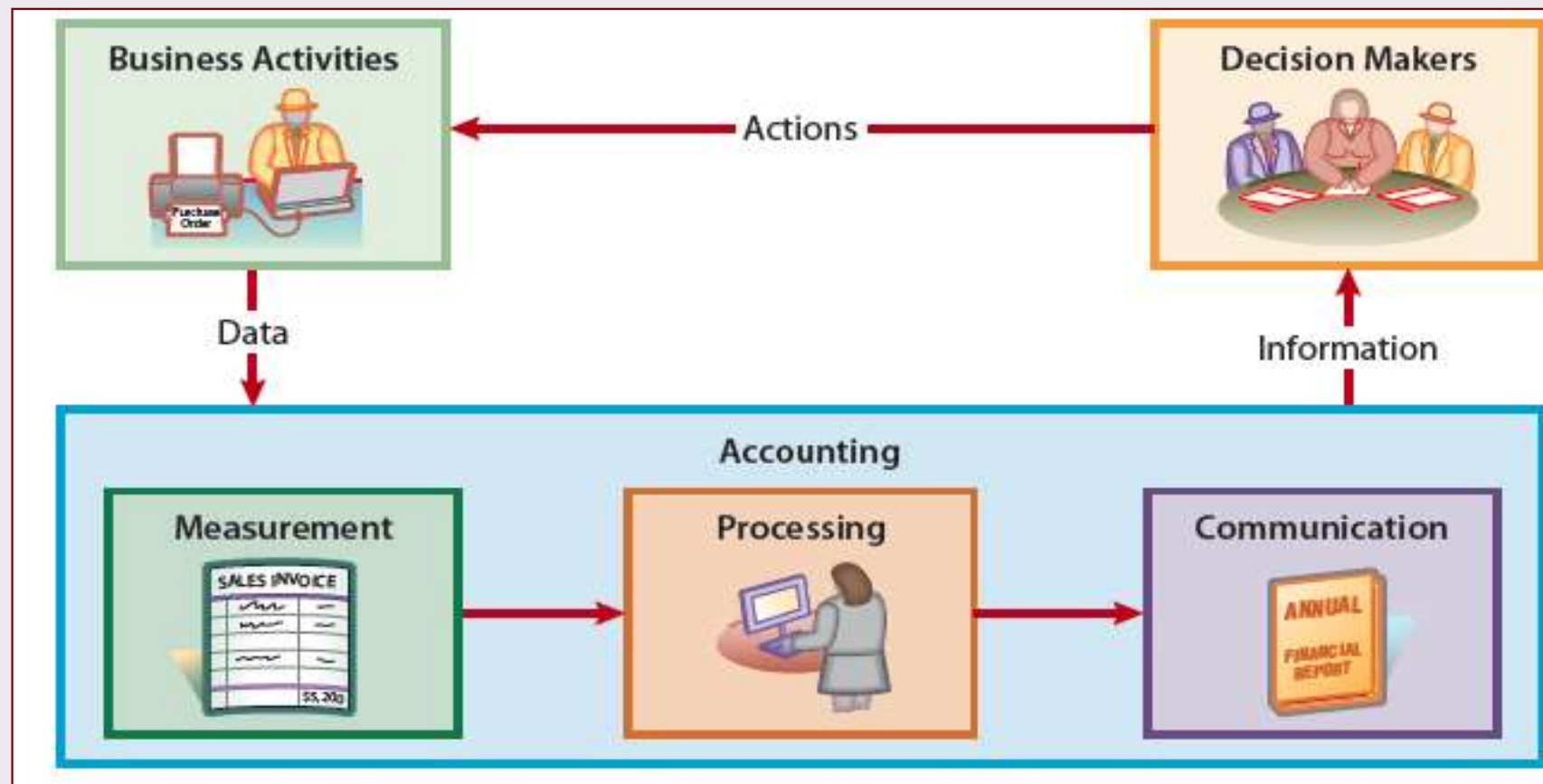
**Communicates
results**

“The basis for
business
decisions”

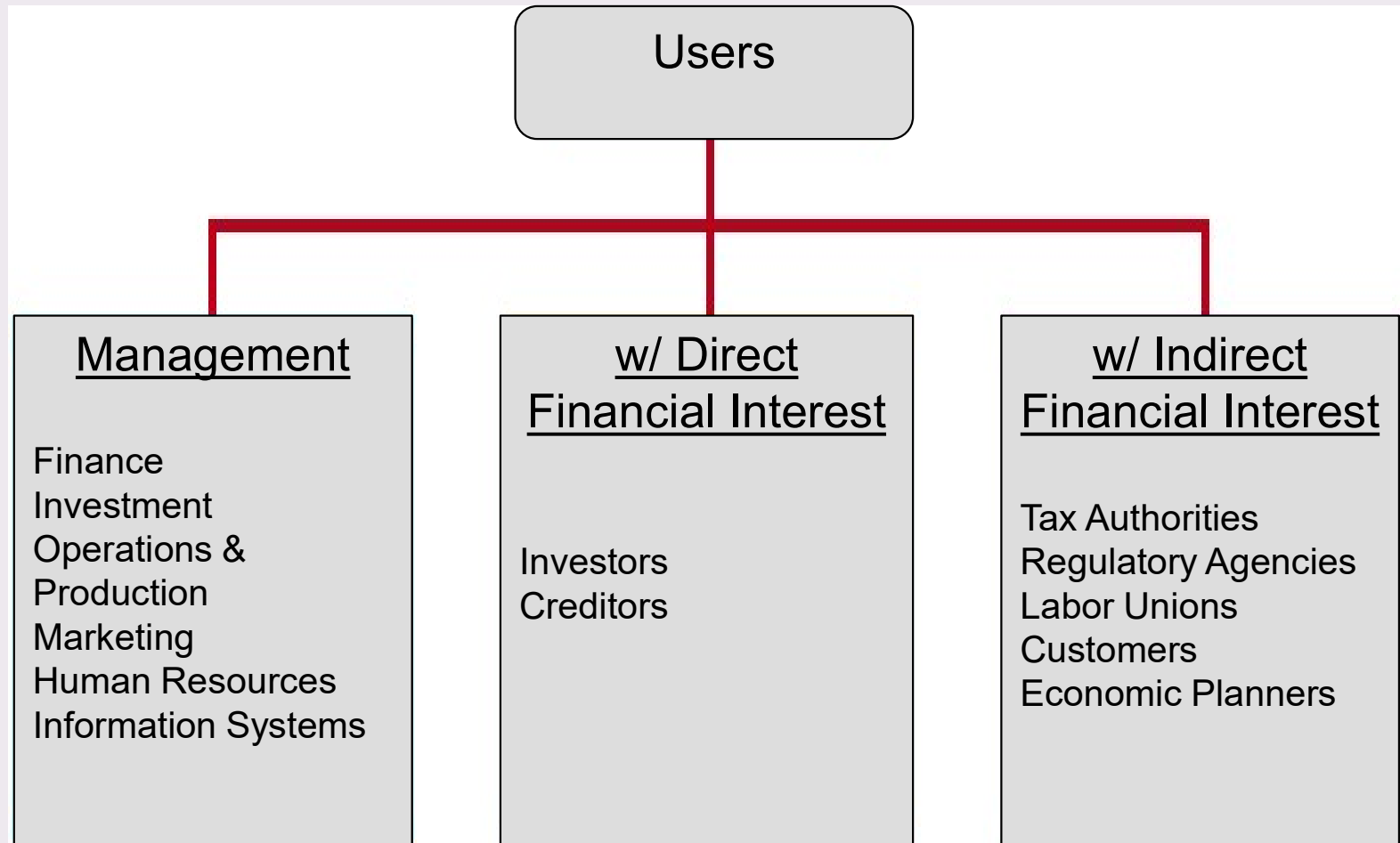
“The language
of the business”

Accounting as an Information System

Accounting is a link between business activities and decision makers.



Users of Accounting Information



Financial and Management Accounting

- **External** decision-makers use **financial accounting** to evaluate how well a business has achieved its goals.
 - These reports are called **financial statements**.
 - They report on a business's financial performance.
- **Internal** decision-makers use information provided by **management accounting** about operating, investing, and financing activities.
 - It provides managers and employees with information about how they have done in the past and what they can expect in the future.

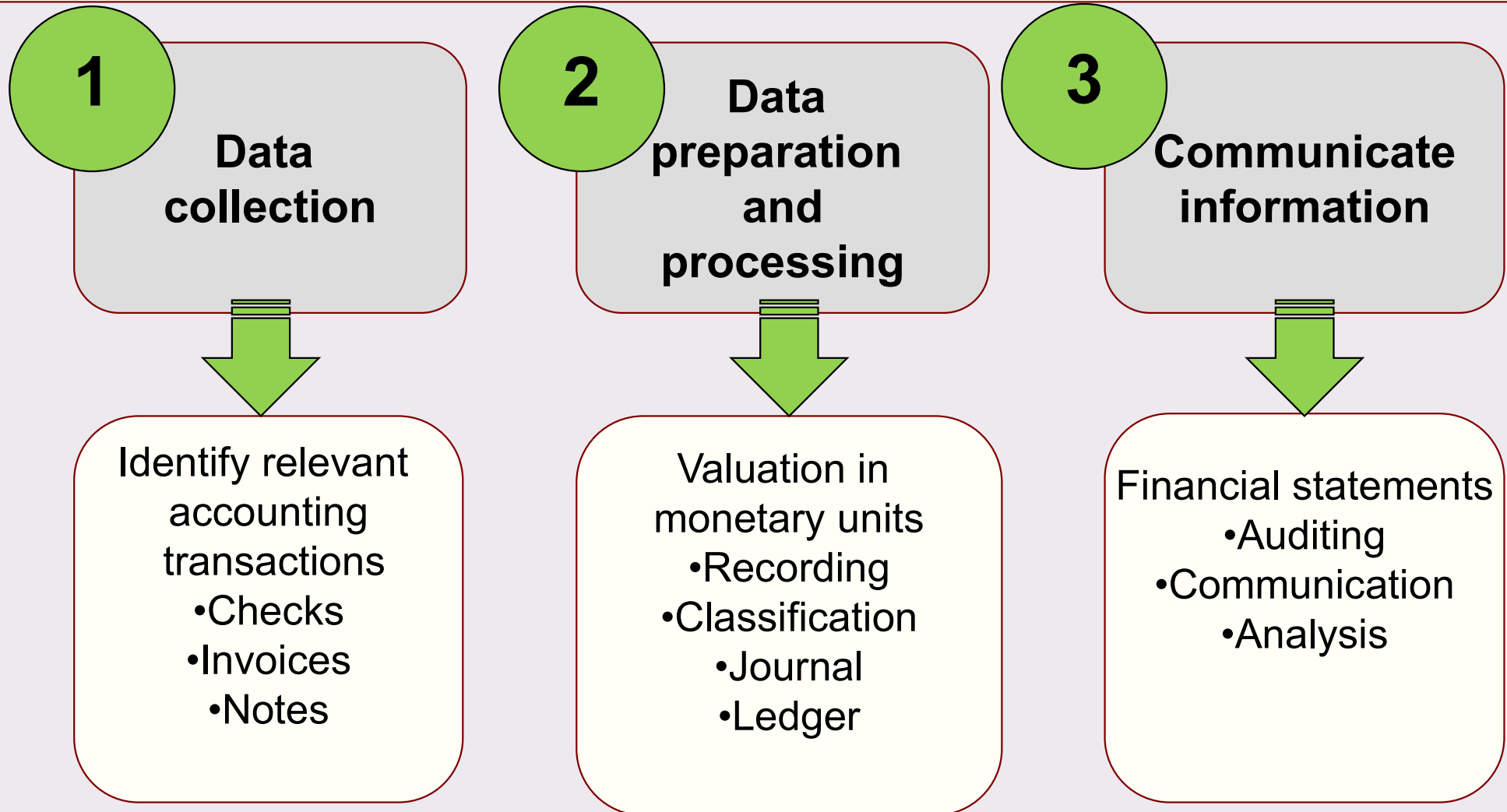
Financial **VS** Management Accounting

	Financial Accounting	Management Accounting
Users	Stockholders, Lenders, Investors, Customers, the Public, Government	Managers, Employees
Format	Reports based on GAAP	Flexible, based on user's needs
Information	Publicly available (audited, objective and verifiable)	Internal (Confidential and private)

Accounting **VS** Book-Keeping

- It is important to distinguish accounting from book-keeping.
 - **Book-keeping** is the process of recording financial transactions and keeping financial records.
 - It is mechanical and repetitive and is usually handled by computers.
 - **Management information systems (MIS)** consist of the interconnected business subsystems, including accounting, that provide the information needed to run a business.

Stages in the Accounting Cycle



Basic Financial Statements

- Balance Sheet
- Income Statement
- Cash Flow Statement
- Statement of Changes in Equity
 - Statement of Retained Earnings

The Balance Sheet

Measures:	The financial position
Reports:	Three items: 1. Assets 2. Liabilities 3. Equity
Dated:	At the moment in time when the accounting period ends (<i>e.g. 31 December 20XX</i>)
Also called:	Statement of Financial Position

The “picture” of the company at a specific given time (the reporting date)

The Balance Sheet

Type of the
report

Rivendell, Inc.

Name of the
company

Balance Sheet

Year-end date

31 Dec 20XX

Assets

Liabilities

Equity

Accounting Equity:
$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The Balance Sheet

- The entity's **financial position** and **risk**:
 - What valuable items it possesses (*assets*)?
 - How much does it owe to third parties?
 - What portion of the capital is invested by the owners and what is borrowed?

The Income Statement

Measures:	The operating performance
Reports:	Revenues and expenses of the year: 1. Revenues and profits 2. Expenses and losses
Dated:	Refers to an accounting period (<i>i.e. For the year ended 31 Dec 2015</i>)
Also called:	Statement of Operations, or Profit and Loss Account

The Income Statement

- Bottom line of Net Income or Net Loss *for the period*:
 - If revenues exceed expenses = *net income*
 - If expenses exceed revenues = *net loss*

Net Income (Loss) = Total Revenues and Profits - Total Expenses and Losses

Income Statement Single-Step Format

<div>Type of the report</div> <div>Name of the company</div> <div>Period</div> <div>Bottom Line</div>		
Rivendell, Inc. Income Statement For the Year ended 31 Dec 20XX		
Revenues:		
Service Revenues		
Expenses:		
Salary Expense		
Rent Expense		
Depreciation		
Utilities		
Income before Taxes		
Income Taxes		
Net Income		

The Income Statement

- The entity's **performance** and **return**:
 - What revenues is it generating?
 - What costs are incurred to generate those revenues?
 - Are the costs more than the revenues???
 - What is the final result?
 - **Profit?** Loss?

Cash Flow Statement

Shows:	<p>How a company's operating, investing, and financing activities have affected cash during a period.</p> <p>Explains the net increase (or decrease) in cash during the period.</p>
Reports:	<p>Cash flows:</p> <ol style="list-style-type: none">1. Operating activities2. Investing activities3. Financing activities
Dated:	<p>Covers a span of time</p> <p>(<i>month, quarter, year</i>)</p>

Cash Flow Statement

- Reports three types of activities:

Operating

Cash flows from selling goods and providing services to customers

Investing

Cash flows from the purchase and sale of long-term assets

Financing

Borrowing and repayment of borrowed funds
Equity transactions (issuing stock,
paying dividends, repurchase
of company stock)

Rivendell, Inc.

Name of the
companyType of the
reportCash Flow Statement
the year ended 31/12/2016

Period

31/12/2016

Cash flows from operating activities:

Net income

€ 833

Adjustments to reconcile net income to net cash provided by
operating activities

530

Net cash provided by operating activities

1,363

Cash flows from investing activities:

Purchase of property and equipment

(548)

Change in other assets, net

94

Net cash used by investing activities

(454)

Cash flows from financing activities:

Proceeds from issuance of debt

1,651

Issuance of stock related to share-based payments

75

Repurchases of common stock

(2,092)

Cash dividends paid

(236)

Net cash used by financing activities

(602)

Effect of foreign exchange rate fluctuations on cash

17

Net increase (decrease) in cash and cash equivalents

324

Cash and cash equivalents at beginning of period

1,561

Cash and cash equivalents at end of period

€ 1,885

The Cash Flow Statement

- Is the entity's *cash* sufficient?
 - How much cash does it generate from its activities?
 - Does this cash cover the investment needs of the entity for future growth?
 - *If not*, in which ways does it handle this problem?

Statement of Changes in Equity

- Provides:
 - a reconciliation of opening and closing equity.
 - details of the various equity accounts that are impacted by the period's total comprehensive income.
 - information about the effects of transactions with owners in their capacity as owners (distributions and capital contributions).

Statement of Changes in Equity

Rivendell, Inc. Statement of Changes in Equity For the Year ended 31 Dec 20XX					
	Pref. stock	Common stock	Additional paid-in capital	Retained earnings	Total
Beg. balance					
Issuance of stock					
Net Income (loss)				X	
Dividends					
Other					
End balance					

Main Assumptions & Principles

Assumptions:

- Economic Entity
- Monetary-Unit
- Time-Period
- Going-Concern

Principles:

- Full Disclosure
- Historical Cost
- Revenue Recognition
- Matching
- Materiality
- Conservatism

Qualitative characteristics:

- Relevance
- Reliability
- Comparability
- Understandability
- Timeliness

Assumptions and Principles 1

- Entity Assumption

Organization stands apart from other organizations and individuals as a separate economic unit.

- Continuity Assumption (Going-Concern)

Entity will remain in operation for the foreseeable future.

Assumptions and Principles 2

- Historical Cost Principle

Assets should be recorded at their actual cost.

- Stable-Monetary-Unit Assumption

Effect of inflation is ignored, based on the assumption that the dollar's/euro's purchasing power is relatively stable.

Assumptions and Principles 3

- Time Period (Periodicity) Assumption

A business's lifetime is uncertain, but it is useful to estimate net income in terms of accounting periods

- Revenue Recognition (Accrual Accounting) and Matching Principle

Recording revenues and expenses in the period they occur, rather than in the period when cash is received or paid, and matching the expenses to the revenues they helped generate.

Generally Accepted Accounting Principles (GAAP)

- Professional framework for measurement and disclosure of financial information
- IFRS and US GAAP
- Define specific guidelines and qualitative characteristics

International Financial Reporting Standards (IFRS)

- Accounting guidelines formulated by the International Accounting Standards Board (IASB)
- Mandatory application by all listed firms in European Union Stock Exchanges from 2005

Requirements for Accounting Information 1

- **Reliable:** Users must be able to rely on it.
 - Is it faithfully represented, neutral, free from material error, prudent and complete?
- **Relevant:** Help in the decision-making process
 - Does it affect users' decisions?
- **Timely:** Information must be available when a decision has to be made.

Requirements for Accounting Information 2

- **Comparable:** The information should be comparable in the long run and between different companies.
 - Inter- and intra-company comparisons
- **Comprehensible:** The information must be comprehensible for its potential users.
 - Presented as understandably as possible
- **At reasonable cost:** Gathering of information should not cost more than the benefit out of using it.

Joint Conceptual Framework

Objective	To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in decision-making			
Fundamental qualitative characteristics	Relevance		Faithful representation	
Enhancing qualitative characteristics	Comparability	Verifiability	Timeliness	Understandability

(Joint Conceptual Framework, FASB and IASB, 2010)

Ethical Financial Reporting

- **Ethics** is especially important in preparing financial reports because users must be able to trust that the reports are accurate and disclose all relevant facts.
- The intentional preparation of misleading financial statements (*fraudulent reporting*) can result from:
 - distortion of records,
 - falsified transactions, and
 - misapplication of various accounting principles.

Sarbanes-Oxley Act

- In response to the accounting scandals at Enron Corporation and WorldCom, the **Sarbanes-Oxley Act** of 2002 was passed.
 - It regulates the financial reporting of public companies and their auditors.
 - It requires chief executives and chief financial officers of publicly traded companies to swear that, based on their knowledge, their quarterly statements and annual reports filed with the security commission are accurate and complete.

Limitation of Accounting Data

- Sometimes **estimates** are necessary!
 - data less objective
- Different methods for the valuation of assets, liabilities, expenses and revenues
 - make it difficult to compare accounting information between companies or in the long run
- Financial accounting concentrates on events happening in the past.

Introduction to Accounting

The Financial Statements

Instructor: Sotirios Karatzimas, Assistant Professor

The Balance Sheet

Type of the
report

Rivendell, Inc.

Name of the
company

Balance Sheet

Year-end date

31 Dec 20XX

Assets

Liabilities

Equity

Accounting Equation:
$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

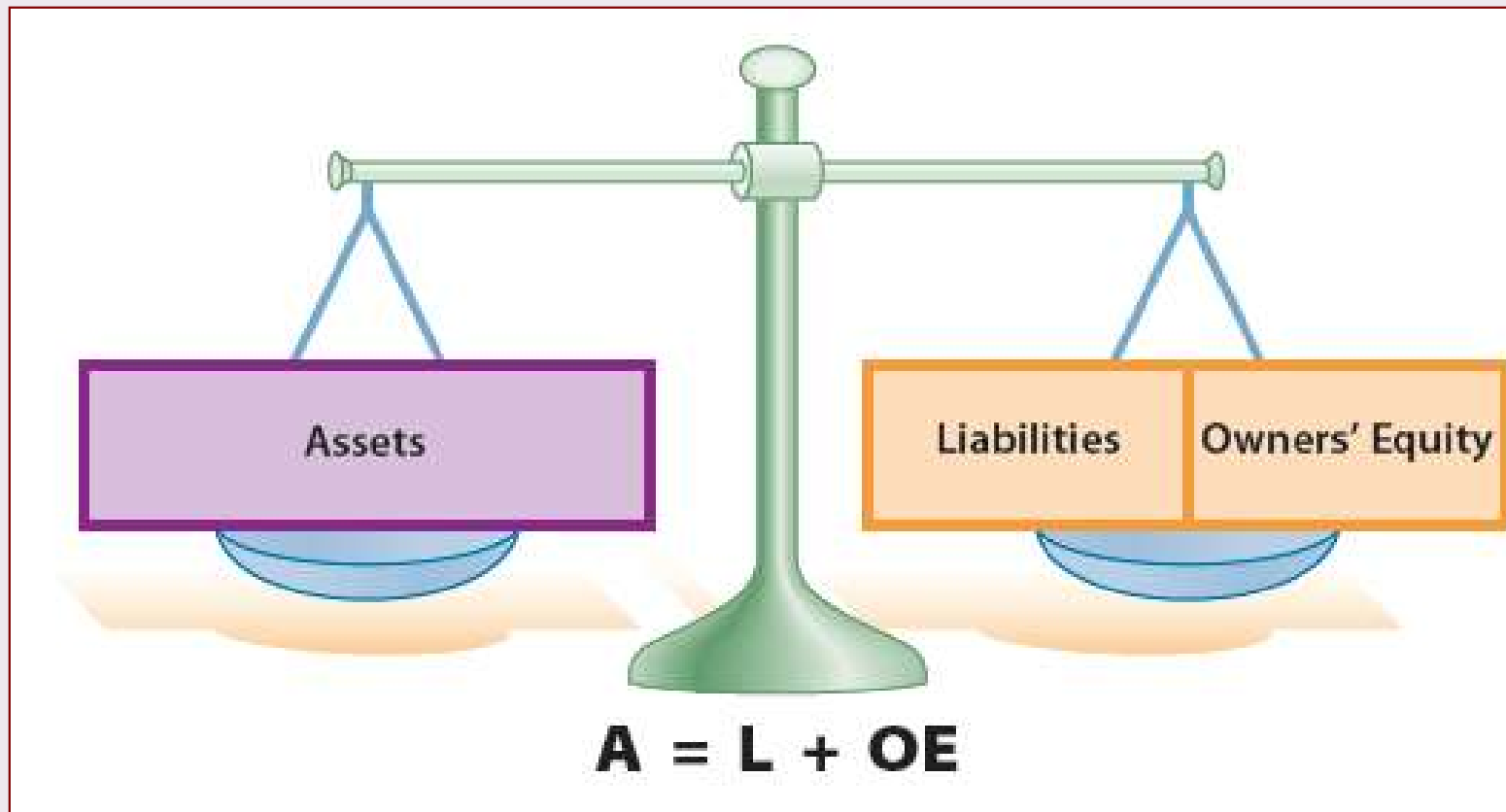
The Accounting Equation

- In accounting terminology:
 1. economic resources → *assets*
 2. creditors' claims → *liabilities*
 3. owners' claims → *equity*
- The accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The Accounting Equation

- The two sides of the equation must always be equal, or “in balance”:



Assets

- **Assets** are the economic resources that are expected to benefit the company's future operations. They include:
 - monetary items (cash and money owed to the company by customers)
 - Non-monetary, physical items (inventories, land, buildings, equipment)
 - Non-physical items (rights granted by patents, trademarks, and copyrights)

Economic
Resources

Expected Future
Benefit



Asset Examples

- Cash and Cash Equivalents
- Accounts Receivable
- Inventories
- Property, Plant and Equipment

Liabilities

- **Liabilities** are a business's present obligations to pay cash, transfer assets, or provide services to other entities in the future. They include:
 - amounts owed to suppliers for goods or services bought on credit (called *accounts payable*)
 - borrowed money such as bank loans
 - salaries and wages owed to employees
 - taxes owed to the government
 - services to be performed

Outsider
Claims



Expected Future
Sacrifice

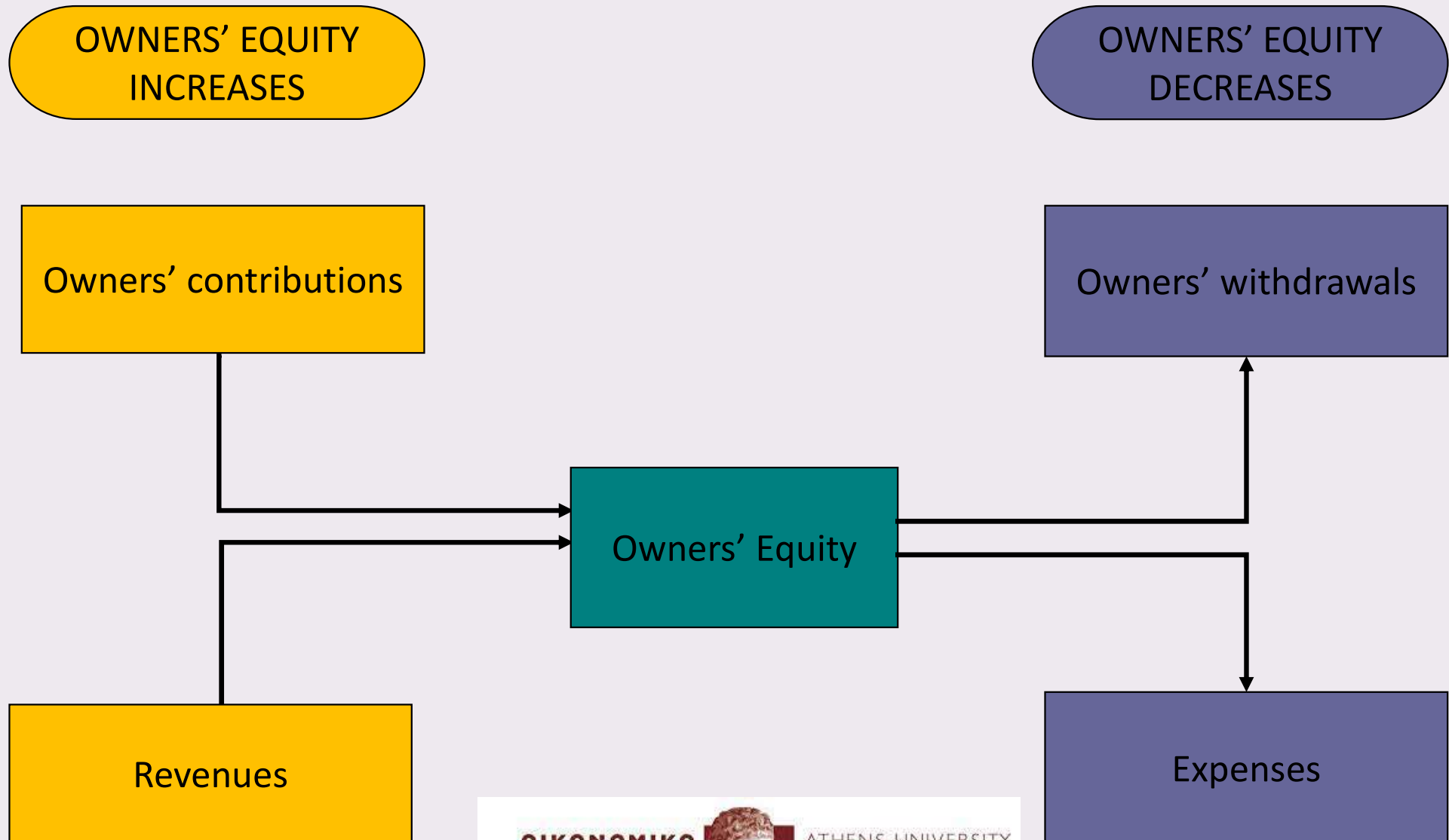
Liabilities examples

- Accounts payable
- Income taxes payable
- Long-term debt
- Current portion of long-term debt

Equity

- The claims of the owners.
- In Corporations owners are the **Shareholders** of the firm.
 - Equity is called Shareholders' Equity.
- In other forms of business (proprietorship, partnership) is called Owners' Equity.

Owners' Equity



Shareholders' Equity

- **Shareholders' equity** represents the claims by the shareholders of a business to the assets of the business.
 - Shareholders equity is what would be left if all liabilities were paid (**net assets**)

Shareholders' Equity = Assets – Liabilities

Insider
Claims

Shareholders'
interest in the
assets

Shareholder's Equity Components

- Shareholder's Equity

- Paid-in Capital

- Common Stock

The amount the stockholders have invested in the corporation. The basic component is **common stock**, which the corporation issues to the stockholders as evidence of their ownership.

- Retained Earnings

- Revenues
 - (Expenses)
 - (Dividends)

Inflows of resources that increase retained earnings by delivering goods or services to customers

Resource outflows that decrease retained earnings due to operations.

Distributions to stockholders (usually cash) generated by net income.

Retained Earnings

Increased by

- Revenues

Decreased by

- Expenses
- Dividends

Example

Alpha Co. has current assets of €360 mil., property, plant, and equipment of €600 mil., and other assets totaling €220 mil. Current liabilities are €210 mil. and long-term liabilities €560 mil.

Required

1. Write the accounting equation.
2. How much are the resources of Alpha?
3. How much does it owe to creditors and how much do the owners own?

Answer

Assets	=	Liabilities	+	Equity
€ 360		€ 210		
600		560		
220				
<hr/>		<hr/>		<hr/>
€ 1.180		€ 770		€ 410

Assets

- Two categories:

Current
Assets

Non-Current Assets
or Long-term Assets

Current Assets

- Expected to be converted to cash, sold, or consumed during the next 12 months *(or within the business's operating cycle if longer than a year)*
- Include:
 - Cash and cash equivalents
 - Short-term investments
 - Accounts and notes receivable
 - Inventory
 - Prepaid expenses

Current Assets



- **Cash and cash equivalents**

Cash is the liquid asset that's the medium of exchange

Cash equivalents include money-market accounts or other financial instruments easily convertible to cash

Current Assets



- Cash and cash equivalents
- **Short-term investments**

Stocks and bonds of other companies the company intends to sell within the next year

Current Assets



- Cash and cash equivalents
- Short-term investments
- **Accounts and notes receivable**

Amounts that the customers owe to the company from the sale of goods and services

Current Assets



- Cash and cash equivalents
- Short-term investments
- Accounts and notes receivable
- **Inventory**

Merchandise that the company sells to customers

Current Assets



- Cash and cash equivalents
- Short-term investments
- Accounts and notes receivable
- Inventory
- **Prepaid expenses**

Amounts paid in advance for expenses such as: advertising, rent, insurance, etc.

Non-Current Assets

- Expected to benefit the company for long periods of time (*over 1 year or over the business's operating cycle if longer than a year*)
- Include
 - Property, plant and equipment
 - Long-term investments
 - Intangible assets

Non-Current Assets



- **Property, plant and equipment**

Tangible assets that include land, buildings, computers, equipment, furniture & fixtures, etc.

Also called *fixed assets*.

Non-Current Assets



- Property, plant and equipment
- Long-term investments

Includes stocks and bonds of other companies that the company does not intend to sell within the next year

Non-Current Assets



- Property, plant and equipment
- Long-term investments
- **Intangibles**

Assets with no physical form, such as patents, trademarks, and goodwill

Assets

Rivendell, Inc. Partial Balance Sheet		
	31 Dec 20X1	31 Dec 20X0
Current assets:		
Cash and cash equivalents	XX	XX
Short-term investments	XX	XX
Inventory	XX	XX
Other current assets	XX	XX
Total Current Assets	XX	XX
Non-Current Assets:		
Intangible Assets	XX	XX
Property and equipment, net	XX	XX
Other non-current assets	XX	XX
Total Assets	XX	XX



The Balance Sheet

Rivendell, Inc.

Balance Sheet

31 Dec 20XX

Assets

Current Assets

- Cash and cash equivalents
- Short-term investments
- Accounts and notes receivable
- Inventory
- Prepaid expenses

Non-Current Assets

- Intangibles
- Property and equipment
- Long-term investments

Liabilities

Equity

Example

	Current Assets	Non-Current Assets
Cash	✓	
Furniture		✓
Receivables	✓	
Mini van		✓
Land		✓
5-year Investment		✓
Inventories	✓	
Office PC		✓
3-month Investment	✓	
Prepaid rent	✓	

Liabilities

- Two main categories:

Current Liabilities
or Short-term

Non-Current
Liabilities
or Long-term

Current Liabilities

- Debts payable in the next year or within the business's operating cycle *(if longer than a year)*
- Include:
 - Accounts payable
 - Income taxes payable
 - Accrued expenses
 - Current maturities of long-term debt

Current Liabilities



- **Accounts payable**

Amounts owed to vendors and suppliers for the purchase of inventory

Current Liabilities



- Accounts payable
- **Income taxes payable**

Tax debts owed to the government

Current Liabilities



- Accounts payable
- Income taxes payable
- **Accrued expenses**

Expenses that are owed but have not been paid:

Interest payable on borrowed money, accrued liabilities for salaries, utilities, and other

Current Liabilities



- Accounts payable
- Income taxes payable
- Accrued expenses
- **Current maturities of long-term debt**

Portion of long-term liabilities that the company will have to pay off within the next year

Non-Current Liabilities

- Debts due beyond one year or the company's normal operating cycle *(if longer than a year)*
- Include
 - Long-term bank loans
 - Long-term notes payable
 - Bonds payable

Non-Current Liabilities



- Long-term notes payable

Notes payable, due on a period more than one year

Non-Current Liabilities



- Long-term notes payable
- **Bonds payable**

Groups of debt securities issued to multiple lenders

Liabilities

Rivendell, Inc. Partial Balance Sheet		
	31 Dec 20X1	31 Dec 20X0
Current Liabilities:		
Current portion of long term debt	XX	XX
Accounts payable	XX	XX
Accrued expenses	XX	XX
Income tax payable	XX	XX
Total Current Liabilities	XX	XX
Non-Current Liabilities:		
Long-term debt	XX	XX
Other long-term liabilities	XX	XX
Total Non-Current Liabilities		
Total Liabilities	XX	XX

The Balance Sheet

Rivendell, Inc.

Balance Sheet

31 Dec 20XX

Assets

Current Assets

- Cash and cash equivalents
- Short-term investments
- Accounts and notes receivable
- Inventory
- Prepaid expenses

Non-Current Assets

- Property and equipment
- Accumulated depreciation
- Long-term investments
- Intangibles

Liabilities

Current Liabilities

- Accounts payable
- Income taxes payable
- Accrued expenses
- Current maturities of long-term debt

Long-term Assets

- Long-term notes payable
- Bonds payable

Equity

Equity

- Represents the stockholders' ownership of the business's assets
- Includes
 - Common stock
 - Additional paid-in capital
 - Retained earnings (*Income/loss*)
 - Treasury stock
 - Revaluation surplus

Equity



- Common stock

Amount that represents the par value of the shares issued to stockholders

Equity



- Common stock
- **Additional paid-in capital**

Amount of cash received on initial sale of the company's stock in excess of the par value

Equity



- Common stock
- Additional paid-in capital
- **Retained earnings**

Portion of net income re-invested into the business

Equity



- Common stock
- Additional paid-in capital
- Retained earnings
- **Treasury stock**

Amounts paid by the company to repurchase its own stock:

- Needs stock for employee compensation plans
- Want to buy low sell high
- Avoid takeover
- Increase EPS

Equity

- Common stock
- Additional paid-in capital
- Retained earnings
- Treasury stock
- **Revaluation surplus**

The net surplus of any upward revaluation of property, plant and equipment recognized directly in equity

Equity

Rivendell, Inc. Partial Balance Sheet		
	31 Dec 2016	31 Dec 2015
Stockholders' Equity:		
Common stock	XX	XX
Additional paid-in capital	XX	XX
Retained earnings	XX	XX
Treasury stock	(XX)	(XX)
Total Stockholders' Equity	XX	XX
Total Liabilities and Stockholders' Equity	XX	XX

The Balance Sheet

Rivendell, Inc.
Balance Sheet
31 Dec 20XX

Assets

Current Assets

- Cash and cash equivalents
- Short-term investments
- Accounts and notes receivable
- Inventory
- Prepaid expenses

Non-Current Assets

- Property and equipment
- Accumulated depreciation
- Long-term investments
- Intangible assets

Liabilities

Current Liabilities

- Accounts payable
- Income taxes payable
- Accrued expenses
- Current maturities of long-term debt

Long-term Assets

- Long-term notes payable
- Bonds payable

Always Remember the Accounting Equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Capital

Example

Account	Asset, Liability or Equity?		
Retained earnings			
Short-term Investments			
Accrued Expenses			
Accounts payable			
Inventory			
Long-term Debt			
Common Stock			
Cash			
Prepaid Expenses			

Classification Based on Liquidity

- Assets and liabilities are presented in order of liquidity:
 1. *Cash* → the most liquid asset.
 2. *Accounts receivable* → relatively liquid
(cash collections usually follow quickly)
 3. *Inventory* → less liquid
(inventory must be sold)
 4. *Equipment and buildings* → even less liquid
(these assets are not for sale)

Balance Sheet Format

- Balance Sheet Formats
 - Report
 - Account

Report Format

Rivendell, Inc.

Balance Sheet

31 Dec 20XX

Assets

Current Assets:

..

Non-Current Assets:

..

Total Assets

Liabilities and Shareholders' Equity

Current Liabilities:

..

Long term Liabilities:

..

Total Liabilities

Shareholders' Equity:

..

Total Shareholders' Equity

Total Liabilities and Shareholders' Equity

Account Format

Rivendell, Inc.

Balance Sheet

31 Dec 20XX

Assets

Current Assets

..

..

Non-Current Assets

..

..

Total Assets

Liabilities

Current Liabilities

..

..

Non-Current Liabilities

..

..

Total Liabilities

Equity

..

..

Example

Prepare the balance sheet of ECONOMY Co. using both the vertical/report and the horizontal/account format.
Also fill in the missing value.

Accounts payable	€25.000
Mini van	€6.000
Loan payable in 2 years	€30.000
Machinery	€10.000
Equipment	€9.000
Retained earnings	€15.000
Cash	€8.000
Inventories	€17.000
Property	€30.000
Accounts Receivable	€18.000
Common stock	?

Income Statement

- Summary of the **revenues earned** and **expenses incurred** by a business over an accounting period.
 - Many consider it the most important financial report
(it shows whether a business achieved its profitability goal)
- Net Income or Loss for the period:
 - If revenues exceed expenses = *net income*
 - If expenses exceed revenues = *net loss*

Important Questions!



- What is Revenue?
 - What is cash receipt?
- What is Expense?
 - What is cash payment?

Result from
operating a
business!

- What is Profit/Income?
- What is Loss?

Revenue Recognition

- The amount of revenue can be **reliably** measured
- It is probable that the economic benefits will be received
- Ownership and control is transferred
 - Refers to cases involving sale of goods

Example

- Company A sells TVs both in cash and with credit. Each TV is sold for €150.
- On 20.09 a cafeteria buys 10 TVs; 6 are paid in cash and the rest are payable in the end of the following month.
- What amount of revenues will the company recognize on the purchase date?
- Cash received: $6 \times €150 = €900$
- Revenue recognition: $10 \times €150 = €1.500$

Accrual & Matching Principle

- Revenues and Expenses are recognized as they are **earned** or **incurred**.
- **Expenses** are matched with the revenues they generated at the Income Statement of the period they refer to!

Example 2

- Company A buys the TVs from a supplier for €90 each.
- For the previous sale:

Sale's Revenue:

$$10 \times €150 = €1.500$$

Cost of the sale:

$$10 \times €90 = €900$$

Matching Principle:

Revenues	1.500
- <u>Cost of Sales</u>	<u>900</u>
Profit from Sale	600

Expense Recognition: Example (1/2)

- StarFish Co. pays its salesmen with a commission of 3% of sales revenue.
- For 2016, total sales revenue reached €250.000.
- The commission to be paid is therefore:
 $€250.000 \times 3\% (=€7.500)$.
- At the end of the period the company managed to pay the 2/3 of the amount (€5.000).
- The remaining €2.500 is owed to the salesmen.

Expense Recognition: Example (2/2)

- At the end of 2016 StarFish Co. recognizes:
 - Expense (i.e. Commission Expense)
 - Cash payment
 - Liability (i.e. Commission Payable)

Profit (Loss) of the period



Sales Revenue

- Cost of Sales

1 **Gross Profit** (or Gross Margin)

- Operating Expenses

2 **Operating Profit** (or Operating Margin)

- Interest Expense

+ Interest Income

3 **Income before Taxes**

- Income Taxes

4 **Net Income (Net Loss)**

Financial Result

Net Sales (Revenues)



- Total sales revenue
 - The amount to be received from customers in return of providing goods or services
- Net of returns and allowances.
 - Sales return is a cancellation of a sale.
 - Sales allowance is a deduction from the original sales invoice price.
- The **major revenue** source for most companies.

Cost of Goods Sold (COGS)



- Also called **Cost of Sales**
- **Cost of the seller** of products (or the provider of services) to customers
- **Largest expense** item for most firms

Gross Profit

- Also called **Gross Margin**
- First step of *profit measurement*
- Difference between Net Sales and COGS

$$\text{Gross profit} = \text{Net sales} - \text{COGS}$$

- Key analytical tool in assessing performance:
 - The amount of profit a company makes from merely selling a product before subtracting other operating costs

Gross Profit

Rivendell, Inc.		
Income Statement		
For the periods ended 31/12/15 and 31/12/2016	2016	2015
Net Sales	50.000	45.000
Cost of Goods Sold	(35.000)	(28.000)
Gross Profit	15.000	17.000

Operating Expenses

- The on-going expenses incurred by the company, apart from direct expenses for goods and costs directly linked to sales:
 - Salaries and Wages
 - Utilities
 - Supplies-Expensed
 - ...

Operating Expenses



- Selling, General and Administrative expenses (SG&A)
 - Selling: relate to the sale of products or services
 - General & Administrative: salaries, rent, insurance, utilities, supplies, depreciation, etc.
- Advertising
 - major expense when marketing is an important element of success

Depreciation



- Cost of assets other than land that will benefit a business enterprise for more than a year is allocated over the asset's service life.
- The amount of expense recognized in any accounting period will depend on
 - the level of investment in the relevant asset (**cost**)
 - estimates with regard to the asset's service life (**useful life**) and residual value
 - the method used (**straight, declining or production units**)

Depreciation

- Used to allocate the cost of tangible fixed assets:
 - Buildings
 - Machinery
 - Equipment
 - Furniture and fixtures
 - Vehicles

Land is never depreciated!

Expect cases of mines, oil-springs, etc.

Amortization

- Allocation process applied to:
 - Patents
 - Copyrights
 - Trademarks
 - Franchises

Repairs and maintenance



- Annual costs of repairing and maintaining property, plant, and equipment
- Should correspond to the level of investment in capital equipment and to the age and condition of fixed assets

Operating Profit

- Second step of *profit measurement*:
- Measures overall performance of company's operations:
 - sales revenue – expenses associated with generating sales

Operating Profit

Rivendell, Inc. Income Statement For the periods ended 31/12/15 and 31/12/2016		
	2016	2015
Net Sales	50.000	45.000
Cost of Goods Sold	(35.000)	(28.000)
Gross Profit	15.000	17.000
Operating Expenses	(3.000)	(4.000)
Operating Profit	12.000	13.000

Other (*Financial*) Income & Expenses

- Revenues and expenses, other than from operations:
 - dividend and interest income
 - interest expense
 - investment gains (losses)
 - gains (losses) from sale of fixed assets

Income Before Taxes

Rivendell, Inc. Income Statement Data For the periods ended 31/12		
	2016	2015
Net Sales	50.000	45.000
Cost of Goods Sold	(35.000)	(28.000)
Gross Profit	15.000	17.000
Operating Expenses	(3.000)	(4.000)
Operating Profit	12.000	13.000
Other Income	1.500	2.000
Other Expense	(2.100)	(1.700)
Income before Taxes	11.400	13.300

Income Taxes

- Companies pay income taxes calculated on their profits.

$$\text{Income Taxes} = \text{Income before Taxes} * \text{Tax rate}$$

Net Income (Loss)

- Also called the “*bottom line*”
- Represents profit/loss after consideration of all revenue and expense

Net Income

Rivendell, Inc. Income Statement For the periods ended 31/12	2016	2015
Net Sales	50.000	45.000
Cost of Goods Sold	(35.000)	(28.000)
Gross Profit	15.000	17.000
Operating Expenses	(3.000)	(4.000)
Operating Profit	12.000	13.000
Interest Income	1.500	2.000
Interest Expense	(2.100)	(1.700)
Income before Taxes	11.400	13.300
Income Taxes 30%	(3.420)	(3.990)
Net Income	7.980	9.310

Example

Account	Income Statement or Balance Sheet?		
Service Revenue			
Delivery Truck			
Fuel Expense			
Cash			
Rent Expense			
Accounts Payable			
Interest Expense			
Interest Receivable			
Prepaid Rent			

Income Statement Format

Income Statement Formats

- Single-step

- All items of revenue are grouped together, then all categories of expense are deducted

- Multi-step

- Several intermediate profit measures are provided prior to the amount of net income

Income Statement Single-Step Format

Rivendell, Inc. Income Statement For the Year ended 31 Dec 20XX		
Revenues:		
Service Revenues		
Expenses:		
Salary Expense		
Rent Expense		
Depreciation		
Utilities		
Income before Taxes		
Income Taxes		
Net Income		

Income Statement Multiple-Step Format

Rivendell, Inc. Income Statement For the Year ended 31 Dec 20XX		
Net Revenues		
Net operating revenues	XX	XX
Cost of goods sold	(XX)	(XX)
Gross Profit	XX	XX
Operating Expenses	(XX)	(XX)
Depreciation and Amortization	(XX)	(XX)
General and Administrative Expenses	(XX)	(XX)
Total Operating Expenses	(XX)	(XX)
Operating Profit	XX	XX
Interest profit	XX	XX
Interest expense	(XX)	(XX)
Income before Taxes	XX	XX
Income Taxes	(XX)	(XX)
Net Income	XX	XX

Special Reporting Issues

Comprehensive Income

All changes in equity during a period except those resulting from investments by owners and distributions to owners.

Includes:

- ◆ all revenues and gains, expenses and losses reported in net income, and
- ◆ all gains and losses that bypass net income but affect stockholders' equity.

Special Reporting Issues

Comprehensive Income

Income Statement (in thousands)

Sales	\$ 285,000
Cost of goods sold	149,000
Gross profit	136,000
Operating expenses:	
Selling expenses	10,000
Administrative expenses	43,000
Total operating expense	53,000
Income from operations	83,000
Other revenue (expense):	
Interest revenue	17,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Net income	\$ 55,000

+

Other Comprehensive Income

- ◆ Unrealized gains and losses on available-for-sale securities.
- ◆ Translation gains and losses on foreign currency.
- ◆ Plus others

Reported in Stockholders' Equity

Special Reporting Issues

Gains and losses that bypass net income but affect stockholders' equity are referred to as

- a. comprehensive income.
- ☒ b. other comprehensive income.
- c. prior period income.
- d. unusual gains and losses.

Special Reporting Issues

Companies must display the components of other comprehensive income in one of three ways:

1. A second separate income statement;
2. A combined income statement of comprehensive income; or
3. As part of the statement of stockholders' equity

Special Reporting Issues

Comprehensive Income

Second income statement

V. GILL INC.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Sales revenue	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net income	<u><u>\$110,000</u></u>

V. GILL INC.
COMPREHENSIVE INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

Net income	\$110,000
Other comprehensive income	
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive income	<u><u>\$140,000</u></u>



Special Reporting Issues

Comprehensive Income

Combined statement

V. Gill Inc.

Combined Statement of Comprehensive Income

For the Year Ended December 31, 2012

Sales revenue	\$ 800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net income	110,000
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive income	<u>\$ 140,000</u>

Special Reporting Issues

Comprehensive Income – Statement of Stockholder's Equity

Illustration 4-20

V. GILL INC. STATEMENT OF STOCKHOLDERS' EQUITY FOR THE YEAR ENDED DECEMBER 31, 2012					
	Total	Compre- hensive Income	Retained Earnings	Accumulated Other Compre- hensive Income	Common Stock
Beginning balance	\$410,000		\$ 50,000	\$60,000	\$300,000
Comprehensive income					
Net income	110,000	\$110,000	110,000		
Other comprehensive income					
Unrealized holding gain, net of tax	30,000	30,000		30,000	
Comprehensive income		\$140,000			
Ending balance	\$550,000		\$160,000	\$90,000	\$300,000

Special Reporting Issues

Comprehensive Income – Balance Sheet Presentation

Illustration 4-21
Presentation of
Accumulated Other
Comprehensive
Income in the
Balance Sheet

V. GILL INC. BALANCE SHEET AS OF DECEMBER 31, 2012 (STOCKHOLDERS' EQUITY SECTION)	
Stockholders' equity	
Common stock	\$300,000
Retained earnings	160,000
Accumulated other comprehensive income	90,000
Total stockholders' equity	<u>\$550,000</u>

Regardless of the display format used, the *accumulated other comprehensive income* of \$90,000 is reported in the stockholders' equity section of the balance sheet.

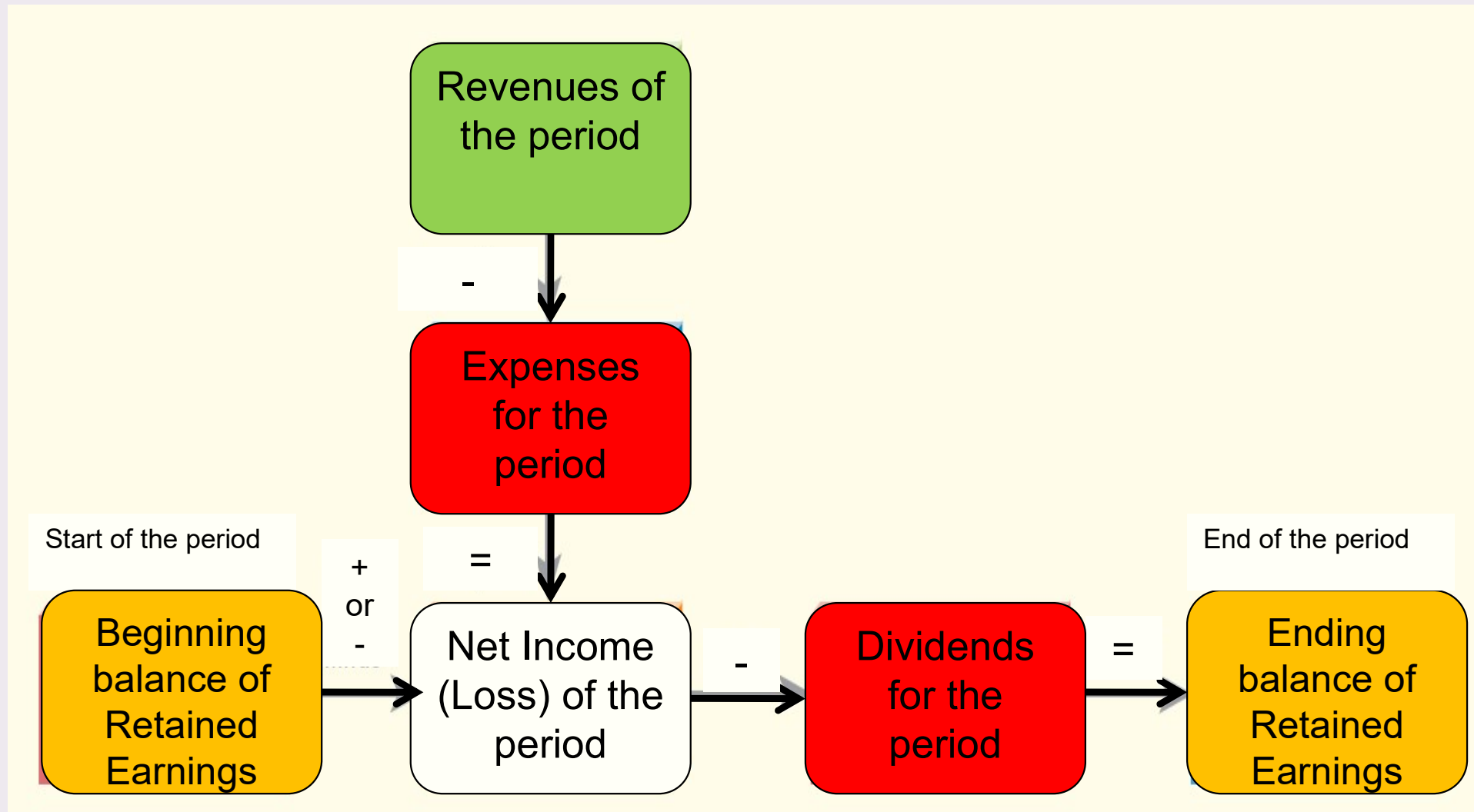
Equity

Equity		
	31 Dec 20X1	31 Dec 20X0
Stockholders' Equity:		
Common stock	XX	XX
Additional paid-in capital	XX	XX
Retained earnings	XX	XX
Treasury stock	(XX)	(XX)
Total Stockholders' Equity	XX	XX

Statement of Changes in Equity

Rivendell, Inc. Statement of Changes in Equity For the Year ended 31 Dec 20X1					
	Pref. stock	Common stock	Additional paid-in capital	Retained earnings	Total
Beg. balance					
Issuance of stock					
Net Income (loss)					
Dividends					
Other					
End balance					

Components of Retained Earnings



Statement of Retained Earnings

Rivendell, Inc. Statement of Retained Earnings For the period ended 31 Dec 20X1	
Retained Earnings, 1 Jan 20X1	10.000
Net Income, year ended 31 Dec 20X1	1.500
Cash Dividends	(500)
Retained Earnings 31 Dec 20X1	11.000

Example

- Beg. balance of Retained Earnings is €150.000.
- Revenues €75.000 and Expenses €35.000.
- Pays €10.000 Dividend.
- What is the End balance of Retained Earnings?

Statement of Retained Earnings	
Retained Earnings, beg. balance	150.000
Net Income (Revenues - Expenses)	40.000
Cash Dividends	(10.000)
Retained Earnings, end balance	180.000

Statement of Retained Earnings - *Recap*

- Shows what a company did with its net income
- Retained Earnings
 1. Portion of net income reinvested into the business
 2. Net income increases retained earnings
 3. Net losses and dividends decrease retained earnings
 4. Net income (net loss) flows from the income statement to the statement of retained earnings
 5. Corporations not obligated to pay dividends

Example

Question	Financial Statement	Answer
How well did the company perform during the year?		
Why did the company's retained earnings change during the year?		
What is the company's financial position at year-end?		
How much cash did the company generate and spend during the year?		

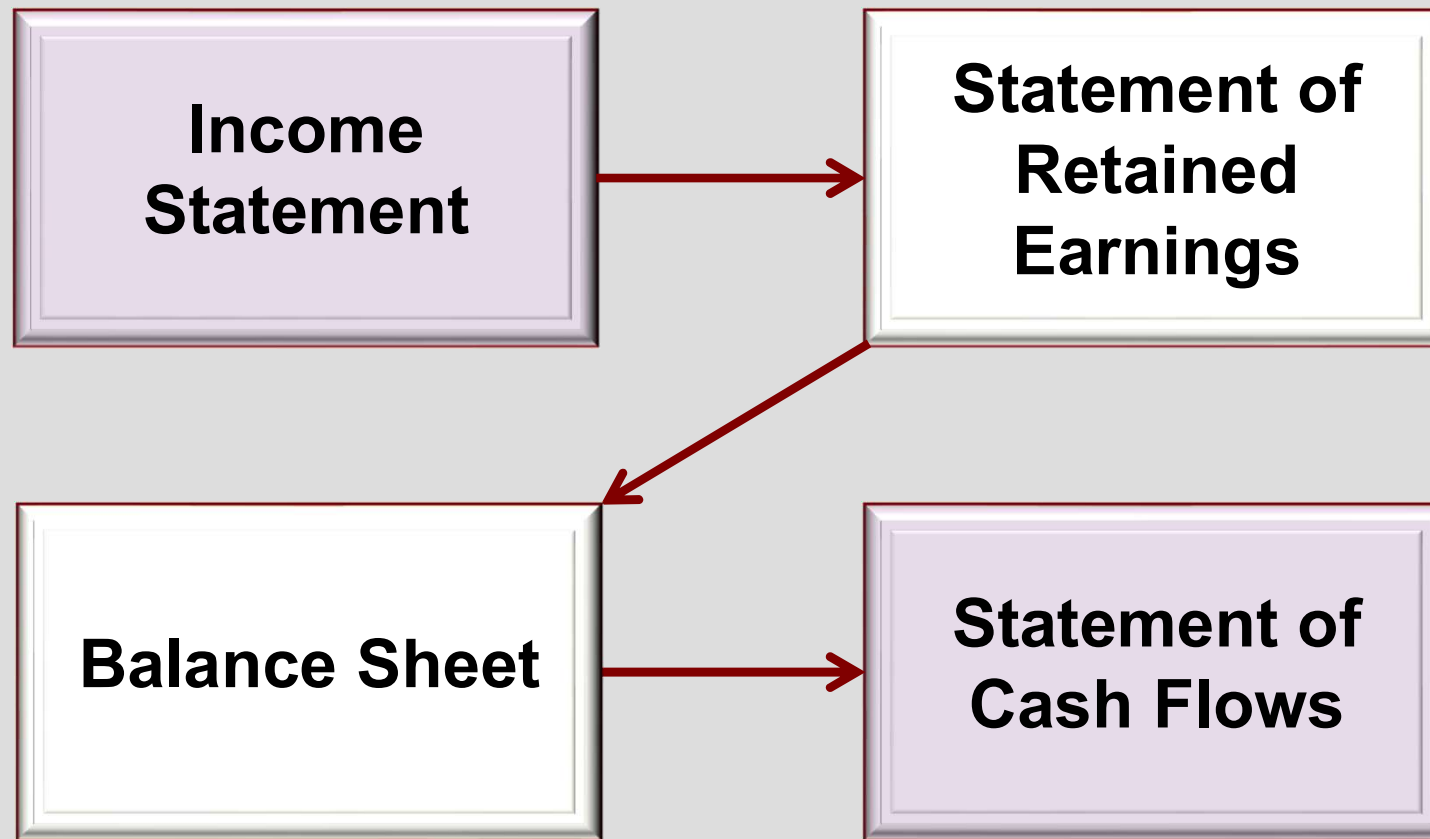
Example 2

Information	Financial Statement
Revenue	
Dividends	
Current liabilities	
Total assets	
Selling, general, and administrative expenses	
Ending cash balance	
Cash spent to acquire a building	
Ending balance of retained earnings	
Net income	

Example 2

Information	Financial Statement
Income tax expense	
Common stock	
Income tax payable	
Long-term debt	
Adjustments to reconcile net income to net cash provided by operations	

Data flow in the financial statements



Relationships between the Financial Statements

The Gap, Inc. Statement of Income (Adapted) 12 Months Ended January 28, 2012		
Net sales	\$	14,549
Expenses		13,716
Net income	\$	833
Statement of Retained Earnings (Adapted)		
Beginning retained earnings	\$	11,767
Net income		833
Cash dividends declared		(236)
Ending retained earnings	\$	12,364

1

Relationships between the Financial Statements

The Gap, Inc.		
Statement of Retained Earnings (Adapted)		
12 Months Ended January 28, 2012		
Beginning retained earnings	\$	11,767
Net income		833
Cash dividends declared		(236)
Ending retained earnings	\$	12,364
Balance Sheet (Adapted)		
Assets	\$	7,422
Liabilities	\$	4,667
Stockholders' equity		
Common stock and additional paid-in capital		2,922
Retained earnings		12,364
Other equity		(12,531)
Total liabilities and stockholders' equity	\$	7,422

Relationships between the Financial Statements

The Gap, Inc. Balance Sheet (Adapted) January 28, 2012		
Assets		
Cash and cash equivalents	\$	1,885
All other assets		5,537
Total assets	\$	7,422
Liabilities	\$	4,667
Stockholders' equity		2,755
Total liabilities and stockholders' equity	\$	7,422
Statement of Cash Flows (Adapted)		
Net cash provided by operating activities	\$	1,363
Net cash used in investing activities		(454)
Net cash used in financing activities		(602)
Effect of foreign exchange rate fluctuations on cash		17
Net increase (decrease) in cash and cash equivalents		324
Cash and cash equivalents, beginning of year		1,561
Cash and cash equivalents, end of year	\$	1,885

3

40

Example

Income Statement	
Revenues	2.775
Expenses	A
Net Income	B
Statement of Retained Earnings	
Beginning balance	7.250
+Net Income	C
-Dividends	500
Ending balance	7.500
Balance Sheet	
Total Assets	D
Liabilities	4.000
Equity	
<i>Common Stock</i>	5.000
<i>Retained Earnings</i>	E
Total Liabilities and Equity	F

Business Transactions

- Transaction (*economic event*)
 - Any event that has a financial impact on the business
 - Can be measured reliably
 - The details are supported by source documents (invoices, receipts, checks, contracts)
- Provides information about an exchange
 - Something given & Something received
 - Dual system (*principle of duality* - *every economic event has two aspects that offset, or balance, each other*)
- Accounting records both sides of a transaction

Example

Purchase goods

} Receive goods
Pay cash or create a credit account

Sell product

} Sell goods
Receive cash or create a credit account

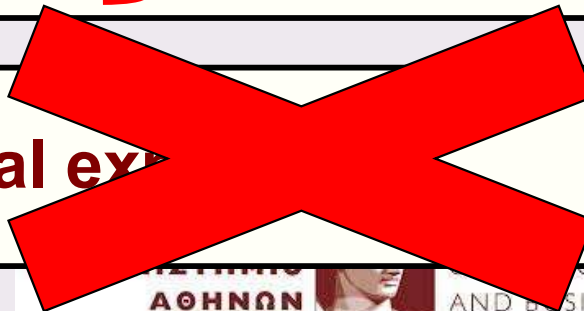
Borrow money

} Receive cash
Create a liability

Repay a loan

} Eliminate or reduce a liability
Pay cash

Pay for personal expenses



Balance Sheet Transactions

Transaction 1: Initial Investment of €400.000 in cash

Assets	=	Liabilities	+	Equity
Cash				Capital (Common Stock)
(1) + 400.000	=			+400.000

Balance Sheet Transactions

Transaction 2: Loan of €100.000 from Bank

	Assets	=	Liabilities	+	Equity
	Cash		Loan		Capital
(1)	+ 400.000	=			+400.000
(2)	+ 100.000	=	+ 100.000		
Bal.	500.000	=	100.000		400.000
	500.000			500.000	

Balance Sheet Transactions

Transaction 3: Acquire Equipment for Cash €15.000

Assets		=	Liabilities	+	Equity
Cash	Equipment		Loan		Capital
Bal. 500.000		=	100.000		400.000
(3) -15.000	+15.000	=			
Bal. 485.000	15.000	=	100.000		400.000
500.000			500.000		

Preparing the Balance Sheet

Balance Sheet 31 Dec 2016

Assets		Liabilities and Equity	
Cash	485.000	Liabilities (note payable)	100.000
Store equipment	15.000	Capital	400.000
Total assets	500.000	Total liabilities & equity	500.000

Example

No	Event
1	On April 1, some friends invest €50.000 to open Alpha Service, Inc. in return for common stock.
2	Alpha purchases land for a new location and pays cash of €40.000.
3	Alpha buys supplies on account, agreeing to pay €3.700 within 30 days.
4	Received €7.000 cash by providing services for customers.
5	Repairs Beta's delivery trucks, and Beta promises to pay Alpha €3.000 within 1 month.
6	Alpha pays €2.700 for the following expenses: rent €1.100, employee salaries €1.200, and utilities €400.
7	Alpha pays €1.900 on account, which means to make a payment toward an account payable.
8	The major shareholder paid €10.000 out of her personal bank account to remodel her house.
9	In transaction 5, Alpha performed services for Beta on account. Alpha now collects €1.000 from Beta.
10	Alpha receives €22.000 from the sale of land, which is the same amount that Alpha paid for the land.
11	Alpha declares a dividend and pays the stockholders €2.100 cash.

Example - Transactions

1: Four friends invest €50.000 to open Alpha Service, Inc., in return for common stock.

Assets		=	Liabilities	+	Shareholders' Equity
Cash					Common Stock
1. +50,000					+50,000

Transactions

2. Alpha purchases land for a new location and pays cash of €40.000.

Assets		=	Liabilities	+	Shareholders' Equity
Cash	Land				Common Stock
1. +50,000					+50,000
2. -40,000	+40,000				

Transactions

3. Alpha buys supplies on account, agreeing to pay €3.700 within 30 days.

Assets			=	Liabilities	+	Shareholders' Equity
Cash	Supplies	Land		Accounts payable		Common Stock
1. +50,000						+50,000
2. -40,000		+40,000				
3.	+3,700			+3,700		

Transactions

4. Received €7.000 cash by providing services for customers.

Assets			=	Liabilities	+	Shareholders' Equity	
Cash	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
							Revenues
1. +50,000						+50,000	
2. -40,000		+40,000					
3.	+3,700			+3,700			
4. +7,000							+7,000

Transactions

5. Repairs Beta's delivery trucks, and Beta promises to pay Alpha €3.000 within 1 month.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Revenues
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000

Transactions

6. Alpha pays €2.700 for the following expenses: rent €1.100, employee salaries €1.200, and utilities €400.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Expenses
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700

Transactions

7. Alpha pays €1.900 on account, which means to make a payment toward an account payable.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Revenues & Expenses
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700
7. -1,900					-1,900			

Transactions

8. The major shareholder paid €10.000 out of her personal bank account to remodel her house.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Revenues & Expenses
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700
7. -1,900					-1,900			

Not An Economic Event

Transactions

9. In transaction 5, Alpha performed services for Beta on account. Alpha now collects €1.000 from Beta.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Revenues & Expenses
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700
7. -1,900					-1,900			
9. +1,000	-1,000							

Transactions

10. Alpha receives €22.000 from the sale of land, which is the same amount that Alpha paid for the land.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Revenues & Expenses
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700
7. -1,900					-1,900			
9. +1,000	-1,000							
10. +22,000			-22,000					

Transactions

11. Alpha declares a dividend and pays the stockholders
€2.100 in cash.

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Accounts receivable	Supplies	Land		Accounts payable		Common Stock	Retained Earnings
								Dividend
1. +50,000							+50,000	
2. -40,000			+40,000					
3.		+3,700			+3,700			
4. +7,000								+7,000
5.	+3,000							+3,000
6. -2,700								- 2,700
7. -1,900					-1,900			
9. +1,000	-1,000							
10. +22,000			-22,000					
11. -2,100								-2,100
<u>33,300</u>	<u>2,000</u>	<u>3,700</u>	<u>18,000</u>		<u>1,800</u>		<u>50,000</u>	<u>5,200</u>
57,000					57,000			

Financial Statements

-Income Statement-

Alpha Service Inc. Income Statement Month ended 30 April		
Service revenues		10.000
Operating Expenses		2.700
Salary expense	1.200	
Rent expense	1.100	
Utilities expense	400	
Net Income		7.300

Financial Statements

-Statement of Retained Earnings-

Alpha Service Inc. Statement of Retained Earnings Month ended 30 April	
Retained earnings, Beginning Balance	0
Plus: Net Income of the period	7.300
Minus: Dividends	(2.100)
Retained earnings, Ending Balance	5.200

Financial Statements

-Balance Sheet-

Alpha Service Inc. Balance Sheet 30 April 2016			
Assets		Liabilities	
Cash	33.300	Accounts payable	1.800
Accounts receivable	2.000	Shareholders' Equity	
Supplies	3.700	Common stock	50.000
Land	18.000	Retained earnings	5.200
Total Assets	57.000	Total Liabilities & Equity	57.000

Example

Jorge opens a business providing physical therapy services. During the first month of operation the following events took place:

Date	Event
Feb 1	Jorge invested €100.000 in the business in return for common stock.
5	The business borrowed €50.000, signing a note payable to the bank.
8	The business paid cash for land costing €105.000. Jorge plans to build an office building on the land.
11	The business purchased medical supplies for €1.700 on account.
12	Officially opens for business.
14	Jorge treated patients and earned service revenue of €5.600, receiving cash for half the revenue earned.
16	The business paid employee salaries of €2.300 for the first half of the month.
25	Jorge treated patients and received €1.500 cash at the time of service.
28	The business paid office rent of €1.000.
28	The business paid €500 on account.

Business transactions

Feb. 1: Invested €100.000 in the business in return for common stock.

Assets

=

Liabilities

+

Shareholders' Equity

Cash

Common
Stock

Business transactions

Feb. 5: The business borrowed €50.000, signing a note payable to the bank.

Assets				=	Liabilities				+	Shareholders' Equity			
Cash					Note payable					Common Stock			
1	100,000										100,000		

Business transactions

Feb. 8: The business paid cash for land costing €105.000.
Jorge plans to build an office building on the land.

Assets		=	Liabilities	+	Shareholders' Equity
Cash			Land		Note payable Common Stock
1	100,000				100,000
5	50,000			50,000	

Business transactions

Feb. 11: The business purchased medical supplies for €1.700 on account.

Assets			=	Liabilities		+	Shareholders' Equity		
Cash				Supplies			Land		
							Accounts payable		
							Note payable		
							Common Stock		
1	100,000							100,000	
5	50,000						50,000		
8	(105,000)				105,000				

Business transactions

Feb. 12: Officially opens for business.

Assets				=	Liabilities		+	Shareholders' Equity										
Cash					Supplies			Land			Accounts payable			Note payable			Common Stock	
1	100,000															100,000		
5	50,000														50,000			
8	(105,000)								105,000									
11						1,700					1,700							

Not An Economic Event

Business transactions

Feb. 14: Jorge treated patients and earned service revenue of €5.600, receiving cash for half the revenue earned.

[illegible]

Business transactions

Feb. 16: Paid employee salaries of €2.300 for the first half of the month.

	Assets				=	Liabilities		+	Shareholders' Equity	
	Cash	Accounts receivable	Supplies	Land		Accounts payable	Note payable		Common Stock	Retained Earnings
1	100,000								100,000	
5	50,000						50,000			
8	(105,000)			105,000						
11			1,700			1,700				
12										
14	2,800	2,800								5,600

Business transactions

Feb. 25: Jorge treated patients and received €1.500 cash at the time of service.

[illegible]

Business transactions

Feb. 28: The business paid office rent of €1.000.

[illegible]

Business transactions

Feb. 28: The business paid €500 on an account payable.

Assets				=	Liabilities		+	Shareholders' Equity	
	Cash	Accounts receivable	Supplies	Land	Accounts payable	Note payable		Common Stock	Retained Earnings
1	100,000							100,000	
5	50,000					50,000			
8	(105,000)			105,000					
11			1,700		1,700				
12									
14	2,800	2,800							5,600
16	(2,300)								(2,300)
25	1,500								1,500
28	(1,000)								(1,000)
€155.000					€155.000				

Questions

- a. How much are total assets?
- b. How much does the business expect to collect from customers?
- c. How much does the business owe in total?
- d. How much of the business's assets does Jorge really own?
- e. How much net income or net loss did the business experience during its first month of operations?

The Account

- Record of all changes (*increases and decreases*) in a particular asset, liability, or stockholders' equity during a period.
- The basic summary device (*or storage unit*) in accounting!
- Two formats: 4-Column and **T-Account**

Four Column Account

Account: Cash				Account No. 101	
Date	Item	Debit	Credit	Balance	
				Debit	Credit
2014					
Apr 2		50,000		50,000	
3			40,000	10,000	

The T-Account

Name of the Account		
Cash		
Dr.		Cr.
100,000		70,000
3,000		400
		1,200
103,000		71,600
Bal.	31,400	

Debit Side (left)

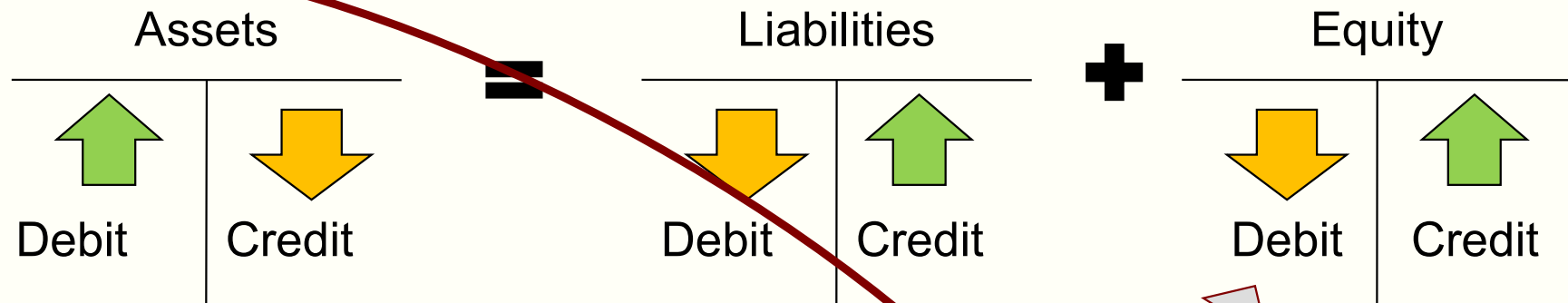
Credit Side (right)

Balance of the Account

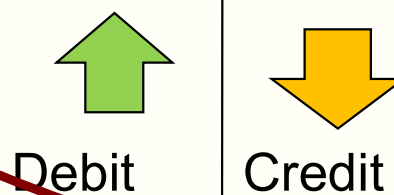
Rules of Double-Entry Accounting

- The double-entry system follows two rules:
 1. Every transaction affects at least two accounts.
 2. Total debits must equal total credits.
- For every transaction:
 - one or more accounts must be debited
 - one or more accounts must be credited

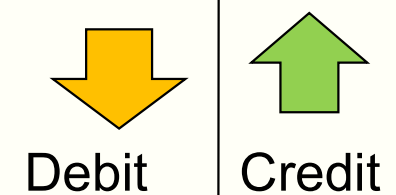
Rules of Debit and Credit



Expenses/Losses



Revenues/Profits



Normal Balance

- The **normal balance** of an account is its usual balance and is the side (debit or credit) that increases the account.

Account	Increases by		Normal balance	
	Debit	Credit	Debit	Credit
Assets	X		X	
Liabilities		X		X
Equity		X		X
Revenues		X		X
Expenses	X		X	

Types of Accounts

- Permanent Accounts
 - Balance Sheet accounts
 - Carried over to the next period.
- Temporary Accounts
 - Revenues and Expenses, Dividends
 - Relate to a limited period.

The Ledger

- In an accounting system, each account is kept on a separate page or card, which are placed together in a book or file called the **general ledger** or the **ledger**.

The Journal

- Chronological record of transactions
- 3 steps
 1. Specify each account affected by the transaction and classify by type
 2. Determine if each account is increased or decreased (debit or credit)
 3. Record in the journal

Journal Entry

Date	Debited account	Debit	Credit
Apr 1	Cash	50.000	
	Common Stock		50.000
	<i>Issued Common Stock</i>		
Explanation			

Post to the Ledger

Journal

		Debit	Credit
Apr 1	Cash	50.000	
	Common Stock		50.000
	<i>Issued Common Stock</i>		

General Ledger

Cash	Common Stock
50.000	50.000

Example

01.01.2017: Received €50.000 cash and issued stock to the shareholders.

Accounting Equation

Assets	=	Liabilities	+	Stockholders' Equity
+ 50.000				+ 50.000

Journal Entry

		Debit	Credit
01/01	Cash	50.000	
	Common Stock		50.000

Ledger Accounts

Cash	Common Stock
50.000 (01.01)	50.000 (01.01)

Example

02.01.2017: Paid €40.000 cash for land.

Accounting Equation

Assets	=	Liabilities	+	Stockholders' Equity
+ 40,000				
- 40,000				

Journal Entry

		Debit	Credit
02/01	Land	40.000	
	Cash		40.000

Ledger Accounts

Cash		Land	
50.000 (01.01)	40.000 (02.01)	40.000 (02.01)	

Example

03.01.2017: Purchased supplies for €3.700 on account.

Accounting Equation

Assets	=	Liabilities	+	Stockholders' Equity
+ 3.700		+ 3.700		

Journal Entry

		Debit	Credit
03/01	Supplies	3.700	
	Accounts Payable		3.700

Ledger Accounts

Supplies	Accounts Payable
3.700 (03.01)	3.700 (03.01)

Example

Date	Event
July 1	Joan invests €40.000 in cash to form Design Inc. In return receives common stock.
1	The firm orders office supplies of €5.200.
3	Joan rents an office for the firm. She pays in advance €3.200 for two months' rent.
5	The business receives the office supplies ordered on July 2 and an invoice for €5.200 to be paid.
6	Purchases equipment totaling €16.320 for which €13.320 was paid in cash and the rest was agreed to be paid next month.
9	The firm paid €2.600 for the amount owed for the office supplies received on July 5.
10	The firm performed services for a customer for which it collected €2.800 in cash.
15	The firm performed services of €9.600 for a customer, that will be collected in the future.
19	Received in advance €1.400 for services to be performed in the future.
22	Received €5.000 for the services provided on July 15.
26	Paid employee salaries, €4.800.
30	Paid cash dividend of €2.800.

The Trial Balance

- An accounting tool used to ensure that the total of debits and credits in the accounts are equal.

Blue Design Studio Trial Balance July 31, 2014		
	DEBIT	CREDIT
Cash	22,480	
Accounts Receivable	4,600	
Office Supplies	5,200	
Prepaid Rent	3,200	
Office Equipment	16,320	
Accounts Payable		6,280
Unearned Revenue		1,400
Common Stock		40,000
Dividends	2,800	
Revenue		12,400
Salaries	4,800	
Utilities	680	
	<u>60,080</u>	<u>60,080</u>

Preparation and Use of a Trial Balance

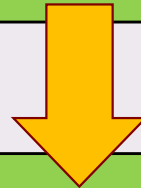
- The steps involved in preparing a trial balance are:
 1. List each account with a balance, **with debit balances in the left column and credit balances in the right column.**
 2. Add each column.
 3. Compare the totals of each column.
- The trial balance proves whether the accounts are *in balance* but does not detect all errors.

Finding Trial Balance Errors

- If the debits and credits in a trial balance are not equal, look for these common errors:
 - A debit was entered in an account as a credit, or vice versa.
 - The balance of an account was computed incorrectly.
 - An error was made in carrying the account balance to the trial balance.
 - The trial balance was summed incorrectly.

Flow of Accounting Data (1/2)

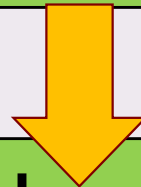
Transaction Occurrence



Transaction **Analysis**



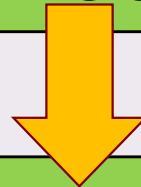
Record to the Journal (*Journalize*)



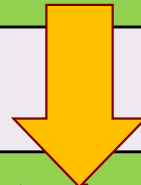
Post to the Ledger (*Posting*)

Flow of Accounting Data (2/2)

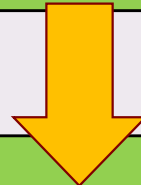
Post to the Ledger (*Posting*)



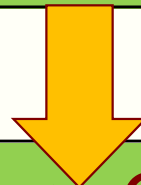
Prepare **Trial Balance**



Adjust the Accounts → **Adjusted Trial Balance** –



Prepare the Financial Statements



Close the Accounts → **Closing Trial Balance**

Chart of Accounts

- Organizations use a **chart of accounts** to list all their accounts and account numbers.
- Account numbers usually have two or more digits.
 - The first digit indicates if the account is an Asset, Liability, Equity, Revenues or Expenses account.
 - The second, third, and higher digits indicate the position of the individual account within the category.

Chart of Accounts

Balance Sheet Accounts

Assets

101 Cash
111 Accounts Receivable
141 Supplies
151 Land
191 Office Furniture

Liabilities

201 Accounts Payable
231 Notes Payable

Stockholders' Equity

301 Common Stock
311 Retained Earnings
312 Dividends

Income Statement Accounts (Part of Stockholders' Equity)

Revenues

401 Service Revenue

Expenses

501 Rent Expense
502 Salary Expense
503 Utilities Expense