

The Fundamentals of Accounting



Learning Objectives



Understand the role and importance of the financial statements.



Define various financial statement terms.



Explain the format of the income statement, balance sheet, and cash flow statement.



Record financial statement transactions.



Understand how transactions move through the financial statements.



Prepare simple financial statements.

The Income Statement



A black calculator and a black pen are resting on a financial statement. The calculator is positioned in the upper right, showing various function keys like MRC, M-, X, 9, 8, 7, 6, 5, 4, 3, 2, 1, 0, AC, ON/C-CE, and =. The pen is positioned in the lower left, pointing towards the table. The financial statement is a multi-column table with various line items and numerical values.

	0	(1,000)	0
issued	208	660	544
repurchased	(1,042)	(5,052)	(2,976)
cash dividends paid	(1,683)	(1,363)	(3,024)
used in financing	(2,513)	(6,751)	(5,382)
erty and equipment	(498)	(491)	(934)
panies, net of			
nd purchases of			
her assets	(8,627)	(69)	(9,502)
tments	(10,047)	(5,896)	(21,346)
m	6,061	1,836	8,886
	7,835	2,603	15,371
	(292)	447	(35)
investing	(5,568)	(1,570)	(7,88)
alents, end of			

The Income Statement



Financial statements are a communication tool.



The income statement is broken into several sections.

The Income Statement

Revenue ← Also called Sales or Turnover

Direct operating costs
(e.g., cost of goods sold)

----- Gross Profit

Indirect operating costs (e.g.,
R&D, administration, selling,
distribution)

----- EBITDA
Earnings before interest,
taxes, depreciation, and
amortization

----- EBIT
Earnings before interest and
taxes

----- EBT
Earnings before taxes

Tax
----- Net income

Time and the Income Statement

The income statement and balance sheet differ in how they relate to time.



Balance Sheet

Shows the financial position at a point in time.



Income Statement

Shows the results of operations over a period of time.



The period of time depends on the reporting requirements for each company.



A company's location also impacts how many times they are required to report..

Matching Principle

One of the key principles that guide the recording of accounting transactions is the matching principle.

If expenses have been incurred to generate revenue, they need to be recorded on the income statement in the same period.



Regular Entries

Happens every day

- Entries made:

- As sales are made
- Payments are received
- Expenses incurred
- Payments are made



Adjusting Entries

Happens at the end of the period

- Entries capture any revenues and expenses that may have been overstated or understated.
- Prepaids, unearned revenue, depreciation or amortization, and accruals for expenses and revenues.

Adjusting Entries - Prepayments

Insurance policies are generally paid upfront for a year or more. This is called a prepayment.



Policies expire over time. They cannot be recorded as an expense at the time of purchase.



Record transaction as prepaid insurance. It is an asset because there is a future economic benefit.

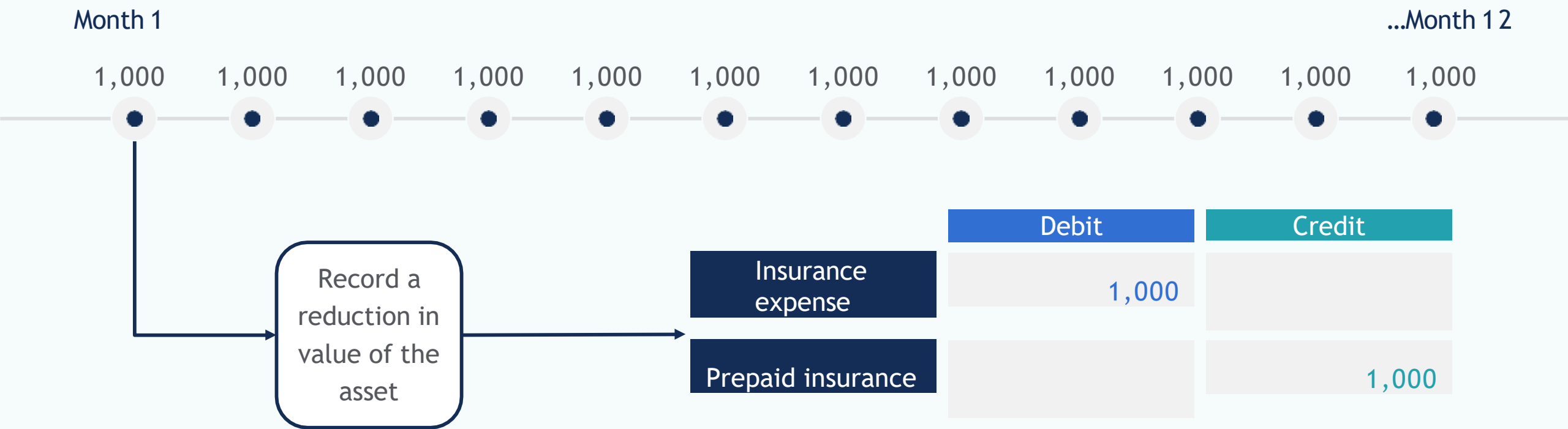
↓

	Debit	Crédit
Prepaid Insurance	✓	
Cash		✓



Adjusting Entries - Prepayments

To demonstrate this process, let's look at an annual insurance policy for 12,000.



 This adjusting entry has an impact on the income statement as well as the balance sheet.

Supplies Prepayment

Imagine that a company purchased its office supplies in bulk at certain times to ensure they always had enough to meet the needs of the office.

	Debit	Cíedit
Supplies	✓	
Cash/Accounts payable		✓



It is not practical to track the use of office supplies.



	Debit	Cíedit
Supplies expense	✓	
Supplies		✓

Supplies Prepayment

Let's look at an example of what happens when a company has supplies left at the end of the year.

 A company buys 10,000 in supplies, so they credit cash 10,000 and debit their supplies 10,000.

 The inventory count at the end of the year indicates there are 3,000 left over..

 We need to make an adjustment to the supplies account to reflect the expenditure of 7,000 of supplies

↓

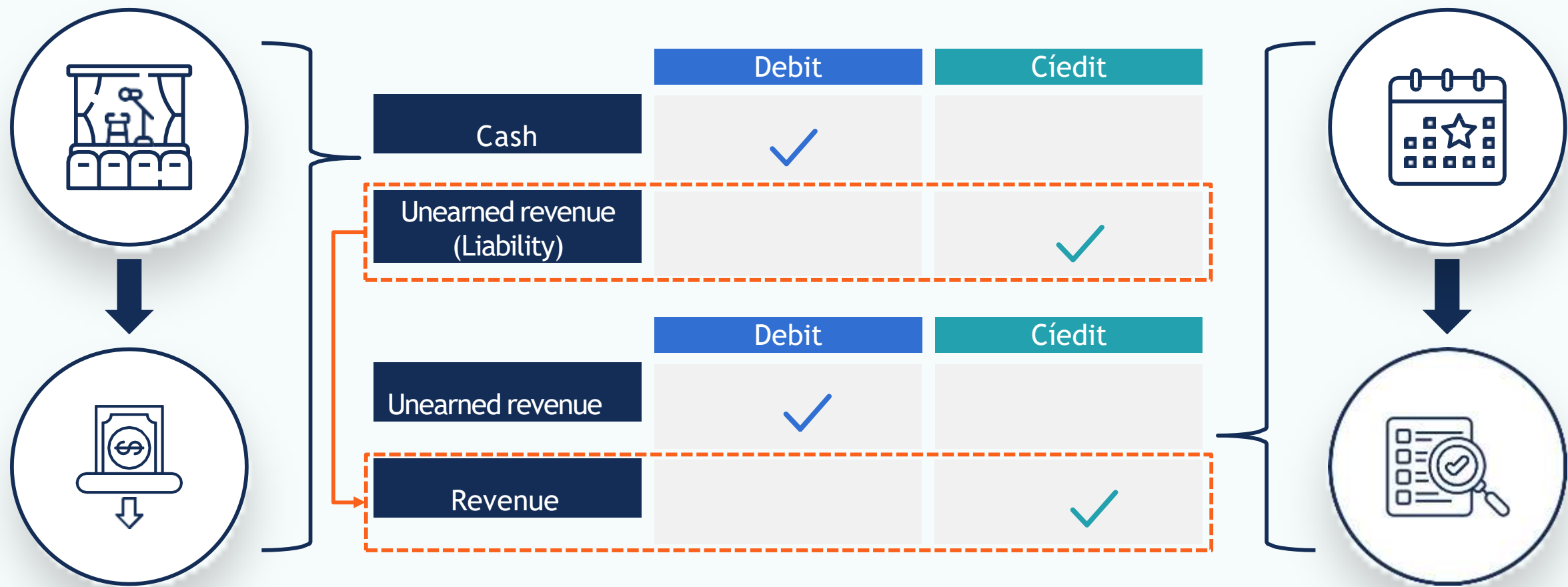
	Debit	Crédit
Supplies expense	7,000	
Supplies		7,000



Adjusting Entries - Unearned Revenue

It is common for clients or customers to pay for goods or services to be delivered at a future date.

An example is putting money down as a deposit (i.e., houses, cars, event spaces, etc.).



Accruals

Sometimes, companies come to the end of a reporting period to realize that some of their revenue and expenses have not been entered.

Revenue

- i.e., Unbilled and unremitted work
- The financial statements need to show the revenues earned in that period and the accounts receivable expected.

	Debit	Credit
Accounts receivable	✓	
Revenue		✓

Expenses

- i.e., Telephone bills and utilities expense
- The financial statements need to show the expenses incurred in that period and the accounts payable expected..

	Debit	Credit
Expense Account	✓	
Accounts payable		✓

Adjusting Entries - Depreciation

The most important adjusting entries concept to understand is depreciation.

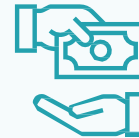
Assets	
Current assets Cash [150,000 - 80,000]	↓ 70,000
Non-current assets Equipment	↑ 80,000
Total	150,000



Equipment was purchased for 80,000.



Equipment has a useful life of 4 years.

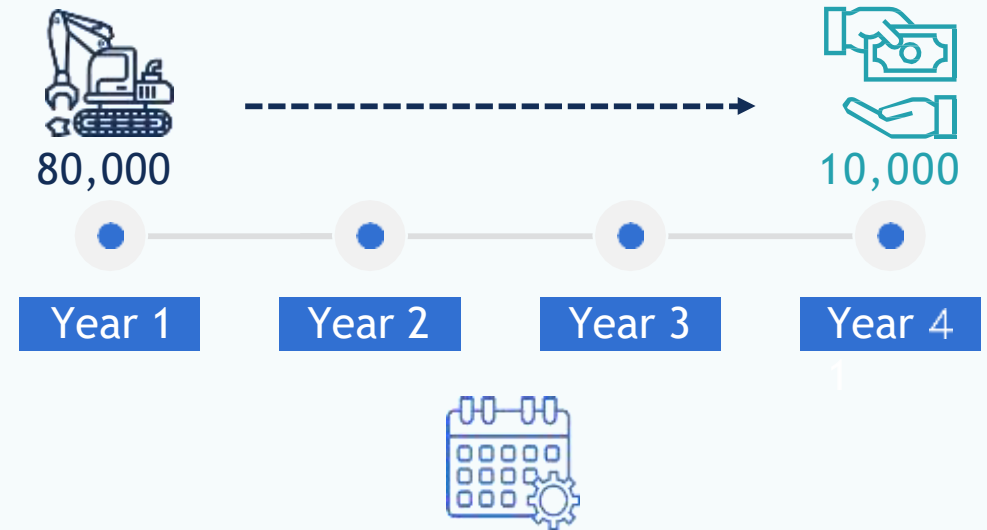


Equipment has a scrap value of 10,000..

Adjusting Entries - Depreciation

The most important adjusting entries concept to understand is depreciation

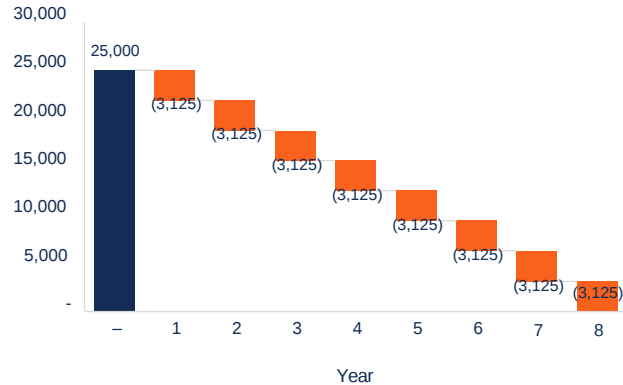
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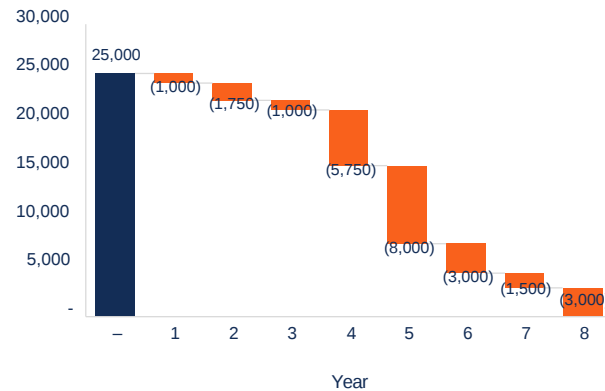
Depreciation Approaches

Depreciation is an expense and is used to reflect the decline in value of the asset over its useful life.

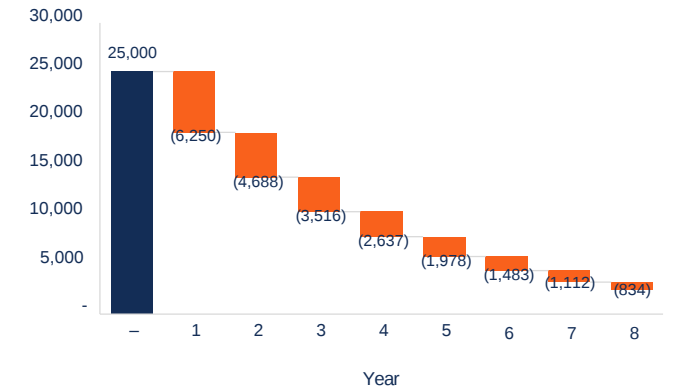
Straight Line



Units of Production Approach



Double Declining Balance Approach



All methods depend on several factors, including the cost of the asset, useful life, how the asset is used, and salvage value.



The business needs to select the depreciation approach that best matches how the asset will be used in the business.

Straight Line Approach

Straight line depreciation assumes that an asset will decline at a consistent rate over its lifetime.

Straight Line Depreciation Approach

Examples

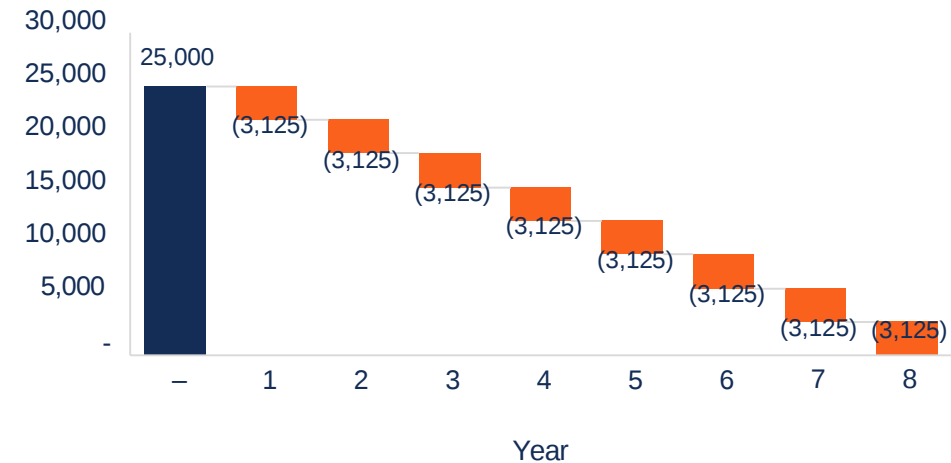


Assets that provide the same level of service or production over time.

Equation

$$= \frac{\text{Cost} - \text{Salvage Value}}{\text{Useful life of asset}}$$

Straight Line Depreciation



$$= \frac{75,000}{5} = 15,000$$

The Impact of Depreciation

Let's go back to our example of purchasing 30,000 in equipment and calculate the depreciation expense using the straight line approach.



Equipment was purchased for 30,000.



Equipment has a useful life of 4 Years.



Equipment has a scrap value of 0,000.



Straight Line Approach

$$= \frac{\text{Cost} - \text{Salvage Value}}{\text{Useful life of asset}}$$

$$= \frac{50,000}{4}$$
$$= 12,500$$

	Debit	Credit
Depreciation	12,500	
Accumulated depreciation		12,500



Contra account or contra-asset account
(contra means against)

Accumulated Depreciation

Accumulated depreciation is an example of a contra-asset account.

Assets	
Current assets: Cash	70,000
Non-current assets	
Equipment	30,000
Accumulated depreciation	(5,500)

Year 1

30,000

(5,500)

24,500

Net Book Value

Accumulated Depreciation

Accumulated depreciation is an example of a contra-asset account.

Assets	
Current assets: Cash	70,000
Non-current assets: Equipment	80,000
Accumulated depreciation	(12,500)

Assets	
Current assets: Cash	70,000
Non-current assets: Equipment	30,000
Accumulated depreciation	(5,000)

Year 1
80,000
(12,500)
67,500

Year 2
80,000
(37,500)
42,500

Year 3
80,000
(25,000)
55,000

Year 4
80,000
(50,000)
30,000

Double Declining Balance Approach

This method recognizes that the business gets more value from an asset at the beginning of its useful life.

Double Declining Balance Approach

Exmples

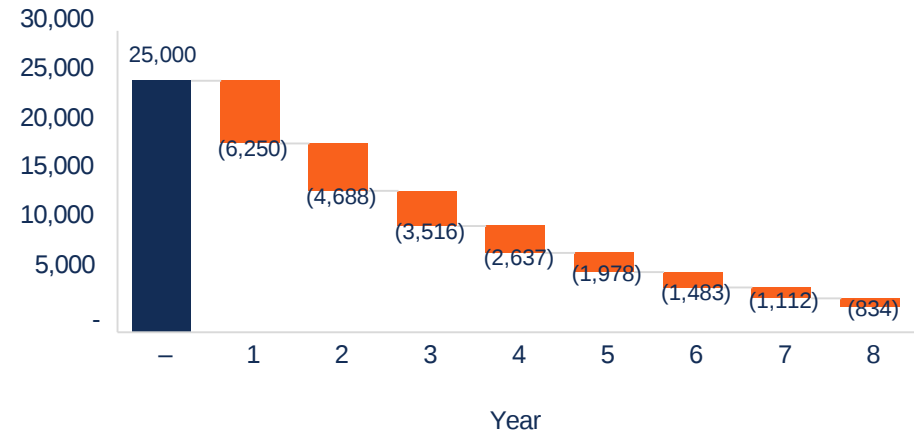


The asset has a higher level of depreciation at the beginning of its life.

Equation

$$\text{Net book value} = \frac{100\%}{\text{Useful life of asset}} : ?$$

Double Declining Balance Depreciation



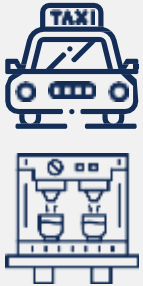
$$= 100\% \div 2 = 2 \times 5,000 = 6,000$$

Units of Production Approach

This method recognizes that the asset's expense directly relates to its productive capacity.

Units of Production Approach

Examples

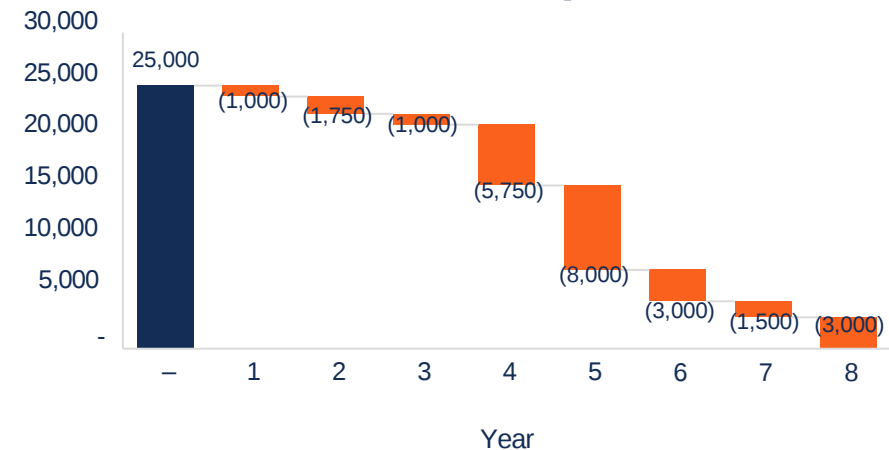


The more the asset is used, the higher the cost of depreciation.

Equation

$$= \frac{\text{\# or units produced}}{\text{Lifetime \# or units}} (\text{Cost} - \text{Salvage Value})$$

Units of Production Depreciation



$$= \frac{2,000}{50,000} (25,000 - 0) = 4\% : (5,000)$$
$$= 1,000$$