

MODULE 1 | CHS 1, 2

MODULE 1: INTRODUCTION to ACCOUNTING & FINANCIAL REPORTING
Chapters 1, 2 & Supplements

Learning Objectives:		Topic*	Ch & Time
1.1	Explain how and why the conceptual framework of accounting and generally accepted accounting principles provide guidance and structure for preparing financial statements.	F	Ch 1 4 hours
1.2	Describe the information provided in each financial statement and how the statements articulate with each other.	F	
1.3	Identify business ownership structures.	F	
1.4	Explain the role of management and the auditor in preparing and issuing an annual report.	F	
1.5	Describe the relationship between assets, liabilities and equity on the balance sheet.	F	
1.6	Identify and explain the classifications within assets, liabilities, and equity.	F	
1.7	Define and calculate the current ratio and debt equity ratio.	A	
1.8	Describe the information presented in an income statement. (See supplement.)	F	
1.9	Calculate return on sales (net profit margin) and return on equity	A	
1.10	Identify and explain the three phases of the management cycle.	F	Ch 2 4 hours
1.11	Identify and explain the four business processes.	F	
1.12	Explain and calculate the operating cycle (accounts receivable turnover and inventory turnover).	A	
1.13	Explain how internal control procedures are used to safeguard assets.	F	
1.14	Prepare a bank reconciliation.	F	

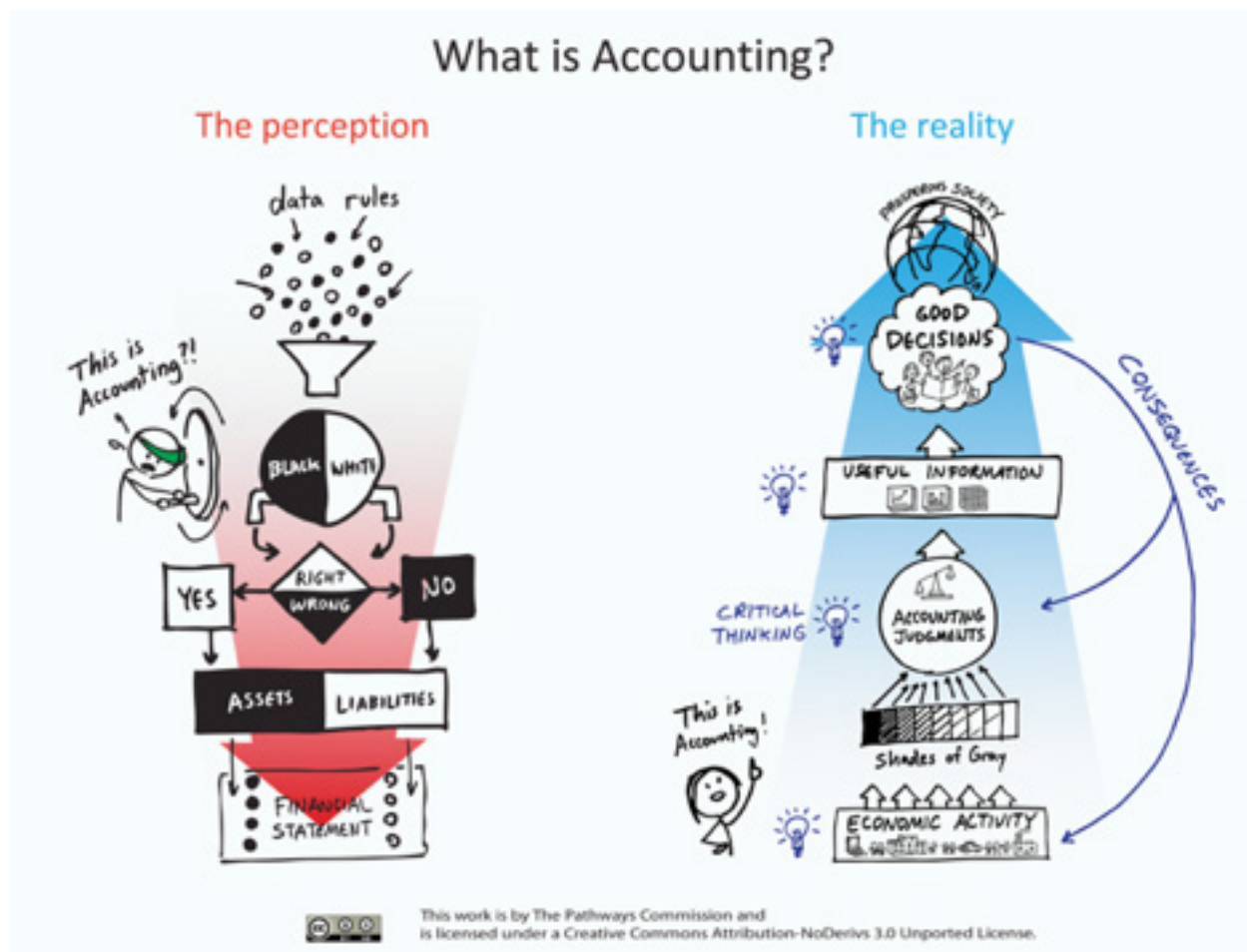
* F: Financial Accounting; M: Managerial Accounting; A: Financial Statement Analysis

Module 1 Total Hours = 8

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NOTES:

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LEARNING OBJECTIVE 1.1: Explain how and why the conceptual framework of accounting and generally accepted accounting principles provide guidance and structure for preparing financial statements.

LEARNING OBJECTIVE 1.2: Describe the information provided in each financial statement and how the statements articulate with each other.



Primary Components of Financial Statements, pg. 24 text

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LEARNING OBJECTIVE 1.3: Identify business ownership structures.

Sole Proprietorships and Partnerships (single or multiple owners)

ADVANTAGES:

- Ease of formation
- Income taxes only at the individual's level
- More owner involvement

DISADVANTAGES:

- Unlimited liability
- Limited ability to raise capital
- Mutual agency (partnerships)

Corporations (Stockholders)

ADVANTAGES:

- Limited liability
- Unlimited life
- Ability to raise capital

DISADVANTAGES:

- Regulatory requirements
- Double taxation

LEARNING OBJECTIVE 1.4: Explain the role of management and the auditor in preparing and issuing an annual report.

LEARNING OBJECTIVE 1.5: Describe the relationship between assets, liabilities and equity on the balance sheet.

LEARNING OBJECTIVE 1.6: Identify and explain the classifications within assets, liabilities, and equity.

LEARNING OBJECTIVE 1.7: Define and calculate the current ratio and debt equity ratio. (see Learning Objective 1.9 Exercise).



See www.investopedia.com for excellent videos and articles.



See www.accountingintheheadlines.com a concise resource for real life news stories and short videos to use in teaching introductory accounting at the college level.

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LEARNING OBJECTIVE 1.8: Describe the information presented in an income statement.

Every business is created to render services and/or sell products (its primary operating activities) with the goal of increasing the wealth of the business's owners. Apple's primary operating activities are selling computers, iPods, iPhones and the goods and services that support their customers' use of these products. The primary objective of the **income statement** is to report how well a company has performed, in financial terms, in conducting its operating activities during a specified time period. In other words, how much has the wealth of the owners' increased (net income) or decreased (net loss) during a specific time period as a result of its operating activities? However, those interested in the performance of a company want to know more about the company's performance than one number. Using a sports analogy to illustrate this point, suppose your favorite team won a critical game that you weren't able to see or listen to, would you be satisfied with knowing the final score? Most fans would want a more detailed report (newspaper sports page or Sports Center on ESPN) of just what happened during the game to determine the outcome. The income statement is similar in that it provides a broader description of the activities that resulted in an increase or decrease the owners' wealth.

To describe the information reported by an income statement we will use the example below. Collyer Corporation is in the business of selling souvenirs to tourists.

COLLYER CORPORATION

Income Statement

For the Year Ended December 31, 2016

Sales		\$1,200,000
Less: Sales Returns		<u>50,000</u>
Net Sales		\$1,150,000
Cost of Goods Sold		<u>400,000</u>
Gross Margin		\$ 750,000
Operating Expenses:		
Advertising Expense	\$200,000	
Wages Expense	100,000	
Administrative Expenses	<u>300,000</u>	
Total Operating Expenses		<u>600,000</u>
Operating Income		\$ 150,000
Non operating Items		
Gain on Sale of Equipment		<u>20,000</u>
Income before Taxes		\$ 170,000
Tax Expense		<u>51,000</u>
Net Income		<u>\$ 119,000</u>

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Net sales reflect the amount earned by selling the firm's products after deducting the sales that were returned. Investors want to know not only how much was sold but also how satisfied the customers are with the product (how much of the product was returned). The cost of goods sold is the cost of buying or producing the products sold by the firm. Gross margin is the difference between the cost of the product and its selling price and is the amount generated by the firm that must cover other costs in order to generate net income for the firm. The operating expenses are the cost of the activities necessary to conduct the firm's primary activities of the business. Spending money on wages and advertising are necessary to operate a souvenir business. Operating income reflects the increase in firm's wealth as a result of its central ongoing operations.

The income statement also reports items that affect the wealth of the owners that occur during a time period but are incidental to its primary operations. In this case, Collyer sold some equipment for more than its cost but Collyer is not in the business of selling equipment. By identifying these events as non-operating, the reader of the financial statement can identify both the cost of the events that support operations and those that are incidental to the operations and assess the performance of the company. In this case the sale of the equipment increased net income but the primary increase in net income is due to operating activities. When the opposite occurs, investors should be concerned about the ability of the firm to generate profit in the future.

The federal government does not make a distinction between operating and nonoperating income when it taxes business entities. Taxes are a cost of doing business and reduce the income generated by the business. As stated earlier, net income represents the increase in wealth of the business's owners, and the income statement describes the financial consequences of the activities that created net income for the time period measured.

In the Appendix the Income Statement of Apple for the fiscal year ended on September 28, 2013 is illustrated. Note that the statement is titled Consolidated Statement of Operations. This reflects the idea that operations generate profits. You may also hear the Income Statement described as the P & L or profit and loss statement. Apple's net income for 2013 is \$37 billion (note that all the statements are presented in millions). Apple provides information for the current period (left column) as well as the previous two periods. This allows users to compare the composition of the current year's results to those of prior years. Apple increased its net sales by \$62,661 million from 2011 to 2013 (\$170,910 - \$108,249) while its net income increased \$11 billion in the same time period (\$37 - \$26). This data is important to financial statement users who are trying to determine how Apple will perform in the future. The trend of past operating performance is important evidence for current and potential stakeholders who are trying to answer the question: "What will Apple's earnings be in the future?"

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INCOME STATEMENT

P1.10 Farwell Company has the following information available from its most recent fiscal year. Use the relevant information to determine the net income (loss) for the period.

- A. Cash sales, \$50,000
- B. Employee salary expense, \$40,000
- C. Common stock issued for cash, \$100,000
- D. Sales on account, \$48,000
- E. Utility expense, \$1,500
- F. Long-term loan received, \$50,000
- G. Interest earned on investments, \$200
- H. Property tax expense, \$12,000
- I. Inventory purchased for resale, \$120,000
- J. Cost of inventory sold, \$70,000
- K. Insurance purchased for the next year, \$4,800
- L. Rent expense, \$12,000

INCOME STATEMENT

P1.10, pg 32

Farwell Company has the following information available from its most recent fiscal year. Use the relevant information to determine the net income (loss) for the period.

• Cash sales, \$40,000	Revenues:		
• Employee salary expense, \$30,000	Cash Sales	\$50,000	
• Common stock issued for cash, \$100,000	Sales on Account	<u>\$48,000</u>	
• Sales on account, \$58,000	Total Revenue		\$98,000
• Utility expense, \$1,500	Expenses:		
• Long term loan received, \$50,000	COGS	70,000	
• Interest earned on investments, \$100	Empl salary expense	40,000	
• Property tax expense, \$10,000	Utility Expense	1,500	
• Inventory purchased for resale, \$120,000	Property tax Expense	12,000	
• Cost of inventory sold, \$102,000	Rent Expense	<u>12,000</u>	
• Insurance purchased for the next year, \$4,800	Total Operating Expenses		<u>\$135,500</u>
• Rent expense, \$12,000	Operating Income		(\$37,500)
	Interest Income		<u>200</u>
	Net Income (loss)		(\$37,300)

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LEARNING OBJECTIVE 1.9 Calculate return on sales (net profit margin) and return on equity.**Financial Analysis****P2.7** The financial statements for Petrisin Company are as follows:

PETRISIN COMPANY		
Comparative Balance Sheet		
December 31, 2014 and 2013		
	<u>2014</u>	<u>2013</u>
Cash	\$24,200	\$20,000
Accounts receivable	45,650	39,000
Inventory	79,200	64,000
Plant and equipment	316,800	265,000
Accumulated depreciation	<u>(88,000)</u>	<u>(72,000)</u>
Total assets	<u>\$377,850</u>	<u>\$316,000</u>
Accounts payable	\$ 26,400	\$ 37,000
Wages payable	3,850	4,000
Taxes payable	7,425	8,500
Bonds payable	110,000	100,000
Common stock	88,000	80,000
Retained earnings	<u>142,175</u>	<u>86,500</u>
Total liabilities and stockholder's equity	<u>\$377,850</u>	<u>\$316,000</u>

PETRISIN COMPANY		
Income Statement		
For the Year Ended December 31, 2014		
Sales		\$400,000
Cost of Goods Sold		<u>231,000</u>
Gross Margin		\$168,250
Operating Expenses:		
Selling Expenses	\$39,000	
Rent Expense	\$45,000	
Depreciation expense	\$11,000	
Bad Debt expense	1,715	
Interest expense	<u>15,000</u>	<u>111,715</u>
Income from Operations		\$ 56,535
Loss on sale of equipment		<u>(2,000)</u>
Income before taxes		\$ 54,535
Income tax expense		<u>11,785</u>
Net Income		<u>\$ 42,750</u>

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CALCULATE RATIOS AND EXPLAIN EACH ONE.

P2.7 Quick ratio:

$$(\$24,200 + \$45,650) / (\$26,400 + \$3,850 + \$7,425) = 1.85$$

Current ratio:

$$(\$24,200 + \$45,650 + \$79,200) / (\$26,400 + \$3,850 + \$7,425) = 3.96$$

Gross margin ratio:

$$\$168,250 / \$400,000 = 42.06\%$$

Return on sales ratio:

$$\$42,750 / \$400,000 = 10.69\%$$

Return on investment ratio:

$$\$42,750 / [(\$377,850 + \$316,000) / 2] = \$42,750 / \$346,925 = 12.32\%$$

Return on owners' equity ratio:

$$\$42,750 / [(\$88,000 + \$80,000 + \$142,175 + \$86,500) / 2] = \$42,750 / \$198,337.5 = 21.55\%$$

Debt to equity ratio:

$$(\$26,400 + \$3,850 + \$7,425 + \$110,000) / (\$88,000 + \$142,175) = 0.64$$

Accounts receivable turnover and days in the collection cycle:

$$\$400,000 / [(\$45,650 + \$39,000) / 2] = 9.45; 365 / 9.45 = 38.62 \text{ days}$$

Inventory turnover and days in the selling cycle:

$$\$231,750 / [(\$79,200 + \$64,000) / 2] = 3.24; 365 / 3.24 = 112.65 \text{ days}$$

Accounts payable turnover and days in the payment cycle:

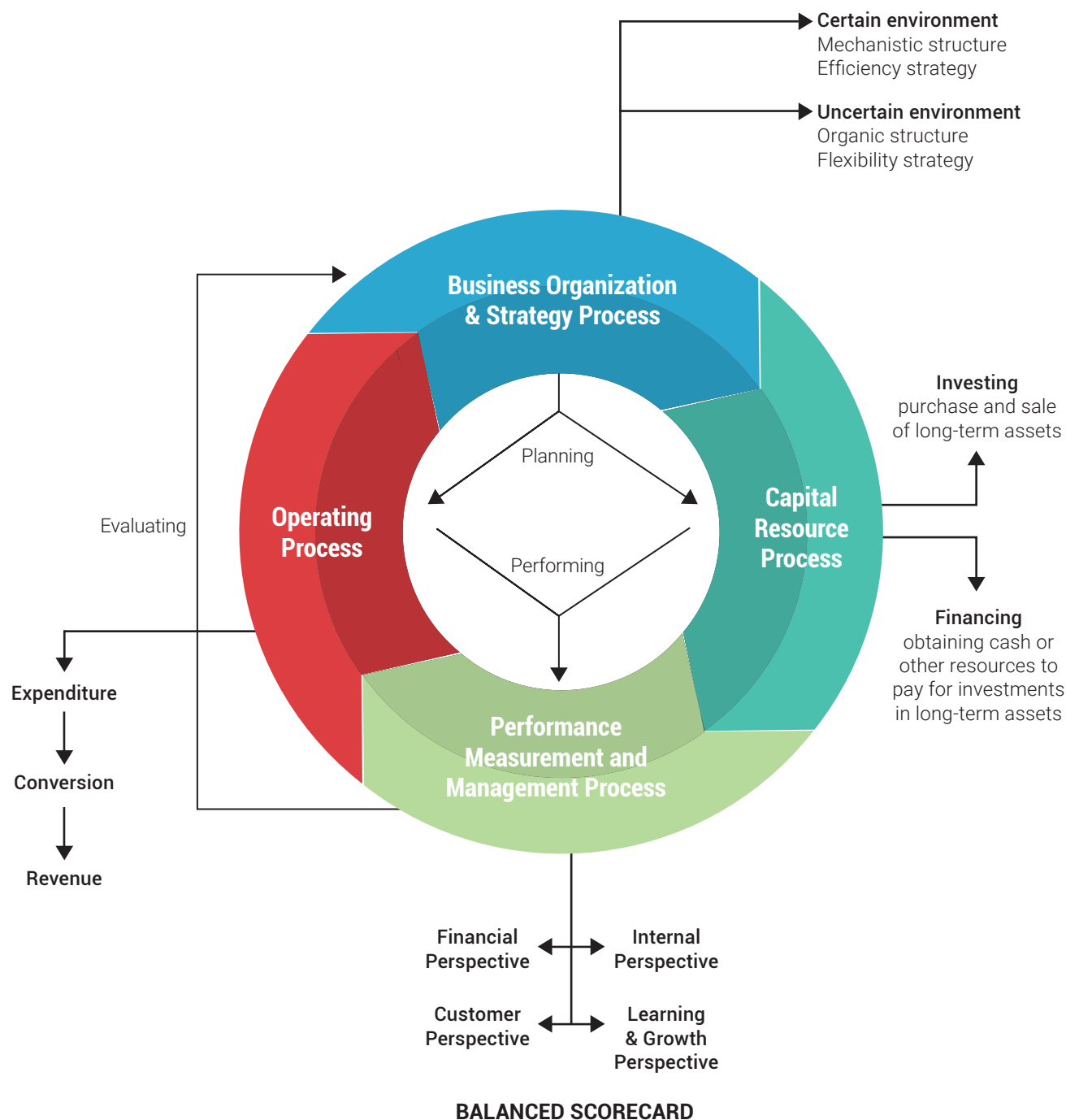
$$\$231,750 / [(\$26,400 + \$37,000) / 2] = 7.31; 365 / 7.31 = 49.93 \text{ days}$$

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LEARNING OBJECTIVE 1.10: Identify and explain the three phases of the management cycle.

LEARNING OBJECTIVE 1.1: Identify and explain the four business processes.

MANAGEMENT CYCLE AND BUSINESS PROCESSES



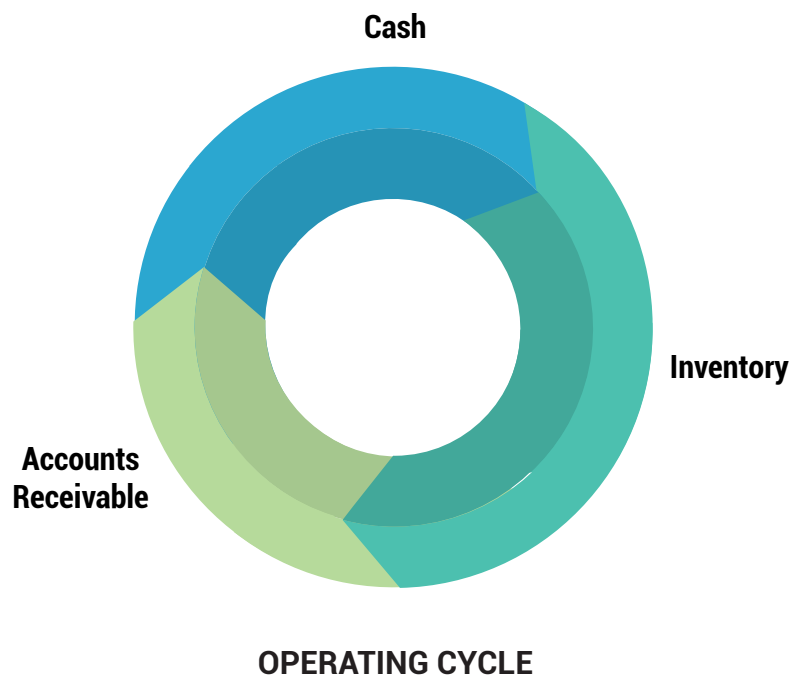
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LEARNING OBJECTIVE 1.12: Explain and calculate the operating cycle (accounts receivable turnover and inventory turnover).

The length of the operating cycle = Days it takes to sell inventory + Days it takes to collect cash from the sale of inventory.

The operating cycle is defined as the length of time it takes cash to become cash again when it is invested in inventory.

Wal Mart has a very small operating cycle but furniture stores have a much longer operating cycle. The shorter the cycle the better the use of cash.



LEARNING OBJECTIVE 1.13: Explain how internal control procedures are used to safeguard assets.



Watch *The Profit*, Season 1, Episode 3 for discussion on internal cash controls

LEARNING OBJECTIVE 1.14: Prepare a bank reconciliation.

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CHAPTERS 1 AND 2 FORMULA GUIDE

Quick Ratio
$$\text{Cash} + \text{Short Term Investments} + \text{Receivables} / \text{Current Liabilities}$$
Current Ratio
$$\text{Current Assets} / \text{Current Liabilities}$$
Gross Margin Ratio
$$\text{Gross Margin} / \text{Sales}$$
Return on Sales Ratio
$$\text{Net Income} / \text{Sales}$$
Return on Investment Ratio (ROI)
$$\text{Net Income} / \text{Average Total Assets}$$
Return on Owner's Equity Ratio
$$\text{Net Income} / \text{Average Owners Equity}$$
Debt to Equity Ratio
$$\text{Total Liabilities} / \text{Total Owners Equity}$$
A/R turnover and days
$$\text{Sales} / \text{Average Accounts Receivable} = \text{turnover}$$
365 / A/R turnover = days
$$\text{Inventory turnover and days}$$
Cost of Goods Sold/ Average Inventory = turnover
$$365 / \text{Inventory turnover} = \text{days}$$
A/P turnover and days
$$\text{Cost of Goods Sold} / \text{Average Accounts Payable} = \text{turnover}$$
$$365 / \text{A/P turnover} = \text{days}$$