chapter 3 Operating Decisions and the Accounting System

Financial Accounting

11e

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The Operating Cycle

Accountants follow the **time period assumption**, which assumes that the long life of a company can be reported in shorter time period such as:

- months
- quarters
- years

Two issues arise when reporting periodic income:

1) Recognition issues: **When** should the effects of operating activities be recognized (recorded)?

2) Measurement issues: **What amounts** should be recognized?

Elements of the Income Statement

Revenues
Increases in assets or settlements of liabilities from the major or central ongoing operations.

Expenses
Decreases in assets or increases in liabilities from ongoing operations incurred to generate revenues.

Gains
Increases in assets or settlements of liabilities from peripheral transactions.

Losses
Decreases in assets or increases in liabilities from peripheral transactions.

Other Income Statement Items

Not all activities affecting the income statement are "central to ongoing operations".

Revenues, expenses, gains, or losses that result from **other activities** that are NOT central to ongoing operations are categorized as **Other Items**.

These items are not included in the subtotal "Income from Operations".

Other items typically include:

- Interest Revenue (also Investment Revenue, Investment Income, or Dividend Revenue)
- Interest Expense
- Losses (Gains) on Sale of Investments

Typical Income Statement Format

Operating Revenues
<u>Less Operating Expenses</u>
Income from Operations
<u>Add/Less: Other Items</u>
Income before Income Taxes *(or Pretax Income)*
<u>Income Tax Expense *(or Provision for Income Taxes)*</u>
Net Income

Corporations are required to disclose earnings per share (EPS) on the income statement or in the notes to the financial statements.

$$\text{Earnings per Share}^{*} = \frac{\text{Net Income}}{\text{Weighted average number of shares of common stock outstanding}}$$

Exhibit 3.1 Chipotle Mexican Grill's Income Statement

**The information has been adapted from actual statements and simplified for this chapter.*

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Statement of Income*
For the Year ended December 31, 2019
(in millions of dollars, except per share data)

			EXPLANATIONS
			Period of time that financial performance was measured
Operating Section (central focus of business)	Restaurant sales revenue	$5,586	*Earned from providing food service to customers during the year*
	Restaurant operating expenses:		
	Supplies expense	1,848	*Cost of food, drink, and packaging supplies used during the year*
	Wages expense	1,472	*Cost of employee wages and salaries for work during the year*
	Rent expense	363	*Cost of renting facilities used during the year*
	Insurance expense	201	*Cost of insurance coverage used during the year*
	Utilities expense	102	*Cost of electric and gas used during the year*
	Repairs expense	73	*Cost of repairing buildings and equipment during the year*
	Other operating expenses	384	*Summary of other operating costs used during the year*
	General and administrative expenses:		
	Training expense	321	*Cost of training employees and managers during the year*
	Advertising expense	142	*Cost of advertising done during the year*
	Depreciation expense	213	*Portion of cost of buildings and equipment used during the year*
	Loss on disposal of assets	23	*Cost of assets sold during the year minus exchange price*
	Total operating expenses	5,142	
	Income from operations	444	*Subtraction of operating expenses from operating revenues*
Other Items Section (not central focus of business)	Other items:		*Revenues/expenses/gains/losses from investments/debt during the year*
	Interest revenue	17	*Earned from investments during the year*
	Interest expense	(3)	*Incurred on debt owed during the year*
	Income before income taxes	458	
	Income tax expense	108	*Also called Provision for Income Taxes for the year*
	Net income	$ 350	*Difference between all revenues and expenses for the year*
	Earnings per share	$12.62	*= $350 million ÷ 27.74 million weighted average shares of stock outstanding (from Chipotle's 10-K)*

*The information has been adapted from actual statements and simplified for this chapter.

How Are Operating Activities Recognized and Measured?

Cash Basis Accounting

- **Cash basis accounting** is used by many sole proprietors and small partnerships to determine performance.
- It is simple and permitted for tax purposes.
- Cash basis accounting records each cash payment as a cash outflow and each cash receipt as a cash inflow.
- This produces **net cash flow** information that is often quite adequate for organizations that do not need to report to external users.

CAUTION: Cash basis accounting may lead to an incorrect interpretation of future company performance. **GAAP does not allow the cash basis of accounting.**

How Are Operating Activities Recognized and Measured?

Accrual Basis Accounting

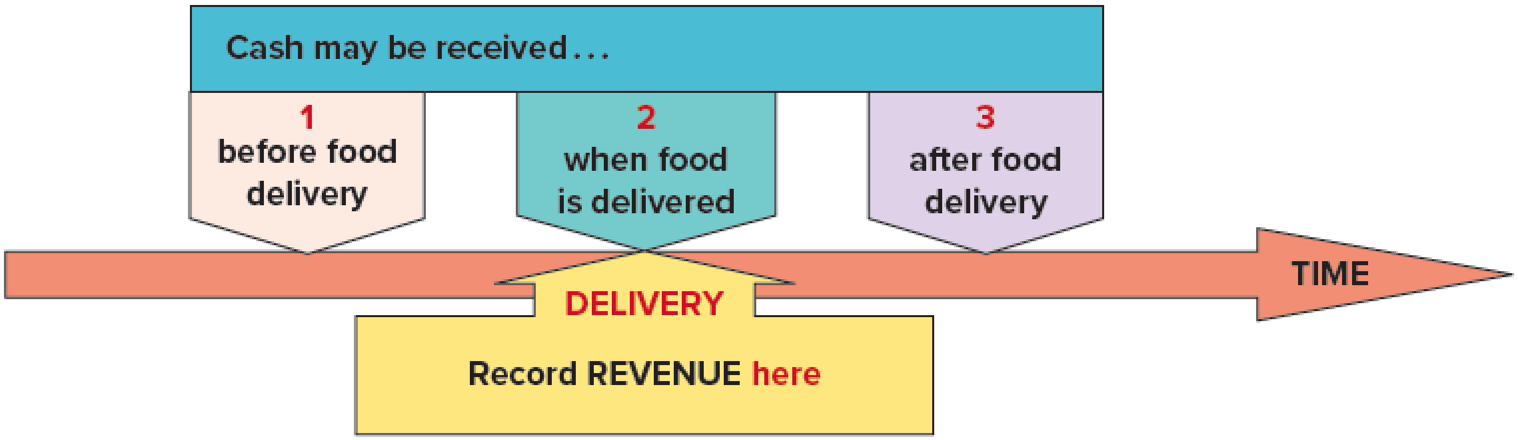
- **Accrual basis accounting** is required by GAAP.

- The accounting principles that determine when revenues and expenses are recorded are the **revenue recognition principle** and the **expense recognition principle** (also called the **matching principle**).

  - **Revenues are recognized when goods and services are provided to customers** (they are earned)

  - **Expenses are recognized in the same period as the revenues to which they relate** (resources are used or debts are incurred to generate revenues), **regardless of when cash is received or paid.**

Revenue Revenues versus Cash Receipts

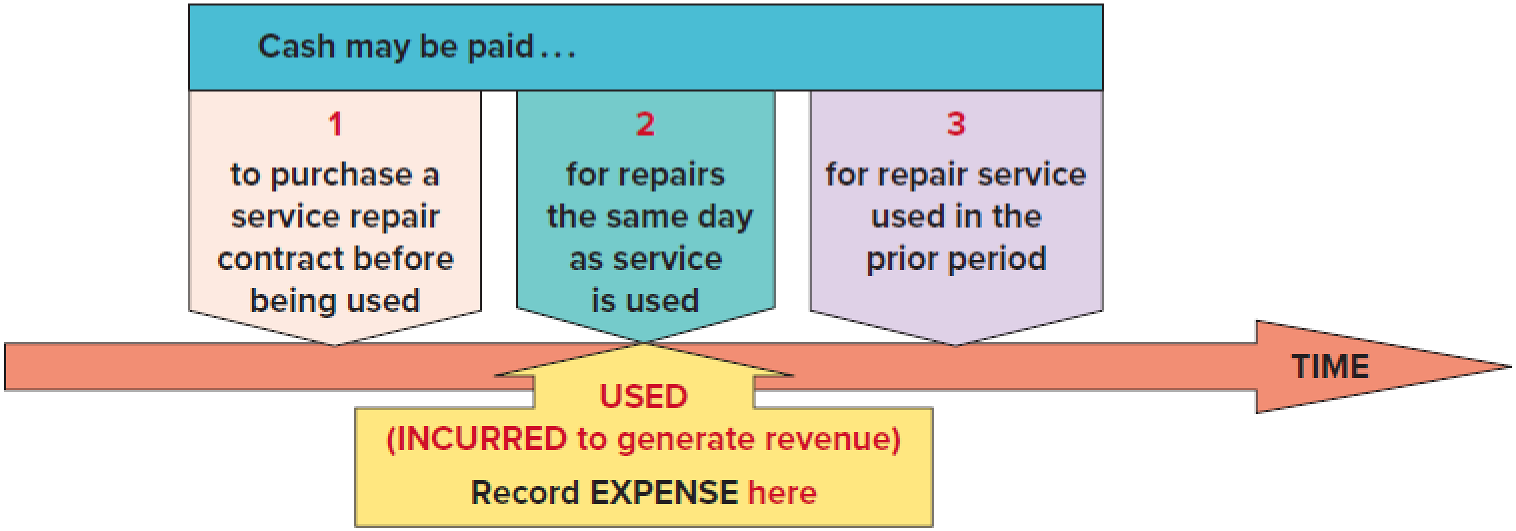


Cash may be received at any of these times:

1. Before the goods or services are delivered.
2. In the same period as the goods or services are delivered.
3. After the goods or services are delivered.

Revenue is always recorded **when the goods or services are delivered**, not when the cash is received from customers.

Recording Expenses versus Cash Payments



Cash may be paid at any of these times:

1. Before the expense is incurred to generate revenue.
2. In the same period as the expense is incurred to generate revenue.
3. After the cost is incurred to generate revenue.

Expense is always recorded **when the cost is incurred**, not when the cash is paid.

In summary:

Understand how revenues and expenses impact the balance sheet and income statement:

REVENUES	EXPENSES
• Increase net income and stockholders' equity	• Decrease net income and stockholders' equity
• ↑ with Credits	• ↑ with Debits
• Accounts have credit balances	• Accounts have debit balances

In-class Journal Entry Examples

KEY RATIO ANALYSIS

Net Profit Margin Ratio

How effective is management in generating profit on every dollar of sales?

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales (or Operating Revenues)}}$$

The 2019 ratio for **Chipotle** using reported amounts (from Exhibit 3.1) is (dollars in millions):

$$\frac{\$350}{\$5{,}586} = 0.0627 \text{ or } 6.27\%$$

COMPARISONS OVER TIME		
Chipotle Mexican Grill, Inc.		
2017	2018	2019
0.0394	0.0363	0.0627

COMPARISONS WITH COMPETITORS	
El Pollo Loco Holdings	Shake Shack Inc.
2019	2019
0.0563	0.041

A rising net profit margin signals more efficient management of sales and expenses.

Note: Net sales is sales revenue less any returns from customers and other reductions. For companies in the service industry, total operating revenues is equivalent to net sales.

Slides below are the same textbook examples; left in slide deck for reference

Analyzing Chipotle's Transactions (1 of 12)

We will now analyze, record, and post to the T-accounts the effects of the first quarter's operating activities for Chipotle.

- The T-accounts begin with the **trial balance amounts** in Exhibit 2.8.
- All amounts are in millions of dollars, except per share information.

For each journal entry:

- When a revenue or expense is recorded, we insert (+R, +SE) for revenues and (+E, −SE) for expenses to emphasize the effect of the transaction on the accounting equation and to see that the equation remains in balance.
- Debits equal credits!

Analyzing Chipotle's Transactions (2 of 12)

(1) **Chipotle sold food and beverages to customers for $1,359; $44 was sold to universities on account** (to be paid by the universities next quarter) **and the rest was received in cash from customers**

	Debit	Credit
(1) Cash (+A)	1,315	
Accounts receivable (+A)	44	
Restaurant sales revenue (+R, +SE)		1,359

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+1,315				Restaurant sales revenue (+R)	+1,359
Accounts receivable	+44					

+ Cash (A) –		
Bal.	357	
(1)	**1,315**	

+ Accounts Receivable (A) –		
Bal.	81	
(1)	**44**	

– Restaurant Sales Revenue (R) +		
	0	Bal.
	1,359	*(1)*

Analyzing Chipotle's Transactions (3 of 12)

***(2)* Assume Chipotle purchased food, beverage, and packaging supplies costing $459 during the quarter, paying $379 in cash, and owing the rest**

	Debit	Credit
(2) Supplies (+A)	459	
Cash (−A)		379
Accounts payable (+L)		80

Assets		=	Liabilities		+	Stockholders' Equity
Supplies	+459		Accounts payable	+80		
Cash	−379					

+ Cash (A) −			
Bal.	357		
(1)	1,315	379	*(2)*

+ Supplies (A) −		
Bal.	26	
(2)	459	

− Accounts Payable (L) +		
	116	Bal.
	80	*(2)*

Analyzing Chipotle's Transactions (4 of 12)

(3) **At the beginning of January, Chipotle paid $207 cash for rent, insurance, and advertising to be used in the future** (all included in the account Prepaid Expenses until used)

	Debit	Credit
(3) Prepaid expenses (+A)	207	
Cash (−A)		207

Assets		=	Liabilities	+	Stockholders' Equity
Prepaid expenses	+207				
Cash	−207				

+ Cash (A) −			
Bal.	357		
(1)	1,315	379	*(2)*
		207	*(3)*

+ Prepaid Expenses (A) −		
Bal.	85	
(3)	207	

Analyzing Chipotle's Transactions (5 of 12)

***(4)* Chipotle paid $65 as training expense for management during the quarter.**

	Debit	Credit
(4) Training expense (+E, −SE)	65	
Cash (−A)		65

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	−65				Training expense (+E)	−65

+ Cash (A) −			
Bal.	357		
(1)	1,315	379	*(2)*
		207	*(3)*
		65	*(4)*

+ Training Expense (E) −		
Bal.	0	
(4)	**65**	

Tip

Reminder: In debiting the expense, the account increases, but it has a negative effect on net income, Retained Earnings and thus stockholders' equity.

Analyzing Chipotle's Transactions (6 of 12)

(5) **Chipotle paid employees $342 for work this quarter and $47 for work last quarter** (recorded last quarter as Wages Expense and Wages Payable for the amount owed to employees who worked then).

	Debit	Credit
(5) Wages expense (+E, −SE)	342	
Wages payable (−L)	47	
Cash (−A)		389

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	−389		Wages payable	−47		Wages expense (+E)	−342

+ Cash (A) −

Bal.	357		
(1)	1,315	379	*(2)*
		207	*(3)*
		65	*(4)*
		389	*(5)*

− Wages Payable (L) +

		127	Bal
(5)	**47**		

+ Wages Expense (E) −

Bal.	0	
(5)	**342**	

Analyzing Chipotle’s Transactions (7 of 12)

(6) **Chipotle sold land costing $21 for $12 cash, resulting in a loss of $9 on the disposal of the**

	Debit	Credit
(6) Cash (+A)	12	
Loss on disposal of assets (+E, −SE)	9	
Land (−A)		21

Tip: Losses on asset disposals are treated similarly to expenses. **Use +E for losses and +R for gains.**

Assets		=	Liabilities	+	Stockholders’ Equity	
Cash	+12				Loss on disposal of assets (+E)	−9
Land	−21					

+ Cash (A) −

Bal.	357		
(1)	1,315	379	*(2)*
(6)	**12**	207	*(3)*
		65	*(4)*
		389	*(5)*

+ Land (A) −

Bal.	33		
		21	*(6)*

+ Loss on Disposal of Assets (E) −

Bal.	0		
(6)	**9**		

Analyzing Chipotle's Transactions (8 of 12)

(7) **Chipotle received $61 cash from customers paying on their accounts.**

	Debit	Credit
(7) Cash (+A)	61	
Accounts receivable (−A)		61

Assets		=	Liabilities	+	Stockholders' Equity
Cash	+61				
Accounts receivable	−61				

+ Cash (A) −			
Bal.	357		
(1)	1,315	379	*(2)*
(6)	12	207	*(3)*
(7)	**61**	65	*(4)*
		389	*(5)*

+ Accounts Receivable (A) −			
Bal.	81		
(1)	44	**61**	*(7)*

Analyzing Chipotle's Transactions (9 of 12)

(8) **During the quarter, assume Chipotle paid $66 on accounts payable to suppliers and paid $25 on utilities payable** (recorded last quarter as Utilities Expense and Utilities Payable for the amount owed for

	Debit	Credit
(8) Accounts payable (–L)	66	
Utilities payable (–L)	25	
Cash (–A)		91

Assets		=	Liabilities		+	Stockholders' Equity
Cash	–91		Accounts payable	–66		
			Utilities payable	–25		

+ Cash (A) –			
Bal.	357		
(1)	1,315	379	*(2)*
(6)	12	207	*(3)*
(7)	61	65	*(4)*
		389	*(5)*
		91	***(8)***

– Accounts Payable (L) +			
		116	Bal.
(8)	**66**	80	*(2)*

– Utilities Payable (L) +			
		156	Bal.
(8)	**25**		

Analyzing Chipotle's Transactions (10 of 12)

(9) **Chipotle paid $117 for utilities used during the quarter and paid $35 for repairs of its buildings and equipment during the quarter.**

	Debit	Credit
(9) Utilities expense (+E, −SE)	117	
Repairs expense (+E, −SE)	35	
Cash (−A)		152

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	−152				Utilities expense (+E)	−117
					Repairs expense (+E)	−35

+ Cash (A) −

	Debit	Credit	
Bal.	357		
(1)	1,315	379	*(2)*
(6)	12	207	*(3)*
(7)	61	65	*(4)*
		389	*(5)*
		91	*(8)*
		152	***(9)***

+ Utilities Expense (E) −

	Debit	Credit
Bal.	0	
(9)	**117**	

+ Repairs Expense (E) −

	Debit	Credit
Bal.	0	
(9)	**35**	

Analyzing Chipotle's Transactions (11 of 12)

(10) **During the quarter, Chipotle sold gift cards to customers for $35 in cash** (expected to be

	Debit	Credit
(10) Cash (+A)	35	
Unearned revenue (+L)		35

Assets		=	Liabilities		+	Stockholders' Equity
Cash	+35		Unearned revenue	+35		

+ Cash (A) −

Bal.	357		
(1)	1,315	379	*(2)*
(6)	12	207	*(3)*
(7)	61	65	*(4)*
(10)	**35**	389	*(5)*
		91	*(8)*
		152	*(9)*

− Unearned Revenue (L) +

		95	Bal.
		35	***(10)***

Analyzing Chipotle's Transactions (12 of 12)

(11) **Assume Chipotle received $3 cash as interest revenue earned during the quarter**.

	Debit	Credit
(11) Cash (+A)	3	
Interest revenue (+R, +SE)		3

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+3				Interest revenue (+R)	+3

+ Cash (A) –

Bal.	357		
(1)	1,315	379	*(2)*
(6)	12	207	*(3)*
(7)	61	65	*(4)*
(10)	35	389	*(5)*
(11)	3	91	*(8)*
		152	*(9)*

– Interest Revenue (R) +

	0	Bal.
	3	*(11)*

Exhibit 3.6 T-Accounts Summary Balance Sheet Accounts

+ Cash (A) −

Bal.	357		
(1)	1,315	379	(2)
(6)	12	207	(3)
(7)	61	65	(4)
(10)	35	389	(5)
(11)	3	91	(8)
		152	(9)
	500		

+ Short-Term Investments (A) −

Bal.	381		
	381		

+ Accounts Receivable (A) −

Bal.	81		
(1)	44	61	(7)
	64		

+ Supplies (A) −

Bal.	26		
(2)	459		
	485		

+ Prepaid Expenses (A) −

Bal.	85		
(3)	207		
	292		

+ Land (A) −

Bal.	33		
		21	(6)
	12		

+ Buildings (A) −

Bal.	1,851		
	1,851		

+ Equipment (A) −

Bal.	862		
	862		

− Accumulated Depreciation (A) +

		1,201	Bal.
		1,201	

+ Operating Lease ROU Assets (A) −

Bal.	2,591		
	2,591		

+ Intangible Assets (A) −

Bal.	74		
	74		

− Accounts Payable (L) +

		116	Bal.
(8)	66	80	(2)
		130	

− Unearned Revenue (L) +

		95	Bal.
		35	(10)
		130	

− Wages Payable (L) +

		127	Bal.
(5)	47		
		80	

− Utilities Payable (L) +

		156	Bal.
(8)	25		
		131	

− Dividends Payable (L) +

		2	Bal.
		2	

− Current Lease Liabilities (L) +

		179	Bal.
		179	

− Notes Payable (L) +

		80	Bal.
		80	

− Long-Term Lease Liabilities (L) +

		2,789	Bal.
		2,789	

− Common Stock (SE) +

		2	Bal.
		2	

− Additional Paid-in Capital (SE) +

		1,482	Bal.
		1,482	

+ Treasury Stock (SE) −

Bal.	2,802		
	2,802		

− Retained Earnings (SE) +

		2,914	Bal.
		2,914	

Exhibit 3.6 T-Accounts Summary Income Statement Accounts

− Restaurant Sales Revenue (R) +

		0	Bal.
		1,359	*(1)*
		1,359	

− Interest Revenue (R) +

		0	Bal.
		3	*(11)*
		3	

+ Wages Expense (E) −

Bal.	0		
(5)	342		
	342		

+ Utilities Expense (E) −

Bal.	0		
(9)	117		
	117		

+ Repairs Expense (E) −

Bal.	0		
(9)	35		
	35		

+ Training Expense (E) −

Bal.	0		
(4)	65		
	65		

+ Loss on Disposal of Assets (E) −

Bal.	0		
(6)	9		
	9		