Chapter 3

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The Operating Cycle

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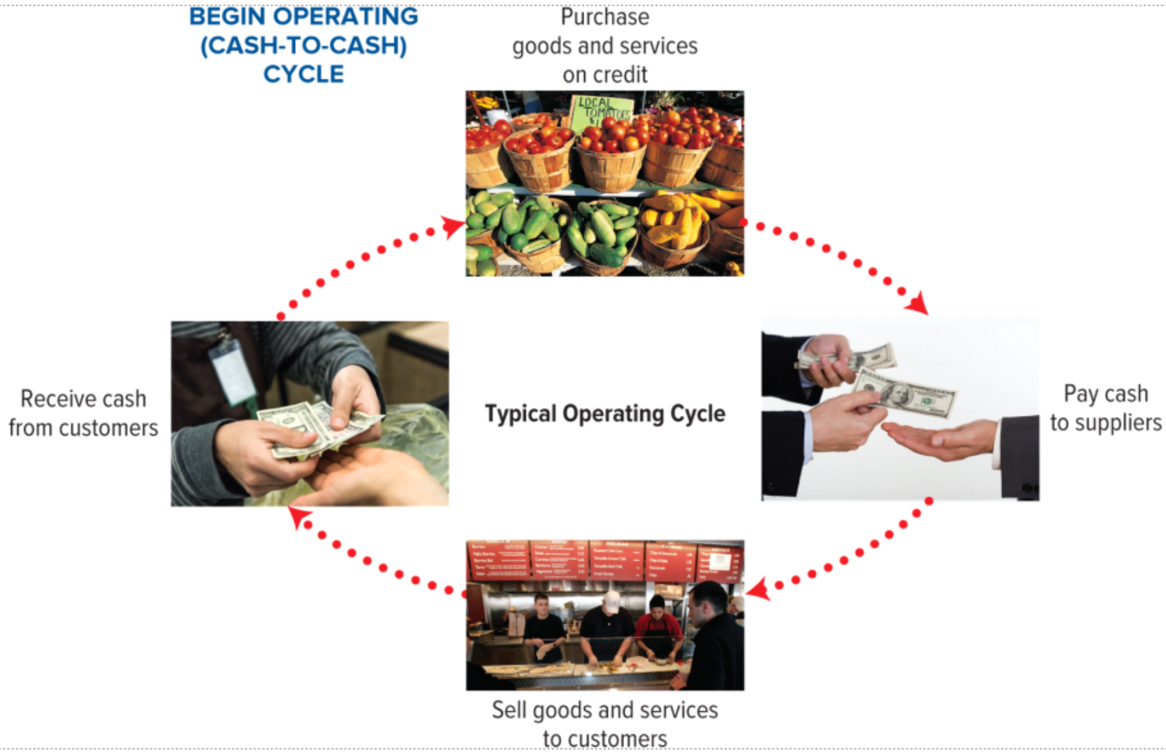


Until a company ceases its activities, the operating cycle is repeated continuously. However, decision makers require information periodically about the company's financial condition and performance.

To measure income for a specific period of time, accountants follow the **time period assumption**, which assumes that the long life of a company can be reported in shorter time periods, such as months, quarters, and years.

Two types of issues arise in reporting periodic income to users:

1. Recognition issues: **When** should the effects of operating activities be recognized (recorded)?
2. Measurement issues: **What amounts** should be recognized?

Multiple Step Income Statement

you can tell if a company uses the multiple-step format if you see the Operating Income subtotal (also called Income from Operations).

EXHIBIT 3.1 Chipotle Mexican Grill's Income Statement

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Statement of Income*
For the Year ended December 31, 2017
(in millions of dollars, except per share data)

Operating activities (central focus of business)	Restaurant sales revenue	$4,477	
	Restaurant operating expenses:		
	Supplies expense	1,536	
	Wages expense	1,206	*Includes salaries expense*
	Rent expense	327	
	Insurance expense	143	
	Utilities expense	85	
	Repairs expense	51	
	Other operating expenses	373	
	General and administrative expenses:		
	Training expense	263	*Includes pre-opening costs*
	Advertising expense	46	
	Depreciation expense	163	
	Loss on disposal of assets	13	
	Total operating expenses	4,206	
	Income from operations	271	
Peripheral activities (not central focus of business)	Other items:		
	Interest revenue	6	
	Interest expense	(1)	
	Income before income taxes	276	
	Income tax expense	100	*Also called Provision for Income Taxes*
	Net income	$ 176	
	Earnings per share	$6.19	*= $176 million Net Income ÷ about 28.4 million weighted average number of common stock shares outstanding (per 2017 annual report)*

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

Operating Revenues != Revenues

Revenues are defined as increases in assets or settlements of liabilities from the major or **central ongoing operations** of the business. Operating revenues result **from the sale of goods or the rendering of services** as the central focus of the business.

Operating Expenses

Expenses are outflows or the using up of assets or increases in liabilities from **ongoing operations** incurred to generate revenues during the period.

Expenditures

any outflow of cash for any purpose, whether to buy equipment, pay off a bank loan, or pay employees their wages.

Gain

Increases in assets or settlements of liabilities from peripheral transactions (Financial, Investment)

Loss

Decreases in assets or increases in liabilities from peripheral transactions (Financial, Investment)

Earnings Per Share

Corporations are required to disclose earnings per share on the income statement or in the notes to the financial statements. At **this introductory level**, we can compute earnings per share simply as net income divided by the

$$\text{Earnings Per Share} = \frac{Net\ Income}{Weighted\ Average\ Number\ of\ Shares\ of\ Stock\ Outstanding}$$

Cash Basis Accounting

Revenues are recorded when cash is received and expenses are recorded when cash is paid, regardless of when the revenues are earned or the expenses incurred.

Cade Company Income Statements	Year 1	Year 2	Year 3	Total
Sales on credit	\$ 60,000	\$60,000	\$60,000	\$180,000
Cash receipts from customers	\$ 20,000	\$70,000	\$90,000	\$180,000
Cash disbursements for:				
Salaries to employees	(30,000)	(30,000)	(30,000)	(90,000)
Insurance for 3 years	(12,000)	(0)	(0)	(12,000)
Supplies	(3,000)	(7,000)	(5,000)	(15,000)
Net operating cash flows	**\$(25,000)**	**\$33,000**	**\$55,000**	**\$ 63,000**

CASH BASIS
Income Measurement
Revenues (= cash receipts)
– Expenses (= cash payments)
Net Income (cash basis)

Using cash basis accounting may lead to an incorrect interpretation of future company performance. Simply looking at the first year, investors and creditors might interpret the negative cash flows as a problem with the company's ability to generate cash flows in the future.

So....

Accrual Accounting

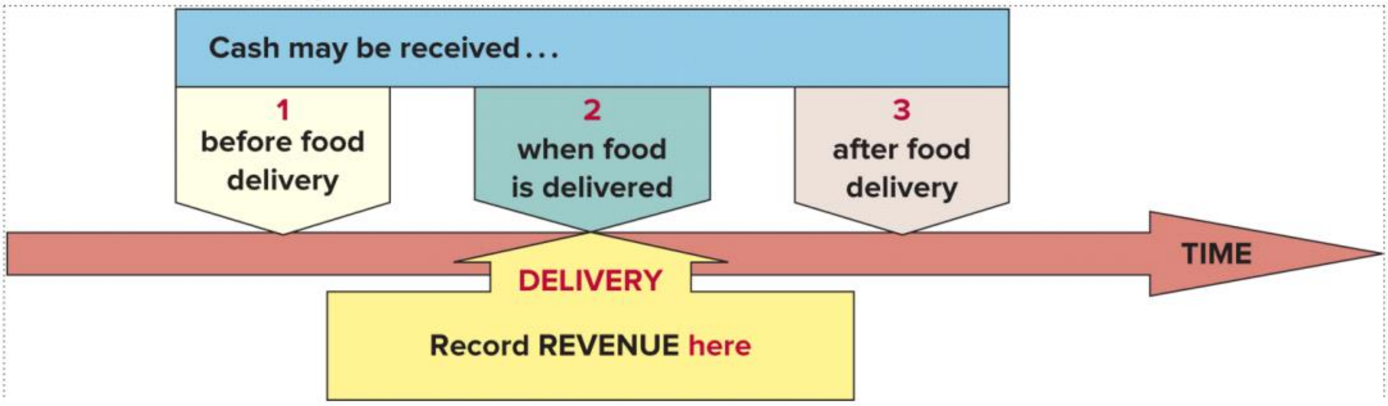
GAAP(General Accepted Accounting Principles) requires this for financial reporting to ensure the financial report reflects all assets or liabilities of a company on a particular date.

Revenue Recognition Principle

The core revenue recognition principle specifies both the timing and amount of revenue to be recognized during an accounting period. It requires that a company recognize revenue

1. **When the company transfers promised goods or services to customers**
2. **In the amount it expects to be entitled to receive.**

EXHIBIT 3.2 Recording Revenues versus Cash Receipts



Five Step Process Revenue Recognition

The FASB and IASB issued a joint revenue recognition accounting standard effective for 2018 financial statements. The standard requires a company to **recognize revenue when it transfers goods and services to customers in the amount it expects to be entitled to receive**. The standard also specifies how to handle more complex contracts with customers. The standard specifies five steps to recognizing revenue:

1. Identify the contract between the company and customer.
2. Identify the performance obligations (promised goods and services).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognize revenue when each performance obligation is satisfied (or over time if a service is provided over time).

Expense Recognition Principle (Matching Principle)

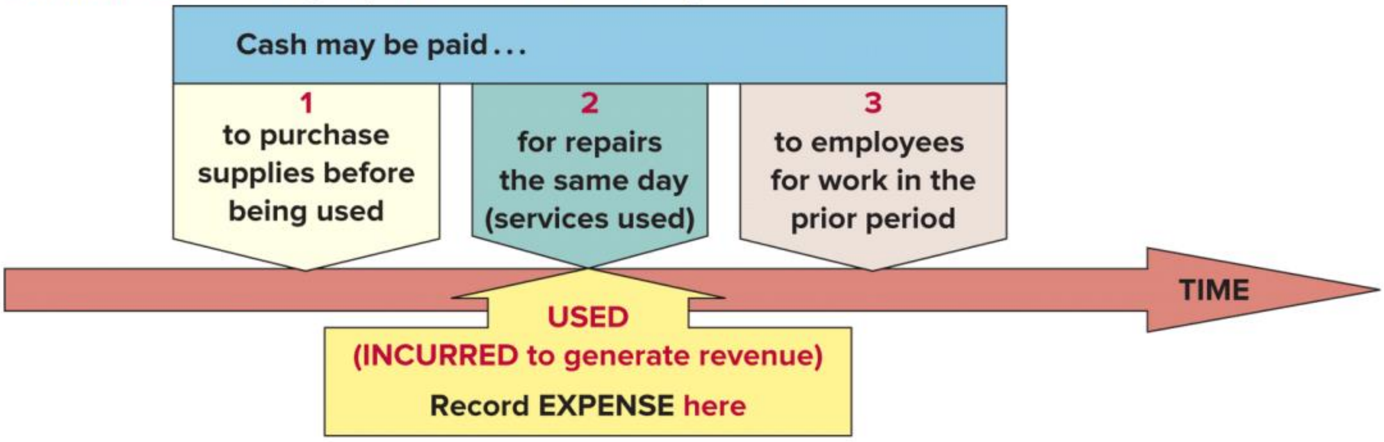
The expense recognition principle(also called the matching principle) requires that <u>costs incurred to generate revenues</u> be recognized **in the same period**—a matching of costs with benefits.

The costs of generating the revenue include expenses incurred such as these:

- Salaries and wages to employees who worked **during the period.**
- Utilities for the electricity used **during the period.**
- Food, beverage, and packaging supplies used **during the period.**
- Facilities rented **during the period.**
- Grills and other equipment used **during the period.**

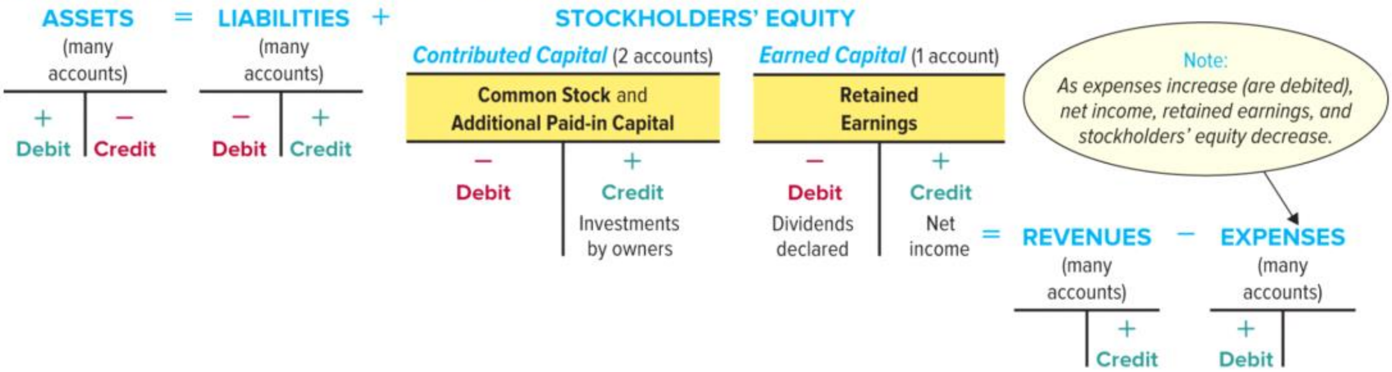
As with revenues and cash receipts, expenses are recorded as incurred, **regardless of when cash is paid.**

EXHIBIT 3.3 Recording Expenses versus Cash Payments



Expanded Transaction Analysis Model

EXHIBIT 3.4 Expanded Transaction Analysis Model



Classified Income Statement

CHIPOTLE MEXICAN GRILL, INC. Consolidated Statement of Income* UNADJUSTED For the Quarter ended March 31, 2018 (in millions of dollars)	
Restaurant sales revenue	$1,228
Restaurant operating expenses:	
Wages expense	177
Utilities expense	75
Repairs expense	19
General and administrative expenses:	
Training expense	41
Loss on disposal of assets	4
Total operating expenses	316
Income from operations	912
Other items:	
Interest revenue	1
Income before income taxes	913
Income tax expense	0
Net income	$ 913

Net Profit Margin

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

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

*Net sales is sales revenue - any returns from customers and other reductions

Interpretations

In General Net profit margin measures how much of every sales dollar generated during the period is profit. A rising net profit margin signals more efficient management of sales and expenses.