BUACCFUND 2020 – SESSION 7

AGENDA

- Revenues and Expenses
- Accruals

REVENUES AND EXPENSES

- Key components of income
- **Revenue**: Increase in net assets from sale of products or services
  - Also known as **sales** or **sales revenue**
  - Increases owners' equity
- **Expense**: Decrease in net assets as a result of consuming or giving up resources in the process of providing products or services to a customer
  - Decreases owners' equity

- *Remember, revenue/expenses belong to the Profit & Loss account*
- *And not to the Balance Sheet!! (where Assets and Liabilities are)*

REVENUES AND EXPENSES

- **Income**: Excess of revenues over expenses
  - Also known as **profits** or **earnings**
    - If expenses exceed revenues, loss is incurred
- **Retained earnings**: Total cumulative owners' equity generated by income or profits
  - Also known as **retained income**

REVENUES AND EXPENSES

- A sales transaction has two phases, a revenue phase and an expense phase
  - Requires two new accounts, Accounts Receivable and Cost of Goods Sold Expense

	Assets		=	Liabilities	+	Stockholders' Equity
	Accounts Receivable	Merchandise Inventory				
Sales on open account	+160,000		=			+ 160,000 (Sales Revenue)
Cost of merchandise inventory sold		–100,000	=			–100,000 (Cost of Goods Sold Expense)

ACCOUNTS RECEIVABLE

- **Accounts receivable:** Amounts owed to a company by customers as a result of the company's delivering goods or services and extending credit in the ordinary course of business
  - Also known as **trade receivables** or **receivables**

COST OF GOODS SOLD

- **Cost of Goods Sold**: Original acquisition cost of the inventory that a company sells to customers during the reporting period
  - Also known as **cost of sales** or **cost of revenue**

MEASURING INCOME

- Under accrual basis
  - Revenue recorded as it is earned
    - Regardless of when cash is received
  - Expenses recorded as they are incurred
    - Regardless of when cash is paid
- Under cash basis
  - Revenue recorded when cash is received
  - Expenses recorded when cash is disbursed

- *Most large firms will have their accounting on accrual basis*

DEPRECIATION

- **Depreciation:** Systematic allocation of the acquisition cost of assets to the expense accounts of the particular accounting periods that benefit from the use of assets

DEPRECIATION

- Equipment with an original cost of $14,000, expected to be used for 140 months

	Assets	=	Liabilities	+	Stockholders' Equity
	Store Equipment				**Retained Earnings**
Recognize expiration of equipment services	–100	=			–100 (Depreciation Expense)

($14,000 ÷ 140 months expected life) = $100 per month

THE BALANCE SHEET EQUATION

- Assets = Liabilities + Stockholders’ equity
- Equation must always remain in balance
- Every transaction can be analyzed via equation

DUAL NATURE OF THE BALANCE SHEET EQUATION

- If items affected are all on one side of the equation:
  - Total amount added must equal total amount subtracted on that side
- If items affected are on opposite sides of the equation:
  - Equal amounts simultaneously added or subtracted on each side

EXPANDED BALANCE SHEET EQUATION

- Income statement is a way of explaining changes between one period's balance sheet and the next period's balance sheet
- The income statement collects all the revenues and expenses for the accounting period and combines them in one place
  - Revenue and expense accounts are nothing more than subdivisions of stockholders' equity - temporary stockholders' equity accounts

EXPANDED BALANCE SHEET EQUATION

(1) Assets = Liabilities + Stockholders' Equity

(2) Assets = Liabilities + Paid-in Capital + Retained Earnings

(3) Assets = Liabilities + Paid-in Capital + Cumulative Revenues - Cumulative Expenses

ADJUSTMENTS TO THE ACCOUNTS

- **Explicit transactions**
  - Observable events such as cash receipts and disbursements, credit purchases, and credit sales
    - Trigger majority of day-to-day routine journal entries

ADJUSTMENTS TO THE ACCOUNTS

- **Implicit transactions**
  - Events, such as the passage of time, that do not generate source documents or any visible evidence that the event actually occurred
    - Not recognized in the accounting records until the end of an accounting period

ADJUSTMENTS OR ADJUSTING ENTRIES

- End-of-period entries that assign financial effects of implicit transactions to the appropriate time periods
- Occur at periodic intervals, usually the end of the accounting period
- Made by recording journal entries in the general journal and then posting them to the general ledger

ADJUSTMENTS OR ADJUSTING ENTRIES

- Important in accrual accounting
  - **Accrue**: To accumulate a receivable (asset) or payable (liability) during a given period, even though no explicit transaction occurs, and to record a corresponding revenue or expense
  - Accruals are not based on explicit transactions, hence not recorded on a day-to-day basis

ADJUSTMENTS OR ADJUSTING ENTRIES

- Affect both an income statement account and a balance sheet account
- Never affect cash
- Help match revenues and expenses to appropriate accounting period
- Ensure that balance sheet correctly states assets and liabilities

AN EXAMPLE OF EXPIRATION OR CONSUMPTION OF UNEXPIRED COSTS

- A company pays **$6,000** rent in advance for the months of January, February, and March
  - Transaction initially recorded as an asset

(a)	Prepaid rent	6,000	
	Cash		6,000

  - End of January, asset declines in value as rent for on

(b)	Rent expense	2,000	
	Prepaid rent		2,000

AN EXAMPLE OF EXPIRATION OR CONSUMPTION OF UNEXPIRED COSTS

- Failing to record the adjusting entry causes:
  - Assets to be overstated by **$2,000**
  - Expenses to be understated by **$2,000**
    - Net income and stockholders' equity are overstated

EARNING OF REVENUES RECEIVED IN ADVANCE

- **Unearned revenue**
  - Cash received from customers who pay in advance for goods or services to be delivered at a future date
  - Also known as **revenue received in advance** or **deferred revenue**
  - Requires recording both the receipt of cash and the liability for future goods or services

EARNING OF REVENUES RECEIVED IN ADVANCE

- Characteristics of unearned revenue
  - An explicit transaction (receipt of cash) in the past creates a liability
  - Subsequent implicit transactions recognize the earning of revenues and the reduction in the liability over time

AN EXAMPLE OF EARNING OF REVENUES RECEIVED IN ADVANCE

- A company receives **$6,000 in cash for rent in advance for the months of** January, February, and March
  - Transaction initially recorded as a liability

(a)	Cash	6,000	
	Unearned rent revenue		6,000

  - End of January, liability decreases as revenue for one month has been earned

(b)	Unearned rent revenue	2,000	
	Rent revenue		2,000

EARNING OF REVENUES RECEIVED IN ADVANCE

- Failing to record adjusting entry causes:
  - Liabilities to be overstated by **$2,000**
  - Revenues to be understated by **$2,000**
    - Net income and stockholders' equity are understated

ACCRUAL OF UNRECORDED EXPENSES

- Some liabilities and the related expenses increase with the passage of time
  - Examples: wages, interest and income taxes
- Characteristics of unrecorded expenses
  - An implicit transaction recognizes a liability and an expense
    - Adjustments to bring each accrued expense and related liability account up to date are made at the end of the accounting period when financial statements are prepared

ACCRUAL OF UNRECORDED EXPENSES

  - Adjustments are necessary to accurately match the expense to the period in which it helps generate revenues
- Subsequent explicit transaction records cash disbursement for liability

AN EXAMPLE OF ACCOUNTING FOR ACCRUAL OF WAGES

- A company makes routine entries for the explicit payment of $500,000 in wages to employees during January

(a) Wages expense	500,000	
Cash		500,000

- Adjusting entry to accrue $75,000 in wages for the last three days wages in January

(b) Wages expense	75,000	
Accrued wages payable		75,000

AN EXAMPLE OF ACCOUNTING FOR ACCRUAL OF WAGES

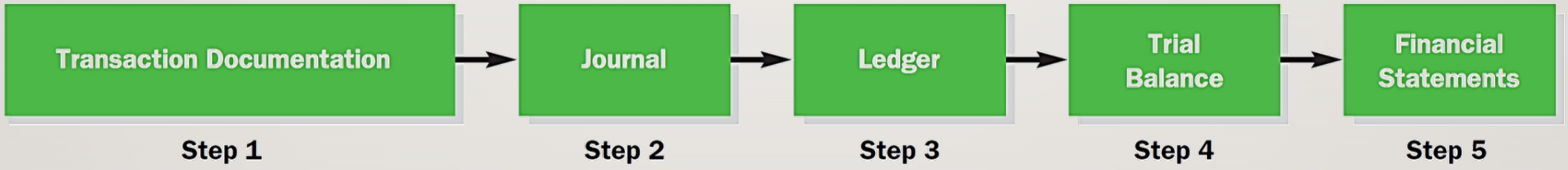
- Failing to record the adjusting entry causes:
  - Liabilities to be understated by $75,000
  - Expenses to be understated by $75,000
    - Net income and stockholders' equity are overstated

AN EXAMPLE OF ACCOUNTING FOR ACCRUAL OF WAGES

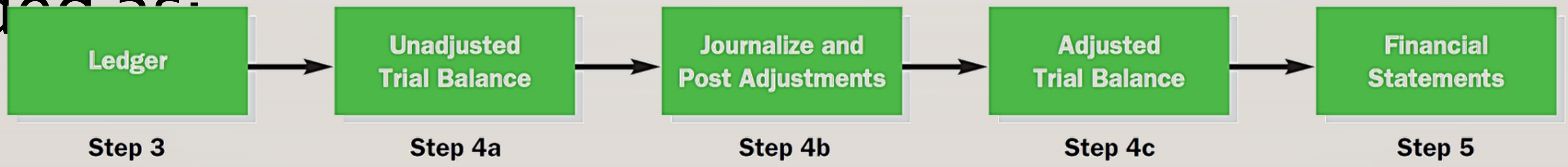
- On the next payroll date, the company will pay off the $75,000 liability for the work performed during the last 3 days of January, together with any wage expense for the first days of February

THE ADJUSTING PROCESS IN PERSPECTIVE

- Steps in recording process:



- Considering adjustments, the fourth step can be further divided as:



Balance sheet example

TEDDY FAB INC.
BALANCE SHEET
December 31, 2100

ASSETS		
Current assets		
Cash and cash equivalents	$	100,000
Accounts receivable		20,000
Inventory		15,000
Prepaid expense		4,000
Investments		10,000
Total current assets		149,000
Property and equipment		
Land		24,300
Buildings and improvements		250,000
Equipment		50,000
Less accumulated depreciation		(5,000)
Other assets		
Intangible assets		4,000
Less accumulated amortization		(200)
Total assets	$	**472,100**

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$	30,000
Notes payable		10,000
Accrued expenses		5,000
Deferred revenue		2,000
Total current liabilities		47,000
Long-term debt		200,000
Total liabilities		247,000
Shareholders' Equity		
Common stock		10,000
Additional paid-in capital		20,000
Retained earnings		197,100
Treasury stock		(2,000)
Total liabilities and shareholders' equity	$	**472,100**

Profit and loss statement example

Profit and loss of company XYX

Total revenue	£100,000
Cost of goods sold	£20,000
Gross profit	£80,000

Operating expenses

Salaries	£10,000
Rent	£10,000
Utilities	£5,000
Depreciation	£5,000
Total operating expenses	£30,000
Operating profit	£50,000
Interest expense	£10,000
Income before taxes	£40,000
Taxes	£10,000

Net income	**£30,000**