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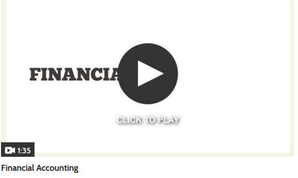
Financial Accounting

By WILL KENTON | Reviewed By DAVID KINDNESS | Updated Jul 12, 2020

What is Financial Accounting?

Financial accounting is a specific branch of accounting involving a process of recording, summarizing, and reporting the myriad of transactions resulting from business operations over a period of time. These transactions are summarized in the preparation of financial statements, including the balance sheet, income statement and cash flow statement, that record the company's operating performance over a specified period.

Work opportunities for a financial accountant can be found in both the public and private sectors. A financial accountant's duties may differ from those of a general accountant, who works for himself or herself rather than directly for a company or organization.



1:35

Financial Accounting

How Financial Accounting Works

Financial accounting utilizes a series of established accounting principles. The selection of accounting principles to use during the course of financial accounting depends on the regulatory and reporting requirements the business faces. For U.S. public companies, businesses are required to perform financial accounting in accordance with generally accepted accounting principles (GAAP).[1] The establishment of these accounting principles is to provide consistent information to investors, creditors, regulators, and tax authorities.

KEY TAKEAWAYS

- Financial Accounting follows the either the accrual basis or the cash basis of accounting.
- Nonprofits, corporations, and small businesses use financial accountants.
- Financial reporting occurs through the use of financial statements in five distinct areas.

The financial statements used in financial accounting present the five main classifications of financial data: revenues, expenses, assets, liabilities and equity. Revenues and expenses are accounted for and reported on the income statement. They can include everything from R&D to payroll.

Important: International public companies also frequently report financial statements in accordance with International Financial Reporting Standards.

Financial accounting results in the determination of net income at the bottom of the income statement. Assets, liabilities and equity accounts are reported on the balance sheet. The balance sheet utilizes financial accounting to report ownership of the company's future economic benefits.

Accrual Method vs. Cash Method

Financial accounting may be performed using either the accrual method, cash method or a combination of the two. Accrual accounting entails recording transactions when the transactions have occurred and the revenue is recognizable.

Cash accounting entails recording transactions only upon the exchange of cash. Revenue is only recorded upon the receipt of payment, and expenses are only recorded upon the payment of the obligation.

Financial Accounting Vs. Managerial Accounting

The key difference between financial and managerial accounting is that financial accounting aims at providing information to parties outside the organization, whereas managerial accounting information is aimed at helping managers within the organization make decisions.

Financial statement preparation using accounting principles is most relevant to regulatory organizations and financial institutions. Because there are numerous accounting rules that do not translate well into business operation management, different accounting rules and procedures are utilized by internal management for internal business analysis.

Special Considerations

The most common accounting designation demonstrating an ability to perform financial accounting within the United States is the Certified Public Accountant (CPA) license. Outside of the United States, holders of the Chartered Accountant (CA) license demonstrate the ability as well. The Certified Management Accountant (CMA) designation is more demonstrative of an ability to perform internal management functions than financial accounting.

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The Financial Accounting Standards Board (FASB) is an independent organization that sets accounting standards for companies and nonprofits in the United States. more

Accounting Principles Definition
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1. RECORDS FINANCIAL TRANSACTIONS
2. SUMMARIZE INFORMATION
3. PREPARES FINANCIAL STATEMENTS
4. INTERPRETS FINANCIAL INFORMATION
5. COMMUNICATES ALL OUTCOMES
6. DETERMINES FINANCIAL POSITION

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Accounting Concepts, Principles and Basic Terms

Definition and introduction

The worldview of accounting and accountants may certainly involve some unhelpful characters poring over formidable figures hunched up in indecipherable columns.

However, a short and sweet description of accounting does exist:

> Accounting is the language of business efficiently communicated by well-organised and honest professionals called accountants.

A more academic definition of accounting is given by the American Accounting Association:

> The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.

The American Institute of Certified Public Accountants defines accounting as:

> The art of recording, classifying, summarising in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof

Accounting not only records financial transactions and conveys the financial position of a business enterprise; it also analyses and reports the information in documents called "financial statements."

Recording every financial transaction is important to a business organisation and its creditors and investors. Accounting uses a formalised and regulated system that follows standardised principles and procedures.

The job of accounting is done by professionals who have educational degrees acquired after years of study. While a small business may have an accountant or a bookkeeper to record money transactions, a large corporation has an accounts department, which supplies information to:

- Managers who guide the company.
- Investors who want to know how the business is doing.
- Analysts and brokerage firms dealing with the company's stock.
- The government, which decides how much tax should be collected from the company.

Accounting Principles

Obviously, if each business organisation conveys its information in its own way, we will have a babel of unusable financial data.

Personal systems of accounting may have worked in the days when most companies were owned by sole proprietors or partners, but they do not anymore, in this era of joint stock companies.

These companies have thousands of stakeholders who have invested millions, and they need a uniform, standardised system of accounting by which companies can be compared on the basis of their performance and value.

Therefore, accounting principles based on certain concepts, convention, and tradition have been evolved by accounting authorities and regulators and are followed internationally.

These principles, which serve as the rules for accounting for financial transactions and preparing financial statements, are known as the "*Generally Accepted Accounting Principles*," or GAAP.

The application of the principles by accountants ensures that financial statements are both informative and reliable.

It ensures that common practices and conventions are followed, and that the common rules and procedures are complied with. This observance of accounting principles has helped developed a widely understood grammar and vocabulary for recording financial transactions.

However, it should be said that just as there may be variations in the usage of a language by two people living in two continents, there may be minor differences in the application of accounting rules and procedures depending on the accountant.

For example, two accountants may choose two equally correct methods for recording a particular transaction based on their own professional judgement and knowledge.

Accounting principles are accepted as such if they are (1) objective; (2) usable in practical situations; (3) reliable; (4) feasible (they can be applied without incurring high costs); and (5) comprehensible to those with a basic knowledge of finance.

Accounting principles involve both accounting concepts and accounting conventions. Here are brief explanations.

Accounting Concepts

1. **Business entity concept:** a business and its owner should be treated separately as far as their financial transactions are concerned.
2. **Money measurement concept:** Only business transactions that can be expressed in terms of money are recorded in accounting, though so-called other types of transactions may be kept separately.
3. **Dual aspect concept:** For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.
4. **Going concern concept:** In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at "fire sale" prices.
5. **Cost concept:** The final assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.
6. **Accounting year concept:** Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.
7. **Matching concept:** This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.
8. **Realisation concept:** According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer.

Accounting Conventions

There are four main conventions in practice in accounting: conservatism; consistency; full disclosure; and materiality.

Conservatism is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.

Consistency prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.

Materiality means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.

Full disclosure entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and shareholders.

Basic Accounting Terms

Here is a quick look at some important accounting terms.

Accounting equation: The accounting equation, the basis for the double-entry system (see below), is written as follows:

Assets = Liabilities + Stakeholders' equity

This means that all the assets owned by a company have been financed from loans from creditors and from equity from investors. "Assets" here stands for cash, account receivables, inventory, etc., that a company possesses.

Accounting methods: Companies choose between two methods—cash accounting or accrual accounting. Under cash basis accounting, preferred by small businesses, all revenues and expenditures at the time when payments are actually received or sent are recorded. Under accrual basis accounting, income is recorded when earned and expenses are recorded when incurred.

Account receivable: The sum of money owed by your customers after goods or services have been delivered and/or used.

Account payable: The amount of money you owe creditors, suppliers, etc., in return for goods and/or services they have delivered.

Accrual accounting: See "accounting methods."

Assets (fixed and current): Current assets are assets that will be used within one year.

For example, cash, inventory, and accounts receivable (see above). Fixed assets (non-current) may provide benefits to a company for more than one year—for example, land and machinery.

Balance sheet: A financial report that provides a gist of a company's assets and liabilities and owner's equity at a given time.

Capital: A financial asset and its value, such as cash and goods. Working capital is current assets minus current liabilities.

Cash accounting: See "accounting methods."

Cash flow statement: The cash flow statement of a business shows the balance between the amount of cash earned and the cash expenditure incurred.

Credit and debit: A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is entered on the right side in an accounting entry. A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is entered on the left in an accounting entry.

Double-entry bookkeeping: Under double-entry bookkeeping, every transaction is recorded in at least two accounts—as a credit in one account and as a debit in another.

For example, an automobile repair shop that collects Rs. 10,000 in cash from a customer enters this amount in the revenue credit side and also in the cash debit side. If the customer had been given credit, "account receivable" (see above) would have been used instead of "cash." (Also see "single-entry bookkeeping," below.)

Financial statement: A financial statement is a document that reveals the financial transactions of a business or a person. The three most important financial statements for businesses are the balance sheet, cash flow statement, and profit and loss statement (all three listed here alphabetically).

General ledger: A complete record of financial transactions over the life of a company.

Journal entry: An entry in the journal that records financial transactions in the chronological order.

Profit and loss statement (income statement): A financial statement that summarises a company's performance by reviewing revenues, costs and expenses during a specific period.

Single-entry bookkeeping: Under the single-entry bookkeeping, mainly used by small or businesses, incomes and expenses are recorded through daily and monthly summaries of cash receipts and disbursements. (Also see "double-entry bookkeeping," above.)

Types of accounting: Financial accounting reports information about a company's performance to investors and creditors. Management accounting provides financial data to managers for business development.

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COLLINS WERE (0000)
December 13, 2012 at 12:35 pm
Reply
Good notes and easy to understand.Only in concepts prudence and neutrality concepts are not identified.Endless.

Osborne Mensah (0000)
May 23, 2010 at 12:34 pm
Reply
Thank you for it is very simple to understand.
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Keisha penny (0000)
April 4, 2016 at 11:02 pm
Reply
How cash basis accounting is different from accrual basis accounting???

pravesa (0000)
August 21, 2012 at 4:46 pm
Reply
in cash basis accounting income are recorded when it is actually received and
expenditure are recorded when it is actually paid.
but in accrual basis income must be recorded in the year when it is earned and expenses
must be recorded in the year in which it is incurred

KAMANA Asiimwe (0000)
December 2, 2016 at 11:34 am
Reply
Thank you so much for your effort, this is a good contribution. however, Collins is right where
are those concepts left, I am not seeing the difference between cash basis accounting and accrual
basis accounting, I've seen that explanations are similar.

Aisha (0000)
November 29, 2012 at 11:39 am
Reply
according to my findings, prudence concept is the same thing as conservatism. they
both have the same meanings. in some books you won't see business entity concept but
economic entity concept. if we still check forward on neutrality, it might tally with one
of those aforementioned concepts.

Adam Usman (0000)
January 11, 2016 at 3:39 am
Reply
Aisha you're absolutely right

Onyeoh isaac (0000)
January 17, 2019 at 2:34 pm
Reply
Briefly explain what is meant by modified basis of accounting?

Deborah Cherikana (0000)
June 21, 2019 at 8:34 pm
Reply
Briefly explain on " Accounting for some transactions and events is regulated while for others transactions and events there is an absence of regulation" with examples

Arradhana (0000)
August 21, 2019 at 12:36 pm
Reply
Sir can you please explain us what is the difference between "statement" , balance "sheet" and "account" .

Raheem Mumba Patel (0000)
August 28, 2019 at 8:38 pm
Reply
What's the difference between accounting concepts and accounting conventions

Esther (0000)
October 31, 2019 at 10:38 am
Reply
Thank you so much for the publish, my questions is what is the difference between realization concepts and accrual concepts?

Nkosha (0000)
November 19, 2019 at 10:39 pm
Reply
Plz can you give a further explanation on the matching concept

Srinivasan K (0000)
December 24, 2019 at 3:39 pm
Reply
Cash Basis : Expense or revenue is accounted only when payment is made or received.
Accrual Basis : Expense or revenue is accounted immediately when the benefit and risk is transferred from seller to buyer. For Eg. Credit sales or credit purchase.

Gigi (0000)
April 7, 2020 at 11:38 am
Reply
Useful notes especially for a person like me who is not in touch with accounting for about half a decade.

Masinda Mudade (0000)
May 7, 2020 at 12:04 pm
Reply
Good refresher to recover gap of accounting knowledge :-)

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Definition

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Rules of accounting that should be followed in preparation of all accounts and financial statements. The four fundamental concepts are
(1) Accruals concept: revenue and expenses are recorded when they occur and not when the cash is received or paid out;
(2) Consistency concept: once an accounting method has been chosen, that method should be used unless there is a sound reason to do otherwise;
(3) Going concern: the business entity for which accounts are being prepared is in good condition and will continue to be in business in the foreseeable future;
(4) Prudence concept (also conservation concept): revenue and profits are included in the balance sheet only when they are realized (or there is reasonable 'certainty' of realizing them) but liabilities are included when there is reasonable 'possibility' of incurring them.

Other concepts include
(5) Accounting equation: total assets equal total liabilities plus owners' equity;
(6) Accounting period: financial records pertaining only to a specific period are to be considered in preparing accounts for that period;
(7) Cost basis: asset value recorded in the account books should be the actual cost paid, and not the asset's current market value;
(8) Entity: accounting records reflect the financial activities of a specific business or organization, not of its owners or employees;
(9) Full disclosure: financial statements and their notes should contain all relevant data;
(10) Lower of cost or market value: inventory is valued either at cost or the market value (whichever is lower);
(11) Maintenance of capital: profit can be realized only after capital of the firm has been restored to its original level, or is maintained at a predetermined level;
(12) Matching: transactions affecting both revenues and expenses should be

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FASB statements of financial accounting concepts (SFAC)

Accounting Standards

Accounting Standards- Objectives, Benefits, Limitations

Financial statements have incredible importance for both internal and external stakeholders. They basically are a report card for the company. So it is important that they are regulated and do not report misleading information. And the Accounting Standards (AS) provide us with a framework for this regulation. Let us take a look.

Solve Questions

Accounting standard (AS) -2 provides that inventories should be valued at_____.

✓ 1 Verified answer

The Accounting standards are mandatory for _____.

✓ 1 Verified answer

Accounting Standard-6 relating to depreciation is applicable to_____.

✓ 1 Verified answer

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Accounting Standards (AS)

Accounting Standards (AS) are basic policy documents. Their main aim is to ensure transparency, reliability, consistency, and comparability of the financial statements. They do so by standardizing accounting policies and principles of a nation/economy. So the transactions of all companies will be recorded in a similar manner if they follow these accounting standards.

These Accounting Standards (AS) are issued by an accounting body or a regulatory board or sometimes by the government directly. In India, the Indian Accounting Standards are issued by the Institute of Chartered Accountants of India (ICAI).

Accounting Standards mainly deal with four major issues of accounting, namely

i. Recognition of financial events

ii. Measurement of financial transactions

iii. Presentation of financial statements in a fair manner

iv. Disclosure requirement of companies to ensure stakeholders are not misinformed

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Objectives of Accounting Standards

Accounting is often considered the language of business, as it communicates to others the financial position of the company. And like every language has certain syntax and grammar rules the same is true here. These rules in the case of accounting are the Accounting Standards (AS). They are the framework of rules and regulations for accounting and reporting in a country. Let us see the main objectives of forming these standards.

1. The main aim is to improve the reliability of financial statements. Now because the financial statements have to be made following the standards the users can rely on them. They know that not conforming to these standards can have serious consequences for the companies.
2. Then there is comparability. Following these standards will allow for inter-firm and intra-firm comparisons. This allows us to check the progress of the firm and its position in the market.
3. It also looks to provide one set of accounting policies that include the necessary disclosure requirements and the valuation methods of various financial transactions.

Benefits of Accounting Standards

Accounting Standards are the ruling authority in the world of accounting. It makes sure that the information provided to potential investors is not misleading in any way. Let us take a look at the benefits of AS.

1] Attains Uniformity in Accounting

Accounting Standards provides rules for standard treatment and recording of transactions. They even have a standard format for financial statements. These are steps in achieving uniformity in accounting methods.

2] Improves Reliability of Financial Statements

There are many stakeholders of a company and they rely on the financial statements for their information. Many of these stakeholders base their decisions on the data provided by these financial statements. Then there are also potential investors who make their investment decisions based on such financial statements.

So it is essential these statements present a true and fair picture of the financial situation of the company. The Accounting Standards (AS) ensure this. They make sure the statements are reliable and trustworthy.

3] Prevents Frauds and Accounting Manipulations

Accounting Standards (AS) lay down the accounting principles and methodologies that all entities must follow. One outcome of this is that the management of an entity cannot manipulate with financial data. Following these standards is not optional, it is compulsory.

So these standards make it difficult for the management to misrepresent any financial information. It even makes it harder for them to commit any frauds.

4] Assists Auditors

Now the accounting standards lay down all the accounting policies, rules, regulations, etc in a written format. These policies have to be followed. So if an auditor checks that the policies have been correctly followed he can be assured that the financial statements are true and fair.

5] Comparability

This is another major objective of accounting standards. Since all entities of the country follow the same set of standards their financial accounts become comparable to some extent. The users of the financial statements can analyze and compare the financial performances of various companies before taking any decisions.

Also, two statements of the same company from different years can be compared. This will show the growth curve of the company to the users.

6] Determining Managerial Accountability

The accounting standards help measure the performance of the management of an entity. It can help measure the management's ability to increase profitability, maintain the solvency of the firm, and other such important financial duties of the management.

Example of account standard: IFRS International Financial Reporting Standards

Management also must wisely choose their accounting policies. Constant changes in the accounting policies lead to confusion for the user of these financial statements. Also, the principle of consistency and comparability are lost.

Limitations of Accounting Standards

There are a few limitations of Accounting Standards as well. The regulatory bodies keep updating the standards to restrict these limitations.

1] Difficulty between Choosing Alternatives

There are alternatives for certain accounting treatments or valuations. Like for example, stocks can be valued by LIFO, FIFO, weighted average method, etc. So choosing between these alternatives is a tough decision for the management. The AS does not provide guidelines for the appropriate choice.

2] Restricted Scope

Accounting Standards cannot override the laws or the statutes. They have to be framed within the confines of the laws prevailing at the time. That can limit their scope to provide the best policies for the situation.

Solved Question for You

Q: Accounting Standards can sometimes be restrictive. True or False?

Ans: One of the major disadvantages of accounting standards is that they can be restrictive and inflexible. Each company faces unique situations and financial transactions. But the company must make these situations fit the guidelines of the accounting standards even if they are not the best way to represent the financial event in question.

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Liabilities are obligations of the company; they are amounts owed to creditors for a past transaction and they usually have the word "payable" in their account title. Along with owner's equity, **liabilities** can be thought of as a source of the company's assets.

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en.wikipedia.org › wiki › Equity_(finance)

Equity (finance) - Wikipedia

In finance, **equity** is ownership of assets that may have debts or other liabilities attached to them. **Equity** is measured for accounting purposes by subtracting liabilities from the value of an asset.

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Equity

Finance

In finance, equity is ownership of assets that may have debts or other liabilities attached to them. Equity is measured for accounting purposes by subtracting liabilities from the value of an asset.

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Double Entry Definition

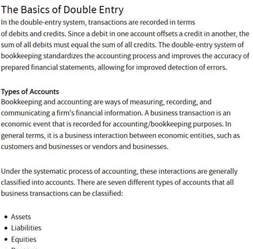
By ADAM HAYES | Reviewed By DAVID KINNESS | Updated Jul 11, 2020

What Is Double Entry?

Double entry, a fundamental concept underlying present-day bookkeeping and accounting, states that every financial transaction has equal and opposite effects in at least two different accounts. It is used to satisfy the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

With a double entry system, credits are offset by debits in a general ledger or T-account.



Double Entry

The Basics of Double Entry

In the double-entry system, transactions are recorded in terms of debits and credits. Since a debit in one account offsets a credit in another, the sum of all debits must equal the sum of all credits. The double-entry system of bookkeeping standardizes the accounting process and improves the accuracy of prepared financial statements, allowing for improved detection of errors.

Types of Accounts

Bookkeeping and accounting are ways of measuring, recording, and communicating a firm's financial information. A business transaction is an economic event that is recorded for accounting/bookkeeping purposes. In general terms, it is a business interaction between economic entities, such as customers and businesses or vendors and businesses.

Under the systematic process of accounting, these interactions are generally classified into accounts. There are seven different types of accounts that all business transactions can be classified:

- Assets
- Liabilities
- Equities
- Revenue
- Expenses
- Gains
- Losses

Bookkeeping and accounting track changes in each account as a company continues operations.

Debits and Credits

Debits and credits are essential to the double entry system. In accounting, a debit refers to an entry on the left side of an account ledger, and credit refers to an entry on the right side of an account ledger. To be in balance, the total of debits and credits for a transaction must be equal. Debits do not always equate to increases and credits do not always equate to decreases.

A debit may increase one account while decreasing another. For example, a debit increases asset accounts but decreases liability and equity accounts, which supports the general accounting equation of Assets = Liabilities + Equity. On the income statement, debits increase the balances in expense and loss accounts, while credits decrease their balances. Debits decrease revenue and gains account balances, while credits increase their balances.

The Double-Entry Accounting System

Double-entry bookkeeping was developed in the mercantile period of Europe to help rationalize commercial transactions and make trade more efficient. It also helped merchants and bankers understand their costs and profits. Some thinkers have argued that double-entry accounting was a key calculative technology responsible for the birth of capitalism.

The accounting equation forms the foundation of the double-entry accounting and is a concise representation of a concept that expands into the complex, expanded and multi-item display of the balance sheet. The balance sheet is based on the double-entry accounting system where total assets of a company are equal to the total of liabilities and shareholder equity.

Essentially, the representation equates all uses of capital (assets) to all sources of capital (where debt capital leads to liabilities and equity capital leads to shareholders' equity). For a company keeping accurate accounts, every single business transaction will be represented in at least of its two accounts.

For instance, if a business takes a loan from a financial entity like a bank, the borrowed money will raise the company's assets and the loan liability will also rise by an equivalent amount. If a business buys raw material by paying cash, it will lead to an increase in the inventory (asset) while reducing cash capital (another asset). Because there are two or more accounts affected by every transaction carried out by a company, the accounting system is referred to as double-entry accounting.

This practice ensures that the accounting equation always remains balanced – that is, the left side value of the equation will always match with the right side value.

KEY TAKEAWAYS

- *Double-entry refers to an accounting concept whereby assets = liabilities + owners' equity.*
- *In the double-entry system, transactions are recorded in terms of debits and credits.*
- *Double-entry bookkeeping was developed in the mercantile period of Europe to help rationalize commercial transactions and make trade more efficient.*
- *The emergence of double-entry has been linked to the birth of capitalism.*

Real World Example of Double Entry

A bakery purchases a fleet of refrigerated delivery trucks on credit; the total credit purchase was $250,000. The new set of trucks will be used in business operations and will not be sold for at least 10 years—their estimated useful life.

To account for the credit purchase, entries must be made in their respective accounting ledgers. Because the business has accumulated more assets, a debit to the asset account for the cost of the purchase ($250,000) will be made. To account for the credit purchase, a credit entry of $250,000 will be made to notes payable. The debit entry increases the asset balance and the credit entry increases the notes payable liability balance by the same amount.

Double entries can also occur within the same class. If the bakery's purchase was made with cash, a credit would be made to cash and a debit to asset, still resulting in a balance.

Related Terms

Accounting Equation
The accounting equation shows that all of a company's total assets equals the sum of the company's liabilities and shareholders' equity. more

Breaking Down Debits
A debit is an accounting entry that results in either an increase in assets or a decrease in liabilities on a company's balance sheet. more

How General Ledgers Work
A general ledger represents the record-keeping system for a company's financial data with debit and credit account records validated by a trial balance. more

T-Account Definition
A T-account is an informal term for a set of financial records that uses double-entry bookkeeping. more

Accounting Cycle
The accounting cycle records and analyzes accounting events related to a company's activities. more

Trial Balance
A trial balance is a bookkeeping worksheet in which the balances of all ledgers are compiled into debit and credit account column totals that are equal. more

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Gains and Losses vs. Revenue and Expenses: What's the Difference?

By INVESTOPEDIA | Updated Aug 4, 2019

Gains & Losses vs. Revenue & Expenses: An Overview

Most companies report such items as revenues, gains, expenses, and losses on their income statements. Though some of the terms will sound similar, there are different practical uses for gains and losses, as well as for revenues and expenses.

Below, we'll take a look at each combination of terms and how they can differ. Ultimately, businesses look to maximize gains and revenues while minimizing expenses and losses. They all affect overall profitability.

KEY TAKEAWAYS

- Gains and losses are the opposing financial results that will be produced through a company's non-primary operations and production processes.
- Revenue describes income earned through the provision of a business's primary goods or services.
- An expense is a cost incurred in the process of producing or offering a primary business operation.

Gains and Losses

Gains and losses are the opposing financial results that will be produced through a company's non-primary operations and production processes. Any time a company produces a profit or realizes increased value through secondary sources, such as via lawsuits, investments in financial instruments, or through the disposal of assets, it is considered to be a (capital) gain.[1]

Conversely, a loss is realized whenever a company loses money through secondary activity. If a company sells an asset, the determination of gain versus loss is dependent on the book value of the asset according to the company's financial documents. A loss will also be recorded if a company is ordered by a judge to pay to settle a lawsuit, or if it loses money on the financial investment.[1]

Gains and losses are treated differently for tax purposes, depending on if they are short-term (usually occurring in 12 months or less) or long-term (taking place over more than one year). Gains can typically also be offset by corresponding losses for tax purposes.[2]

Financial analysts and investors typically care less about losses and gains, since many of them are likely to be one time events, and are not related to a company's primary business activities.

Revenues and Expenses

Unlike gains and losses, revenues and expenses are not opposite financial results of the same activities. Rather, revenue is the term used to describe income earned through the provision of a business' primary goods or services, while expense is the term for a cost incurred in the process of producing or offering a primary business operation. Investors and analysts will typically give far more weight to these metrics than losses or gains.

Revenues are the gross proceeds a company receives when it sells its goods or services and is sometimes simply referred to as "sales." Because there is always a set of costs involved (both fixed and variable) with production, these must be deducted as expenses from revenue to compute a company's net profit.

Of the four terms being considered, expenses are the most diverse. Expenses can be related to a multitude of different types of costs such as labor (salaries, wages, and employee benefits), marketing and advertising, rent, utility bills, insurance, taxes, interest, depreciation, and amortization. Expenses can also be recorded into any number of different line items on an income statement to reflect the particular type of expense.

Several financial ratios and metrics take account of revenues and expenses, such as the frequently used EBITDA metric, which is earnings before interest, taxes, depreciation, and amortization. In other words, it is revenues fewer expenses related to the production of goods sold.

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An income statement is one of the three major financial statements that reports a company's financial performance over a specific accounting period. more

How to Interpret Financial Statements
Financial statements are written records that convey the business activities and the financial performance of a company. Financial statements include the balance sheet, income statement, and cash flow statement. more

Understanding Cost of Goods Sold – COGS
Cost of goods sold (COGS) is defined as the direct costs attributable to the production of the goods sold in a company. more

Profit Margin
Profit margin gauges the degree to which a company or a business activity makes money. It represents what percentage of sales has turned into profits. more

Liability
A liability is something a person or company owes, usually a sum of money. more

What Is a Capital Asset?
A capital asset is an asset with a useful life longer than a year that is not intended for sale in the regular course of the business's operation. more

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primary and secondary records in accounting

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Journal is known as a '**primary record** book' or 'book of original entry'. Ledger is known as a '**secondary record** book' or ' book of final entry'. The process of recording of transactions in the journal is called as 'Journalising'. ... Journal book is only a subsidiary book and doesn't help in preparing of final **accounts**. Mar 15, 2017

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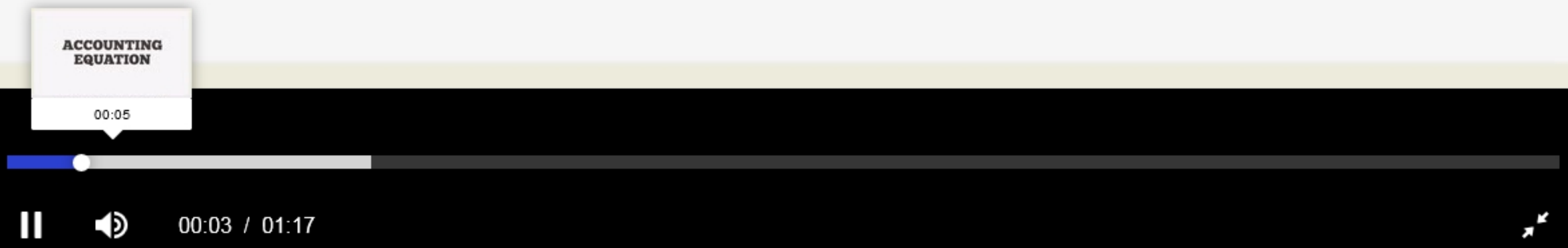

ACCOUNTING EQUATION

ASSETS =

LIABILITIES + SHAREHOLDER OR OWNER EQUITY

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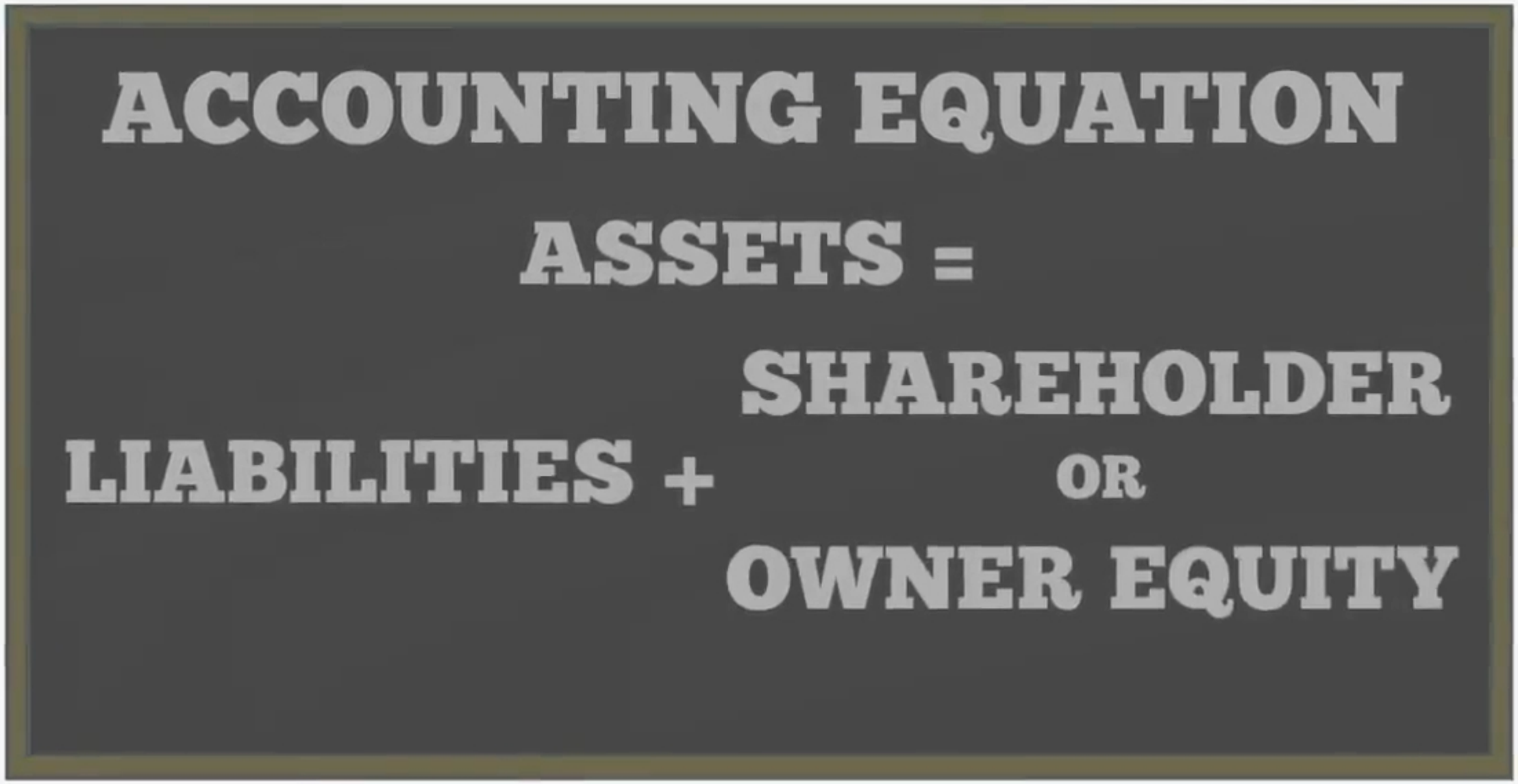

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JANUARY 24, 2015

ASSETS

- ACCOUNTS RECEIVABLE
- CASH
- INVENTORY
- INVESTMENTS
- BUILDINGS AND EQUIPMENT

LIABILITIES

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- LOANS
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LIABILITIES

LOANS
ACCOUNTS PAYABLE
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EQUITY

CAPITAL STOCK
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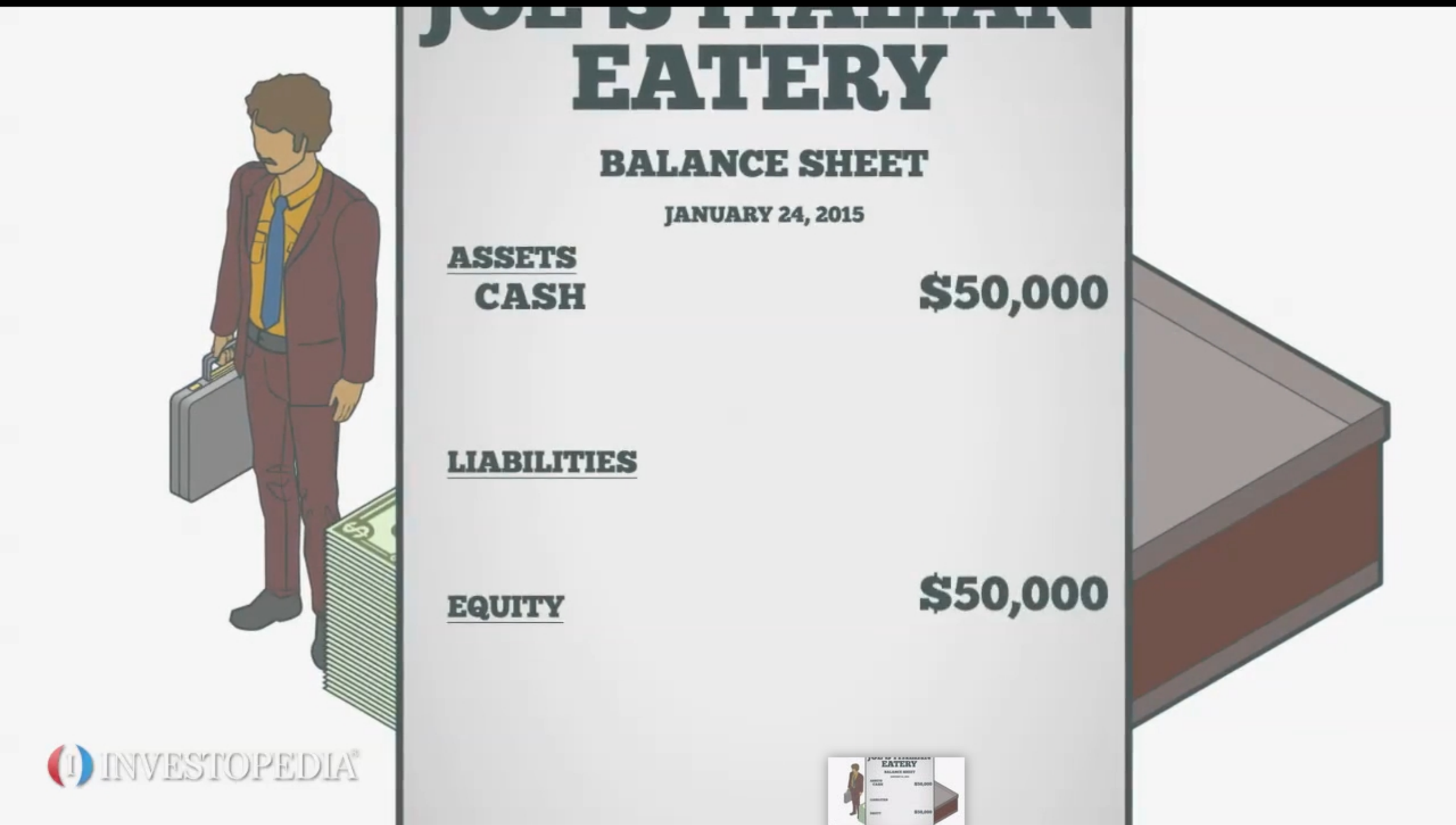

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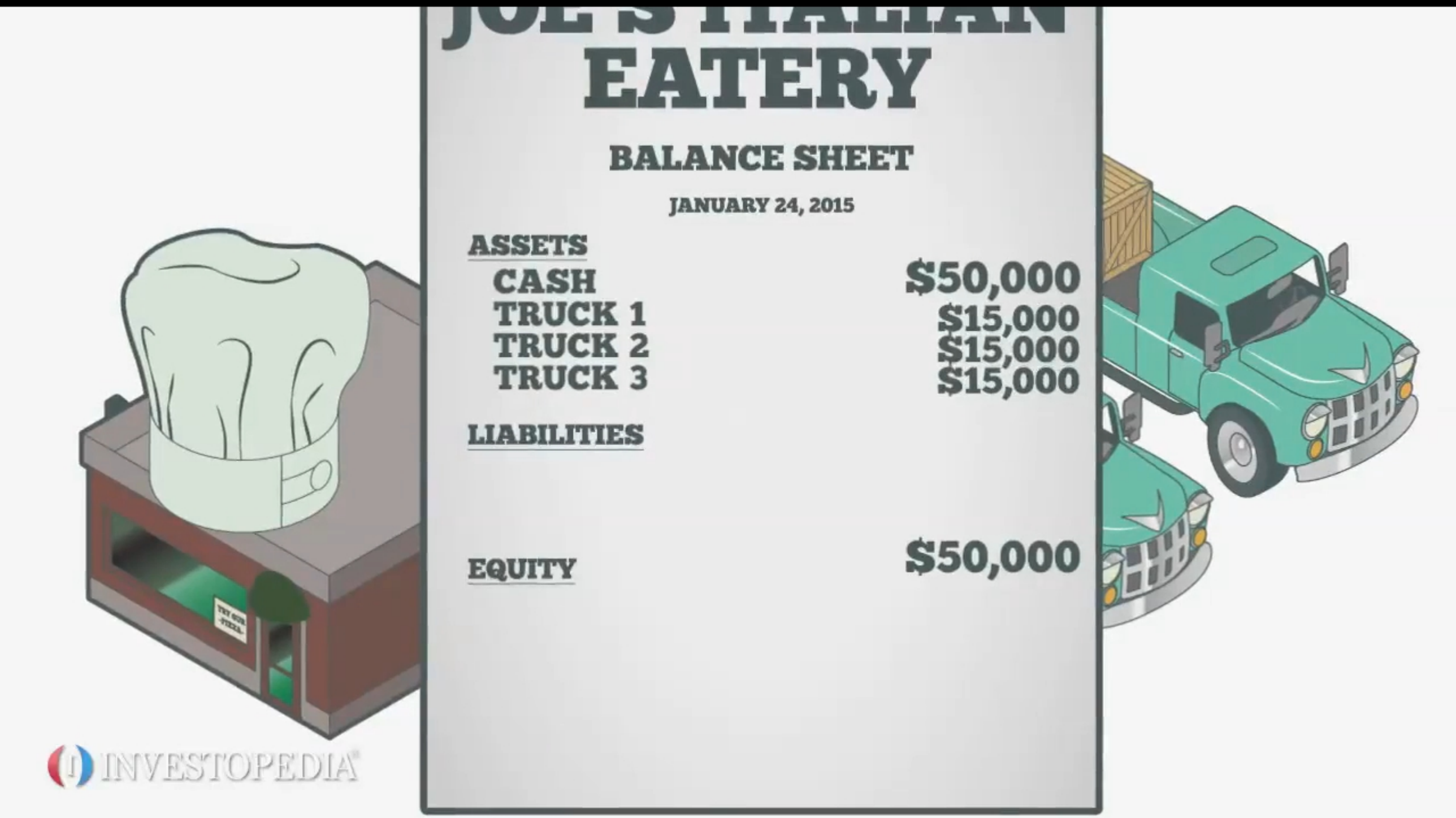

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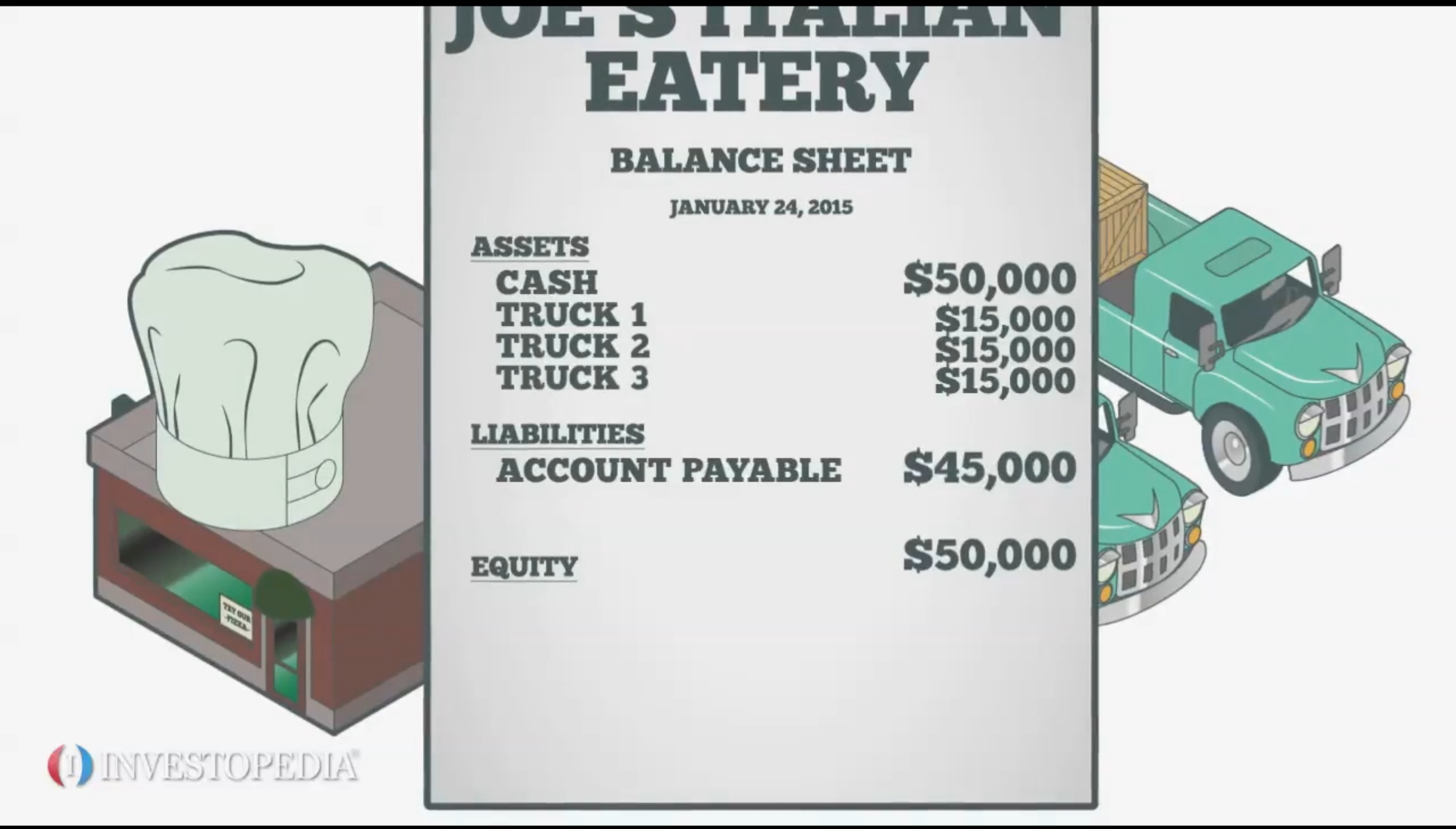

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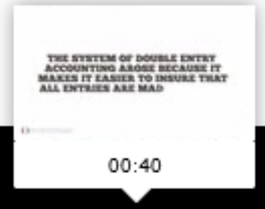

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ABC CO.

ACCOUNTING RECORDS

	DEBIT	CREDIT
CASH	$7,000	
CONSULTING REVENUE		$7,000

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00:22

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Journal

By JAMES CHEN | Updated Apr 29, 2019

What is a Journal?

A journal is a detailed account that records all the financial transactions of a business, to be used for future reconciling of and transfer to other official accounting records, such as the general ledger. A journal states the date of a transaction, which accounts were affected, and the amounts, usually in a double-entry bookkeeping method.

Understanding Journals

For accounting purposes, a journal is a physical record or digital document kept as a book, spreadsheet or data within accounting software. When a business transaction is made, a bookkeeper enters the financial transaction as a journal entry. If the expense or income affects one or more business accounts, the journal entry will detail that as well. Journaling is an essential part of objective record-keeping and allows for concise review and records-transfer later in the accounting process. Journals are often reviewed as part of a trade or audit process, along with the general ledger.

KEY TAKEAWAYS

- A journal is a detailed record of all the transactions done by a business.
- When a journal entry is recorded into a company's journal, it's usually

Feedback

GENERAL JOURNAL

Date	Accounts		Debits	Credits
01-17-X3	Accounts Receivable		8,000	
	Service Revenue			8,000
	Provided services to customers on account			
01-18-X3	Accounts Payable		500	
	Cash			500
	Paid half of the utility bill received on Jan. 15			
01-25-X3	Cash		4,800	
	Accounts Receivable			4,800
	Received 60% of the amount due on the receivable that was established on Jan. 17			
01-28-X3	Land		15,000	
	Cash			5,000
	Notes Payable			10,000
	Purchased land by giving $5,000 cash, and promising to pay the remainder in 90 days			

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Trial Balance

By WILL KENTON | Reviewed By JANET BERRY-JOHNSON | Updated Feb 4, 2020

What Is a Trial Balance?

A trial balance is a bookkeeping worksheet in which the balance of all ledgers are compiled into debit and credit account column totals that are equal. A company prepares a trial balance periodically, usually at the end of every reporting period. The general purpose of producing a trial balance is to ensure the entries in a company's bookkeeping system are mathematically correct.

Trial Balance

Feedback

XAO CORPORATION
Trial Balance
January 31, 20X3

	Debits	Credits
Cash	$26,300	
Accounts receivable	3,200	
Land	15,000	
Accounts payable		$ 500
Notes payable		10,000
Capital stock		25,000
Service revenues		12,000
Advertising expense	2,000	
Utilities expense	1,000	
	$47,500	$47,500

General Ledger Example Account

General Ledger Sheet					Sheet No: 21
Account: Electricity Expense					Account No: 640
Date	Details	Ref.	Debit	Credit	Balance
2018					
Mar 15	To Accounts Payable	J1	4,000		4,000
June 17	To Accounts Payable	J3	3,640		7,640
Sept 14	By Accounts Payable	J5		430	7,210

General Ledger Definition

By WILL KENTON | Reviewed By JANET BERRY-JOHNSON | Updated Jan 31, 2020

What Is a General Ledger?

A general ledger represents the record-keeping system for a company's financial data with debit and credit account records validated by a trial balance. The general ledger provides a record of each financial transaction that takes place during the life of an operating company.

The general ledger holds account information that is needed to prepare the company's financial statements, and transaction data is segregated by type into accounts for assets, liabilities, owners' equity, revenues, and expenses.

1:37

General Ledger

How a General Ledger Works

A general ledger is the foundation of a system used by accountants to store and organize financial data used to create the firm's financial statements. Transactions are posted to individual sub-ledger accounts, as defined by the company's chart of accounts.

The transactions are then closed out or summarized to the general ledger, and the accountant generates a trial balance, which serves as a report of each ledger account's balance. The trial balance is checked for errors and adjusted by posting additional necessary entries, and then the adjusted trial balance is used to generate the financial statements.

How a General Ledger Functions with Double Entry Accounting

A general ledger is used by businesses that employ the double-entry bookkeeping method, which means that each financial transaction affects at least two sub-ledger accounts and each entry has at least one debit and one credit transaction. Double-entry transactions, called journal entries, are posted in two columns, with debit entries on the left and credit entries on the right, and the total of all debit and credit entries must balance.

The accounting equation, which underlies double-entry accounting, is as follows:

$$\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$$

The balance sheet follows this format and shows information at a detailed account level. For example, the balance sheet shows several asset accounts, including cash and accounts receivable, in its short-term assets section.

The double-entry accounting method works based on the accounting equation's requirement that transactions posted to the accounts on the left of the equal sign in the formula must equal the total of transactions posted to the account (or accounts) on the right. Even if the equation is presented differently (such as Assets = Liabilities + Stockholders' Equity), the balancing rule always applies.

What Does a General Ledger Tell You?

The transaction details contained in the general ledger are compiled and summarized at various levels to produce a trial balance, income statement, balance sheet, statement of cash flows, and many other financial reports. This helps accountants, company management, analysts, investors, and other stakeholders assess the company's performance on an ongoing basis.

When expenses spike in a given period, or a company records other transactions that affect its revenues, net income, or other key financial metrics, the financial statement data often doesn't tell the whole story.

In the case of certain types of accounting errors, it becomes necessary to go back to the general ledger and dig into the detail of each recorded transaction to locate the issue. At times, this can involve reviewing dozens of journal entries, but it is imperative to maintain reliably error-free and credible company financial statements.

KEY TAKEAWAYS

- The general ledger is the foundation of a company's double-entry accounting system.
- General ledger accounts encompass all the transaction data needed to produce the income statement, balance sheet, and other financial reports.
- General ledger transactions are a summary of transactions made as journal entries to sub-ledger accounts.
- The trial balance is a report that lists every general ledger account and its balance, making adjustments easier to check and errors easier to locate.

The Balance Sheet Transaction Example

If a company receives payment from a client for a $200 invoice, for example, the company accountant increases the cash account with a $200 debit and completes the entry with a credit, or reduction, of $200 to accounts receivable. The posted debit and credit amounts are equal.

In this instance, one asset account (cash) is increased by $200, while another asset account (accounts receivable) is reduced by $200. The net result is that both the increase and the decrease only affect one side of the accounting equation. Thus, the equation remains in balance.

Example of an Income Statement Transaction

The income statement follows its own formula, which can be written as follows:

$$\text{Revenue} - \text{Expenses} = \text{Net Income (NI) or Net Profit}$$

It is possible for an accounting transaction to impact both the balance sheet and the income statement simultaneously.

For example, assume that a company bills its client for $500. The accountant would enter this transaction into the accounting ledger by posting a $500 debit (increase) to accounts receivable (a balance sheet asset account) and a $500 credit (increase) to revenue, which is an income statement account. Debits and credits both increase by $500, and the totals stay in balance.

Learn More About the General Ledger

For related insight into general ledgers, consider reading more about double entry accounting.

Related Terms

Breaking Down Debits
A debit is an accounting entry that results in either an increase in assets or a decrease in liabilities on a company's balance sheet. more

Closing Entry Definition
A closing entry is a journal entry made at the end of the accounting period whereby data are moved from temporary accounts to permanent accounts. more

Accounting Cycle
The accounting cycle records and analyzes accounting events related to a company's activities. more

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Ledgers

Posting and Balancing of Ledgers

The journal consists of all entries, but what if we are asked about transactions with a particular account? We can't count and find the total amount or number of transactions as they are probably done on different dates. Hence, different accounts are made to record transactions related to that particular account. In the end, balancing of the ledger is done to get the status of the particular ledger at the end of the financial year.

Solve Questions

What is a journal? Give a specimen of journal showing at least five entries.

1 Verified answer

An entry which has more than one debit and or credit is called _____.

1 Verified answer

If the goods are sold, the entry should be recorded in the journal.

1 Verified answer

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Ledger Posting

After the transactions are recorded in the journal, it is then posted in the principal book called as 'Ledger'. The process of transferring the entries from journal to respective ledger accounts is called ledger posting. Balancing of ledgers is carried to find out differences at the end of the year.

Ledger posting is entering information in the ledger, in respective accounts from the journal for individual records. The account debited is posted on the debit side and the account credited is posted on the credit side of the same account.

This process is carried throughout the year and at the end of the financial year the ledger accounts are closed and are totaled and balanced. This process is called the balancing of the ledger accounts.

Understand the concept of Journal Entries here in detail.

Rules for posting of entries in the ledger

1. A separate account is opened for each account and entries from the journal are posted in respective ledger account accordingly.
2. The words like 'To' and 'By' are used while posting the entries in the ledger accounts. 'To' is used when accounts are posted in the debit side column of a particular account. 'By' is used when accounts are posted in the credit side column of a particular account. These words may not have meaning but are used to represent the debit and credit accounts.
3. The account which is debited in the journal should also be debited in the ledger book but the reference should be of respective credit account.

Balancing of Ledger

At the end of every accounting year all the accounts which are operated in the ledger book are closed, totaled and balanced. Balancing of ledgers means finding the difference between the debit and credit amounts of a particular account i.e. heavier total and lighter total difference and recording that difference amount on the lighter total side.

Steps for Balancing Ledger Account

1. First of all, calculate the totals of debit and credit columns separately on a rough sheet to avoid mistakes. Find out the difference between the heavier total and lighter total by subtracting the lower from higher. The difference is called a Balance amount.
2. If the total of the debit side is heavier than that of the credit side, the balance is called as "Debit Balance" and is written on the credit side balance is called as "Debit Balance" and is written on the credit side (the side with lower amount) of that particular account as "By Balance c/d" or "By Balance c/FD". Here, c/d means carried down and c/FD means carried forward.
3. Similarly, if the total of the credit side is more than that of debit side total, the balance is called "Credit Balance". The difference amount is written on the debit side of the account as "To balance c/d" or "To balance c/fd"
4. Once we get the heavier total it should be written in both the columns' total. Draw double lines across the total below the amounts which indicates the account is closed and balanced.
5. Last year's closing balance is the opening balance of the current year. So, if there is debit it should be shown on the debit side of a particular account as "To Balance b/d" or "To Balance b/fd". Here, b/d means brought down and b/fd means brought forward.

Note: Nominal accounts are not balanced; the balances are transferred to profit and loss account.

Solved Question for You

Question: Prepare Stationery Account for the year ended 31.12.2017

2018		Amount
JAN 1	Stock in hand	480
APRIL 5	Stationery purchased through Cheque	800
NOV 15	Stationery purchased from Kamal Stationery mart on credit	1280
DEC 31	Stock in hand	240

Stationery A/c

Dr.				Cr.		
Date	Particulars	Amount		Date	Particulars	Amount
2018				2018		
Jan 1	To Balance b/d	480		Dec 31	By Profit & Loss A/c	2,320
April 5	To Bank A/c	800				
Nov 15	To Kamal Stationery Mart	1,280		Dec 31	By balance c/d	240
	Total	2,560			Total	2,560
2019				2019		
Jan 1	To balance b/d	240				

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Books Of Original Entry
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BROWSE
Ledgers
- Posting and Balancing of Ledgers

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Paul's Guitar Shop, Inc.
Adjusted Trial Balance
December 31, 2015

Account	Debit	Credit
Cash	$ 32,800	
Accounts Receivable	300	
Prepaid Rent	1,000	
Inventory	39,800	
Leasehold Improvements	100,000	
Accumulated Depreciation		2,000
Accounts Payable		$ 49,000
Accrued Expenses		450
Unearned Income		1,000
Long-term Liabilities		99,500
Common Stock		10,000
Dividends	1,000	
Revenues		27,800
Cost of Goods Sold	10,200	
Depreciation Expense	2,000	
Rent Expense	500	
Supplies Expense	500	
Utilities Expense	400	
Wages Expense	750	
Interest Expense	500	
Totals	**$ 189,750**	**$ (189,750)**

Errors Disclosed by a Trial Balance:

The errors which cause a mismatch in the trial balance totals are frequently referred to as errors disclosed in a Trial Balance. However, the mismatch does not automatically point to the actual errors. It is only the diligence and ingenuity of the person preparing the accounts which would help in the location of the errors.

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The various errors which would cause a mismatch in the trial balance totals are as follows:

(i) Wrong Totaling in a Subsidiary Book:

For example, if the total of the purchase for a month is stuck as Rs. 26,150 instead of Rs. 26,250 then the debit in the purchases account would be Rs. 26,150 (as the total from the subsidiary book will be posted to the debit of the purchase account). The total of the credits posted in the individual suppliers' a/c would be Rs. 26,250 and in the Trial Balance the posted in the individual suppliers' a/c would be Rs. 26,250 and in the Trial Balance the total credits will exceed total debits by Rs. 100.

(ii) Wrong Calculation of Balances in a Ledger Account:

For example, if the debit balance in the furniture a/c has been taken as Rs. 5,650 instead of Rs. 5,850 then the Trial Balance will show the total credits exceeding the total debits by Rs. 200.

(iii) Partial Omission of an Entry:

If the debit or credit aspect of a transaction has been omitted to be recorded, the Trial Balance will disagree. For example, if a cash sale of Rs. 800 is omitted to be recorded in the Sales a/c then the total debits will exceed the total credits by Rs. 800.

(iv) Posting an Aspect of a Transaction More than Once:

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For example, if an amount of Rs. 2,000 paid to XY Limited has been posted to the debit of XY Limited a/c twice, then the debits will exceed the credits by Rs. 2,000.

(v) Debit Entries Wrongly Recorded as Credit Entries of Vice-versa:

For example, if an amount of Rs. 3,500 received from Z is posted to the credits of Z's a/c then the debits will exceed the credits by Rs. 7,000.

(vi) Errors in Totaling the Debit Column or the Credit Column of the Trial Balance:

Obviously, if a total mistake occurs while casting either the debit side or credit side of the Trial Balance, it will not tally.

(vii) Balance of Ledger Accounts are Wrongly Transferred to the Trial Balance:

For example, the balance of Rs. 46,945 in the Plant and Machinery a/c is transferred to the trial balance as Rs. 46,495. This will cause the credits to exceed the debit by Rs. 450.

(viii) Omitting to Include an Account's Balance in the Trial Balance:

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When an account which is outstanding in the ledger account is omitted to be include in the trial balance, it will not tally.

Suspense Account:

When a combination of the various errors mentioned above have been committed, the mismatch in the totals of the Trial Balance will be totally different for the amounts of the individual transactions and only through scrutiny and checking of the books of accounts will help in detecting the errors.

Sometimes, when the Trial Balance disagrees and sufficient time is not available to scrutinize the books, the accountant will include 'Suspense A/c' in the Trial Balance to make it agree and proceed with the preparation of Profit and 'Loss A/c' and Balance Sheet.

For instance, if the totals of the credits in a Trial Balance exceed the debits by Rs. 2,550 then a suspense a/c with a debit balance of 2,550 will be included in the Trial Balance. At a later date, the books may be scrutinised to detect the errors and the rectification entries passed to clear the balance in the Suspense A/c.

Errors not Disclosed by Trial Balance:

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Even though a trial balance may be in agreement, certain errors might have been committed while recording the transactions. Such errors are referred to as errors not committed while recording the transactions. Such errors are referred to as errors not disclosed by Trial Balance.

The errors which will not cause a mismatch in the totals of a Trial Balance are as follows:

(a) Omission of the Recording of a Transaction from the Books of Accounts:

If the withdrawal of goods worth Rs. 1,200 by the proprietor is omitted to be recorded in the books, the Trial Balance will still agree as both the debit and credit aspects have been omitted to be recorded.

(b) Recording a Transaction at an Amount which is Totally Different from the Actual Amount:

If the purchases of goods worth Rs. 7,500 are recorded in the Purchase book as Rs. 5,700 the error will not cause the trial balance to disagree.

(c) Compensating Errors:

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These are quite difficult to detect. If a cash discount of Rs. 215 allowed to a customer has been posted to the credit of his account as Rs. 251 and a cash sale of Rs. 2,851 has been posted to sales account as Rs. 2,815, then the excess credit caused by the first error would be exactly compensated by the lower credit recorded by the second error and the trial balance will be in agreement.

(d) Posting of an Aspect of a Transaction on the Correct Side of Wrong Account:

If the amount of Rs. 800 received from MN Ltd. a debtor, is posted to the credit of NM Ltd. a/c, also a debtor, the Trial Balance totals will still agree, because both are debit accounts and the total effect is the same and the total effect is the same.

(e) Recording Both Aspects of a Transaction More than Once in the Books of Accounts:

If a sales of Rs. 3,500 made to PQR Ltd. is entered in the Sales Book twice, the error will not cause a mismatch in the totals of Trial Balance.

(f) Errors of Principle:

If the machinery a/c is debited for an amount of repair charges incurred for the machinery, the error will not be disclosed by the Trial Balance. This is because that both machinery a/c and repairs a/c are debit a/c and it is a question of principle that repairs charges should not be debited to the machinery a/c. Hence, the total effect will be the same and therefore the Trial Balance will tally.

Suspense Account

By ANDREW BLOOMENTHAL | Updated Apr 1, 2020

A suspense account is a section of a general ledger where an organization records ambiguous entries that still need further analysis to determine their proper classification and/or correct destination. In the context of investing, a suspense account is a brokerage account where an investor temporarily parks his cash until he can deploy that money towards the purchase of new investments.

KEY TAKEAWAYS

- A suspense account is a catch-all section of a general ledger used by companies to record ambiguous entries that require clarification.
- Suspense accounts are routinely cleared out once the nature of the suspended amounts are resolved, and are subsequently shuffled to their correctly designated accounts.
- Suspense accounts are frequently used by mortgage lenders when a borrower accidentally falls short on a monthly payment, or if a borrower chooses to break up the monthly payment obligation into partial amounts.
- In investing, suspense accounts hold an investor's money until it can be reinvested.

Understanding Suspense Accounts

Suspense accounts contain entries where there are uncertainties or discrepancies. For example, if an individual makes a deposit but accidentally writes down an account number incorrectly, that money will be housed in a suspense account until the error is corrected. In another scenario, a customer may issue a payment, but fail to specify which invoice he intends to pay off with those funds.

Regardless of the uncertainties in question, suspense accounts are cleared out once the confusion is resolved, at which time the funds are promptly re-shuffled to their correctly designated accounts. At his time, the suspect account should theoretically achieve a balance of zero dollars. While there is no definitive timetable for conducting a clearing-out process, many businesses attempt to regularly accomplish this on a monthly or quarterly basis.

Mortgage Suspense Accounts

A mortgage servicer may use suspense accounts to hold funds when a borrower falls short on a required monthly loan repayment, where the suspense account functions as a catch-all vessel that secures the funds. At this time, the mortgage servicer may elect to distribute the partial amount received to various silos, including principal amount owed, accrued interest, property tax payments, and homeowner's insurance programs.

In some cases, a borrower deliberately makes partial payments, by intentionally dividing his monthly payment into two chunks. In such cases, mortgage servicers can use suspense accounts to house the first partial payment until the second payment is remitted. After receiving sufficient funds to make a full payment, the mortgage servicer then applies the combined balance to the correct account.

Brokerage Suspense Accounts

Similar to business suspense accounts, brokerage suspense accounts temporarily hold funds while transactions are completed. For example, if an investor sells off a group of securities valued at $500, but plans to quickly invest that amount of money in a different set of investments, the $500 from the sale would be moved to a suspense account until it can be allocated toward the new purchase.

Important: The amount of funds held in suspense account is referred to as the "suspense balance."

Related Terms

Accounting Error
An accounting error is an error in an accounting entry that was not intentional, and when spotted is immediately fixed. more

Breaking Down Debits
A debit is an accounting entry that results in either an increase in assets or a decrease in liabilities on a company's balance sheet. more

Delinquent Mortgage Definition
A delinquent mortgage is a home loan where the borrower has failed to make their required payments on time. more

Accrue
To accrue means to accumulate over time, and is most commonly used when referring to the interest, income, or expenses of an individual or business. more

Federal Housing Administration (FHA) Loan
A Federal Housing Administration (FHA) loan is a mortgage insured by the FHA that is designed for lower-income borrowers. more

Liability
A liability is something a person or company owes, usually a sum of money. more

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International Financial Reporting Standards (IFRS)

By BARCLAY PALMER | Reviewed By GORDON SCOTT | Updated Jan 29, 2020

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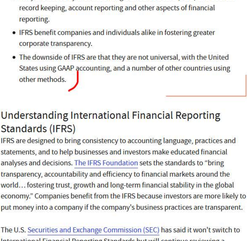
What Are IFRS?
Standard IFRS Requirements
History of IFRS
Understanding IFRS
IFRS vs. American Standards

What Are International Financial Reporting Standards (IFRS)?

International Financial Reporting Standards (IFRS) set common rules so that financial statements can be consistent, transparent, and comparable around the world. IFRS are issued by the International Accounting Standards Board (IASB). They specify how companies must maintain and report their accounts, defining types of transactions, and other events with financial impact. IFRS were established to create a common accounting language so that businesses and their financial statements can be consistent and reliable from company to company and country to country.



International Financial Reporting Standards (IFRS)

KEY TAKEAWAYS

- International Financial Reporting Standards (IFRS) were established to bring consistency to accounting standards and practices, regardless of the company or the country.
- They are issued by the Accounting Standards Board (IASB) and address record keeping, account reporting and other aspects of financial reporting.
- IFRS benefit companies and individuals alike in fostering greater corporate transparency.
- The downside of IFRS are that they are not universal, with the United States using GAAP accounting, and a number of other countries using other methods.

Understanding International Financial Reporting Standards (IFRS)

IFRS are designed to bring consistency to accounting language, practices and statements, and to help businesses and investors make educated financial analyses and decisions. The IFRS Foundation sets the standards to "bring transparency, accountability and efficiency to financial markets around the world… fostering trust, growth and long-term financial stability in the global economy." Companies benefit from the IFRS because investors are more likely to put money into a company if the company's business practices are transparent.

The U.S. Securities and Exchange Commission (SEC) has said it won't switch to International Financial Reporting Standards but will continue reviewing a proposal to allow IFRS information to supplement U.S. financial filings. GAAP has been called "the gold standard" of accounting. However, some argue that the global adoption of IFRS would save money on duplicative accounting work, and the costs of analyzing and comparing companies internationally.

IFRS are sometimes confused with International Accounting Standards (IAS), which are the older standards that IFRS replaced. IAS was issued from 1973 to 2000, and the International Accounting Standards Board (IASB) replaced the International Accounting Standards Committee (IASC) in 2001.

120

IFRS are used in at least 120 countries, as of 2020, including those in the European Union (EU) and many in Asia and South America, but the U.S. uses Generally Accepted Accounting Principles (GAAP).

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

- Statement of Financial Position: This is also known as a balance sheet. IFRS influences the ways in which the components of a balance sheet are reported.
- Statement of Comprehensive Income: This can take the form of one statement, or it can be separated into a profit and loss statement and a statement of other income, including property and equipment.
- Statement of Changes in Equity: Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.
- Statement of Cash Flow: This report summarizes the company's financial transactions in the given period, separating cash flow into Operations, Investing, and Financing.

In addition to these basic reports, a company must also give a summary of its accounting policies. The full report is often seen side by side with the previous report, to show the changes in profit and loss. A parent company must create separate account reports for each of its subsidiary companies.

IFRS vs. American Standards

Differences exist between IFRS and other countries' Generally Accepted Accounting Principles (GAAP) that affect the way a financial ratio is calculated. For example, IFRS is not as strict on defining revenue and allows companies to report revenue sooner, so consequently, a balance sheet under this system might show a higher stream of revenue than GAAP's. IFRS also has different requirements for expenses; for example, if a company is spending money on development or an investment for the future, it doesn't necessarily have to be reported as an expense (it can be capitalized).

Another difference between IFRS and GAAP is the specification of the way inventory is accounted for. There are two ways to keep track of this, first in first out (FIFO) and last in first out (LIFO). FIFO means that the most recent inventory is left unsold until older inventory is sold; LIFO means that the most recent inventory is the first to be sold. IFRS prohibits LIFO, while American standards and others allow participants to freely use either.

History of IFRS

IFRS originated in the European Union, with the intention of making business affairs and accounts accessible across the continent. The idea quickly spread globally, as a common language allowed greater communication worldwide. Although the U.S. and some other countries don't use IFRS, most do, and they are spread all over the world, making IFRS the most common global set of standards.

The IFRS website has more information on the rules and history of the IFRS.

The goal of IFRS is to make international comparisons as easy as possible. That goal hasn't fully been achieved because, in addition to the U.S. using GAAP, some countries use other standards. And U.S. GAAP is different from Canadian GAAP. Synchronizing accounting standards across the globe is an ongoing process in the international accounting community.

Related Terms

Accounting Principles Definition
Accounting principles are the rules and guidelines that companies must follow when reporting financial data. more

Generally Accepted Accounting Principles (GAAP)
GAAP is a common set of accounting principles, standards, and procedures that public companies in the U.S. must follow when they compile their financial statements. more

Proportional Consolidation
Proportional consolidation is a former method of accounting for joint ventures, which was abolished by the IFRS as of Jan. 1, 2013. more

Financial Accounting Standards Board (FASB)
The Financial Accounting Standards Board (FASB) is an independent organization that sets accounting standards for companies and nonprofits in the United States. more

Accounting Changes and Error Correction
Accounting Changes and error correction refers to guidance on reflecting accounting changes and errors in financial statements. more

International Accounting Standards (IAS)
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An **income statement** is a financial **statement** that shows you how profitable your business was over a given reporting period. It shows your revenue, minus your expenses and losses. Nov 27, 2019

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Understanding an Income Statement (Definition and Examples)

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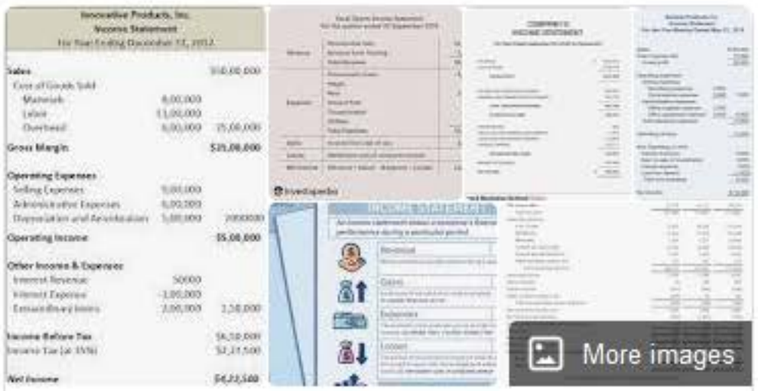

Income statement

An income statement or profit and loss account is one of the financial statements of a company and shows the company's revenues and expenses during a particular period. It indicates how the revenues are transformed into the net income or net profit.

Wikipedia

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Profit and Loss Statement (P&L)

By NATHAN REIFF | Reviewed By JULIUS MANSA | Updated Apr 28, 2020

What Is a Profit and Loss Statement (P&L)?

The profit and loss (P&L) statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a fiscal quarter or year. The P&L statement is synonymous with the income statement. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Some refer to the P&L statement as a statement of profit and loss, income statement, statement of operations, statement of financial results or income, earnings statement or expense statement.

P&L management refers to how a company handles its P&L statement through revenue and cost management.

KEY TAKEAWAYS

- The P&L statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period.
- The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement.
- It is important to compare P&L statements from different accounting periods, as the changes in revenues, operating costs, R&D spending, and net earnings over time are more meaningful than the numbers themselves.
- Together with the balance sheet and cash flow statement, the P&L statement provides an in-depth look at a company's financial performance.

Understanding a Profit and Loss Statement (P&L)

Investopedia/Grace Kim

The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement. It is often the most popular and common financial statement in a business plan as it quickly shows how much profit or loss was generated by a business.

The income statement, like the cash flow statement, shows changes in accounts over a set period. The balance sheet, on the other hand, is a snapshot, showing what the company owns and owes at a single moment. It is important to compare the income statement with the cash flow statement since, under the accrual method of accounting, a company can log revenues and expenses before cash changes hands.

The income statement follows a general form as seen in the example below. It begins with an entry for revenue, known as the top line, and subtracts the costs of doing business, including the cost of goods sold, operating expenses, tax expenses, and interest expenses. The difference, known as the bottom line, is net income, also referred to as profit or earnings. You can find many templates for creating a personal or business P&L statement online for free.

It is important to compare income statements from different accounting periods, as the changes in revenues, operating costs, research and development spending, and net earnings over time are more meaningful than the numbers themselves. For example, a company's revenues may grow, but its expenses might grow at a faster rate.

Profit and Loss Statement (P&L) Example

Below is Caterpillar Inc.'s income or P&L statement for 2013 and 2014 (all figures in USD millions except per-share data):[1]

Twelve Months Ended December 31,	2014	2013
Sales and revenues:		
Sales of Machinery, Energy & Transportation	52,142	52,694
Revenues of Financial Products	3,042	2,962
Total sales and revenues	55,184	55,656
Operating costs:		
Cost of goods sold	39,767	40,727
Selling, general and administrative expenses	5,697	5,547
Research and development expenses	2,135	2,046
Interest expense of Financial Products	624	727
Other operating (income) expenses	1,633	981
Total operating costs	49,856	50,028
Operating profit	5,328	5,628
Interest expense excluding Financial Products	484	465
Other income (expense)	239	(35)
Consolidated profit before taxes	5,083	5,128
Provision (benefit) for income taxes	1,380	1,319
Profit of consolidated companies	3,703	3,809
Equity in profit (loss) of unconsolidated affiliated companies	8	(6)
Profit of consolidated and affiliated companies	3,711	3,803
Less: Profit (loss) attributable to noncontrolling interests	16	14
Profit [footnote 1: Profit attributable to common shareholders]	3,695	3,789
Profit per common share	5.99	5.87
Profit per common share – diluted [footnote 2: Diluted by assumed exercise of stock-based compensation awards using the treasury stock method]	5.88	5.75
Weighted-average common shares outstanding (millions)		
- Basic	617.2	645.2
- Diluted [see footnote 2]	628.9	658.6
Cash dividends declared per common share	2.70	2.32

tOne can use the income statement to calculate several metrics, including the gross profit margin, the operating profit margin, the net profit margin and the operating ratio. Together with the balance sheet and cash flow statement, the income statement provides an in-depth look at a company's financial performance.

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Financial Statement Analysis
Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes. more

Income Statement
An income statement is one of the three major financial statements that reports a company's financial performance over a specific accounting period. more

Understanding a Common Size Financial Statement
A common size financial statement allows for easy analysis between companies or between periods for a company. It displays all items as percentages of a common base figure rather than as absolute numerical figures. more

Understanding Accounting Ratios
Accounting ratios, also known as financial ratios, are used to measure the efficiency and profitability of a company based on its financial reports. more

Cash Flow Statement
A cash flow statement is a financial statement that provides aggregate data regarding all cash inflows and outflows a company receives. more

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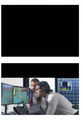
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Cash Flow Statement

By ADAM HAYES | Reviewed By JULIUS MANSA | Updated Aug 9, 2020

What Is a Cash Flow Statement?

A cash flow statement is a financial statement that provides aggregate data regarding all cash inflows a company receives from its ongoing operations and external investment sources. It also includes all cash outflows that pay for business activities and investments during a given period.

A company's financial statements offer investors and analysts a portrait of all the transactions that go through the business, where every transaction contributes to its success. The cash flow statement is believed to be the most intuitive of all the financial statements because it follows the cash made by the business in three main ways—through operations, investment, and financing. The sum of these three segments is called net cash flow.

These three different sections of the cash flow statement can help investors determine the value of a company's stock or the company as a whole.

KEY TAKEAWAYS

- A cash flow statement provides data regarding all cash inflows a company receives from its ongoing operations and external investment sources.
- The cash flow statement includes cash made by the business through operations, investment, and financing—the sum of which is called net cash flow.
- The first section of the cash flow statement is cash flow from operations, which includes transactions from all operational business activities.
- Cash flow from investment is the second section of the cash flow statement , and is the result of investment gains and losses.
- Cash flow from financing is the final section, which provides an overview of cash used from debt and equity.

Understanding Cash Flow

How Cash Flow Statements Work

Every company that sells and offers its stock to the public must file financial reports and statements with the Securities and Exchange Commission (SEC).[1] The three main financial statements are the balance sheet and income statement. The cash flow statement is an important document that helps open a wind interested parties insight into all the transactions that go through a company.

There are two different branches of accounting—accrual and cash. Most public companies use accrual accounting, which means the income statement is not the same as the company's cash position. The cash flow statement, though, is focused on cash accounting.

Profitable companies can fail to adequately manage cash flow, which is why the cash flow statement is a critical tool for companies, analysts, and investors. The cash flow statement is broken down into three different business activities: operations, investing, and financing.

Let's consider a company that sells a product and extends credit for the sale to its customer. Even though it recognizes that sale as revenue, the company may not receive cash until a later date. The company earns a profit on the income statement and pays income taxes on it, but the business may bring in more or less cash than the sales or income figures.

> **Important:** Investors and analysts should use good judgment when evaluating changes to working capital, as some companies may try to boost up their cash flow before reporting periods.

Cash Flows From Operations

This is the first section of the cash flow statement covers cash flows from operating activities (CFO) and includes transactions from all operational business activities. The cash flows from operations section begins with net income, then reconciles all noncash items to cash items involving operational activities. So, in other words, it is the company's net income, but in a cash version.

This section reports cash flows and outflows that stem directly from a company's main business activities. These activities may include buying and selling inventory and supplies, along with paying its employees their salaries. Any other forms of in and outflows such as investments, debts, and dividends are not included.

Companies are able to generate sufficient positive cash flow for operational growth. If there is not enough generated, they may need to secure financing for external growth in order to expand.

For example, accounts receivable is a noncash account. If accounts receivable go up during a period, it means sales are up, but no cash was received at the time of sale. The cash flow statement deducts receivables from net income because it is not cash. The cash flows from the operations section can also include accounts payable, depreciation, amortization, and numerous prepaid items booked as revenue or expenses, but with no associated cash flow.

Cash Flows From Investing

This is the second section of the cash flow statement looks at cash flows from investing (CFI) and is the result of investment gains and losses. This section also includes cash spent on property, plant, and equipment. This section is where analysts look to find changes in capital expenditures (capex).

When capex increases, it generally means there is a reduction in cash flow. But that's not always a bad thing, as it may indicate that a company is making investment into its future operations. Companies with high capex tend to be those that are growing.

While positive cash flows within this section can be considered good, investors would prefer companies that generate cash flow from business operations—not through investing and financing activities. Companies can generate cash flow within this section by selling equipment or property.

Cash Flows From Financing

Cash flows from financing (CFF) is the last section of the cash flow statement. The section provides an overview of cash used in business financing. It measures cash flow between a company and its owners and its creditors, and its source is normally from debt or equity. These figures are generally reported annually on a company's 10-K report to shareholders .

Analysts use the cash flows from financing section to determine how much money the company has paid out via dividends or share buybacks. It is also useful to help determine how a company raises cash for operational growth.

Cash obtained or paid back from capital fundraising efforts, such as equity or debt, is listed here, as are loans taken out or paid back.

When the cash flow from financing is a positive number, it means there is more money coming into the company than flowing out. When the number is negative, it may mean the company is paying off debt, or is making dividend payments and/or stock buybacks.

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Cash Flow Statement
+ FINANCIAL RATIOS
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Cash Flow Statement: Analyzing Cash Flow From Investing Activities

Cash Flow Statement

Diana's Goat Grooming

Month Ended January 31, 2019

Cash Flow from Operations	
Net income	$60,000
Additions to Cash	
Depreciation	$20,000
Increase in Accounts Payable	$10,000
Subtractions from Cash	
Increase in Accounts Receivable	($20,000)
Increase in inventory	($30,000)
Net Cash from Operations	$40,000
Cash Flow from Investing	
Purchase of equipment	($5,000)
Cash Flow from Financing	
Notes payable	$7,500
Cash Flow for Month Ended December 31, 2018	**$42,500**

Understanding the Cash Flow Statement

By CHRIS B. MURPHY | Updated Sep 9, 2020

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The Bottom Line

The statement of cash flows, or the cash flow statement, is a financial statement that summarizes the amount of cash and cash equivalents entering and leaving a company.

The cash flow statement (CFS) measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses. The cash flow statement complements the balance sheet and income statement and is a mandatory part of a company's financial reports since 1987.[1]

In this article, we'll show you how the CFS is structured, and how you can use it when analyzing a company.

KEY TAKEAWAYS

- A cash flow statement is a financial statement that summarizes the amount of cash and cash equivalents entering and leaving a company.
- The cash flow statement measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses.
- The cash flow statement complements the balance sheet and income statement and is a mandatory part of a company's financial reports since 1987.[1]
- The main components of the cash flow statement are cash from operating activities, cash from investing activities, and cash from financing activities.
- The two methods of calculating cash flow are the direct method and the indirect method.

How to Use a Cash Flow Statement

The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how money is being spent. The CFS is important since it helps investors determine whether a company is on a solid financial footing.

Creditors, on the other hand, can use the CFS to determine how much cash is available (referred to as liquidity) for the company to fund its operating expenses and pay its debts.

The Structure of the Cash Flow Statement

The main components of the cash flow statement are:

1. Cash from operating activities
2. Cash from investing activities
3. Cash from financing activities
4. Disclosure of noncash activities is sometimes included when prepared under the generally accepted accounting principles (GAAP).[2]

It's important to note that the CFS is distinct from the income statement and balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded on credit. Therefore, cash is not the same as net income, which on the income statement and balance sheet includes cash sales and sales made on credit.

Cash From Operating Activities

The operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services.

Important: Generally, changes made in cash, accounts receivable, depreciation, inventory, and accounts payable are reflected in cash from operations.

These operating activities might include:

- Receipts from sales of goods and services
- Interest payments
- Income tax payments
- Payments made to suppliers of goods and services used in production
- Salary and wage payments to employees
- Rent payments
- Any other type of operating expenses.[3]

In the case of a trading portfolio or an investment company, receipts from the sale of loans, debt, or equity instruments are also included. When preparing a cash flow statement under the indirect method, depreciation, amortization, deferred tax, gains or losses associated with a non-current asset, and dividends or revenue received from certain investing activities are also included. However, purchases or sales of long-term assets are not included in operating activities.

What is a Cash Flow Statement?

How Cash Flow Is Calculated

Cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses, and credit transactions (appearing on the balance sheet and income statement) resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income (income statement) and total assets and liabilities (balance sheet). So, because not all transactions involve actual cash items, many items have to be re-evaluated when calculating cash flow from operations.

As a result, there are two methods of calculating cash flow: the direct method and the indirect method.

Direct Cash Flow Method

The direct method adds up all the various types of cash payments and receipts, including cash paid to suppliers, cash receipts from customers, and cash paid out in salaries. These figures are calculated by using the beginning and ending balances of a variety of business accounts and examining the net decrease or increase in the accounts.

Indirect Cash Flow Method

With the indirect method, cash flow from operating activities is calculated by first taking the net income off of a company's income statement. Because a company's income statement is prepared on an accrual basis, revenue is only recognized when it is earned and not when it is received. Net income is not an accurate representation of net cash flow from operating activities, so it becomes necessary to adjust earnings before interest and taxes (EBIT) for items that affect net income, even though no actual cash has yet been received or paid against them. The indirect method also makes adjustments to add back non-operating activities that do not affect a company's operating cash flow.

For example, depreciation is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into net sales for calculating cash flow.

FAST FACT

The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Accounts Receivable and Cash Flow

Changes in accounts receivable (AR) on the balance sheet from one accounting period to the next must also be reflected in cash flow. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts—the amount by which AR has decreased is then added to net sales. If accounts receivable increases from one accounting period to the next, the amount of the increase must be deducted from net sales because, although the amounts represented in AR are revenue, they are not cash.

Inventory Value and Cash Flow

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more raw materials. If the inventory was paid with cash, the increase in the value of inventory is deducted from net sales. A decrease in inventory would be added to net sales. If inventory was purchased on credit, an increase in accounts payable would occur on the balance sheet, and the amount of the increase from one year to the other would be added to net sales.

The same logic holds true for taxes payable, salaries payable, and prepaid insurance. If outstanding bills are paid, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings.

Cash From Investing Activities

Investing activities include any sources and uses of cash from a company's investments. A purchase or sale of an asset, loans made to vendors or received from customers, or any payments related to a merger or acquisition is included in this category. In short, changes in equipment, assets, or investments relate to cash from investing.[3]

Usually, cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings, or short-term assets such as marketable securities. However, when a company divests an asset, the transaction is considered "cash in" for calculating cash from investing.

Cash From Financing Activities

Cash from financing activities includes the sources of cash from investors or banks, as well as the uses of cash paid to shareholders. Payment of dividends, payments for stock repurchases, and the repayment of debt principal (loans) are included in this category.

Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to bondholders, the company is reducing its cash.

Example of a Cash Flow Statement

Below is an example of a cash flow statement:

Cash Flow Statement Company XYZ
FY Ended 31 Dec 2017
All figures in USD

Cash Flow From Operations	
Net Earnings	1,000,000
Additions to Cash	
Depreciation	10,000
Decrease in Accounts Receivable	15,000
Increase in Accounts Payable	15,000
Increase in Taxes Payable	3,000
Reductions From Cash	
Increase in Inventory	(30,000)
Net Cash From Operations	1,013,000
Cash Flow From Investing	
Equipment	(500,000)
Cash Flow From Financing	
Notes Payable	10,000
Cash Flow for FY Ended 31 Dec 2017	**1,522,000**

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From this CFS, we can see that the cash flow for the fiscal year 2017 was $1,522,000. The bulk of the positive cash flow stems from cash earned from operations, which is a good sign for investors. It means that core operations are generating business and that there is enough money to buy new inventory. The purchasing of new equipment shows that the company has the cash to invest in inventory for growth. Finally, the amount of cash available to the company should ease investors' minds regarding the notes payable, as cash is plentiful to cover that future loan expense.

Negative Cash Flow Statement

Of course, not all cash flow statements look this healthy or exhibit a positive cash flow, but negative cash flow should not automatically raise a red flag without further analysis. Sometimes, negative cash flow is the result of a company's decision to expand its business at a certain point in time, which would be a good thing for the future. This is why analyzing changes in cash flow from one period to the next gives the investor a better idea of how the company is performing, and whether or not a company may be on the brink of bankruptcy or success.

Balance Sheet and Income Statement

As we have already discussed, the cash flow statement is derived from the income statement and the balance sheet. Net earnings from the income statement are the figure from which the information on the CFS is deduced. As for the balance sheet, the net cash flow to the CFS from one year to the next should equal the increase or decrease of cash between the two consecutive balance sheets that apply to the period that the cash flow statement covers. For example, if you are calculating cash flow for the year 2019, the balance sheets from the years 2018 and 2019 should be used.

The Bottom Line

A cash flow statement is a valuable measure of strength, profitability, and the long-term future outlook for a company. The CFS can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a cash flow statement to predict future cash flow, which helps with matters of budgeting.

For investors, the cash flow statement reflects a company's financial health since typically the more cash that's available for business operations, the better. However, this is not a hard and fast rule. Sometimes, a negative cash flow results from a company's growth strategy in the form of expanding its operations.

By studying the cash flow statement, an investor can get a clear picture of how much cash a company generates and gain a solid understanding of the financial well being of a company.

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Capital Expenditures vs. Revenue Expenditures: What's the Difference?

By J.B. MAVERICK | Updated Sep 24, 2020

Capital Expenditures vs. Revenue Expenditures: An Overview

The differences between capital expenditures and revenue expenditures include whether the purchases will be used over the long-term or short-term. Capital expenditures (CAPEX) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, buildings, or equipment. Capital expenditures are typically one-time large purchases of fixed assets that will be used for revenue generation over a longer period.

Revenue expenditures are typically referred to as ongoing operating expenses, which are short-term expenses that are used in running the daily business operations.

KEY TAKEAWAYS

- Capital expenditures (CAPEX) are funds used by a company to acquire, upgrade, and maintain physical assets such as equipment.
- Capital expenditures are typically one-time large purchases of fixed assets that will be used for revenue generation over a longer period.
- Revenue expenditures are the ongoing operating expenses, which are short-term expenses used to run the daily business operations.

Revenue Expenditures

Revenue expenditures are short-term expenses used in the current period or typically within one year. Revenue expenditures include the expenses required to meet the ongoing operational costs of running a business, and thus are essentially the same as operating expenses (OPEX).

Revenue expenditures also include the ordinary repair and maintenance costs that are necessary to keep an asset in working order without substantially improving or extending the useful life of the asset. Revenue expenses related to existing assets include repairs and regular maintenance as well as repainting and renewal expenses. Revenue expenditures can be considered to be recurring expenses in contrast to the one-off nature of most capital expenditures.

Types of Revenue Expenditures

Other examples of revenue expenditures include the following:

- Salaries and employee wages
- Any overhead expense, such as salaries for the corporate office, which typically fall under selling, general, and administrative expenses (SG&A)
- Research and development (R&D)
- Utilities and Rent
- Business travel
- Property taxes

Revenue Expenditures Accounting Treatment

Revenue expenditures or operating expenses are recorded on the income statement. These expenses are subtracted from the revenue that a company generates from sales to eventually arrive at the net income or profit for the period.

Revenue expenses can be fully tax-deducted in the same year the expenses occur. In other words, the expenses reduce profit from a tax standpoint, and thus, reduce the taxable income for the tax period.

Capital Expenditures

Capital expenditures represent significant investments of capital that a company makes to maintain or, more often, to expand its business and generate additional profits. Capital expenditures consist of the purchase of long-term assets, which are assets that last for more than one year but typically have a useful life of many years.

Capital expenditures are often used for buying fixed assets, which are physical assets such as equipment. As a result, capital expenditures are typically for larger amounts than revenue expenditures. However, there are exceptions when large asset purchases are consumed in the short term or the current accounting period.

Types of Capital Expenditures

Capital expenditures can include the purchase of the following:

- A facility or factory, including an upgrade or expansion
- Vehicles, such as trucks used for the delivery of products
- Manufacturing equipment
- Computers
- Furniture

Capital expenditures are often used to undertake new projects or investments by a company. Typically, the purpose of CAPEX is to expand a company's ability to generate revenue and earnings. Conversely, revenue expenditures are the operational expenses for running the day-to-day business and the maintenance costs that are necessary to keep the asset in working order.

Companies often use debt financing or equity financing to cover the substantial costs involved in acquiring major assets for expanding their business. Debt financing can involve borrowing money from a bank or issuing corporate bonds, which are IOUs to investors who buy them and get paid interest periodically. Equity financing involves issuing shares of stock or equity to investors to raise funds for expansion and capital improvements.

CAPEX Accounting Treatment

The purchases or cash outflows for capital expenditures are shown in the investing section of the cash flow statement (CFS). The CFS shows all of the inflows and outflows of cash in a particular period. When a company buys equipment, for example, they must show the cash outflow on their CFS. In addition, the equipment must also be recorded within total assets on the balance sheet.

Since long-term assets provide income-generating value for a company for a period of years, companies are not allowed to deduct the full cost of the asset in the year the expense is incurred. Instead, they must recover the cost through year-by-year depreciation over the useful life of the asset. In other words, the cost of capital expenditures are spread out over many periods or years, whereas revenue expenditures are expensed in the current year or period.

> **Important:** While keeping operating expenses under control can boost profit in the short-term, CAPEX spending can grow revenue in the long-term.

Example of Capital and Revenue Expenditures

Tesla Inc. (TSLA) is an automobile manufacturer of electric vehicles. Below is a truncated portion of the company's income statement and cash flow statement as of the company's 10-Q report filed on June 30, 2020.[1]

Revenue Expenditures

As stated earlier, revenue expenditures or operating expenses are reported on the income statement, which are highlighted in blue below.

- Total operating expenses for Tesla were $940 million for Q2 2020.
- The Q2 2020 revenue expenditures decreased from $1.088 billion that was reported in Q2 2019.
- We can also see that the $148 million reduction in OPEX ($1,088 - $940), in 2020 directly helped the company's net income for that quarter, in which a $327 million net income gain was recorded.

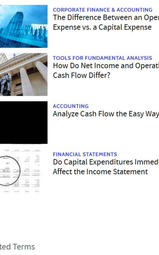
Tesla Inc. - Income Statement (portion)		
	Quarter Ending June 30	
	2020	2019
Revenues		
Automotive sales	$ 4,511	$ 5,168
Automotive leasing	269	228
Total automotive revenues	4,779	5,396
Energy generation and storage	370	309
Services and other	467	405
Total revenues	5,616	6,050
Cost of revenues		
Automotive sales	3,714	4,254
Automotive leasing	149	106
Total automotive cost of revenues	3,863	4,360
Energy generation and storage	349	326
Services and other	558	743
Total cost of revenues	4,769	5,429
Gross profit	1,267	921
Operating expenses		
Research and development	279	334
Selling, general and administrative	663	847
Restructuring and other	—	157
Total operating expenses	940	1,088
Income (loss) from operations	327	(167)

Revenue Expenditures Example from Tesla Inc. Investopedia

Capital Expenditures

The cash outflows for CAPEX are shown in the investing section of the cash flow statement.

- Total capital expenditures for Tesla were $1.046 billion for Q2 2020.
- The Q2 2020 CAPEX figure was an increase from $557 million reported in Q2 2019.
- We can see that the increase was the result of $1.001 billion in purchases of property and equipment as well as $46 million in purchases of solar energy systems.



Capital Expenditures Example using Tesla Inc. Investopedia

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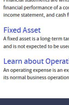
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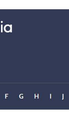
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Trading statement

From Wikipedia, the free encyclopedia

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The **trading statement** is an expanded version of sales portion of the Income statement. The trading statement's main objective is to determine sales, cost of sales and gross profit.[1] The trading statement it's part of effective book keeping within the accounting discipline.

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V · T · E

Primary formula [edit]

Sales - Cost of Sales = Gross Profit

Cost of sales [edit]

The main parts of a cost of sales calculation consists of:

- Opening inventories (The amount of inventories that the entity has on hand from the previous year)
- + Purchases (The amount of inventories that the entity purchases over the course of the year)
- = Goods available for sale (Opening inventories + Purchases +/- other items)
- - Closing inventories (Inventory on hand at the end of the year)

Example [edit]

- Question:

A business entity purchases £10400 worth of equipment in order to construct computers. During the financial year, £1400 worth of equipment is returned to the entity by its customers as the equipment was determined to be faulty. The previous financial year, the entity had £3000 worth of equipment left over. The entity makes use

Income statement for XYZ business For the period ending 31st of December 2010		
	$	$
Sales		200,000
Cost of goods sold		(120,000)
Gross profit		80,000
Other income:		20,500
Rent received	20,000	
Interest received	500	
Other expenses:		(61,060)
Salaries	16,000	
Telephone & internet	10,000	
Water & electricity	7,300	
Property rates and taxes	3,000	
Insurance	2,500	
Advertising costs	14,000	
Stationery	654	
Bank charges	906	
Tax expense	6,700	
NET PROFIT		39,440

Balance Sheet

By ADAM HAYES | Reviewed By MARGARET JAMES Q | Updated May 13, 2020

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EXPAND+

What is a Balance Sheet?

A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity at a specific point in time, and provides a basis for computing rates of return and evaluating its capital structure. It is a financial statement that provides a snapshot of what the company owns and owes, as well as the amount invested by shareholders.

The balance sheet is used alongside other important financial statements such as the income statement and statement of cash flows in conducting fundamental analysis or calculating financial ratios.

KEY TAKEAWAYS

- A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity.
- The balance sheet is one of the three (income statement and statement of cash flows being the other two) core financial statements used to evaluate a business.
- The balance sheet is a snapshot, representing the state of a company's finances (what it owns and owes) as of the date of publication.
- Fundamental analysts use balance sheets, in conjunction with other financial statements, to calculate financial ratios.

An Introduction To The Balance Sheet

Formula Used for a Balance Sheet

The balance sheet adheres to the following accounting equation, where assets on one side, and liabilities plus shareholders' equity on the other, balance out:

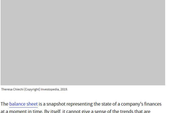
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

This formula is intuitive: a company has to pay for all the things it owns (assets) by either borrowing money (taking on liabilities) or taking it from investors (issuing shareholders' equity).

For example, if a company takes out a five-year, $4,000 loan from a bank, its assets (specifically, the cash account) will increase by $4,000. Its liabilities (specifically, the long-term debt account) will also increase by $4,000, balancing the two sides of the equation. If the company takes $8,000 from investors, its assets will increase by that amount, as will its shareholders' equity. All revenues the company generates in excess of its expenses will go into the shareholders' equity account. These revenues will be balanced on the assets side, appearing as cash, investments, inventory, or some other asset.

Assets, liabilities and shareholders' equity each consist of several smaller accounts that break down the specifics of a company's finances. These accounts vary widely by industry, and the same terms can have different implications depending on the nature of the business. Broadly, however, there are a few common components investors are likely to come across.

What's On the Balance Sheet?



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The balance sheet is a snapshot representing the state of a company's finances at a moment in time. By itself, it cannot give a sense of the trends that are playing out over a longer period. For this reason, the balance sheet should be compared with those of previous periods. It should also be compared with those of other businesses in the same industry since different industries have unique approaches to financing.

A number of ratios can be derived from the balance sheet, helping investors get a sense of how healthy a company is. These include the debt-to-equity ratio and the acid-test ratio, along with many others. The income statement and statement of cash flows also provide valuable context for assessing a company's finances, as do any notes or addenda in an earnings report that might refer back to the balance sheet.

Assets

Within the assets segment, accounts are listed from top to bottom in order of their liquidity – that is, the ease with which they can be converted into cash. They are divided into current assets, which can be converted to cash in one year or less, and non-current or long-term assets, which cannot.

Here is the general order of accounts within current assets:

- Cash and cash equivalents are the most liquid assets and can include Treasury bills and short-term certificates of deposit, as well as hard currency.
- Marketable securities are equity and debt securities for which there is a liquid market.
- Accounts receivable refers to money that customers owe the company, perhaps including an allowance for doubtful accounts since a certain proportion of customers can be expected not to pay.
- Inventory goods available for sale, valued at the lower of the cost or market price.
- Prepaid expenses represent the value that has already been paid for, such as insurance, advertising contracts or rent.

Long-term assets include the following:

- Long-term investments are securities that will not or cannot be liquidated in the next year.
- Fixed assets include land, machinery, equipment, buildings and other durable, generally capital-intensive assets.
- Intangible assets include non-physical (but still valuable) assets such as intellectual property and goodwill. In general, intangible assets are only listed on the balance sheet if they are acquired, rather than developed in-house. Their value may thus be wildly understated - by not including a globally recognized logo, for example – or just as wildly overstated.

Liabilities

Liabilities are the money that a company owes to outside parties, from bills it has to pay to suppliers to interest on bonds it has issued to creditors to rent, utilities and salaries. Current liabilities are those that are due within one year and are listed in order of their due date. Long-term liabilities are due at any point after one year.

Current liabilities accounts might include:

- current portion of long-term debt
- bank indebtedness
- interest payable
- wages payable
- customer prepayments
- dividends payable and others
- earned and unearned premiums
- accounts payable

Long-term liabilities can include:

- Long-term debt, interest and principal on bonds issued
- Pension fund liability, the money a company is required to pay into its employees' retirement account
- Deferred tax liability, taxes that have been accrued but will not be paid for another year. Besides timing, this figure reconciles differences between requirements for financial reporting and the way tax is assessed, such as depreciation calculations.)

Some liabilities are considered off the balance sheet, meaning that they will not appear on the balance sheet.

Shareholders' Equity

Shareholders' equity is the money attributable to a business' owners, meaning its shareholders. It is also known as "net assets," since it is equivalent to the total assets of a company minus its liabilities, that is, the debt it owes to non-shareholders.

Retained earnings are the net earnings a company either reinvests in the business or use to pay off debt; the rest is distributed to shareholders in the form of dividends.

Treasury stock is the stock a company has repurchased. It can be sold at a later date to raise cash or reserved to repel a hostile takeover.

Some companies issue preferred stock, which will be listed separately from common stock under shareholders' equity. Preferred stock is assigned an arbitrary par value – as is common stock, in some cases – that has no bearing on the market value of the shares (often, par value is just $0.01). The "common stock" and "preferred stock" accounts are calculated by multiplying the par value by the number of shares issued.

Additional paid-in capital or capital surplus represents the amount shareholders have invested in excess of the "common stock" or "preferred stock" accounts, which are based on par value rather than market price. Shareholders' equity is not directly related to a company's market capitalization: the latter is based on the current price of a stock, while paid-in capital is the sum of the equity that has been purchased at any price.

Example of a Balance Sheet

EXXON MOBIL CORPORATION
CONSOLIDATED COMPARE BALANCE SHEETS
(Million of USD)

	Year-To-Date
Assets	
Current assets	
Cash and cash equivalents	3,947
Total accounts receivable - net	27,889
Inventories	
Crude oil and petroleum products	12,247
Chemicals	2,000
Other current assets	1,973
Total current assets	48,056
Property, plant and equipment - net	168,267
Goodwill and other intangibles	4,000
Other assets, including investments - net	19,000
Total assets	239,323
Liabilities	
Current liabilities	
Notes and loans payable	19,312
Accounts and other payables	27,000
Income taxes payable	2,000
Total current liabilities	48,312
Long-term debt	25,000
Deferred income taxes	17,000
Deferred income tax liabilities	17,000
Other long-term liabilities and deferred income	25,000
Other long-term obligations	76,000
Total liabilities	208,312
Commitments and contingencies (Note 5)	
Equity	
Common stock without par value	
(9,000 shares issued in 2012, 5,000 million been issued)	15,250
Earnings reinvested	429,243
Accumulated other comprehensive income	-18,782
Common stock held in treasury	
(3,000 shares in December 31, 2012 and 1,750 million shares in December 31, 2011)	-157,218
Total Exxon Mobil Corporation	268,493
Noncontrolling interest	1,518
Total equity	270,011
Total liabilities and equity	239,323

Exxon Mobil Corporation - Investopedia

Limitations of Balance Sheets

The balance sheet is an invaluable piece of information for investors and analysts; however, it does have some drawbacks. Since it is just a snapshot in time, it can only use the difference between the balance in time and another single point in time in the past. Because it is static, many financial ratios draw on data included in both the balance sheet and the more dynamic income statement and statement of cash flows to paint a fuller picture of what's going on with a company's business.

Different accounting systems and ways of dealing with depreciation and inventories will also change the figures posted to a balance sheet. Because of this, managers have some ability to game the numbers to look more favorable. Pay attention to the balance sheet's footnotes in order to determine which systems are being used in their accounting and to look out for red flags.

Learn More About Balance Sheets

The balance sheet is an important document for investors and analysts alike.

For related insight on balance sheets, investigate more about how to read balance sheets, whether balance sheets always balance and how to evaluate a company's balance sheet.

Related Terms

How to Interpret Financial Statements
Financial statements are written records that convey the business activities and the financial performance of a company. Financial statements include the balance sheet, income statement, and cash flow statement. more

Accounting Equation
The accounting equation shows that all of a company's total assets equals the sum of the company's liabilities and shareholders' equity. more

Equity
Equity typically refers to shareholders' equity, which represents the residual value to shareholders after debts and liabilities have been settled. more

Financial Statement Analysis
Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes. more

Cash Flow From Financing Activities – CFF
Cash flow from financing activities (CFF) is a section of a company's cash flow statement, which shows the net flows of cash used to fund the company. more

Liability
A liability is something a person or company owes, usually a sum of money. more

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Reading the Balance Sheet

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(In millions, except number of shares)

		December 28, 2019
ASSETS:		
Current assets:		
Cash and cash equivalents	$	39,771
Marketable securities		67,391
Accounts receivable, net		20,970
Inventories		4,097
Vendor non-trade receivables		18,976
Other current assets		12,026
Total current assets		163,231
Non-current assets:		
Marketable securities		99,899
Property, plant and equipment, net		37,031
Other non-current assets		40,457
Total non-current assets		177,387
Total assets	**$**	**340,618**
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$	45,111
Other current liabilities		36,263
Deferred revenue		5,573
Commercial paper		4,990
Term debt		10,224
Total current liabilities		102,161
Non-current liabilities:		
Term debt		93,078
Other non-current liabilities		55,848
Total non-current liabilities		148,926
Total liabilities		**251,087**
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid-in capital, $0.00001 par value: 12,600,000 shares authorized; 4,384,959 and 4,443,236 shares issued and outstanding, respectively		45,972
Retained earnings		43,977
Accumulated other comprehensive income/(loss)		(418)
Total shareholders' equity		89,531

20 comments

What are provisions relating to financial statements under the New companies act 2013

1. Section 129 of companies act 2013, provides for preparation of financial statements.

2. 2(40) to include balance sheet, profit and loss account/income and expenditure account, cash flow statement, statement of changes in equity and any explanatory note annexed to the above.

3. New section 129 corresponds to existing section 210. It provides that the financial statements shall give a true and fair view of the state of affairs of the company and shall comply with the accounting standards notified under new section 133.

4. It is also provided that the financial statements shall be prepared in the form provided in new schedule III **of Companies Act, 2013**.

5. It may be noted that in the new schedule III the provisions for preparation of balance sheet and statement of profit and loss have been given which are on the same lines as in the existing schedule VI.

6. Further, in the new Schedule III detailed instructions have been given for preparation of consolidated financial statements as consolidation of accounts of subsidiary companies is now made mandatory in section 129.

7. It may be noted that for the first time a provision has been made in the new section 129(3)that if a company has one or more subsidiaries it will have to prepare a consolidated financial statement of the company and of all the subsidiaries in the form provided in the **new schedule III of Companies Act, 2013**.

8. The company has also to attack along with its financial statement, a separate statement containing the salient features of the financials of the subsidiary companies in such form as may prescribed by the rules.

9. It is also provided that if the company has interest in any associate company or a joint venture the accounts of that company as well as joint venture shall be consolidated.

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Depreciation

By ALICIA TUJOVLA | Reviewed by JANET BERRY-JOHNSON Updated Jan 10, 2020

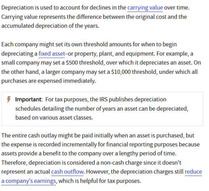
What Is Depreciation?

Depreciation is an accounting method of allocating the cost of a tangible or physical asset over its useful life or life expectancy. Depreciation represents how much of an asset's value has been used up. Depreciating assets helps companies earn revenue from an asset while expensing a portion of its cost each year the asset is in use. If not taken into account, it can greatly affect profits.

Businesses can depreciate long-term assets for both tax and accounting purposes. For example, companies can take a tax deduction for the cost of the asset, meaning it reduces taxable income. However, the Internal Revenue Service (IRS) states that when depreciating assets, companies must spread the cost out over time. The IRS also has rules for when companies can take a deduction.[1]

KEY TAKEAWAYS

- Per the matching principle of accounting, depreciation ties the cost of using a tangible asset with the benefit gained over its useful life.
- There are many types of depreciation, including straight-line and various forms of accelerated depreciation.
- Accumulated depreciation refers to the sum of all depreciation recorded on an asset to a specific date.
- The carrying value of an asset on the balance sheet is its historical cost minus all accumulated depreciation.
- The carrying value of an asset after all depreciation has been taken is referred to as its salvage value.



Depreciation

Understanding Depreciation

Depreciation is an accounting convention that allows a company to write off an asset's value over a period of time, commonly the asset's useful life. Assets such as machinery and equipment are expensive. Instead of realizing the entire cost of the asset in year one, depreciating the asset allows companies to spread out that cost and generate revenue from it.

Depreciation is used to account for declines in the carrying value over time. Carrying value represents the difference between the original cost and the accumulated depreciation of the years.

Each company might set its own threshold amounts for when to begin depreciating a fixed asset—or property, plant, and equipment. For example, a small company may set a $500 threshold, over which it depreciates an asset. On the other hand, a larger company may set a $10,000 threshold, under which all purchases are expensed immediately.

> **Important**: For tax purposes, the IRS publishes depreciation schedules detailing the number of years an asset can be depreciated, based on various asset classes.

The entire cash outlay might be paid initially when an asset is purchased, but the expense is recorded incrementally for financial reporting purposes because assets provide a benefit to the company over a lengthy period of time. Therefore, depreciation is considered a non-cash charge since it doesn't represent an actual cash outflow. However, the depreciation charges still reduce a company's earnings, which is helpful for tax purposes.

The matching principle under generally accepted accounting principles (GAAP) is an accrual accounting concept that dictates that expenses must be matched to the same period in which the related revenue is generated. Depreciation helps to tie the cost of an asset with the benefit of its use over time. In other words, each year, the asset is put to use and generates revenue, the incremental expense associated with using up the asset is also recorded.

The total amount that's depreciated each year, represented as a percentage, is called the depreciation rate. For example, if a company had $100,000 in total depreciation over the asset's expected life, and the annual depreciation was $15,000; the rate would 15% per year.

Recording Depreciation

When an asset is purchased, it is recorded as a debit to increase an asset account, which then appears on the balance sheet, and a credit to reduce cash or increase accounts payable, which also appears on the balance sheet. Neither side of this journal entry affects the income statement, where revenues and expenses are reported. In order to move the cost of the asset from the balance sheet to the income statement, depreciation is taken on a regular basis.

At the end of an accounting period, an accountant will book depreciation for all capitalized assets that are not fully depreciated. The journal entry for this depreciation consists of a debit to depreciation expense, which flows through to the income statement, and a credit to accumulated depreciation, which is reported on the balance sheet. Accumulated depreciation is a contra asset account, meaning its natural balance is a credit which reduces the net asset value. Accumulated depreciation on any given asset is its cumulative depreciation up to a single point in its life.

As stated earlier, carrying value is the net of the asset account and accumulated depreciation. The salvage value is the carrying value that remains on the balance sheet after all depreciation has been taken until the asset is sold or otherwise disposed. It is based on what a company expects to receive in exchange for the asset at the end of its useful life. As such, an asset's estimated salvage value is an important component in the calculation of depreciation.

Example of Depreciation

If a company buys a piece of equipment for $50,000, it could expense the entire cost of the asset in year one or write the value of the asset off over the asset's 10-year useful life. This is why business owners like depreciation. Most business owners prefer to expense only a portion of the cost, which boosts net income.

In addition, the company can scrap the equipment for $10,000 at the end of its useful life, which means it has a salvage value of $10,000. Using these variables, the accountant calculates depreciation expense as the difference between the cost of the asset and its salvage value, divided by the useful life of the asset. The calculation in this example is (50,000 - $10,000) / 10, which is $4,000 of depreciation expense per year.

This means the company's accountant does not have to expense the entire $50,000 in year one, even though the company paid out that amount in cash. Instead, the company only has to expense $4,000 against net income. The company expenses another $4,000 next year and another $4,000 the year after that, and so on until the asset reaches its $10,000 salvage value in ten years.

Types of Depreciation

Straight-Line

Depreciating assets using the straight-line method is typically the most basic way to record depreciation. It reports equal depreciation expense each year throughout the entire useful life until the entire asset is depreciated to its salvage value. The example above used straight-line depreciation.

Assume, for another example, that a company buys a machine at a cost of $5,000. The company decides on a salvage value of $1,000 and a useful life of five years. Based on these assumptions, the depreciable amount is $4,000 ($5,000 cost - $1,000 salvage value) and the annual depreciation using the straight-line method is: $4,000 depreciable amount / 5 years, or $800 per year. As a result, the depreciation rate is 20% ($800/$4,000). The depreciation rate is used in both the declining balance and double-declining balance calculations.

Declining Balance

The declining balance method is an accelerated depreciation method. This method depreciates the machine at its straight-line depreciation percentage times its remaining depreciable amount each year. Because an asset's carrying value is higher in earlier years, the same percentage causes a larger depreciation expense amount in earlier years, declining each year.

Using the straight-line example above, the machine costs $5,000, has a salvage value of $1,000, a 5-year life, and is depreciated at 20% each year, so the expense is $800 in the first year ($4,000 depreciable amount * 20%), $640 in the second year ($4,000 - $800) * 20%), and so on.

Double Declining Balance (DDB)

The double-declining balance (DDB) method is another accelerated depreciation method. After taking the reciprocal of the useful life of the asset and doubling it, this rate is applied to the depreciable base, book value, for the remainder of the asset's expected life. For example, an asset with a useful life of five years would have a reciprocal value of 1/5 or 20%. Double the rate, or 40%, is applied to the asset's current book value for depreciation. Although the rate remains constant, the dollar value will decrease over time because the rate is multiplied by a smaller depreciable base each period.

Sum-of-the-Year's-Digits (SYD)

The sum-of-the-year's-digits (SYD) method also allows for accelerated depreciation. To start, combine all the digits of the expected life of the asset. For example, an asset with a five-year life would have a base of the sum of the digits one through five, or 1+ 2 + 3 + 4 + 5 = 15. In the first depreciation year, 5/15 of the depreciable base would be depreciated. In the second year, only 4/15 of the depreciable base would be depreciated. This continues until year five depreciates the remaining 1/15 of the base.

Units of Production

This method requires an estimate for the total units an asset will produce over its useful life. Depreciation expense is then calculated per year based on the number of units produced. This method also calculates depreciation expenses based on the depreciable amount.

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Salvage Value Definition
Salvage value is the estimated book value of an asset after depreciation. It is an important component in the calculation of a depreciation schedule. more

How the Double Declining Balance Depreciation Method Works
The double declining balance depreciation method is an accelerated depreciation method that multiplies an asset's value by a depreciation rate. more

Straight Line Basis Definition
Straight-line basis is the simplest method of calculating depreciation and amortization, the process of expensing an asset over a specific period. more

Accelerated Depreciation
Accelerated depreciation is any depreciation method used for accounting or income tax purposes that allow for higher deductions in the earlier years. more

Fully Depreciated Asset
A fully depreciated asset has already expended its full depreciation allowance where only its salvage value remains. more

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than the straight-line depreciation model if an asset depreciates more quickly or has greater production capacity during its earlier years.

Units of Production Depreciation

Units of production assigns an equal expense rate to each unit produced, which makes it most useful for assembly or production lines. The formula involves using historical costs (the price of an asset based on its nominal or original cost when acquired by the company) and estimated salvage values. The method then determines the expense for the accounting period multiplied by the number of units produced.

Special Considerations

Overall, companies have several different options for depreciating the value of an asset over time. Most companies use a standard depreciation methodology for all of the company's assets. Thus, depreciation methodologies are typically industry-specific.

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Auditor's Report

By WILL KENTON | Updated Aug 19, 2019

What Is an Auditor's Report?

The auditor's report is a written letter from the auditor containing the opinion of whether a company's financial statements comply with generally accepted accounting principles (GAAP). The independent and external audit report is typically published with the company's annual report. The auditor's report is important because banks and creditors require an audit of a company's financial statements before lending to them. In this article, we explain what goes into an auditor's report as well as review an example of an audit report.

IFRS

How an Auditor's Report Works

An auditor's report is a written letter attached to a company's financial statements that express its opinion on a company's compliance with standard accounting practices. The auditor's report is required to be filed with a public company's financial statements when reporting earnings to the Securities and Exchange Commission (SEC). However, an auditor's report is not an evaluation of whether a company is a good investment. Also, the audit report is not an analysis of the company's earnings performance for the period. Instead, the report is merely a measure of the reliability of the financial statements.

KEY TAKEAWAYS

- The auditor's report is a document containing the auditor's opinion of whether a company's financial statements comply with GAAP.
- The audit report is important because banks, creditors, and regulators require an audit of a company's financial statements.
- A clean audit report means a company followed accounting standards while an unqualified report means there might be errors.
- An adverse report means that the financial statements might have had discrepancies, misrepresentations, and didn't adhere to GAAP.

The Components of an Auditor's Report

The auditor's letter follows a standard format, as established by generally accepted auditing standards (GAAS). A report usually consists of three paragraphs.

- The first paragraph states the responsibilities of the auditor and directors.
- The second paragraph contains the scope, stating that a set of standard accounting practices was the guide.
- The third paragraph contains the auditor's opinion.

An additional paragraph may inform the investor of the results of a separate audit on another function of the entity. The investor will key in on the third paragraph, where the opinion is stated.

The type of report issued will be dependent on the findings by the auditor. Below are the most common types of reports issued for companies.

Clean or Unqualified Report

A clean report means that the company's financial records are correct and conform to the guidelines set out by GAAP. A majority of audits end in unqualified, or clean, opinions.

Qualified Opinion

A qualified opinion means that although a company didn't follow the proper accounting standards, the company didn't do anything wrong. For example, a mistake might have been made in calculating operating expenses or profit. Auditors typically state the specific reasons and areas where the issues are present so that the company can fix them.

Adverse Opinion

An adverse opinion means that the auditor found that not only did the company not follow accounting guidelines, but there were discrepancies in the financials. An adverse opinion indicates that the auditor might have suspicions of material misstatements or misrepresentations in the financial statements, but does not have enough evidence to clearly express that opinion. An adverse opinion is the worst possible outcome for a company and can have a lasting impact and legal ramifications if not corrected.

Disclaimer of Opinion

A disclaimer of opinion means that for some reason, the auditor couldn't complete the audit or chooses not to provide an opinion on the company. Examples can include when an auditor can't be impartial or wasn't allowed access to certain financial information.

> **Important:** Regulators and investors will reject a company's financial statements following an adverse opinion from an auditor. Also, if illegal activity exists, corporate officers might face criminal charges.

Example of an Auditor's Report

Excerpts from the audit report by Deloitte & Touche LLP for Starbucks Corporation, dated November 17, 2017:

Paragraph 1
"We have audited the accompanying consolidated balance sheets of Starbucks Corporation and subsidiaries…and related consolidated statements of earnings, comprehensive income, equity, and cash flows. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits."

Paragraph 2
"We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements."

Paragraph 3
"In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Starbucks Corporation and subsidiaries…in conformity with accounting principles generally accepted in the United States of America."

Paragraph 4
"We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board, [and] expressed an unqualified opinion on the Company's internal control over financial reporting."

Related Terms

Auditor
An auditor is a person authorized to review and verify the accuracy of business records and ensure compliance with tax laws. more

Short-Form Report
A short-form report is a brief summary of an audit that has been performed on a company's financial statements. more

Adverse Opinion Definition
An adverse opinion is an opinion made by an auditor indicating that a company's financial statements are misrepresented, misstated or inaccurate. more

Internal Auditor (IA) Definition
Internal auditors (IA) are employed by companies to provide independent and objective evaluations of financial and operational business activities. more

Auditor's Opinion Definition
A certification provided by the independent auditor of a company's financial records that accompanies and opines on the audited financial statements. more

Unqualified Audit
An unqualified audit is a complete audit that has been performed and researched thoroughly. more

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- Limited company
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Directors' report – What is a directors' report?

A directors' report is a financial document that larger limited companies are required to file at end of the financial year.

> Financial reporting is an essential part of running a business. Automatically generate financial reports with Debitoor and get an instant overview of your company's finances.

At the end of each accounting year, private limited companies are required to provide a set of financial reports known as statutory accounts. Amongst these accounts is the directors' report, which is produced by the board of directors and outlines the financial state of the company.

The other reports which make up a company's statutory accounts include: a balance sheet; a profit and loss statement; and, in some cases, an auditor's report.

Which companies need to create directors' reports?

Only large organisations are required to produce directors' reports; small companies or micro-entities are exempt. A private limited company is no longer considered a small company, and must therefore submit a directors' report to HMRC, once it fulfils at least two of the following criteria:

- A turnover of more than £10.2 million
- £5.1 million or more on the balance sheet

- How well the company is complying with financial regulations, accounting standards and social responsibility requirements.

By knowing this information, shareholders can make better informed decisions and can hold the directors of the company to greater account.

What is included in a directors' report?

As a minimum, a directors report should always state:

- The names of each director who served during the reporting year;
- A summary of the company's trading activities;
- A summary of future prospects;
- The principle activities of the company and, if relevant, the principle activities of its subsidiaries;
- Recommendations for dividends for the reporting year;
- Any financial events that occurred after the date on the balance sheet, if these events could affect the company's finances;
- Significant changes to the company's fixed assets.

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Voluntary disclosure

From Wikipedia, the free encyclopedia

Voluntary disclosure is the provision of information by a company's management beyond requirements such as generally accepted accounting principles and Securities and Exchange Commission rules,[1][2] where the information is believed to be relevant to the decision-making of users of the company's annual reports.[2]

Voluntary disclosure is carried out by many companies,[1] although the extent and type of voluntary disclosure differs by geographic region, industry, and company size.[3] The extent of voluntary disclosure is also affected by the firm's corporate governance structure[3][4] and ownership structure;[4] in particular, research has found that top executives have a significant influence on their firms' voluntary disclosures, and that managers have unique disclosure styles related to their personal backgrounds including their career paths and military experience.[5]

Voluntary disclosure has also been identified as an important area in financial reporting research.[3] There are links between firm choices to voluntarily disclose certain information and what they are required to disclose via mandatory disclosures. [6]

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Overview and practices [edit]

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Costs and benefits [edit]

Voluntary disclosure benefits investors, companies and the economy; for example, it helps investors make better capital allocation decisions and lowers firms' cost of capital, the latter of which also benefits the general economy.[1][2] It may also reduce conflicts of interest in widely held firms.[7]

Voluntary disclosure is also affected by shareholder demands; for example 60 percent of the companies on the S&P 100 adopted voluntary disclosure policies in response to shareholder demand for information on corporate political spending.[8]

Firms, however, balance the benefits of voluntary disclosure against the costs, which may include the cost of procuring the information to be disclosed, and decreased competitive advantage.[1][2]

Regulatory and academic opinion [edit]

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Types and examples [edit]

Voluntary disclosures can include strategic information such as company characteristics and strategy, nonfinancial information such socially responsible practices, and financial information such as stock price information.[2] The Financial Accounting Standards Board classified voluntary disclosures into the six categories below,[1] while Meek, Roberts and Gray (1995) classified them into three major groups: strategic, nonfinancial and financial information.[2]

Business data
For example, a breakdown of market share growth and information on new products.

Analysis of business data
For example, trend analyses and comparisons with competitors.

Forward-looking information
For example, sales forecast breakdowns and plans for expansion.

Information about management and shareholders
For example, information on stockholders and creditors, and shareholding breakdowns.

Company background
For example, product descriptions and long-term objectives.

Information about intangible assets
For example, research and development and customer relations.[1] Intellectual Capital Disclosures are prevalent among many knowledge-based companies and are used to help stakeholders understand how an organization uses its knowledge, skills, relationships, and processes to create value [9].

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Categories: Accounting research | Accounting terminology

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Financial Statement Analysis

By WILL KENTON | Reviewed By DAVID KINDNESS | Updated Sep 21, 2020

What Is Financial Statement Analysis?

Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes. External stakeholders use it to understand the overall health of an organization as well as to evaluate financial performance and business value. Internal constituents use it as a monitoring tool for managing the finances.

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Financial Statement Analysis

Analyzing Financial Statements

The financial statements of a company record important financial data on every aspect of a business's activities. As such they can be evaluated on the basis of past, current, and projected performance.

In general, financial statements are centered around generally accepted accounting principles (GAAP) in the U.S. These principles require a company to create and maintain three main financial statements: the balance sheet, the income statement, and the cash flow statement. Public companies have stricter standards for financial statement reporting. Public companies must follow GAAP standards which requires accrual accounting.[1] Private companies have greater flexibility in their financial statement preparation and also have the option to use either accrual or cash accounting.[2]

Several techniques are commonly used as part of financial statement analysis. Three of the most important techniques include horizontal analysis, vertical analysis, and ratio analysis. Horizontal analysis compares data horizontally, by analyzing values of line items across two or more years. Vertical analysis looks at the vertical affects line items have on other parts of the business and also the business's proportions. Ratio analysis uses important ratio metrics to calculate statistical relationships.

Financial Statements

As mentioned, there are three main financial statements that every company creates and monitors: the balance sheet, income statement, and cash flow statement. Companies use these financial statements to manage the operations of their business and also to provide reporting transparency to their stakeholders. All three statements are interconnected and create different views of a company's activities and performance.

Balance Sheet

The balance sheet is a report of a company's financial worth in terms of book value. It is broken into three parts to include a company's assets, liabilities, and shareholders' equity. Short-term assets such as cash and accounts receivable can tell a lot about a company's operational efficiency. Liabilities include its expense arrangements and the debt capital it is paying off. Shareholder's equity includes details on equity capital investments and retained earnings from periodic net income. The balance sheet must balance with assets minus liabilities equaling shareholder's equity. The resulting shareholder's equity is considered a company's book value. This value is an important performance metric that increases or decreases with the financial activities of a company.

Income Statement

The income statement breaks down the revenue a company earns against the expenses involved in its business to provide a bottom line, net income profit or loss. The income statement is broken into three parts which help to analyze business efficiency at three different points. It begins with revenue and the direct costs associated with revenue to identify gross profit. It then moves to operating profit which subtracts indirect expenses such as marketing costs, general costs, and depreciation. Finally it ends with net profit which deducts interest and taxes.

Basic analysis of the income statement usually involves the calculation of gross profit margin, operating profit margin, and net profit margin which each divide profit by revenue. Profit margin helps to show where company costs are low or high at different points of the operations.

Cash Flow Statement

The cash flow statement provides an overview of the company's cash flows from operating activities, investing activities, and financing activities. Net income is carried over to the cash flow statement where it is included as the top line item for operating activities. Like its title, investing activities include cash flows involved with firmwide investments. The financing activities section includes cash flow from both debt and equity financing. The bottom line shows how much cash a company has available.

Free Cash Flow and Other Valuation Statements

Companies and analysts also use free cash flow statements and other valuation statements to analyze the value of a company. Free cash flow statements arrive at a net present value by discounting the free cash flow a company is estimated to generate over time. Private companies may keep a valuation statement as they progress toward potentially going public.

KEY TAKEAWAYS

- Financial statement analysis is used by internal and external stakeholders to evaluate business performance and value.
- Financial accounting calls for all companies to create a balance sheet, income statement, and cash flow statement which form the basis for financial statement analysis.
- Horizontal, vertical, and ratio analysis are three techniques analysts use when analyzing financial statements.

Financial Performance

Financial statements are maintained by companies daily and used internally for business management. In general both internal and external stakeholders use the same corporate finance methodologies for maintaining business activities and evaluating overall financial performance.

When doing comprehensive financial statement analysis, analysts typically use multiple years of data to facilitate horizontal analysis. Each financial statement is also analyzed with vertical analysis to understand how different categories of the statement are influencing results. Finally ratio analysis can be used to isolate some performance metrics in each statement and also bring together data points across statements collectively.

Below is a breakdown of some of the most common ratio metrics:

Balance sheet: asset turnover, quick ratio, receivables turnover, days to sales, debt to assets, and debt to equity

Income statement: gross profit margin, operating profit margin, net profit margin, tax ratio efficiency, and interest coverage

Cash Flow: Cash and earnings before interest, taxes, depreciation, and amortization (EBITDA). These metrics may be shown on a per share basis.

Comprehensive: Return on assets (ROA) and return on equity (ROE). Also DuPont Analysis.

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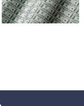
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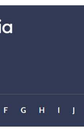
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Ratio Analysis

By ANDREW BLOOMENTHAL | Reviewed By DAVID KINDNESS | Updated May 14, 2020

What Is Ratio Analysis?

Ratio analysis is a quantitative method of gaining insight into a company's liquidity, operational efficiency, and profitability by studying its financial statements such as the balance sheet and income statement. Ratio analysis is a cornerstone of fundamental equity analysis.

KEY TAKEAWAYS

- Ratio analysis compares line-item data from a company's financial statements to reveal insights regarding profitability, liquidity, operational efficiency, and solvency.
- Ratio analysis can mark how a company is performing over time, while comparing a company to another within the same industry or sector.
- While ratios offer useful insight into a company, they should be paired with other metrics, to obtain a broader picture of a company's financial health.

2:24

Ratio Analysis

What Does Ratio Analysis Tell You?

Investors and analysts employ ratio analysis to evaluate the financial health of companies by scrutinizing past and current financial statements. Comparative data can demonstrate how a company is performing over time and can be used to estimate likely future performance. This data can also compare a company's financial standing with industry averages while measuring how a company stacks up against others within the same sector.

Investors can use ratio analysis easily, and every figure needed to calculate the ratios is found on a company's financial statements.

Ratios are comparison points for companies. They evaluate stocks within an industry. Likewise, they measure a company today against its historical numbers. In most cases, it is also important to understand the variables driving ratios as management has the flexibility to, at times, alter its strategy to make its stock and company ratios more attractive. Generally, ratios are typically not used in isolation but rather in combination with other ratios. Having a good idea of the ratios in each of the four previously mentioned categories will give you a comprehensive view of the company from different angles and help you spot potential red flags.

Examples of Ratio Analysis Categories

The various kinds of financial ratios available may be broadly grouped into the following six silos, based on the sets of data they provide:

1. Liquidity Ratios
Liquidity ratios measure a company's ability to pay off its short-term debts as they become due, using the company's current or quick assets. Liquidity ratios include the current ratio, quick ratio, and working capital ratio.

2. Solvency Ratios
Also called financial leverage ratios, solvency ratios compare a company's debt levels with its assets, equity, and earnings, to evaluate the likelihood of a company staying afloat over the long haul, by paying off its long-term debt as well as the interest on its debt. Examples of solvency ratios include: debt-equity ratios, debt-assets ratios, and interest coverage ratios.

3. Profitability Ratios
These ratios convey how well a company can generate profits from its operations. Profit margin, return on assets, return on equity, return on capital employed, and gross margin ratios are all examples of profitability ratios.

4. Efficiency Ratios
Also called activity ratios, efficiency ratios evaluate how efficiently a company uses its assets and liabilities to generate sales and maximize profits. Key efficiency ratios include: turnover ratio, inventory turnover, and days' sales in inventory.

5. Coverage Ratios
Coverage ratios measure a company's ability to make the interest payments and other obligations associated with its debts. Examples include the times interest earned ratio and the debt-service coverage ratio.

6. Market Prospect Ratios
These are the most commonly used ratios in fundamental analysis. They include dividend yield, P/E ratio, earnings per share (EPS), and dividend payout ratio. Investors use these metrics to predict earnings and future performance.

For example, if the average P/E ratio of all companies in the S&P 500 index is 20, and the majority of companies have P/Es between 15 and 25, a stock with a P/E ratio of seven would be considered undervalued. In contrast, one with a P/E ratio of 50 would be considered overvalued. The former may trend upwards in the future, while the latter may trend downwards until each aligns with its intrinsic value.

Examples of Ratio Analysis in Use

Ratio analysis can predict a company's future performance—for better or worse.Successful companies generally boast solid ratios in all areas, where any sudden hint of weakness in one area may spark a significant stock sell-off. Let's look at a few simple examples

Net profit margin, often referred to simply as profit margin or the bottom line, is a ratio that investors use to compare the profitability of companies within the same sector. It's calculated by dividing a company's net income by its revenues. Instead of dissecting financial statements to compare how profitable companies are, an investor can use this ratio instead. For example, suppose company ABC and company DEF are in the same sector with profit margins of 50% and 10%, respectively. An investor can easily compare the two companies and conclude that ABC converted 50% of its revenues into profits, while DEF only converted 10%.

Using the companies from the above example, suppose ABC has a P/E ratio of 100, while DEF has a P/E ratio of 10. An average investor concludes that investors are willing to pay $100 per $1 of earnings ABC generates and only $10 per $1 of earnings DEF generates.

Important: Ratios are typically only comparable across companies within the same sector. For example, a debt-equity ratio that might be normal for a utility company might be deemed unsustainably high for a technology play.

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Coverage ratios measure a company's ability to service its debt and meet its financial obligations. more

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Liquidity Ratio Definition

By ADAM HAYES | Updated Aug 19, 2020

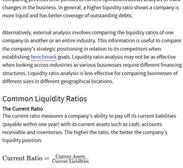
What Are Liquidity Ratios?

Liquidity ratios are an important class of financial metrics used to determine a debtor's ability to pay off current debt obligations without raising external capital. Liquidity ratios measure a company's ability to pay debt obligations and its margin of safety through the calculation of metrics including the current ratio, quick ratio, and operating cash flow ratio.

Current liabilities are analyzed in relation to liquid assets to evaluate the coverage of short-term debts in an emergency.

KEY TAKEAWAYS

- Liquidity ratios are an important class of financial metrics used to determine a debtor's ability to pay off current debt obligations without raising external capital.
- Common liquidity ratios include the quick ratio, current ratio, and days sales outstanding.
- Liquidity ratios determine a company's ability to cover short-term obligations and cash flows, while solvency ratios are concerned with a longer-term ability to pay ongoing debts.



Using Liquidity Ratios

Understanding Liquidity Ratios

Liquidity is the ability to convert assets into cash quickly and cheaply. Liquidity ratios are most useful when they are used in comparative form. This analysis may be internal or external.

For example, internal analysis regarding liquidity ratios involves using multiple accounting periods that are reported using the same accounting methods. Comparing previous time periods to current operations allows analysts to track changes in the business. In general, a higher liquidity ratio shows a company is more liquid and has better coverage of outstanding debts.

Alternatively, external analysis involves comparing the liquidity ratios of one company to another or an entire industry. This information is useful to compare the company's strategic positioning in relation to its competitors when establishing benchmark goals. Liquidity ratio analysis may not be as effective when looking across industries as various businesses require different financing structures. Liquidity ratio analysis is less effective for comparing businesses of different sizes in different geographical locations.

Common Liquidity Ratios

The Current Ratio

The current ratio measures a company's ability to pay off its current liabilities (payable within one year) with its current assets such as cash, accounts receivable and inventories. The higher the ratio, the better the company's liquidity position:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The Quick Ratio

The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets and therefore excludes inventories from its current assets. It is also known as the "acid-test ratio":

$$\text{Quick ratio} = \frac{C + MS + AR}{CL}$$

where:

$C = \text{cash \& cash equivalents}$

$MS = \text{marketable securities}$

$AR = \text{accounts receivable}$

$CL = \text{current liabilities}$

Another way to express this is:

$$\text{Quick ratio} = \frac{(\text{Current assets} - \text{inventory} - \text{prepaid expenses})}{\text{Current liabilities}}$$

Days Sales Outstanding (DSO)

DSO refers to the average number of days it takes a company to collect payment after it makes a sale. A higher DSO means that a company is taking unduly long to collect payment and is tying up capital in receivables. DSOs are generally calculated quarterly or annually:

$$\text{DSO} = \frac{\text{Average accounts receivable}}{\text{Revenue per day}}$$

Liquidity Crisis

A liquidity crisis can arise even at healthy companies if circumstances arise that make it difficult for them to meet short-term obligations such as repaying their loans and paying their employees. The best example of such a far-reaching liquidity catastrophe in recent memory is the global credit crunch of 2007-09. Commercial paper—short-term debt that is issued by large companies to finance current assets and pay off current liabilities—played a central role in this financial crisis.

A near-total freeze in the $2 trillion U.S. commercial paper market made it exceedingly difficult for even the most solvent companies to raise short-term funds at that time and hastened the demise of giant corporations such as Lehman Brothers and General Motors Company (GM).[2]

But unless the financial system is in a credit crunch, a company-specific liquidity crisis can be resolved relatively easily with a liquidity injection, as long as the company is solvent. This is because the company can pledge some assets if required to raise cash to tide over the liquidity squeeze. This route may not be available for a company that is technically insolvent since a liquidity crisis would exacerbate its financial situation and force it into bankruptcy.

The Difference Between Solvency Ratios and Liquidity Ratios

In contrast to liquidity ratios, solvency ratios measure a company's ability to meet its total financial obligations. Solvency relates to a company's overall ability to pay debt obligations and continue business operations, while liquidity focuses more on current financial accounts. A company must have more total assets than total liabilities to be solvent and more current assets than current liabilities to be liquid. Although solvency does not relate directly to liquidity, liquidity ratios present a preliminary expectation regarding a company's solvency.

The solvency ratio is calculated by dividing a company's net income and depreciation by its short-term and long-term liabilities. This indicates whether a company's net income is able to cover its total liabilities. Generally, a company with a higher solvency ratio is considered to be a more favorable investment.

Examples of Liquidity Ratios

Let's use a couple of these liquidity ratios to demonstrate their effectiveness in assessing a company's financial condition.

Consider two hypothetical companies—Liquids Inc. and Solvents Co.—with the following assets and liabilities on their balance sheets (figures in millions of dollars). We assume that both companies operate in the same manufacturing sector (i.e., industrial glues and solvents).

Balance Sheet (in millions of dollars)	Liquids Inc.	Solvents Co.
Cash	$5	$1
Marketable Securities	$5	$2
Accounts Receivable	$10	$2
Inventories	$10	$5
Current Assets (a)	$30	$10
Plant and Equipment (b)	$25	$65
Intangible Assets (c)	$20	$0
Total Assets (a + b + c)	$75	$75
Current Liabilities* (d)	$10	$25
Long-Term Debt (e)	$50	$10
Total Liabilities (d + e)	$60	$35
Shareholders' Equity	$15	$40

*In our example, we will assume that current liabilities only consist of accounts payable and other liabilities, with no short-term debt.

Liquids Inc.

- Current ratio = $30 / $10 = 3.0
- Quick ratio = ($30 – $10) / $10 = 2.0
- Debt to equity = $50 / $15 = 3.33
- Debt to assets = $50 / $75 = 0.67

Solvents Co.

- Current ratio = $10 / $25 = 0.40
- Quick ratio = ($10 – $5) / $25 = 0.20
- Debt to equity = $10 / $40 = 0.25
- Debt to assets = $10 / $75 = 0.13

We can draw a number of conclusions about the financial condition of these two companies from these ratios.

Liquids Inc. has a high degree of liquidity. Based on its current ratio, it has $3 of current assets for every dollar of current liabilities. Its quick ratio points to adequate liquidity even after excluding inventories, with $2 in assets that can be converted rapidly to cash for every dollar of current liabilities.

However, financial leverage based on its solvency ratios appears quite high. Debt exceeds equity by more than three times, while two-thirds of assets have been financed by debt. Note as well that close to half of non-current assets consist of intangible assets (such as goodwill and patents). As a result, the ratio of debt to tangible assets—calculated as ($50/$15)—is 0.91, which means that over 90% of tangible assets (plant, equipment, and inventories, etc.) have been financed by borrowing. To summarize, Liquids Inc. has a comfortable liquidity position, but it has a dangerously high degree of leverage.

Solvents Co. is in a different position. The company's current ratio of 0.4 indicates an inadequate degree of liquidity with only 40 cents of current assets available to cover every $1 of current liabilities. The quick ratio suggests an even more dire liquidity position, with only 20 cents of liquid assets for every $1 of current liabilities.

Financial leverage, however, appears to be at comfortable levels, with debt at only 25% of equity and only 13% of assets financed by debt. Even better, the company's asset base consists wholly of tangible assets, which means that Solvents Co.'s ratio of debt to tangible assets is about one-seventh that of Liquids Inc. (approximately 13% vs. 91%). Overall, Solvents Co. is in a dangerous liquidity situation, but it has a comfortable debt position.

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The current ratio is a liquidity ratio that measures a company's ability to cover its short-term obligations with its current assets. more

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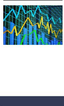
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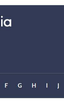
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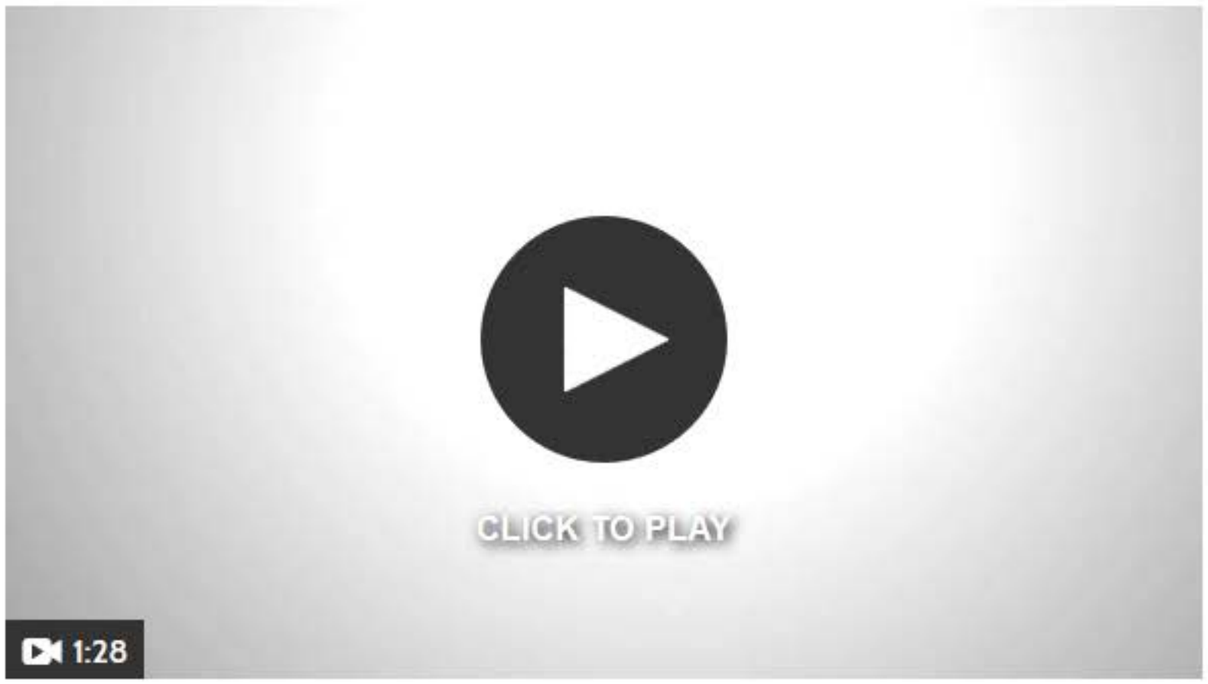
The ratio is used to evaluate a company's financial leverage. The D/E ratio is an important metric used in corporate finance. It is a measure of the degree to which a company is financing its operations through debt versus wholly-owned funds. More specifically, it reflects the ability of shareholder equity to cover all outstanding debts in the event of a business downturn.

The debt-to-equity ratio is a particular type of gearing ratio.



The Debt To Equity Ratio

D/E Ratio Formula and Calculation

$$\text{Debt/Equity} = \frac{\text{Total Liabilities}}{\text{Total Shareholders' Equity}}$$

The information needed for the D/E ratio is on a company's balance sheet. The balance sheet requires total shareholder equity to equal assets minus liabilities, which is a rearranged version of the balance sheet equation:

Feedback

Turnover Ratios

The turnover ratios are used to check the efficiency of the company that how it uses its assets to earn revenue. The sales figure is compared with the assets (different assets) to measure how much of the assets are used to generate the number of sales.

In a business, there are requirements for different types of assets and these are used to generate the revenue of the business so that the business can run. The turnover ratios are categorized under efficiency ratios as these ratios measures how a company or business is utilizing different assets to achieve its revenue. Here the 'revenue' is construed differently for each type of turnover ratios. For example, in receivable's turnover ratio, only the amount of credit sales is used not the total sales figure and but for inventory turnover ratio, the total sales or the COGS is used. These ratios are more specific to the asset and revenue (denominator) is defined depending on the relationship between the asset and the revenue.

WHAT IS TURNOVER RATIO?

The turnover ratio can be defined as the ratio to calculate the quantity of any asset which is used by a business to generate revenue through its sales. It is the relation between the amount of company's asset and the revenue generated from them. To be more precise, it is an efficiency ratio to check how efficiently the company is using different assets to extract earnings from them (individually as well as on a whole). A higher ratio is considered to be better as it would indicate that the company is optimally using the resources to earn revenue and it would imply a higher ROI and the funds invested are used the least.

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2 Types of Turnover Ratios with Formula
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2.5 Average Collection Period
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3 Uses of Turnover Ratios

TYPES OF TURNOVER RATIOS WITH FORMULA

CAPITAL EMPLOYED TURNOVER RATIO

It indicates the relation between the capital employed in a business and the sales or revenue the business generates out of it. The capital whether used in a proper direction to generate revenue or not and how efficiently it has been employed is measured with this ratio. The formulae for

Capital employed turnover Ratio = Sales / Capital Employed

TOTAL ASSET TURNOVER RATIO

It is a ratio which determines the connection between the sales and the total asset of a company. It checks for the efficiency with which the company's all assets are utilized to earn revenue. The formula for

Total Asset Turnover Ratio = Sales (Net Sales) / Total Assets of the Company

DEBTORS TURNOVER RATIO

It is the ratio which calculates the quickness of the conversion of the debtors or credit sales amount to cash. It is also known as the receivables turnover ratio as it measures the credit sales against the average debtors for a year. The formula for

Debtors Turnover Ratio = Net Credit Sales / Average account Receivable

FIXED ASSET TURNOVER RATIO

This is the ratio which measures how much sale is generated from churning the fixed assets of the company and how efficiently it is done. The fixed assets of a company are very crucial in revenue generation and thus the optimization of the fixed asset use increases the sales if done properly. The formula for

Fixed Asset Turnover Ratio = Sales or Net Sales / Fixed Assets

AVERAGE COLLECTION PERIOD

It shows the amount of time required to convert the credit sales into cash. It states the average time period given to the debtors to make their payments. The formula for

Average Collection Period or Debt Collection Period = Days in a year / Debtors Turnover Ratio

INVENTORY TURNOVER RATIO

It is also referred as the stock turnover ratio which is used to measure the number of sales generated from its inventory and how efficiently the inventories in a company is used. The formula for

Inventory Turnover Ratio = Cost of Goods Sold / Average Stock

or

Inventory Turnover Ratio= Sales / Closing Inventory.

The **turnover ratio** can be defined as the ratio to calculate the quantity of any asset or liabilities which is used by a business to generate revenue through its sales. The **turnover ratios** are categorized under efficiency ratios as these ratios measures how a company or business is utilizing its different assets to increase its revenue.

Capital Employed Turnover Ratio	Capital employed turnover Ratio = Sales / Capital employed
Total Asset Turnover Ratio	Total Asset Turnover Ratio= Sales (Net Sales) / Total assets of the company
Debtors Turnover Ratio	Debtors Turnover Ratio = Net Credit Sales / Average account Receivable
Fixed Asset Turnover Ratio	Fixed Asset Turnover Ratio = Sales or Net Sales / Fixed Assets
Average Collection Period	Average Collection Period or Debt Collection Period = Days in a year / Debtors Turnover Ratio
Inventory Turnover Ratio	Inventory Turnover Ratio = Cost of Goods Sold / Average Stock

USES OF TURNOVER RATIOS

The turnover ratios analysis is important to the internal as well as the external parties of the company. To the internal members like the managing body and the board of directors, they check this ratio to evaluate their efficiency in managing the different assets and liabilities and where to make the correction and increase their efficiency or not. For the external parties like the investors, creditors, they check these ratios to find out the capabilities of the company's management and evaluate whether their investment will reap profit or go in vain. The Turnover Ratios uses to the debtors are to find how many days credit they will receive.1

References

1. Turnover ratios — AccountingTools. AccountingTools. [Source]

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About The Author

Sanjay Bulaki Borad
Sanjay Borad is the founder & CEO of eFinanceManagement. He is passionate about keeping and making things simple and easy. Running this blog since 2009 and trying to explain "Financial Management Concepts in Layman's Terms".

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Hello sir I have a doubt regarding inventory turnover ratio , I have taken online course on finance in which they are describing formula as follow inventory turnover ratio = net sales / average inventory
it is correct ?
Reply

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2 Comments

pritesh
Hello sir I have a doubt regarding inventory turnover ratio , I have taken online course on finance in which they are describing formula as follow inventory turnover ratio = net sales / average inventory
it is correct ?
Reply

Sanjay Bulaki Borad
Hi Pritesh,
Thanks for writing in. Please refer our article on Inventory Turnover Ratio. I hope that will clear your doubt about the two formula. Both the formula are in use.
Reply

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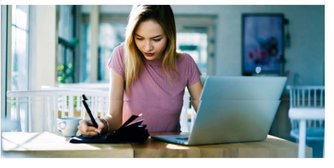

Profitability Ratios: Types of Profitability Ratios and Why they Matter

by Michelle Black • January 31, 2020 · UNCATEGORIZED

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There are numerous financial metrics you can use to monitor the success of your business. If you're not currently tracking your company's profitability ratios, you probably should be.

Read on for a breakdown of what profitability ratios are and how to calculate them. You'll also discover why this information matters to your business in the first place.

What Are Profitability Ratios?

Profitability ratios measure a company's ability to earn a profit relative to its sales revenue, operating costs, balance sheet assets, and shareholders' equity. These financial metrics can also show how well companies use their existing assets to generate profit and value for owners and shareholders.

Types of Profitability Ratios

Profitability ratios are broken down into two groups — margin ratios and return ratios. The various types of calculations can help you measure your company's financial performance in several ways.

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Margin Ratios

Margin ratios examine how effectively a company transforms sales revenue into profits. Here's a simple break down of three common margin ratios — gross profit margin, operating profit margin, and net profit margin.

Gross Profit Margin:

Gross profit margin is typically the first profitability ratio calculated by businesses. It measures how much sales income a company has left over after it covers the cost of goods sold (COGS). This figure is known as a company's gross profit margin.

You can calculate your company's gross profit margin with the formula below. The initial figures you need to complete the formula should be available on your business' income statement.

Gross Profit = Revenue (aka Net Sales) − Gross Profit Margin %

A higher gross profit margin indicates that you are more money left over to cover operating expenses, taxes, depreciation, and other business costs. It may also result in higher ending profits for owners and shareholders.

Operating Profit Margin:

Once you calculate your gross profit ratio, you can use the figure to help find your operating profit. Operating profit, or earnings before interest and taxes (EBIT), takes your gross profit and deducts operating expenses. These expenses may include commissions, administrative expenses, and other general costs.
general costs.

A company's operating profit reveals how much revenue is left over after it covers both COGS and operating expenses. The operating profit margin shows the percentage of revenue that remains once these costs are deducted from your net sales.

You can calculate your company's operating profit margin using the formula below. Again, both initial figures you need for your calculations may appear on your company's income statement.

Operating Profit = Revenue (aka Net Sales) − Operating Profit Margin %

If your company shows a low operating profit margin (especially if your gross profit margin is healthy), it might be a sign that you're spending too much on operating costs.

Net Profit Margin:

As a small business owner, the profitability measurement that may matter most to you is your company's net profit margin ratio. It reveals how much of the money your company earns makes its way to the bottom line.

Specifically, net profit margin shows the percentage of profit your company keeps from its sales revenue after all expenses (operating and non-operating) are paid.

Here is the formula you can use to calculate your company's net profit margin. Check your income statement for the initial figures you need to plug into the equation.

Net Income = Revenue (aka Net Sales) ÷ Net Profit Margin %

A high net profit margin typically indicates a company that is operating successfully. Your business is doing a good job managing costs and pricing its goods or services.

Return Ratios

Return ratios show whether a business generates a profit for its owners or shareholders. Two of the most common return ratios that businesses calculate are return on assets (ROA) and return on equity (ROE).

Return on Assets

Your company's return on assets, also called return on investment, is all about efficiency. It indicates how good your company is at turning its investments into a profit. Put another way, ROA measures how successfully your company uses the assets at its disposal to improve its bottom line.

Financial managers may calculate ROA in a few different ways. A simple formula used to find your company's return on assets is below.

Net Income = Total Assets × Return on Assets %

A high ROA may indicate that your company can earn income efficiently using its available assets.

Return on Equity

Investors in a business may be more concerned with return on equity calculations than other financial metrics. ROE shows how well a company can use shareholder investments to generate profits. It's a measure of a shareholder's return on his or her investment.

You can calculate a company's return on equity using the formula below. The net income figure can be found on your income statement. Shareholder's equity may be available on your company's balance sheet.

Net Income = Average Shareholder's Equity × Return on Equity %

ROE is often used to evaluate company management. A low ROE may indicate that management is doing a poor job at using its investors' funds to generate a return.

Why Profitability Ratios Matter

Every business is concerned with making a profit. As an owner or shareholder, the easiest way to tell if a company is generating a healthy bottom line is to review its profitability ratios.

Why Are Profitability Ratios Useful?

- **Profitability ratios can attract new investors.** Investors want to know that a company has the potential to turn a healthy profit before they invest any cash in it. Reviewing a company's the potential to turn a healthy profit before they invest any cash in it. Reviewing a company's profitability ratios is a simple way to analyze whether a business is performing well in that area.
- **You can compare your company's performance with competitors.** As a startup or small business, you might not earn the same amount of income as a more established business in your industry. Your company's earnings might not even be close. Yet by comparing profitability ratios (aka percentages), you can see how your business measures up to others. Earning less money than another company doesn't automatically mean your business is less profitable.
- **Financial ratios can help uncover areas in your business that need work.** While it's important to track your company's basic financial statements, these numbers alone may not tell the whole story. When you add on profitability ratios, you can discover if your business performs with efficiency in specific areas. For example, if you find that your gross profit margin is decreasing over time, it could indicate that you need to get your cost of goods sold under control.

How to Improve Your Profitability Ratios

Profitability ratios can help you measure the financial well being of your company. If you don't like the financial metrics these reports reveal, here are five strategies you can use to try to boost your company's bottom line.

1. **Cut unprofitable services and products from your lineup.** In general, it's best to focus on the services and products that generate the highest profits for your business.
2. **Reduce inventory.** When you cut back on slow-moving products, it can have the added benefit of reducing your inventory. Less money tied up in older inventory may free up cash to invest in other areas of your business.
3. **Increase your prices.** Raising prices can potentially boost profits, but the process is tricky. Before you increase prices across the board, consider starting with a test on a few products or services.
4. **Lower costs.** Your business might generate a lot of sales, but if your expenses are high, it can cut into your profit margins. There are numerous ways to cut costs. You can negotiate better prices with vendors or buy supplies elsewhere. You might consider relocating your headquarters or leasing out unused space in your warehouse to someone else. The possibilities are practically endless.
5. **Attract new customers.** In general, it's easier (and more cost-effective) to keep the customers you already have. But if you manage the process carefully, expanding your market might give your company a boost in the sales department. Plus, if you've recently increased your prices, it may be necessary to seek out new customers to pay the higher costs.

Final Word: Profitability Ratios

Even if you're not at a stage in your business where you're looking for investors, tracking financial ratios can be useful. But ratios can mislead you if you don't run these calculations regularly.

Imagine a pool company, for example. This particular retailer would likely get very different results if it ran profitability ratio calculations before and after the summer season.

Your best bet is to track profitability over time. It's fine to start with a small set of reports, but run them at regular intervals (e.g., monthly, quarterly, etc.). Then, as your business grows, you can add additional reports, hopefully gaining more knowledge to improve your business in the future. You can even hire a professional to run these calculations for you and help you analyze the best way to react to the results you discover.

Finally, remember that your company's profitability isn't the only figure you should be tracking as a small business owner. It's also wise to monitor your business credit scores. Nav makes it easy to keep an eye on your business credit reports and scores. You can access both for free when you register for a Nav account.

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This article was originally written on January 15, 2020 and updated on January 31, 2020.

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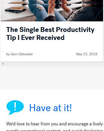

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Leverage is an investment strategy of using borrowed money—specifically, the use of various financial instruments or borrowed capital—to increase the potential return of an investment. **Leverage** can also refer to the amount of debt a firm uses to finance assets.
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DuPont Analysis

By MARSHALL HARGRAVE | Reviewed By AMY DRURY | Updated Sep 21, 2020

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Example of DuPont Analysis Use
Limitations of DuPont Analysis
Formula and Calculation
DuPont Analysis Components
DuPont Analysis vs. ROE

What Is the DuPont Analysis?

The DuPont analysis (also known as the DuPont identity or DuPont model) is a framework for analyzing fundamental performance popularized by the DuPont Corporation. DuPont analysis is a useful technique used to decompose the different drivers of return on equity (ROE). The decomposition of ROE allows investors to focus on the key metrics of financial performance individually to identify strengths and weaknesses.

There are three major financial metrics that drive return on equity (ROE): operating efficiency, asset use efficiency and financial leverage. Operating efficiency is represented by net profit margin or net income divided by total sales or revenue. Asset use efficiency is measured by the asset turnover ratio. Leverage is measured by the equity multiplier, which is equal to average assets divided by average equity.

KEY TAKEAWAYS

- The DuPont analysis is a framework for analyzing fundamental performance originally popularized by the DuPont Corporation.
- DuPont analysis is a useful technique used to decompose the different drivers of return on equity (ROE).
- An investor can use analysis like this to compare the operational efficiency of two similar firms. Managers can use DuPont analysis to identify strengths or weaknesses that should be addressed.

Formula and Calculation of DuPont Analysis

The Dupont analysis is an expanded return on equity formula, calculated by multiplying the net profit margin by the asset turnover by the equity multiplier.

$$\text{DuPont Analysis} = \text{Net Profit Margin} \times \text{AT} \times \text{EM}$$

where:

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Revenue}}$$

$$\text{AT} = \text{Asset turnover}$$

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Average Total Assets}}$$

$$\text{EM} = \text{Equity multiplier}$$

$$\text{Equity Multiplier} = \frac{\text{Average Total Assets}}{\text{Average Shareholders' Equity}}$$

1:41

DuPont Analysis

What DuPont Analysis Tells You

A DuPont analysis is used to evaluate the component parts of a company's return on equity (ROE). This allows an investor to determine what financial activities are contributing the most to the changes in ROE. An investor can use analysis like this to compare the operational efficiency of two similar firms. Managers can use DuPont analysis to identify strengths or weaknesses that should be addressed.

DuPont Analysis Components

DuPont analysis breaks ROE into its constituent components to determine which of these factors are most responsible for changes in ROE.

Net Profit Margin

The net profit margin is the ratio of bottom line profits compared to total revenue or total sales. This is one of the most basic measures of profitability.

One way to think about the net margin is to imagine a store that sells a single product for $1.00. After the costs associated with buying inventory, maintaining a location, paying employees, taxes, interest, and other expenses, the store owner keeps $0.15 in profit from each unit sold. That means the owner's profit margin is 15%, which can be calculated as follows:

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Revenue}} = \frac{\$0.15}{\$1.00} = 15\%$$

The profit margin can be improved if costs for the owner were reduced or if prices were raised, which can have a large impact on ROE. This is one of the reasons that a company's stock will experience high levels of volatility when management makes a change to its guidance for future margins, costs, and prices.

Asset Turnover Ratio

The asset turnover ratio measures how efficiently a company uses its assets to generate revenue. Imagine a company had $100 of assets, and it made $1,000 of total revenue last year. The assets generated 10 times their value in total revenue, which is the same as the asset turnover ratio and can be calculated as follows:

$$\text{Asset Turnover Ratio} = \frac{\text{Revenue}}{\text{Average Assets}} = \frac{\$1,000}{\$100} = 10$$

A normal asset turnover ratio will vary from one industry group to another. For example, a discount retailer or grocery store will generate a lot of revenue from its assets with a small margin, which will make the asset turnover ratio very large. On the other hand, a utility company owns very expensive fixed assets relative to its revenue, which will result in an asset turnover ratio that is much lower than that of a retail firm.

The ratio can be helpful when comparing two companies that are very similar. Because average assets include components like inventory, changes in this ratio can signal that sales are slowing down or speeding up earlier than it would show up in other financial measures. If a company's asset turnover rises, its ROE will improve.

Financial Leverage

Financial leverage, or the equity multiplier, is an indirect analysis of a company's use of debt to finance its assets. Assume a company has $1,000 of assets and $250 of owner's equity. The balance sheet equation will tell you that the company also has $750 in debt (assets - liabilities = equity). If the company borrows more to purchase assets, the ratio will continue to rise. The accounts used to calculate financial leverage are both on the balance sheet; so analysts will divide average assets by average equity rather than the balance at the end of the period, as follows:

$$\text{Financial Leverage} = \frac{\text{Average Assets}}{\text{Average Equity}} = \frac{\$1,000}{\$250} = 4$$

Most companies should use debt with equity to fund operations and growth. Not using any leverage could put the company at a disadvantage compared with its peers. However, using too much debt in order to increase the financial leverage ratio—and therefore increase ROE—can create disproportionate risks.

Example of DuPont Analysis Use

An investor has been watching two similar companies, SuperCo and Gear Inc., that have recently been improving their return on equity compared to the rest of their peer group. This could be a good thing if the two companies are making better use of assets or improving profit margins.

In order to decide which company is a better opportunity, the investor decides to use DuPont analysis to determine what each company is doing to improve its ROE and whether that improvement is sustainable.

	SuperCo		Gearinc	
	Year 1	Year 2	Year 1	Year 2
Net Income	$1,000.00	$1,200.00	$2,200.00	$2,100.00
Revenue	$10,000.00	$10,000.00	$17,500.00	$17,500.00
Profit Margin	0.1	0.12	0.12	0.12
Revenue	$10,000.00	$10,000.00	$17,500.00	$17,500.00
Ave. Assets	10,000.00	9,800.00	18,750.00	18,750.00
Asset Turnover	1	1.02	2	2
Ave. Assets	10,000.00	9,800.00	18,750.00	18,750.00
Ave. Equity	10,000.00	10,000.00	10,000.00	10,500.00
Financial Leverage	1.0	2.4	1.75	1.8
ROE	10%	30%	42%	50%

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As you can see in the table, SuperCo improved its profit margins by increasing net income and reducing its total assets. SuperCo's changes improved its profit margin and asset turnover. The investor can deduce from the information that SuperCo also reduced some of its debt since average equity remained the same.

Looking closely at Gear Inc., the investor can see that the entire change in ROE was due to an increase in financial leverage. This means Gear Inc. borrowed more money, which reduced average equity. The investor is concerned because the additional borrowings didn't change the company's net income, revenue or profit margin, which means the leverage may not be adding any real value to the firm.

Or, as a real-life example, consider Wal-Mart Stores (NYSE: WMT). Wal-Mart has a net income over the trailing twelve months of $5.2 billion, revenue of $512 billion, assets of $227 billion, and shareholders' equity of $72 billion.

The company's profit margin is 1%, or $5.2 billion / $512 billion. Its asset turnover is 2.3, or $512 billion / $227 billion. The financial leverage (or equity multiplier) is 3.2, or $227 billion / $72 billion. Thus, its return on equity (ROE) is 7.4%, or 1% x 2.3 x 3.2.

DuPont Analysis vs. ROE

The return on equity (ROE) metric is net income divided by shareholders' equity. The Dupont analysis is still the ROE, just an expanded version. The ROE calculation alone reveals how well a company utilizes capital from shareholders.

With a Dupont analysis, investors and analysts can dig into what drives changes in ROE, or why an ROE is considered high or low. That is, a Dupont analysis can help deduce whether its profitability, use of assets or debt that's driving ROE.

Limitations of Using DuPont Analysis

The biggest drawback of the DuPont analysis is that, while expansive, it still relies on accounting equations and data that can be manipulated. Plus, even with its comprehensiveness, the Dupont analysis lacks context as to why the individual ratios are high or low, or even whether they should be considered high or low at all.

Related Terms

Asset Turnover Ratio
Asset turnover ratio measures the value of a company's sales or revenues generated relative to the value of its assets. more

Equity Multiplier Definition
Equity Multiplier is a financial leverage ratio that measures the portion of the company's assets that are financed by stockholder's equity. more

Return
In finance, a return is the profit or loss derived from investing or saving. more

How Return on Equity Works
Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE could be thought of as the return on net assets. more

How to Calculate Net Profit Margin
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Leverage Ratio Definition

By ADAM GREES | Reviewed by DAVID EDMONDS ⓘ | Updated Apr 30, 2020

What Is a Leverage Ratio?

A leverage ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans) or assesses the ability of a company to meet its financial obligations. The leverage ratio category is important because companies rely on a mixture of equity and debt to finance their operations, and knowing the amount of debt held by a company is useful in evaluating whether it can pay off its debts as they come due. Several common leverage ratios are discussed below.

- A leverage ratio is any one of several financial measurements that assesses the ability of a company to meet its financial obligations.
- A leverage ratio may also be used to measure a company's mix of operating expenses to get an idea of how changes in output will affect operating income.
- Common leverage ratios include the debt-equity ratio, equity multiplier, degree of financial leverage, and consumer leverage ratio.
- Banks have regulatory oversight on the level of leverage they are can hold.

1:13

Understanding The Leverage Ratio

What Does a Leverage Ratio Tell You?

Too much debt can be dangerous for a company and its investors. However, if a company's operations can generate a higher rate of return than the interest rate on its loans, then the debt may help to fuel growth. Uncontrolled debt levels can lead to credit downgrades or worse. On the other hand, too few debts can also raise questions. A reluctance or inability to borrow may be a sign that operating margins are tight.

There are several different ratios that may be categorized as a leverage ratio, but the main factors considered are debt, equity, assets, and interest expenses.

A leverage ratio may also be used to measure a company's mix of operating expenses to get an idea of how changes in output will affect operating income. Fixed and variable costs are the two types of operating costs; depending on the company and the industry, the mix will differ.

Finally, the consumer leverage ratio refers to the level of consumer debt compared to disposable income and is used in economic analyses and by policymakers.

Banks and Leverage Ratios

Banks are among the most leveraged institutions in the United States. The combination of fractional reserve banking and Federal Deposit Insurance Corporation (FDIC) protection has produced a banking environment with limited lending risks.

To compensate for this, three separate regulatory bodies, the FDIC, the Federal Reserve, and the Comptroller of the Currency, review and restrict the leverage ratios for American banks.[1] This means they restrict how much money a bank can lend relative to how much capital the bank devotes to its own assets. The level of capital is important because banks can "write down" the capital portion of their assets if total asset values drop. Assets financed by debt cannot be written down because the bank's bondholders and depositors are owed those funds.

Banking regulations for leverage ratios are complicated. The Federal Reserve created guidelines for bank holding companies, although these restrictions vary depending on the rating assigned to the bank. In general, banks that experience rapid growth or face operational or financial difficulties are required to maintain higher leverage ratios.[2]

There are several forms of capital requirements and minimum reserve placed on American banks through the FDIC and the Comptroller of the Currency that indirectly regulate leverage ratios. The level of scrutiny paid to leverage ratios has increased since the Great Recession of 2007 to 2009 when banks that were "too big to fail" were a calling card to make banks more cautious. These restrictions naturally limit the number of loans made because it is more difficult and more expensive for a bank to raise capital than it is to borrow funds. Higher capital requirements can reduce dividends or dilute share value if more shares are issued.

For banks, the tier 1 leverage ratio is most commonly used by regulators.

Leverage Ratios for Evaluating Solvency and Capital Structure

Perhaps the most well known financial leverage ratio is the debt-to-equity ratio.

The Debt-to-Equity (D/E) Ratio

This is expressed as:

$$\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Shareholders' Equity}}$$

For example, United Parcel Service's long-term debt for the quarter ending December 2019 was $23.8 billion. United Parcel Service's total shareholders' equity for the ending December 2019 was $3.1 billion. The company's D/E for the quarter was 8.61. That is considered high.[3]

A high debt/equity ratio generally indicates that a company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense. If the company's interest expense gets too high, it may increase the company's chances of a default or bankruptcy.

Typically, a D/E ratio greater than 2.0 indicates a risky scenario for an investor. However, this yardstick can vary by industry. Businesses that require large capital expenditures (CapEx), such as utility and manufacturing companies, may need to secure more loans than other companies. It's a good idea to measure a firm's leverage ratios against past performance and with companies operating in the same industry for better understanding the data. Fedex has a D/E ratio of 1.78, so there is cause for concern where UPS is concerned. However, most analysts consider that UPS seems enough cash to cover its debts.

The Equity Multiplier

The equity multiplier is similar, but replaces debt with assets in the numerator:

$$\text{Equity Multiplier} = \frac{\text{Total Assets}}{\text{Total Equity}}$$

For example, assume that Macy's (NYSE: M) has assets valued at $33.85 billion and stockholder equity of $4.32 billion. The equity multiplier would be:

$$\$19.85 \text{ billion} \div \$4.32 \text{ billion} = 4.59$$

Although debt is not specifically referenced in the formula, it is an underlying factor given that total assets includes debt.

Remember that *Total Assets = Total Debt + Total shareholders' Equity*. The company's high ratio of 4.59 means that assets are mostly funded with debt than equity. From the equity multiplier calculation, Macy's assets are financed with $15.53 billion in liabilities.

The equity multiplier is a component of the DuPont analysis for calculating return on equity (ROE):

$$\text{DuPont analysis} = NPM \times AT \times EM$$

where:

NPM = net profit margin

AT = asset turnover

EM = equity multiplier

The Debt-to-Capitalization Ratio

An indicator that measures the amount of debt in a company's capital structure is the debt-to-capitalization ratio, which measures a company's financial leverage. It is calculated as:

$$\text{Total debt to capitalization} = \frac{(SD + LD)}{(SD + LD + SE)}$$

where:

SD = short-term debt

LD = long-term debt

SE = shareholders' equity

In this ratio, operating leases are capitalized and equity includes both common and preferred shares. Instead of using long-term debt, an analyst may decide to use total debt to measure the debt used in a firm's capital structure. The formula, in this case, would include minority interest and preferred shares in the denominator.

Degree of Financial Leverage

Degree of financial leverage (DFL) is a ratio that measures the sensitivity of a company's earnings per share (EPS) to fluctuations in its operating income, as a result of changes in its capital structure. It measures the percentage change in EPS for a unit change in earnings before interest and taxes (EBIT) and is represented as:

$$DFL = \frac{\text{\% change in } EPS}{\text{\% change in } EBIT}$$

where:

EPS = earnings per share

$EBIT$ = earnings before interest and taxes

DFL can alternatively be represented by the equation below:

$$DFL = \frac{EBIT}{EBIT - \text{Interest}}$$

This ratio indicates that the higher the degree of financial leverage, the more volatile earnings will be. Since interest is usually a fixed expense, leverage magnifies returns and EPS. This is good when operating income is rising, but it can be a problem when operating income is under pressure.

The Consumer Leverage Ratio

The consumer leverage ratio is used to quantify the amount of debt the average American consumer has relative to their disposable income.

Some economists have stated that the rapid increase in consumer debt levels has been a contributing factor to corporate earnings growth over the past few decades. Others blamed the high level of consumer debt as a major cause of the great recession.

$$\text{Consumer leverage ratio} = \frac{\text{Total household debt}}{\text{Disposable personal income}}$$

Understanding how debt amplifies returns is the key to understanding leverage. Debt is not necessarily a bad thing, particularly if the debt is taken on to invest in projects that will generate positive returns. Leverage can thus multiply returns, although it can also magnify losses if returns turn out to be negative.

The Debt-To-Capital Ratio

The debt-to-capital ratio is a measurement of a company's financial leverage. It is one of the more meaningful debt ratios because it focuses on the relationship of debt liabilities as a component of a company's total capital base. Debt includes all short-term and long-term obligations. Capital includes the company's debt and shareholders' equity.

This ratio is used to evaluate a firm's financial structure and how it is financing operations. Typically, if a company has a high debt-to-capital ratio compared to its peers, it may have a higher default risk due to the effect the debt has on its operations. The oil industry seems to have about a 40% debt-to-capital threshold. Above that level, debt costs increase considerably.

The Debt-To-EBITDA Leverage Ratio

The debt-to-EBITDA leverage ratio measures a company's ability to pay off its incurred debt. Commonly used by credit agencies, this ratio determines the probability of defaulting on loaned debt. Since oil and gas companies typically have a lot of debt on their balance sheets, this ratio is useful in determining how many years of EBITDA would be required to pay back all the debt. Typically, it can be alarming if the ratio is over 3, but this can vary depending on the industry.

The Debt-To-EBITDAX Ratio

Another variation of the debt-to-EBITDA ratio is the debt-to-EBITDAX ratio, which is similar, except EBITDAX is EBITDA before exploration costs for successful efforts companies. This ratio is commonly used in the United States to normalize different accounting treatments for exploration expenses (the method chosen versus the successful efforts method).

Exploration costs are typically found in the financial statements as exploration, abandonment, and dry hole costs. Other noncash expenses that should be added back in are impairments, accretion of asset retirement obligations, and deferred taxes.

The Interest Coverage Ratio

Another leverage ratio concerned with interest payments is the interest coverage ratio. One problem with only reviewing the total debt liabilities for a company is they do not tell you anything about the company's ability to service the debt. This is exactly what the interest coverage ratio is for.

This ratio, which equals operating income divided by interest expenses, showcases the company's ability to make interest payments. Generally, a ratio of 3.0 or higher is desirable, although this varies from industry to industry.

The Fixed-Charge Coverage Ratio

Times interest earned (TIE), also known as a fixed-charge coverage ratio, is a variation of the interest coverage ratio. This leverage ratio attempts to highlight cash flow relative to interest owed on long-term liabilities.

To calculate this ratio, find the company's earnings before interest and taxes (EBIT), then divide by the interest expense of long-term debts. Use pre-tax earnings because interest is tax deductible; the full amount of earnings can eventually be used to pay interest. Again, higher numbers are more desirable.

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Capital Structure

By ALICIA TUOVILA | Reviewed By AMY DRURY | Updated Jul 14, 2020

What Is Capital Structure?

The capital structure is the particular combination of debt and equity used by a company to finance its overall operations and growth. Debt comes in the form of bond issues or loans, while equity may come in the form of common stock, preferred stock, or retained earnings. Short-term debt is also considered to be part of the capital structure.

KEY TAKEAWAYS

- Capital structure is how a company funds its overall operations and growth.
- Debt consists of borrowed money that is due back to the lender, commonly with interest expense.
- Equity consists of ownership rights in the company, without the need to pay back any investment.
- The Debt-to-Equity (D/E) ratio is useful in determining the riskiness of a company's borrowing practices.

1:47

Capital Structure

Understanding Capital Structure

Both debt and equity can be found on the balance sheet. Company assets, also listed on the balance sheet, are purchased with this debt and equity. Capital structure can be a mixture of a company's long-term debt, short-term debt, common stock, and preferred stock. A company's proportion of short-term debt versus long-term debt is considered when analyzing its capital structure.

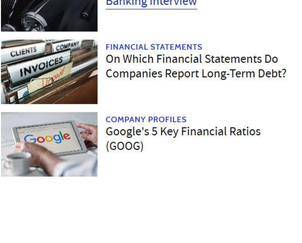
When analysts refer to capital structure, they are most likely referring to a firm's debt-to-equity (D/E) ratio, which provides insight into how risky a company's borrowing practices are. Usually, a company that is heavily financed by debt has a more aggressive capital structure and therefore poses greater risk to investors. This risk, however, may be the primary source of the firm's growth.

Debt is one of the two main ways a company can raise money in the capital markets. Companies benefit from debt because of its tax advantages; interest payments made as a result of borrowing funds may be tax deductible. Debt also allows a company or business to retain ownership, unlike equity. Additionally, in times of low interest rates, debt is abundant and easy to access.

Equity allows outside investors to take partial ownership in the company. Equity is more expensive than debt, especially when interest rates are low. However, unlike debt, equity does not need to be paid back. This is a benefit to the company in the case of declining earnings. On the other hand, equity represents a claim by the owner on the future earnings of the company.

Types of Capitalization Structures

Firms can either issue either more debt or equity to fund its operations. By issuing equity, firms give up some ownership in the company without the need to pay back investors; by issuing debt, companies increase their leverage by needing to pay back investors. A company's debt-to-equity ratio is a measure of risk for investors.



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Measures of Capital Structure

Companies that use more debt than equity to finance their assets and fund operating activities have a high leverage ratio and an aggressive capital structure. A company that pays for assets with more equity than debt has a low leverage ratio and a conservative capital structure. That said, a high leverage ratio and an aggressive capital structure can also lead to higher growth rates, whereas a conservative capital structure can lead to lower growth rates.

> **Important:** It is the goal of company management to find the ideal mix of debt and equity, also referred to as the optimal capital structure, to finance operations.

Analysts use the debt-to-equity (D/E) ratio to compare capital structure. It is calculated by dividing total liabilities by total equity. Savvy companies have learned to incorporate both debt and equity into their corporate strategies. At times, however, companies may rely too heavily on external funding, and debt in particular. Investors can monitor a firm's capital structure by tracking the D/E ratio and comparing it against the company's industry peers.

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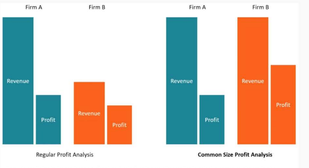
Common Size Analysis

A financial analysis tool that expresses each line item as a percentage of the base amount for a given period

What is Common Size Analysis?

Common size analysis, also referred as vertical analysis, is a tool that financial managers use to analyze financial statements. It evaluates financial statements by expressing each line item as a percentage of the base amount for that period. The analysis helps to understand the impact of each item in the financial statement and its contribution to the resulting figure.



Firm A's profit looks larger from an absolute basis, but is actually smaller in relative terms as shown in the **Common Size Analysis**

The technique can be used to analyze the three primary financial statements, i.e., balance sheet, income statement, and cash flow statement. In the balance sheet, the common base item to which other line items are expressed is total assets, while in the income statement, it is total revenues.

Formula for Common Size Analysis

Common size financial statement analysis is computed using the following formula:

$$\text{Percentage of Base} = \frac{\text{Amount of Individual item}}{\text{Amount of Base Item}} \times 100$$

Types of Common Size Analysis

Common size analysis can be conducted in two ways, i.e., vertical analysis and horizontal analysis. Vertical analysis refers to the analysis of specific line items in relation to a base item within the same financial period. For example, in the balance sheet, we can assess the proportion of inventory by dividing the inventory line using total assets as the base item.

On the other hand, horizontal analysis refers to the analysis of specific line items and comparing them to a similar line item in the previous or subsequent financial period. Although common size analysis is not as detailed as trend analysis using ratios, it does provide a simple way for financial managers to analyze financial statements.

Balance Sheet Common Size Analysis

The balance sheet common size analysis mostly uses the total assets value as the base value. On the balance sheet, the total assets value equals the value of total liabilities and shareholders' equity. A financial manager or investor uses the common size analysis to see how a firm's capital structure compares to rivals. They can make important observations by analyzing specific line items in relation to the total assets.

For example, if the value of long-term debts in relation to the total assets value is too high, it shows that the company's debt levels are too high. Similarly, looking at the retained earnings in relation to the total assets as the base value can reveal how much of the annual profits are retained on the balance sheet.

Let's take the example of ABC Company whose balance sheet for 2017 is as follows:

	Amount	Percent
Assets		
Current Assets		
Total Cash	14,500	14.5%
Inventories	12,000	12%
Prepaid Expenses	500	0.5%
Accounts receivable	18,000	18%
Total Current Assets	45,000	45%
Non-Current Assets		
Property, Plant, and Equipment	52,000	52%
Goodwill	3,000	3%
Total Assets	100,000	100%
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	15,000	15%
Salaries payable	10,000	10%
Accrued Expenses	5,000	5%
Total Current Liabilities	30,000	30%
Long-term debt	30,000	30%
Shareholder's Equity	40,000	40%
Total Liabilities and Stockholder's Equity	100,000	100%

From the table above, we can deduce that cash represents 14.5% of the total assets while inventory represents 12% of the total assets. In the liabilities section, we can deduce that accounts payable represent 15%, salaries 10%, long-term debt 30%, and shareholder's equity 40% of the total liabilities and stockholder's equity.

Income Statement Common Size Analysis

The base item in the income statement is usually the total sales or total revenue. Common size analysis is used to calculate net profit margin, as well as gross and operating margins. The ratios tell investors and finance managers how the company is doing in terms of revenues, and they can make predictions of future revenues. Companies can also use this tool to analyze competitors to know the proportion of revenues that goes to advertising, research and development, and other essential expenses.

We can compute common size income statement analysis for ABC Company for 2017.

Revenues	Amount	Percent
Cost of Goods Sold	100,000	100%
Gross Profit	70,000	70%
Operating Expenses	30,000	30%
Research and Development	10,000	10%
Advertising	3,000	3%
General and Administrative	2,000	2%
Total Operating Expenses	15,000	15%
Operating income	15,000	15%
Interest expense	2,000	2%
Income Before Income Taxes	13,000	13%
Income tax expense	3,000	3%
Net Income	10,000	10%

By looking at this income statement, we can see that in 2017, the amount of money that the company invested in research and development (10%) and advertising (3%). The company also pays interest to the shareholders, which is 2% of the total revenue for the year. The net operating income or earnings after interest and taxes represent 10% of the total revenues, and it shows the health of the business's core operating areas. The net income can be compared to the previous year's net income to see how the company's performance year-on-year.

Importance of Common Size Analysis

One of the benefits of using common size analysis is that it allows investors to identify drastic changes in a company's financial statement. This mainly applies when the financials are compared over a period of two or three years. Any significant movements in the financials across several years can help investors decide whether to invest in the company. For example, large drops in profit margins in two or more consecutive years may indicate that the company is going through financial distress. Similarly, considerable increases in the value of assets may mean that the company is implementing an expansion or acquisition strategy, making the company attractive to investors.

Common size analysis is also an excellent tool to compare companies of different sizes but in the same industry. Looking at their financial data can reveal their strategy and their largest expenses that give them a competitive edge over other comparable companies. For example, some companies may sacrifice margins to gain a large market share, which increases revenues at the expense of profit margins. Such a strategy allows the company to grow faster than comparable companies because they are more preferred by investors.

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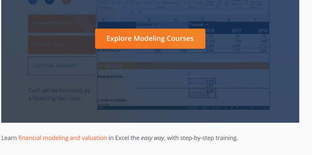

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Tax Planning

By JULIA KAGAN | Reviewed By GORDON SCOTT | Updated Mar 31, 2020

What Is Tax Planning?

Tax planning is the analysis of a financial situation or plan from a tax perspective. The purpose of tax planning is to ensure tax efficiency. Through tax planning, all elements of the financial plan work together in the most tax-efficient manner possible. Tax planning is an essential part of an individual investor's financial plan. Reduction of tax liability and maximizing the ability to contribute to retirement plans are crucial for success.

How Tax Planning Works

Tax planning covers several considerations. Considerations include timing of income, size, and timing of purchases, and planning for other expenditures. Also, the selection of investments and types of retirement plans must complement the tax filing status and deductions to create the best possible outcome.

KEY TAKEAWAYS

- Tax planning is the analysis of finances from a tax perspective, with the purpose of ensuring maximum tax efficiency.
- Considerations of tax planning include timing of income, size, timing of purchases, and planning for expenditures.
- Tax planning strategies can include saving for retirement in an IRA or engaging in tax gain-loss harvesting.

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Tax Avoidance

By JULIA KAGAN | Reviewed By JANET BERRY-JOHNSON | Updated Sep 28, 2020

What Is Tax Avoidance?

Tax avoidance is the use of legal methods to minimize the amount of income tax owed by an individual or a business. This is generally accomplished by claiming as many deductions and credits as are allowable. It may also be achieved by prioritizing investments that have tax advantages, such as buying municipal bonds.

Tax avoidance is not the same as tax evasion, which relies on illegal methods such as underreporting income and falsifying deductions. [1]

Tax Avoidance Vs. Tax Evasion

Tax Avoidance Explained

Millions of taxpayers use some form of tax avoidance if only by taking the child tax credit, investing in a retirement account, or taking the mortgage tax deduction. Every tax deduction and credit available in the U.S. Tax Code was placed there by the U.S. Congress for the benefit or the relief of some or all taxpayers.

KEY TAKEAWAYS

- Anyone who invests in a retirement fund, uses the mortgage deduction, or takes the child tax credit is practicing tax avoidance.
- These are legal tax breaks offered to encourage certain behaviors, such as saving for retirement or buying a home.
- At 2,600 pages, the U.S. Tax Code contains many other tax breaks, but it usually takes a professional tax preparer to figure them out.

The combined efforts of Congress over decades have resulted in a U.S. Tax Code that is more than 2,600 pages long and far too complicated for anyone without an accounting degree to tackle. (The legend that the Tax Code contains 70,000 pages has been debunked. This figure represents annotated versions of the statutes that include related case law.) [2]

The Code's sheer complexity causes many taxpayers to miss out on tax breaks they could benefit from claiming.

Avoiding Tax Avoidance

In fact, more than 90% of individuals now use the standard deduction rather than itemizing deductions. [3] In part, that is because the standard deduction has increased to $12,400 for individuals and $24,800 for couples as of $10,000. [4] For most Americans since 2018, that negates the usefulness even of the mortgage interest deduction—especially now that the same tax bill that increased the standard deduction capped deductions for state and local taxes at $10,000. [5]

Still, there are plenty of small business owners, freelancers, investors, and others who save every business expense receipt that may be eligible for a deduction. Others leap to the IRS challenge and angle for every tax deduction and credit they can get.

Most Common Tax Avoidance Tactics

If you're saving money for your retirement, you're probably engaging in tax avoidance. And that's a good thing.

> **Important:** Many business owners, freelancers, and investors find it necessary to save every receipt that may be useful for the purpose of legal tax avoidance.

Every individual who contributes to an employer-sponsored retirement plan or invests in an individual retirement account (IRA) is engaging in tax avoidance.

- If the account is a so-called "traditional" plan, the investor gets an immediate tax break equalling the amount they contribute each year, up to a limit that is revised annually. Income taxes on the money will be owed when it is withdrawn after the saver retires. [6] The retiree's taxable income will probably be lower then, as will the taxes owed on that income. That's tax avoidance.
- If it is a Roth plan, the investor saves after-tax money and the tax break will come after retirement, in the form of tax-free savings. [7] In this case, the entire balance of the account is tax-free. Roths allow the saver to permanently avoid income taxes on the money their contributions earn over the year.

How Congress Encourages Tax Avoidance

Tax avoidance is built into the Internal Revenue Code. Lawmakers use the Tax Code to manipulate citizen behavior by offering tax credits, deductions, or exemptions. By doing so, they are indirectly subsidizing various essential services such as health insurance, retirement saving, and higher education. Or, they may use the Tax Code to advance national goals, such as greater energy efficiency.

Some of these tax policies disproportionately advantage citizens with higher incomes. Federal estate taxes have been abolished for everyone who inherits less than $11.58 million. Capital gains are taxed at a lower rate than most earned income. Mortgage interest is deductible on both a first home and a second (but not a third) home.

Tax Avoidance Complicates the Tax Code

The expanding use of tax avoidance in the U.S. Tax Code has made it one of the most complex tax codes in the world. Taxpayers spend billions of hours each year filing tax returns, with much of that time used looking for ways to avoid paying higher taxes. [8]

Because the tax code changes every year to some extent, families have a difficult time making decisions about retirement, savings, and education. Businesses especially suffer the consequences of an ever-evolving Tax Code that affects hiring decisions and growth strategies.

Eliminating or reducing tax avoidance is at the core of most proposals seeking to change the Tax Code. The proposals that have been introduced over the last decade seek to simplify the process by flattening tax rates and removing most tax avoidance provisions. Proponents of establishing a flat tax rate, for example, argue that it would eliminate the need to pursue tax avoidance strategies. (Opponents, however, call the flat tax concept regressive.)

Tax Avoidance vs. Tax Evasion

In short, most Americans practice tax avoidance. It is a major American industry.

Tax evasion, on the other hand, is illegal. It happens when people underreport or fail to report income or revenue earned to a taxing authority. Some practice tax evasion by not paying taxes at all.

Tax evasion is punishable by jail time, a fine, or both.

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Tax Evasion

By JULIA KAGAN | Reviewed By JANET BERRY-JOHNSON | Updated May 29, 2020

What Is Tax Evasion?

Tax evasion is an illegal activity in which a person or entity deliberately avoids paying a true tax liability. Those caught evading taxes are generally subject to criminal charges and substantial penalties. To willfully fail to pay taxes is a federal offense under the Internal Revenue Service (IRS) tax code.

Tax Avoidance Vs. Tax Evasion

Understanding Tax Evasion

Tax evasion applies to both the illegal nonpayment as well as the illegal underpayment of taxes. Even if a taxpayer fails to submit appropriate tax forms, the IRS can still determine if taxes were owed based on the information required to be sent in by third parties, such as W-2 information from a person's employer or 1099s. Generally, a person is not considered to be guilty of tax evasion unless the failure to pay is deemed intentional.

> **Important:** Tax evasion occurs when a person or business illegally avoids paying their tax liability, which is a criminal charge that's subject to penalties and fines.

Failure to pay proper taxes can lead to criminal charges. In order for charges to be levied, it must be determined that the avoidance of taxes was a willful act on the part of the taxpayer. Not only can a person be liable for payment of any taxes that have been left unpaid, but they can also be found guilty of official charges and may be required to serve jail time. According to the IRS, the penalties include jail time of no more than five years, a fine of no more than $250,000 for individuals or $500,000 for corporations, or both—along with the costs of prosecution.

KEY TAKEAWAYS

- Tax evasion can be either the illegal non-payment or underpayment of actual tax liabilities due.
- Tax evasion can be determined by the IRS regardless of whether or not tax forms were filed with the agency.
- To determine tax evasion, the agency must be able to show that the avoidance of taxes was willful on the part of the taxpayer.
- While tax evasion is illegal, tax avoidance includes finding legal ways (within the law) to reduce taxpayer obligations.

Requirements for Tax Evasion

When determining if the act of failure to pay was intentional, a variety of factors are considered. Most commonly, a taxpayer's financial situation will be examined in an effort to confirm if the nonpayment was the result of committing fraud or of the concealment of reportable income.

A failure to pay may be judged fraudulent in cases where a taxpayer made efforts to conceal assets by associating them with a person other than themselves. This can include reporting income under a false name and Social Security number (SSN), which can also constitute identity theft. A person may be judged as concealing income for failure to report work that did not follow traditional payment recording methods. This can include acceptance of a cash payment for goods or services rendered without reporting them properly to the IRS during a tax filing.

In most cases of corporate tax evasion listed on the IRS website, the tax liability was underrepresented. Many business owners undervalued the sums of their receipts to the agency, an act which was deemed to be the purposeful evasion of tax. These were documented to be sources of income, revenue, and profits that were not accurately reported.

Tax Evasion vs. Tax Avoidance

While tax evasion requires the use of illegal methods to avoid paying proper taxes, tax avoidance uses legal means to lower the obligations of a taxpayer. This can include efforts such as charitable giving to an approved entity or the investment of income into a tax deferred mechanism, such as an individual retirement account (IRA). In the case of an IRA, taxes on the invested funds are not paid until the funds, and any applicable interest payments, have been withdrawn.

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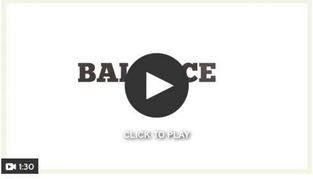
Balanced Scorecard

By EVAN TARVER | Reviewed By THOMAS BROCK | Updated Jul 5, 2020

What Is a Balanced Scorecard?

A balanced scorecard is a strategic management performance metric used to identify and improve various internal business functions and their resulting external outcomes. Balanced scorecards are used to measure and provide feedback to organizations. Data collection is crucial to providing quantitative results as managers and executives gather and interpret the information and use it to make better decisions for the organization.



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Balanced Scorecard

KEY TAKEAWAYS

- A balanced scorecard is a performance metric used to identify, improve, and control a business's various functions and resulting outcomes.
- It was first introduced in 1992 by David Norton and Robert Kaplan, who took previous metric performance measures and adapted them to include nonfinancial information.
- The balanced scorecard involves measuring four main aspects of a business: learning and growth, business processes, customers, and finance.

Understanding Balanced Scorecards

Accounting academic Dr. Robert Kaplan and business executive and theorist Dr. David Norton first introduced the balanced scorecard. The *Harvard Business Review* first published it in the 1992 article "The Balanced Scorecard—Measures That Drive Performance." Both Kaplan and Norton took previous metric performance measures and adapted them to include nonfinancial information.

Important: Companies can easily identify factors hindering business performance and outline strategic changes tracked by future scorecards.

The balanced scorecard model reinforces good behavior in an organization by isolating four separate areas that need to be analyzed. These four areas, also called legs, involve learning and growth, business processes, customers, and finance.

The balanced scorecard is used to attain objectives, measurements, initiatives, and goals that result from these four primary functions of a business. Companies can easily identify factors hindering business performance and outline strategic changes tracked by future scorecards.

The balanced scorecard can provide information about the company as a whole when viewing company objectives. An organization may use the balanced scorecard model to implement strategy mapping to see where value is added within an organization. A company also uses a balanced scorecard to develop strategic initiatives and strategic objectives.

Characteristics of the Balanced Scorecard Model

Information is collected and analyzed from four aspects of a business:

1. **Learning and growth** are analyzed through the investigation of training and knowledge resources. This first leg handles how well information is captured and how effectively employees use the information to convert it to a competitive advantage over the industry.
2. **Business processes** are evaluated by investigating how well products are manufactured. Operational management is analyzed to track any gaps, delays, bottlenecks, shortages, or waste.
3. **Customer perspectives** are collected to gauge customer satisfaction with quality, price, and availability of products or services. Customers provide feedback about their satisfaction with current products.
4. **Financial data**, such as sales, expenditures, and income are used to understand financial performance. These financial metrics may include dollar amounts, financial ratios, budget variances, or income targets.

These four legs encompass the vision and strategy of an organization and require active management to analyze the data collected. The balanced scorecard is thus often referred to as a management tool rather than a measurement tool.

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use to their advantage.

The Four Perspectives

The Balanced Scorecard approach helps companies focus on four key perspectives: the customer perspective, the learning and growth perspective, the internal business processes perspective, and the financial perspective. Within each of these perspectives, the company identifies those things that are most important to stakeholders and establish measures that they will use to monitor performance. For instance, under the customer perspective, the company may monitor levels of customer satisfaction while under the learning and growth perspective, the company might monitor the impact of training on performance. Under the internal business process perspective, the company might monitor order processing turnaround and under the financial perspective, the company might monitor days in A/R (accounts receivable). The idea is to balance all of these perspectives, and the measures within them, so that all stakeholder needs are being considered equally.

Linking the Scorecard to Company Strategies

The scorecard, or the grouping of perspectives that the company will monitor, is integrally linked to the company's strategy. In linking the scorecard to the company's strategy, the company will focus on cause and effect relationships, performance drivers and financial linkages.

Feedback and Continued Learning

Feedback and continued learning is a key element of the Balanced Scorecard approach. As companies monitor their measures across the four perspectives, they will identify areas of opportunity for improvement and implement tactics to improve their scores. Feedback is gathered from multiple perspectives with both employees and customers having a role in identifying areas of opportunity, supplying new ideas and affecting improvement potential.

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Cost Accounting

By ALICIA TUOVILA | Reviewed By JANET BERRY-JOHNSON | Updated Jan 28, 2020

What Is Cost Accounting?

Cost accounting is a form of managerial accounting that aims to capture a company's total cost of production by assessing the variable costs of each step of production as well as fixed costs, such as a lease expense.

KEY TAKEAWAYS

- Cost accounting is used internally by management in order to make fully informed business decisions.
- Unlike financial accounting, which provides information to external financial statement users, cost accounting is not required to adhere to set standards and can be flexible to meet the needs of management.
- Cost accounting considers all input costs associated with production, including both variable and fixed costs.
- Types of cost accounting include standard costing, activity-based costing, lean accounting, and marginal costing.

Feedback

Opportunity Cost

By ADAM HAYES | Reviewed by AMY DRURY ⓘ | Updated Aug 21, 2020

What Is Opportunity Cost?

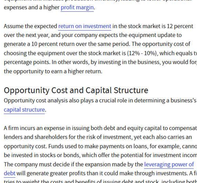
Opportunity costs represent the potential benefits an individual, investor, or business *misses out on* when choosing one alternative over another. The idea of opportunity costs is a major concept in economics.

Because by definition they are unseen, opportunity costs can be easily overlooked if one is not careful. Understanding the potential missed opportunities foregone by choosing one investment over another allows for better decision-making.

While financial reports do not show opportunity costs, business owners often use the concept to make educated decisions when they have multiple options before them. Bottlenecks, for instance, are often a result of opportunity costs.

KEY TAKEAWAYS

- Opportunity cost is the forgone benefit that would have been derived by an option not chosen.
- To properly evaluate opportunity costs, the costs and benefits of every option available must be considered and weighed against the others.
- Considering the value of opportunity costs can guide individuals and organizations to more profitable decision-making.



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Opportunity Cost

Opportunity Cost Formula and Calculation

$$\text{Opportunity Cost} = \text{FO} - \text{CO}$$

where:

$\text{FO} = \text{Return on best foregone option}$

$\text{CO} = \text{Return on chosen option}$

The formula for calculating an opportunity cost is simply the difference between the expected returns of each option. Say that you have option A to invest in the stock market hoping to generate capital gain returns. Option B, on the other hand is to reinvest your money back into the business, expecting that newer equipment will increase production efficiency, leading to lower operational expenses and a higher profit margin.

Assume the expected return on investment in the stock market is 12 percent over the next year, and your company expects the equipment update to generate a 10 percent return over the same period. The opportunity cost of choosing the equipment over the stock market is (12% - 10%), which equals two percentage points. In other words, by investing in the business, you would forgo the opportunity to earn a higher return.

Opportunity Cost and Capital Structure

Opportunity cost analysis also plays a crucial role in determining a business's capital structure.

A firm incurs an expense in issuing both debt and equity capital to compensate lenders and shareholders for the risk of investment, yet each also carries an opportunity cost. Funds used to make payments on loans, for example, cannot be invested in stocks or bonds, which offer the potential for investment income. The company must decide if the expansion made by the leveraging power of debt will generate greater profits than it could make through investments. A firm tries to weight the costs and benefits of issuing debt and stock, including both monetary and non-monetary considerations, in order to arrive at an optimal balance that minimizes opportunity costs. Because opportunity cost is a forward-looking consideration, the actual rate of return for both options is unknown today, making this evaluation in practice tricky.

Assume the company in the above example foregoes new equipment and instead invests in the stock market. If the selected securities decrease in value, the company could end up losing money rather than enjoying the expected 12 percent return.

For the sake of simplicity, assume the investment yields a return of 0%, meaning the company gets out exactly what it put in. The opportunity cost of choosing this option is 10% - 0%, or 10%. It is equally possible that, had the company chosen new equipment, there would be no effect on production efficiency, and profits would remain stable. The opportunity cost of choosing this option is then 12% rather than the expected 2%.

It is important to compare investment options that have a similar risk. Comparing a Treasury bill, which is virtually risk-free, to investment in a highly volatile stock can cause a misleading calculation. Both options may have expected returns of 5%, but the U.S. Government backs the rate of return of the T-bill, while there is no such guarantee in the stock market. While the opportunity cost of either option is 0 percent, the T-bill is the safer bet when you consider the relative risk of each investment.

Comparing Investments

When assessing the potential profitability of various investments, businesses look for the option that is likely to yield the greatest return. Often, they can determine this by looking at the expected rate of return for an investment vehicle. However, businesses must also consider the opportunity cost of each option.

Assume that, given a set amount of money for investment, a business must choose between investing funds in securities or using it to purchase new equipment. No matter which option the business chooses, the potential profit it gives up by not investing in the other option is the opportunity cost. Indeed, it is unavoidable.

Opportunity Cost vs. Sunk Cost

The difference between an opportunity cost and a sunk cost is the difference between money already spent in the past and potential returns not earned in the future on an investment because the capital was invested elsewhere. Buying 1,000 shares of company A at $10 a share, for instance, represents a sunk cost of $10,000. This is the amount of money paid out to make an investment, and getting that money back requires liquidating stock at or above the purchase price. But the opportunity cost instead asks where could have that $10,000 been put to use in a better way.

From an accounting perspective, a sunk cost could also refer to the initial outlay to purchase an expensive piece of heavy equipment, which might be amortized over time, but which is sunk in the sense that you won't be getting it back. An opportunity cost would be to consider the forgone returns possibly earned elsewhere when you buy a piece of heavy equipment with an expected return on investment (ROI) of 5% vs. one with an ROI of 4%.

Again, an opportunity cost describes the returns that one *could have* earned if he or she invested the money in another instrument. Thus, while 1,000 shares in company A might eventually sell for $12 a share, netting a profit of $2,000, during the same period, company B increased in value from $10 a share to $15. In this scenario, investing $10,000 in company A returned $2,000, while the same amount invested in company B would have returned a larger $5,000. The $3,000 difference is the opportunity cost of choosing company A over company B.

As an investor that has already sunk money into investments, you might find another investment that promises greater returns. The opportunity cost of holding the underperforming asset may rise to where the rational investment option is to sell and invest in the more promising investment.

Risk vs. Opportunity Cost

In economics, risk describes the possibility that an investment's actual and projected returns are different and that the investor loses some or all of the principal. Opportunity cost concerns the possibility that the returns of a chosen investment are lower than the returns of a forgone investment. The key difference is that risk compares the actual performance of an investment against the projected performance of the same investment, while opportunity cost compares the actual performance of an investment against the actual performance of a different investment.

Still, one could consider opportunity costs when deciding between two risk profiles. If investment A is risky but has an ROI of 25% while investment B is far less risky but only has an ROI of 5%, even though investment A may succeed, it may not. And if it fails, then the opportunity cost of going with option B will be salient.

Example of Opportunity Cost

When making big decisions like buying a home or starting a business, you will probably scrupulously research the pros and cons of your financial decision, but most day-to-day choices aren't made with a full understanding of the potential opportunity costs. If they're cautious about a purchase, many people just look at their savings account and check their balance before spending money. Often, people don't think about the things they must give up when they make those decisions.

The problem comes up when you never look at what else you could do with your money or buy things without considering the lost opportunities. Having takeout for lunch occasionally can be a wise decision, especially if it gets you out of the office for a much-needed break.

However, buying one cheeseburger every day for the next 25 years could lead to several missed opportunities. Aside from the missed opportunity for better health, spending that $4.50 on a burger could add up to just over $52,000 in that time frame, assuming a very achievable 5% rate of return.

This is a simple example, but the core message holds true for a variety of situations. It may sound like overkill to think about opportunity costs every time you want to buy a candy bar or go on vacation. Even clipping coupons versus going to the supermarket empty-handed is an example of an opportunity cost unless the time used to clip coupons is better spent working in a more profitable venture than the savings promised by the coupons. Opportunity costs are everywhere and occur with every decision made, big or small.

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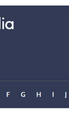
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Outlay Cost

By WILL KENTON | Updated Jun 15, 2020

What Is an Outlay Cost?

An outlay cost is a cost incurred in order to execute a strategy or acquire an asset. Outlay costs are also paid to vendors to acquire goods such as inventory or services, such as consulting or software design. They are concrete expenses that are actually incurred in order to achieve a goal.

KEY TAKEAWAYS

- Outlay costs are any costs incurred to acquire an asset or execute a strategy, but can also be costs paid to vendors for goods or services.
- For corporations, outlay costs for new projects include start-up, production, and asset acquisition costs.
- Outlay costs do not include foregone profits or benefits—also known as opportunity costs. Total costs include both the outlay cost and opportunity cost.
- Outlay costs reduce earnings immediately with cash accounting, while with accrual accounting they are split across all periods the expense applies and matched to related revenues.

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Sunk Cost

By ALICIA TUOVILA | Reviewed By AMY DRURY | Updated Jun 30, 2020

What Is a Sunk Cost?

A sunk cost refers to money that has already been spent and which cannot be recovered. In business, the axiom that one has to "spend money to make money" is reflected in the phenomenon of the sunk cost. A sunk cost differs from future costs that a business may face, such as decisions about inventory purchase costs or product pricing. Sunk costs are excluded from future business decisions because the cost will remain the same regardless of the outcome of a decision.

KEY TAKEAWAYS

- Sunk costs are those which have already been incurred and which are unrecoverable.
- In business, sunk costs are typically not included in consideration when making future decisions, as they are seen as irrelevant to current and future budgetary concerns.
- Sunk costs are in contrast to relevant costs, which are future costs that have yet to be incurred.

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Direct Cost

By WILL KENTON | Reviewed By MARGARET JAMES | Updated Jun 27, 2020

What Is a Direct Cost?

A direct cost is a price that can be directly tied to the production of specific goods or services. A direct cost can be traced to the cost object, which can be a service, product, or department. Direct and indirect costs are the two major types of expenses or costs that companies can incur. Direct costs are often variable costs, meaning they fluctuate with production levels such as inventory. However, some costs, such as indirect costs are more difficult to assign to a specific product. Examples of indirect costs include depreciation and administrative expenses.

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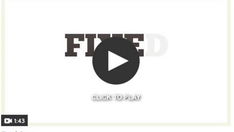
Fixed Cost

By WILL KENTON | Reviewed By DAVID KINDNESS | Updated May 29, 2020

What Is a Fixed Cost?

A fixed cost is a cost that does not change with an increase or decrease in the amount of goods or services produced or sold. Fixed costs are expenses that have to be paid by a company, independent of any specific business activities. In general, companies can have two types of costs, fixed costs or variable costs, which together result in their total costs. Shutdown points tend to be applied to reduce fixed costs.



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Fixed Costs

Understanding Fixed Costs

Companies have a wide range of different costs associated with their business. These costs are broken out by indirect, direct, and capital costs on the income statement and notated as either short-term or long-term liabilities on the balance sheet. Together both fixed costs and variable costs make up the total cost structure of a company. Cost analysts are responsible for analyzing both fixed and variable costs through various types of cost structure analysis. In general, costs are a key factor influencing total profitability.

Companies have some flexibility in breaking down costs on their financial statements. As such fixed costs can be allocated throughout the income statement. The proportion of variable vs. fixed costs a company incurs and their allocations can depend on the industry they are in. Variable costs are costs directly associated with production and therefore change depending on business output. Fixed costs are usually negotiated for a specified time period and do not change with production levels. Fixed costs, however, can decrease on a per unit basis when they are associated with the direct cost portion of the income statement, fluctuating in the breakdown of costs of goods sold.

Fixed costs are usually established by contract agreements or schedules. These are base costs involved in operating a business comprehensively. Once established, fixed costs do not change over the life of an agreement or cost schedule. A company starting a new business would likely begin with fixed costs for rent and management salaries. All types of businesses have fixed cost agreements that they monitor regularly. While these fixed costs may change over time, the change is not related to production levels but rather new contractual agreements or schedules. Examples of fixed costs include rental lease payments, salaries, insurance, property taxes, interest expenses, depreciation, and potentially some utilities.

KEY TAKEAWAYS

- Cost structure management is an important part of business analysis that looks at the effects of fixed and variable costs on a business overall.
- Fixed costs are set over a specified period of time and do not change with production levels.
- Fixed costs can be direct or indirect expenses and therefore may influence profitability at different points along the income statement.

Financial Statement Analysis

Companies can associate both fixed and variable costs when analyzing costs per unit. As such, cost of goods sold can include both variable and fixed costs. Comprehensively, all costs directly associated with the production of a good are summed collectively and subtracted from revenue to arrive at gross profit. Variable and fixed cost accounting will vary for each company depending on the costs they are working with. Economies of scale can also be a factor for companies who can produce large quantities of goods. Fixed costs can be a contributor to better economies of scale because fixed costs can decrease per unit when larger quantities are produced. Fixed costs that may be directly associated with production will vary by company but can include costs like direct labor and rent.

Fixed costs are also allocated in the indirect expense section of the income statement which leads to operating profit. Depreciation is one common fixed cost that is recorded as an indirect expense. Companies create a depreciation expense schedule for asset investments with values falling over time. For example, a company might buy machinery for a manufacturing assembly line that is expensed over time using depreciation. Another primary fixed, indirect cost is salaries for management.

Companies will also have interest payments as fixed costs which are a factor for net income. Fixed interest expenses are deducted from operating profit to arrive at net profit.

Any fixed costs on the income statement are also accounted for on the balance sheet and cash flow statement. Fixed costs on the balance sheet may be either short-term or long-term liabilities. Finally, any cash paid for the expenses of fixed costs is shown on the cash flow statement. In general, the opportunity to lower fixed costs can benefit a company's bottom line by reducing expenses and increasing profit.

Cost Structure Management

In addition to financial statement reporting, most companies will closely follow their cost structures through independent cost structure statements and dashboards. Independent cost structure analysis helps a company fully understand its variable vs. fixed costs and how they affect different parts of the business as well as the total business overall. Many companies have cost analysts dedicated solely to monitoring and analyzing the fixed and variable costs of a business.

Ratios

Fixed cost ratio: The fixed cost ratio is a simple ratio that divides fixed costs by net sales to understand the proportion of fixed costs involved in production.

Fixed charge coverage ratio: The fixed charge coverage ratio is a type of solvency metric that helps analyze a company's ability to pay its fixed-charge obligations. The fixed charge coverage ratio is calculated from the following equation:

EBIT + fixed charges before tax / fixed charges before tax + interest

Other Considerations

Breakeven analysis: Breakeven analysis involves using both fixed and variable costs to identify a production level in which revenue will equal costs. This can be an important part of cost structure analysis. A company's breakeven production quantity is calculated by:

Breakeven quantity = fixed costs / (sales price per unit – variable cost per unit)

A company's breakeven analysis can be important for decisions on fixed and variable costs. Breakeven analysis also influences the price at which a company chooses to sell its products.

Operating leverage: Operating leverage is another cost structure metric used in cost structure management. The proportion of fixed to variable costs will influence a company's operating leverage. Higher fixed costs help operating leverage to increase. With a higher operating leverage, companies can produce more profit per additional unit produced.

Operating leverage = [Q(P-V)] / [Q(P-V)-F]

Where:

Q = number of units

P = price per unit

V = variable cost per unit

F = fixed costs

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Fixed and Variable Costs

Fixed costs or Constant costs are not a function of the output. That is, they do not vary with the output up to a certain extent. They require a fixed expenditure of funds regardless of the output.

For example, rent, property taxes, interest on loans, etc. However, note that fixed costs can vary with the size of the plant and are usually a function of capacity. Therefore, we can conclude that fixed costs do not vary with the output volume within a capacity level.

Businesses cannot avoid fixed costs and are applicable as long as the business is operating. Alternate names for fixed costs are inescapable or uncontrollable costs.

It is important to note here, that some fixed costs continue even after the suspension of business. For example, costs associated with storing of machines that the business cannot sell in the market, etc.

Variable costs are cost concepts which are a function of the output in the production period. Variable costs vary directly with the output. Some examples of variable costs are the cost of raw materials, wages, etc. Sometimes, they vary proportionally with the output too. However, these variations depend on the utilization of fixed facilities and resources during the production process.

Solved Question on Cost Concepts

Feedback

A cost sheet is a statement that shows the various components of total cost for a product and shows previous data for comparison. You can deduce the ideal selling price of a product based on the cost sheet.

A cost sheet document can be prepared either by using historical cost or by referring to estimated costs. A historical cost sheet is prepared based on the actual cost incurred for a product. An estimated cost sheet, on the other hand, is prepared based on estimated cost just before the production begins.

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Cost sheets help with a number of essential business processes:

1. **Determining cost:** The main objective of the cost sheet is to obtain an accurate product cost. It gives you both the total cost and cost per unit of a product.

2. **Fixing selling price:** In order to fix the selling price of a product, you need to create a cost sheet so you can see the details of its production cost.

3. **Cost comparison:** It helps the management compare the current cost of a product with a previous per unit cost for the same product. Comparing the costs helps management take corrective measures if costs have increased.

4. **Cost control:** The cost sheet is an important document for a manufacturing unit, as it helps in controlling production costs. Using an estimated cost sheet aids in monitoring labour, material and overhead costs at each step of production.

Importance of cost sheet

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4. **Cost control:** The cost sheet is an important document for a manufacturing unit, as it helps in controlling production costs. Using an estimated cost sheet aids in monitoring labour, material and overhead costs at each step of production.

5. **Decision-making:** Some of the most important decisions management makes are based on the cost sheet. Whenever a business needs to produce or buy a component, or quote prices for its goods on a tender, managers refer to the cost sheet.

Types of cost

Costs are broadly classified into four types: fixed cost, variable cost, direct cost, and indirect cost.

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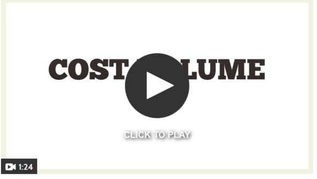
Cost-Volume-Profit – CVP Analysis Definition

By WILL KENTON | Reviewed By JANET BERRY-JOHNSON | Updated Jan 31, 2020

What Is Cost-Volume-Profit – CVP Analysis?

Cost-volume-profit (CVP) analysis is a method of cost accounting that looks at the impact that varying levels of costs and volume have on operating profit. The cost-volume-profit analysis, also commonly known as break-even analysis, looks to determine the break-even point for different sales volumes and cost structures, which can be useful for managers making short-term economic decisions.

The cost-volume-profit analysis makes several assumptions, including that the sales price, fixed costs, and variable cost per unit are constant. Running this analysis involves using several equations for price, cost and other variables, then plotting them out on an economic graph.



Cost-Volume Profit Analysis

Cost-Volume-Profit Analysis Formula Is

The CVP formula can be used to calculate the sales volume needed to cover costs and break even, in the CVP breakeven sales volume formula, as follows:

$$\text{Breakeven Sales Volume} = \frac{FC}{CM}$$

where:

$FC = \text{Fixed costs}$

$CM = \text{Contribution margin} = \text{Sales} - \text{Variable Costs}$

To use the above formula to find a company's target sales volume, simply add a target profit amount per unit to the fixed-cost component of the formula. This allows you to solve for the target volume based on the assumptions used in the model.

What Does Cost-Volume-Profit Analysis Tell You?

The contribution margin is used in the determination of the break-even point of sales. By dividing the total fixed costs by the contribution margin ratio, the break-even point of sales in terms of total dollars may be calculated. For example, a company with $100,000 of fixed costs and a contribution margin of 40% must earn revenue of $250,000 to break even.

Profit may be added to the fixed costs to perform CVP analysis on a desired outcome. For example, if the previous company desired an accounting profit of $50,000, the total sales revenue is found by dividing $150,000 (the sum of fixed costs and desired profit) by the contribution margin of 40%. This example yields a required sales revenue of $375,000.

CVP analysis is only reliable if costs are fixed within a specified production level. All units produced are assumed to be sold, and all fixed costs must be stable in a CVP analysis. Another assumption is all changes in expenses occur because of changes in activity level. Semi-variable expenses must be split between expense classifications using the high-low method, scatter plot or statistical regression.

KEY TAKEAWAYS

- Cost-volume-price analysis is a way to find out how changes in variable and fixed costs affect a firm's profit.
- Companies can use the formula result to see how many units they need to sell to break even (cover all costs) or reach a certain minimum profit margin.

Contribution Margin and Contribution Margin Ratio

CVP analysis also manages product contribution margin. Contribution margin is the difference between total sales and total variable costs. For a business to be profitable, the contribution margin must exceed total fixed costs. The contribution margin may also be calculated per unit. The unit contribution margin is simply the remainder after the unit variable cost is subtracted from the unit sales price. The contribution margin ratio is determined by dividing the contribution margin by total sales.

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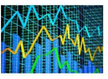

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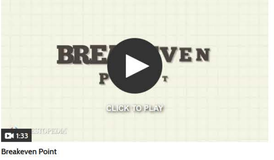
Breakeven Point (BEP)

By CORY MITCHELL | Reviewed By GORDON SCOTT | Updated Aug 22, 2020

What is the Breakeven Point (BEP)?

In accounting, the break-even point formula is determined by dividing the total fixed costs associated with production by the revenue per individual unit minus the variable costs per unit. In this case, fixed costs refer to those which do not change depending upon the number of units sold. Put differently, the breakeven point is the production level at which total revenues for a product equal total expenses.

The term is also used in investing. The breakeven point formula for a stock or futures trade is determined by comparing the market price of an asset to the original cost; the break even point is when the two prices are equal. For options trading, the breakeven point is the market price that an underlying asset must reach for an option buyer to avoid a loss if they exercise the option. For a call buyer, the breakeven point is when the underlying is equal to the strike price plus the premium paid, while the BEP for a put position is when the underlying is equal to the strike price minus the premium paid. The breakeven point doesn't typically factor in commission costs, although these fees could be included if desired.



Breakeven Point

Understanding Breakeven Point (BEP)

Traders have a BEP on trades, and businesses also have breakeven points. A company's breakeven is calculated by taking fixed costs and dividing it by the gross profit margin percentage.

$$\text{Business Breakeven} = \frac{\text{Fixed Costs}}{\text{Gross Profit Margin}}$$

The breakeven formula provides a dollar figure they need to breakeven. This can be converted into units by calculating the contribution margin (unit sale price less variable costs). Dividing the fixed costs by the contribution margin will provide how many units are needed to breakeven.

Stock Market Breakeven Point (BEP) Example

Assume an investor buys Microsoft stock at $110. That is now their breakeven point on the trade. If the price moves above $110, the investor is making money. If the stock drops below $110, they are losing money. If the price stays right at $110, they are at the BEP, because they are not making or losing anything.

Call Option Breakeven Point Example

Assume that an investor pays a $5 premium for an Apple stock call option with a $170 strike price. That means the investor has the right to buy 100 shares of Apple at $170 per share at any time before the options expires. The breakeven point for the call option is the $170 strike price plus the $5 call premium, or $175. If the stock is trading below this, the benefit of the option has not exceeded its cost.

If the stock is trading at $190 per share, the call owner buys Apple at $170 and sells the securities at the $190 market price. The profit is $190 less the $175 breakeven price, or $15 per share.

KEY TAKEAWAYS

- In accounting, the breakeven point is calculated by dividing the fixed costs of production by the price per unit minus the variable costs of production.
- The breakeven point is the level of production at which the costs of production equal the revenues for a product.
- In investing, the breakeven point is said to be achieved when the market price of an asset is the same as its original cost.

Put Option Breakeven Point Example

Assume an investor pays a $4 premium for a Facebook put option with a $180 strike price. That allows the put buyer to sell 100 shares of Facebook stock at $180 per share until the option's expiration date. The put position's breakeven price is $180 minus the $4 premium, or $176. If the stock is trading above that price, the benefit of the option has not exceeded its cost.

If the stock is trading at a market price of $170, for example, the trader has a profit of $6 (breakeven of $176 minus the current market price of $170).

Business Breakeven Point (BEP) Example

The information required to calculate a business's BEP can be found on their financial statements.

The first pieces of information required are the fixed costs and the gross margin percentage.

Assume a company has $1 million in fixed costs and a gross margin of 37%.

Their breakeven point is $2.7 million ($1 million / 0.37). In this break even point example, the company must generate $2.7 million in revenue to cover their fixed and variable costs. If they generate more sales, the company will have a profit. If they generate fewer sales, they will have a loss.

It is also possible to calculate how many units need to be sold to cover the fixed costs, which will result in the company breaking even.

To do this, calculate the contribution margin, which is the sale price of the product less variable costs.

Assume a company has a $50 sale price for their product and variable costs of $10. The contribution margin is $40 ($50 - $10).

Divide the fixed costs by the contribution margin to determine how many units the company has to sell: $1 million / $40 = 25,000 units. If the company sells more units than this they will have profit. If they sell less, they will have a loss.

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By INVESTOPEDIA STAFF | Updated Sep 22, 2020

What Is the Contribution Margin?

The contribution margin can be stated on a gross or per-unit basis. It represents the incremental money generated for each product/unit sold after deducting the variable portion of the firm's costs.

The contribution margin is computed as the selling price per unit, minus the variable cost per unit. Also known as dollar contribution per unit, the measure indicates how a particular product contributes to the overall profit of the company. It provides one way to show the profit potential of a particular product offered by a company and shows the portion of sales that helps to cover the company's fixed costs. Any remaining revenue left after covering fixed costs is the profit generated.

The Formula for Contribution Margin Is

The contribution margin is computed as the difference between the sale price of a product and the variable costs associated with its production and sales process.

$$\text{Contribution Margin} = \text{Sales Revenue} - \text{Variable Costs}$$

The above formula is also used as a ratio, to arrive at an answer in percentage terms, as follows:

$$\text{Contribution Margin Ratio} = \frac{\text{Sales Revenue} - \text{Variable Costs}}{\text{Sales Revenue}}$$

What Does the Contribution Margin Tell You?

The contribution margin is the foundation for break-even analysis used in the overall cost and sales price planning for products. The contribution margin

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$$\text{Contribution Margin Ratio} = \frac{\text{Sales Revenue} - \text{Variable Costs}}{\text{Sales Revenue}}$$

What Does the Contribution Margin Tell You?

The contribution margin is the foundation for break-even analysis used in the overall cost and sales price planning for products. The contribution margin helps to separate out the fixed cost and profit components coming from product sales and can be used to determine the selling price range of a product, the profit levels that can be expected from the sales, and structure sales commissions paid to sales team members, distributors or commission agents.

Fixed Cost Versus Variable Cost

One-time costs for items such as machinery are a typical example of a fixed cost, that stays the same regardless of the number of units sold, although it becomes a smaller percentage of each unit's cost as the number of units sold increases. Other examples include services and utilities that may come at a fixed cost and do not have an impact on the number of units produced or sold. For example, if the government offers unlimited electricity at a fixed monthly cost of $100, then manufacturing ten units or 10,000 units will have the same fixed cost towards electricity.

Another example of fixed cost is a website hosting provider that offers unlimited hosting space to its clients at a fixed cost. Whether the client puts one or ten websites, and whether the client uses 100 MB or 2 GB of hosting space, the hosting cost remains the same. In these kinds of scenarios, electricity and web-hosting cost(s) will not be considered in the contribution margin formula as it represents a fixed cost. Fixed monthly rents or salaries paid to administrative staff also fall in the fixed cost category.

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Top 10 Managerial Uses of Break-Even Analysis

Article Based by Mrunal S

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The following points highlight the top ten managerial uses of break-even analysis, the managerial uses are: 1. Safety Margin 2. Target Profit 3. Change in Price 4. Change in Costs 5. Decision on Choice of Technique of Production 6. Make or Buy Decision 7. Plant Expansion Decisions 8. Plant Shut Down Decisions 9. Advertising and Promotion Mix Decisions 10. Decision Regarding Addition or Deletion of Product Line.

Use # 1. Safety Margin:

The break-even chart helps the management to know at a glance the profits generated at the various levels of sales. The safety margin refers to the extent to which the firm can afford a decline before it starts incurring losses.

The formula to determine the sales safety margin is:

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Safety Margin = (Sales – BEP)/Sales x 100

From the numerical example at the level of570 units of output and sales, the firm is earning profit, the safety margin can be found out by applying the formula

Safety Margin = 570 – 150/570 x 100 = 40%

This means that the firm which is now selling 570 units of the product can afford to decline sales upto 40 per cent. The margin of safety may be negative as well, if the firm is incurring any loss. In that case, the percentage tells the extent of sales that should be increased in order to reach the point where there will be no loss.

Use # 2. Target Profit:

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The break-even analysis can be utilised for the purpose of calculating the volume of sales necessary to achieve a target profit.

When a firm has some target profit, this analysis will help in finding out the extent of increase in sales by using the following formula:

Target Sales Volume = Fixed Cost + Target Profit/Contribution Margin Per Unit.

By way of illustration, we can take Table 1 given above. Suppose the firm fixes the profit as Rs. 100, then the volume of output and sales should be 570 units. Only at this level, it gets a profit of Rs. 100. By using the formula, the same result will be obtained.

Use # 3. Change in Price:

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The management is often faced with a problem of whether to reduce the selling price or raise the selling price in order to maintain or enhance profits or not. Before taking a decision on this question, the management will have to consider a profit. A reduction in price leads to a reduction in the contribution margin.

This means that the volume of sales will have to be increased even to maintain the previous level of profit. The higher the reduction in the contribution margin, the higher is the increase in sales needed to ensure the previous profit.

The formula for determining the new volume of sales to maintain the same profit, given a reduction in price, will be

New Sales Volume = Total Fixed Cost + Total Profit/New Selling Price – Average Variable Cost

For example, suppose a firm has a fixed cost of Rs. 8,000 and the profit target is Rs.20,000. If the sales price is Rs.8 and the average variable cost is Rs. 4, then the total volume of sales should be 7,000 units on the basis of the formula given under target price.

Suppose the firm decides to reduce the selling price from Rs.8 to Rs. 7, then the new sales volume should be on the basis of the above formula:

New Sales Volume = 8,000 + 20,000/7-4

= Rs. 6,330

From this, we can infer that by reducing the price from Rs. 8 to Rs. 7, the firm has to increase the sales from Rs. 7,000 to Rs 9,330 if it wants to maintain the target profit of Rs. 20,000. In the same way, the sales [illegible] the executive can calculate the new volume of sales if it increases the price.

Use # 4. Change in Costs:

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When costs undergo change, the selling price and the quantity produced and sold also undergo changes.

Changes in cost can be in two ways:

(i) Change in variable cost, and

(ii) Change in fixed cost.

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(i) Variable Cost Change:

An increase in variable costs leads to a reduction in the contribution margin. This reduction in the contribution margin will shift the break-even point downward. Conversely, with the fall in the proportion of variable costs, contribution margins increase and break-even point moves upwards.

Under conditions of changing variable costs, the formula to determine the new quantity or the new selling price are:

(a) New Quantity or Sales Volume = Contribution to Margin/Present Selling Price – New Variable Cost Per Unit

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(b) New Selling Price = Present Sale Price + New Variable Cost- Present Variable Cost
Present Variable Cost

Example:

The contribution margin is Rs. 64,000, the present sale price is Rs.10 and the present variable cost is Rs.6. If the variable cost per unit goes up from Rs.6 to Rs. 7, what will be the new sales volume and price?

New Sales Volume = 64,000 /10-7 = 64,000 /3 = 21,300 units

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New Sales Price = (10-7=6) = Rs.11.

(ii) Fixed Cost Change:

An increase in fixed cost of a firm may be caused either due to a tax on assets or due to an increase in remuneration of management, etc. It will increase the contribution margin and thus push the break-even point upwards. Again to maintain the earlier level of profits, a new level of sales volume or new price has to be found out.

New Sales Volume = Present Sale Volume + (New Fixed Cost + Present Fixed Costs)/(Present Selling Price-Present Variable Cost)

New Sale Price = Present Sale Price + (New Fixed Costs – Present Fixed Costs)/Present Sale Volume

Example:

The fixed cost of a firm increases from Rs. 5,000 to Rs. 6,000. The variable cost is Rs. 5 and the sale price is Rs. 10 and the firm sells 1,000 units of the product

New Sales Volume = 1,000 + 6,000 – 5,000/10-5 = 1,000+1,000/5 = 1,000+200 = 1,200 units

New Sale Price =10 + 6,000-5,000/1,000 = 10 + 1,000/1,000 = Rs 10 + Re 1

= Rs. 11

Use # 5. Decision on Choice of Technique of Production:

A firm has to decide about the most economical production process both at the planning and expansion stages. There are many techniques available to produce a product. These techniques will differ in terms of capacity and costs.

The breakeven analysis is the most simple and helpful in the case of decision on a choice of technique of production. For example, for low levels of output, some conventional methods may be most profitable as they require minimum fixed cost.

For high levels of output, only automatic machines may be most profitable. By showing the cost of different alternative techniques at different levels of output, the break-even analysis helps the decision of the choice among these techniques.

Use # 6. Make or Buy Decision:

Firms often have the option of making certain components or for purchasing them from outside the concern. Break-even analysis can enable the firm to decide whether to make or buy.

Example:

A manufacturer of car buys a certain components at Rs. 20 each. In case he makes it himself, his fixed and variable cost would be Rs. 24,000 and Rs.8 per component respectively.

BEP = Fixed Cost/Purchase Price – Variable Cost

=24,000/20-8 = 24,000/12 = 2,000 units

From this, we can infer that the manufacturer can produce the parts himself if he needs more than 2,000 units per year.

However, certain considerations need to be taken account of in a buying decision, such as:

(i) Is the required quality of the product available?

(ii) Is it supply from the market certain and timely?

(iii) Do the supplies of the components try to take any monopoly advantage?

Use # 7. Plant Expansion Decisions:

The break-even analysis may be adopted to reveal the effect of an actual or proposed change in operation condition. This may be illustrated by showing the impact of a proposed plant on expansion on costs, volume and profits. Through the break-even analysis, it would be possible to examine the various implications of this proposal.

Example:

A company has the capacity to produce goods worth of Rs. 40 crores a year. Its fixed costs are Rs.10 crores and variable Rs. 20 crores a year. For this, it has incurred a fixed cost of Rs. 20 crores, the variable costs being 60% of the sales revenue.

Now the company is planning to incur an additional Rs. 6 crores in fixed costs to expand its production capacity from Rs. 40 crores to Rs.60 crores. The survey shows that the firm's sales can be increased from Rs. 40 crores to Rs. 50 crores. Should the firm go in for expansion?

BEP at present capacity = Fixed Cost/Margin Contribution %

= Rs. 10 crores/40% = Rs. 25 Crores

BEP at the proposed capacity = Rs. 16 crores/40% = Rs. 40 Crores

Increase in break-even point = Rs.40 crores-Rs. 25 crores

= Rs. 15 crores.

Thus we can infer that the firm should go in for expansion only if its sales expand by more than Rs. 15 crores from its earlier level of Rs. 40 crores.

Use # 8. Plant Shut Down Decisions:

In the shut-downs decisions, a distinction should be made between out of pocket and sunk costs. Out of pocket costs include all the variable costs plus the fixed cost which do not vary with output. Sunk fixed costs are the expenditures previously made but from which benefits still remain to be obtained e.g., depreciation.

Use # 9. Advertising and Promotion Mix Decisions:

The main objective of advertisement is to stimulate or increase sales to all customers—former, present and future. If there is keen competition, the firm has to undertake vigorous campaign of advertisement. The management has to examine these marketing activities that stimulate consumer purchasing and dealer effectiveness.

The break-even point concept helps the management to know about the circumstances. It enables him not only to take appropriate decision but by showing how these additional fixed cost would influence BEP. The advertisement cost pushes up the total cost curve by the amount of advertisement expenditure.

Use # 10. Decision Regarding Addition or Deletion of Product Line:

If a product has outlived its utility in the market immediately, the production must be abandoned by the management and examined what would be its consequent effect on revenue and cost. Alternatively, the management may like to add a product to its existing product line because it expects the product as a potential profit spinner. The break-even analysis helps in such a decision.

Example:

A fan manufacturer possesses the following data regarding his firm:

Total Fixed Cost = Rs. 1,50,000

Volume of Sales = 5,00,000 units

The manufacturer is considering whether or not to drop heaters from its product line and replace it with a fancy kind of fan.

He knows that if he takes the decision of dropping heaters and replaces it with fancy fans his output and cost data would be:

To find out the impact of proposed change, we need to compare profits in the two situations. Firstly, we have to find out the contribution ratio of each product.

Thus the contribution ratio of the entire product line = 0.167 + 0.08 + 0.141 = 0.388.

Total Contribution = Rs. 5,00,000 x 0.388 = Rs. 1,94,000

Profit = Rs. 1,94,000 – Rs.1,50,000 = Rs 44,000

From the above analysis, we can infer that the manufacturer should drop heaters from his product line and add fancy fans to his product line so as to earn more profit.

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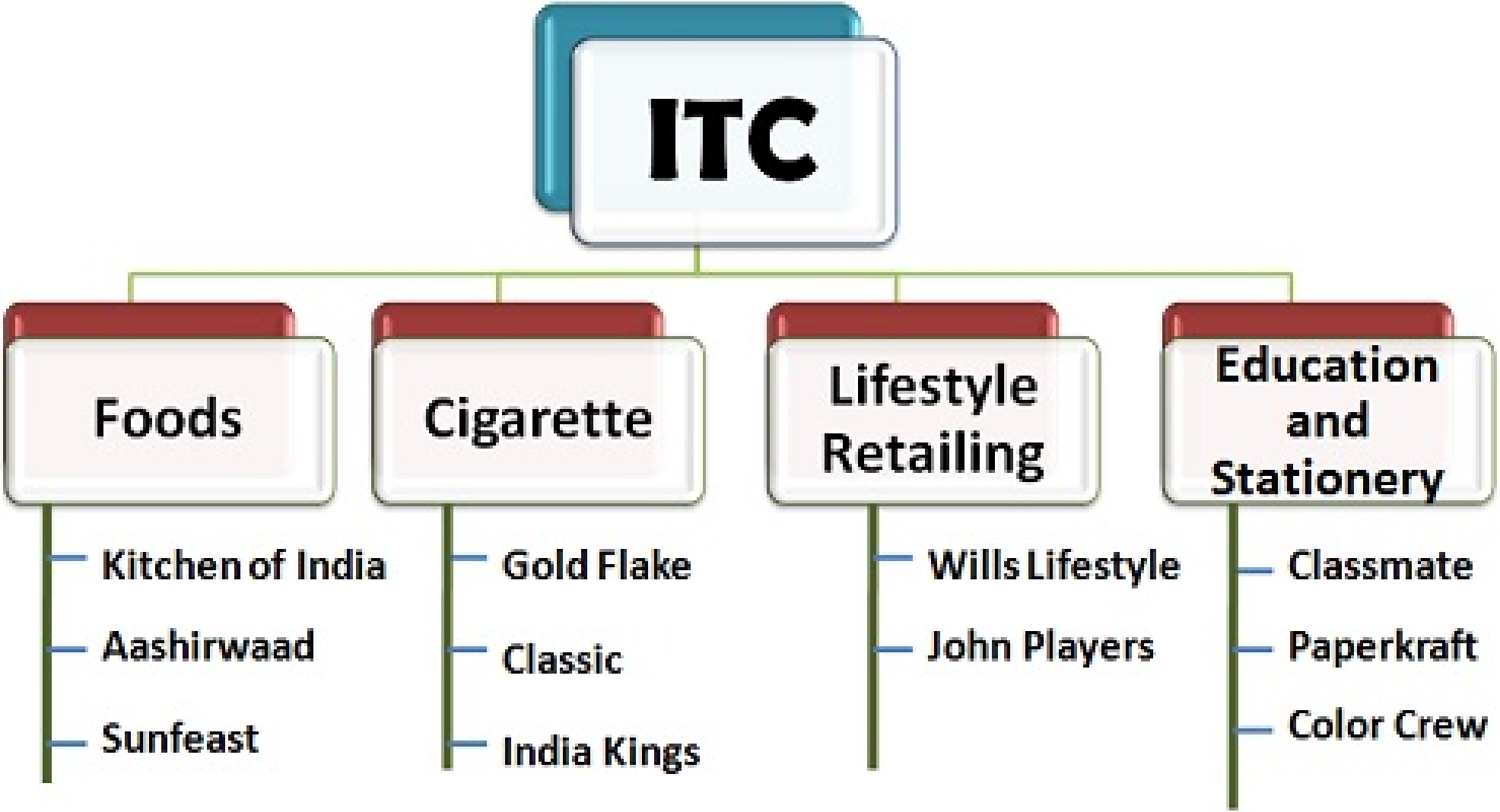
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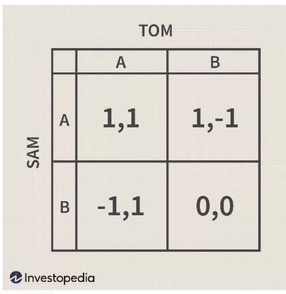
Nash Equilibrium

By JAMES CHEN | Reviewed By GORDON SCOTT | Updated Feb 3, 2020

What Is the Nash Equilibrium?

Nash equilibrium is a concept within game theory where the optimal outcome of a game is where there is no incentive to deviate from their initial strategy. More specifically, the Nash equilibrium is a concept of game theory where the optimal outcome of a game is one where no player has an incentive to deviate from his chosen strategy after considering an opponent's choice.

Overall, an individual can receive no incremental benefit from changing actions, assuming other players remain constant in their strategies. A game may have multiple Nash equilibria or none at all.



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The Nash Equilibrium

Understanding the Nash Equilibrium

Nash equilibrium is named after its inventor, John Nash, an American mathematician. It is considered one of the most important concepts of game theory, which attempts to determine mathematically and logically the actions that participants of a game should take to secure the best outcomes for themselves. The reason why Nash equilibrium is considered such an important concept of game theory relates to its applicability. The Nash equilibrium can be incorporated into a wide range of disciplines, from economics to the social sciences.

KEY TAKEAWAYS

- The Nash Equilibrium is a decision-making theorem within game theory that states a player can achieve the desired outcome by not deviating from their initial strategy.
- In the Nash equilibrium, each player's strategy is optimal when considering the decisions of other players. Every player wins because everyone gets the outcome they desire.
- The prisoners' dilemma is a common game theory example and one that adequately showcases the effect of the Nash Equilibrium.

To quickly find the Nash equilibrium or see if it even exists, reveal each player's strategy to the other players. If no one changes his strategy, then the Nash equilibrium is proven.

Real-World Example of the Nash Equilibrium

Imagine a game between Tom and Sam. In this simple game, both players can choose strategy A, to receive $1, or strategy B, to lose $1. Logically, both players choose strategy A and receive a payoff of $1. If you revealed Sam's strategy to Tom and vice versa, you see that no player deviates from the original choice. Knowing the other player's move means little and doesn't change either player's behavior. The outcome A represents a Nash equilibrium.

Special Consideration: The Prisoner's Dilemma

The prisoner's dilemma is a common situation analyzed in game theory that can employ the Nash equilibrium. In this game, two criminals are arrested and each is held in solitary confinement with no means of communicating with the other. The prosecutors do not have the evidence to convict the pair, so they offer each prisoner the opportunity to either betray the other by testifying that the other committed the crime or cooperate by remaining silent.

If both prisoners betray each other, each serves five years in prison. If A betrays B but B remains silent, prisoner A is set free and prisoner B serves 10 years in prison or vice versa. If each remains silent, then each serves just one year in prison. The Nash equilibrium in this example is for both players to betray each other. Even though mutual cooperation leads to a better outcome if one prisoner chooses mutual cooperation and the other does not, one prisoner's outcome is worse.

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How Game Theory Works
Game theory is a framework for modeling scenarios in which conflicts of interest exist among the players. more

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Zero-Sum Game
A situation in which one person's gain is equivalent to another's loss, so that the net change in wealth or benefit is zero. A zero-sum game may have as few as two players, or millions of participants. more

Traveler's Dilemma Definition
The traveler's dilemma demonstrates the paradox of rationality—that making decisions illogically often produces a better payoff in game theory. more

Robert J. Aumann Definition
Robert J Aumann is a mathematician and economist famous for his work on game theory, who won the 2005 Nobel Prize in Economics. more

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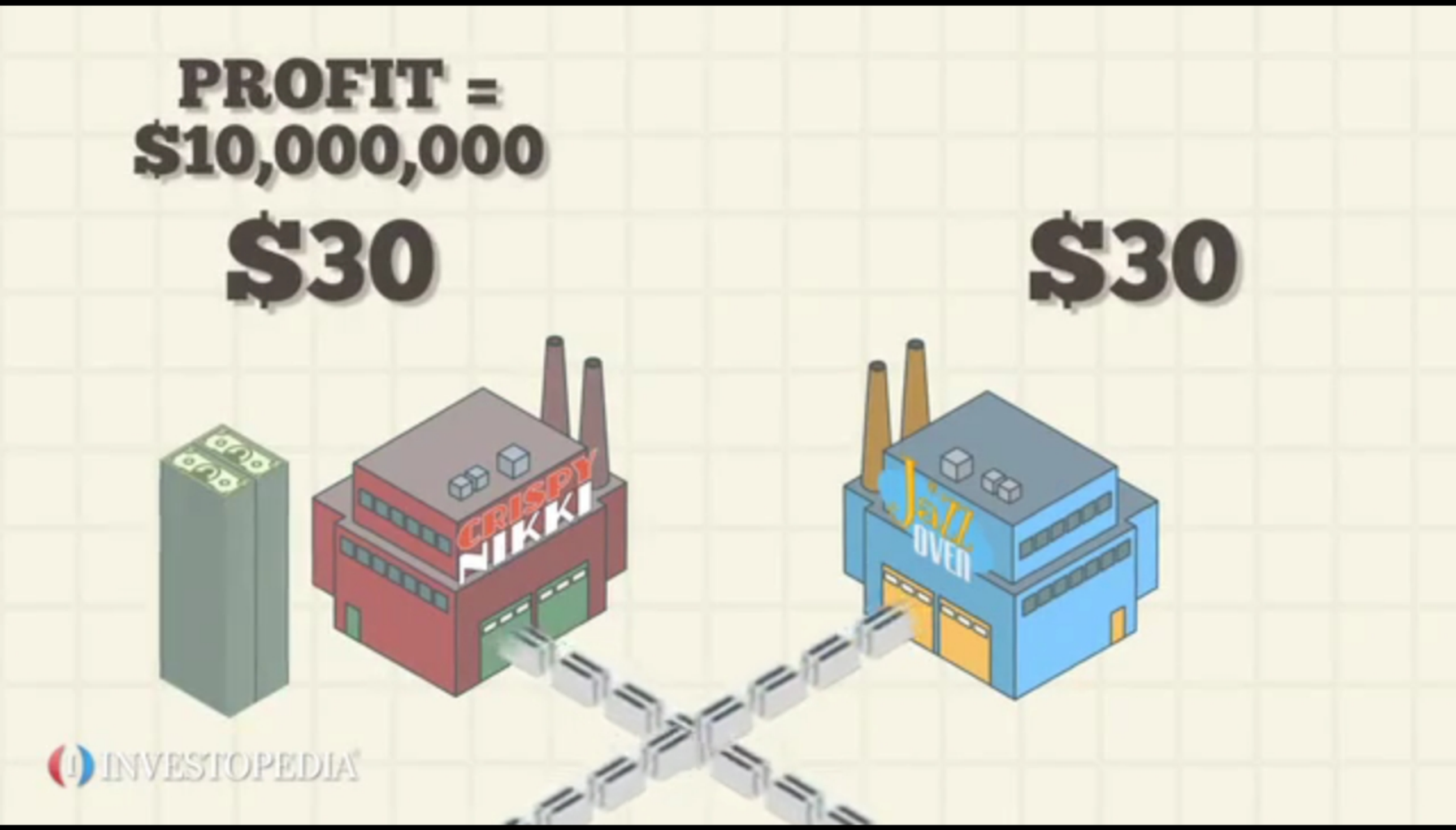

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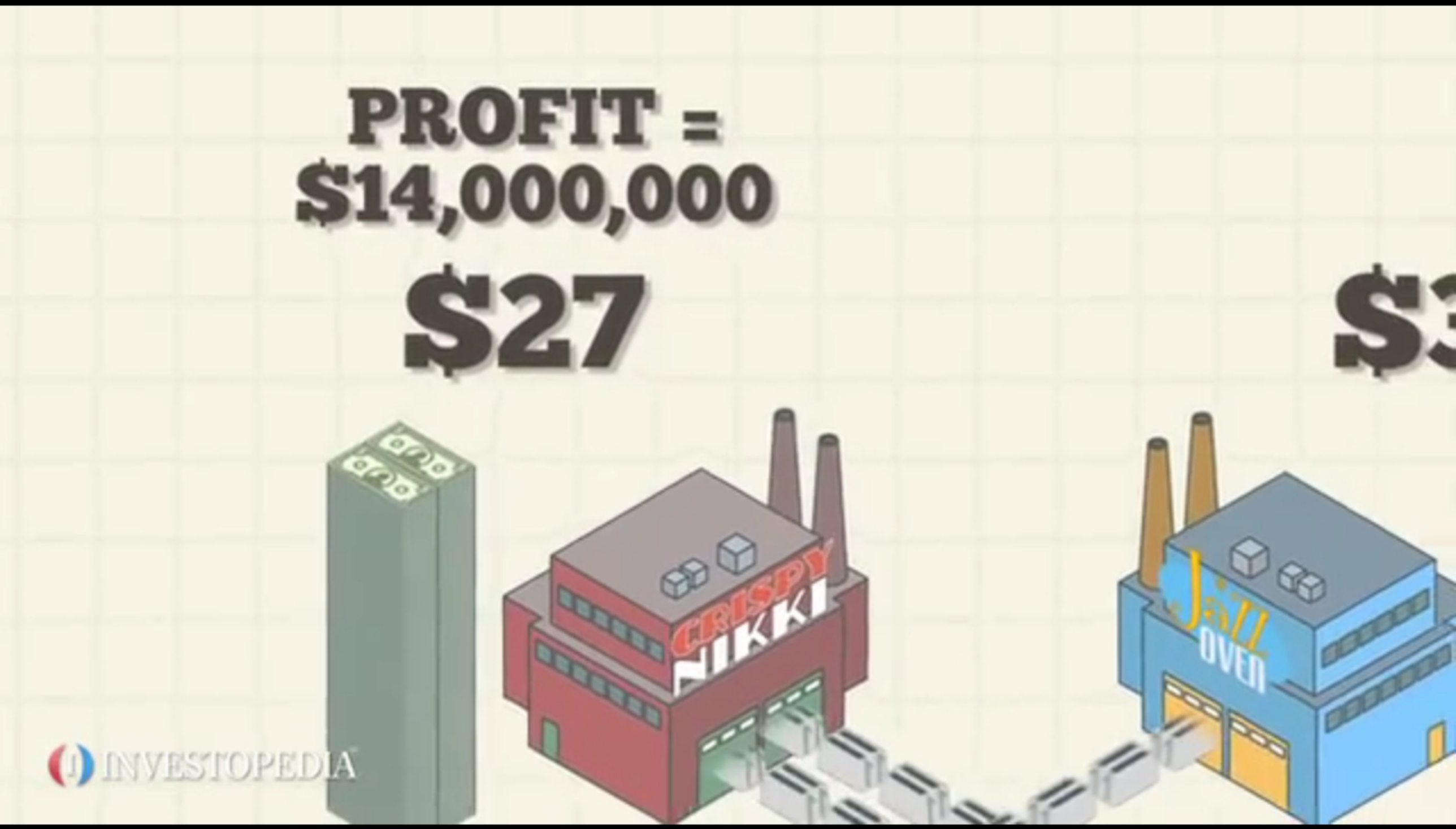

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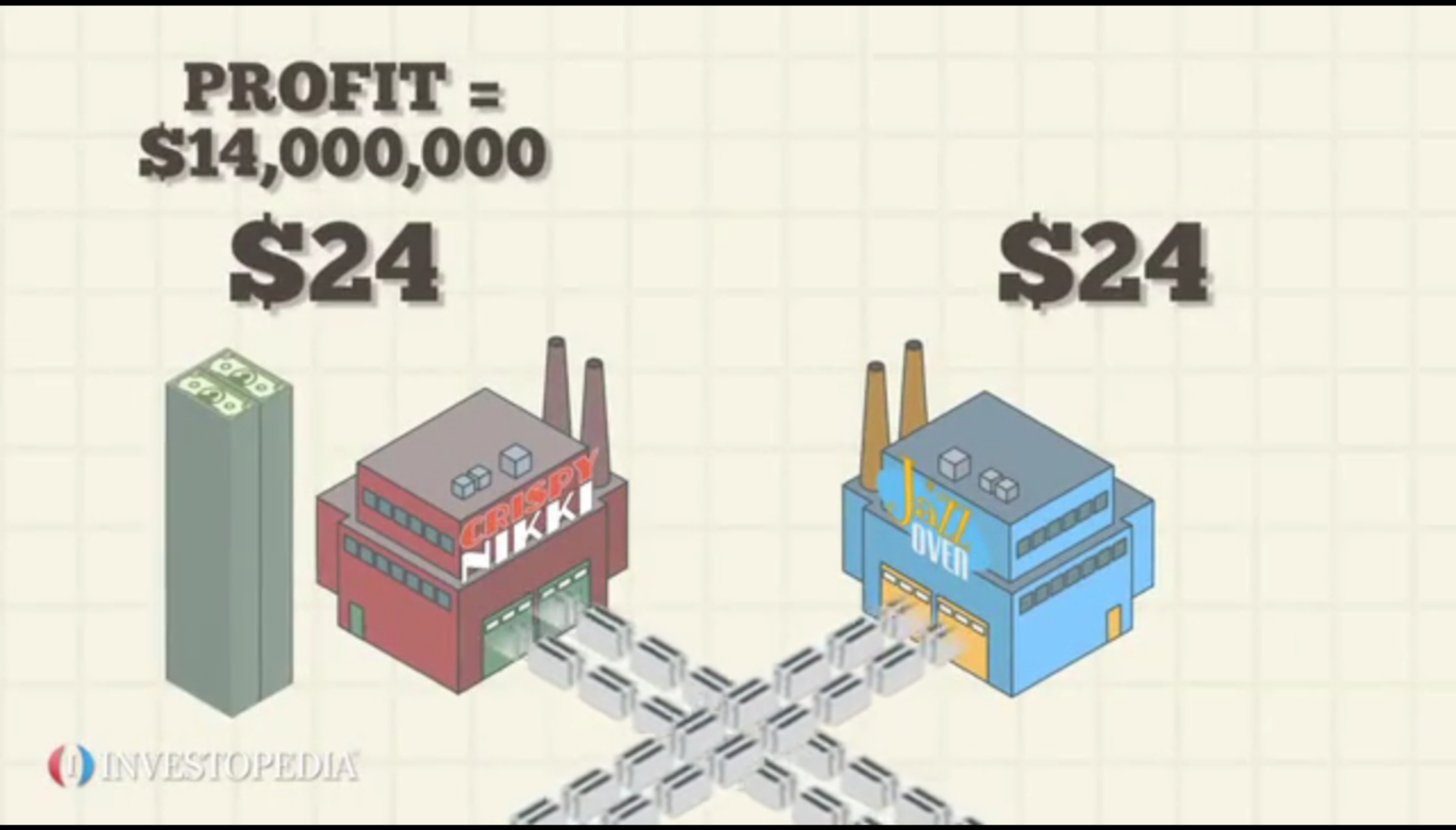

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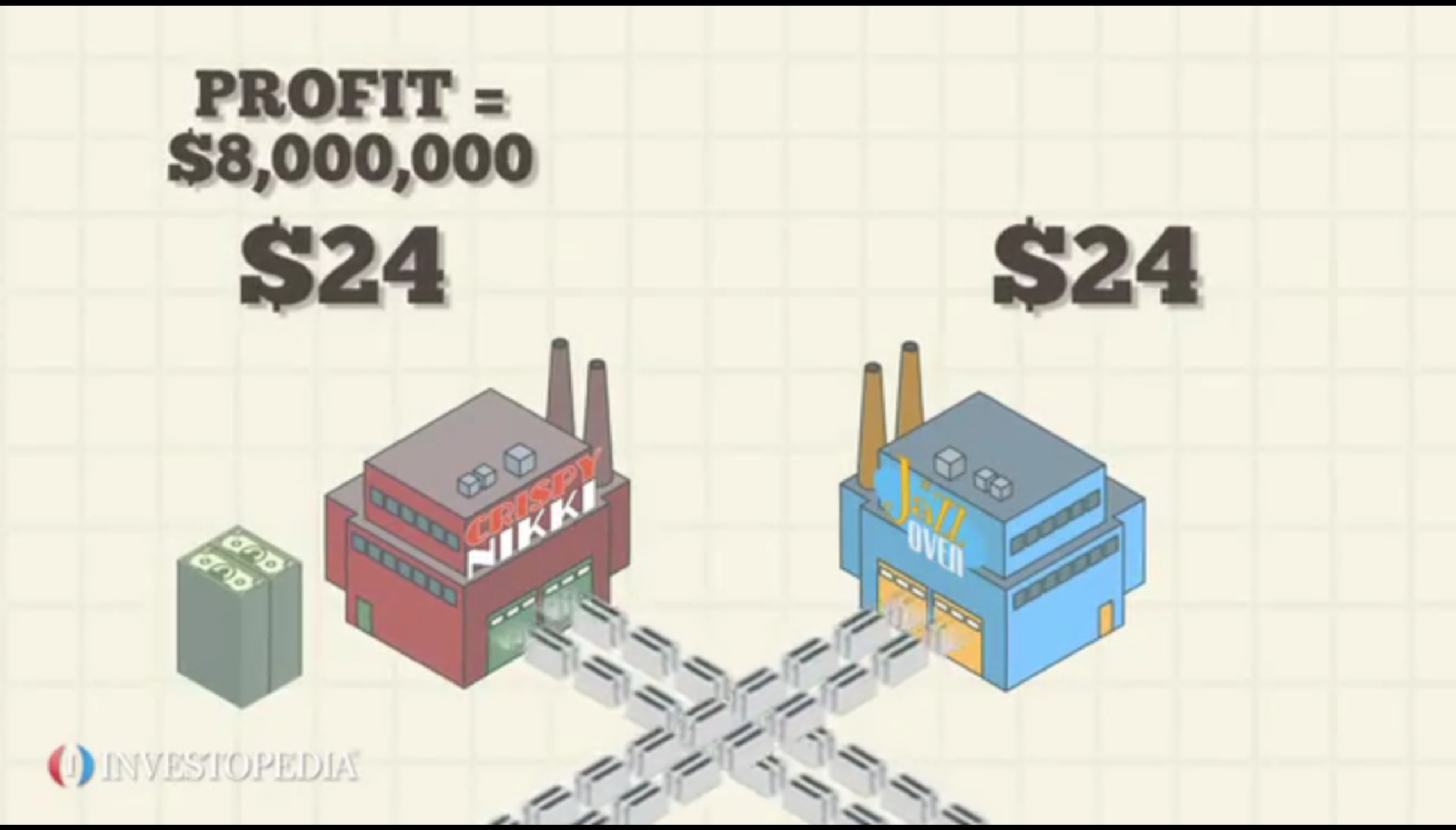
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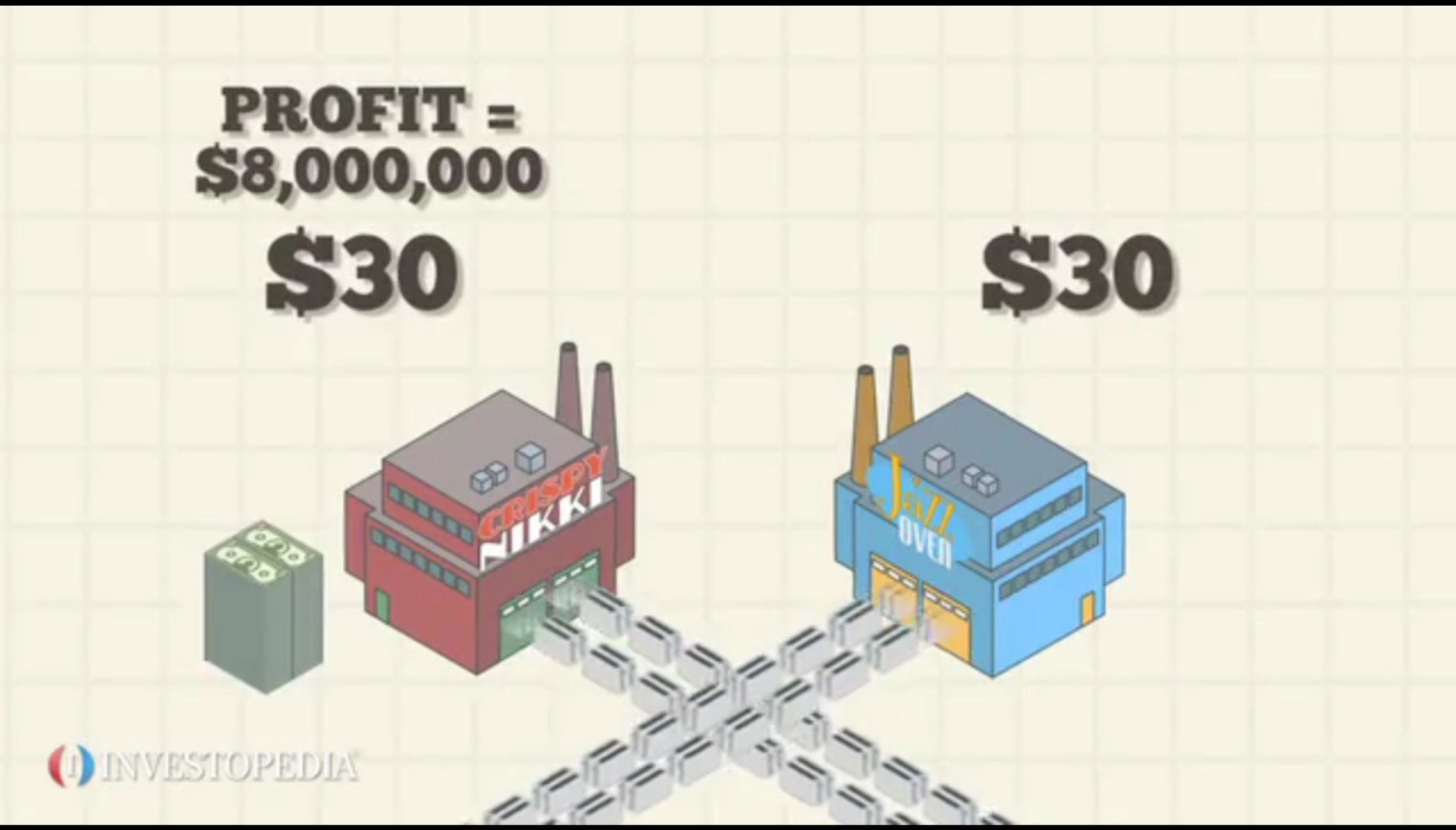

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Retained Earnings

By WILL KENTON | Reviewed By JANET BERRY-JOHNSON | Updated Feb 6, 2020

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What Is Retained Earnings?

Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders. A business generates earnings that can be positive (profits) or negative (losses).

Positive profits give a lot of room to the business owner(s) or the company management to utilize the surplus money earned. Often this profit is paid out to shareholders, but it can also be re-invested back into the company for growth purposes. The money not paid to shareholders counts as retained earnings.

15-164
Revised March 27, 2018

Hertz Global Holdings, Inc.

Christopher Noe, Lauren Pully, and Cate Reavis

In the June 7-8, 2014 weekend edition of *The Wall Street Journal*, an article entitled "Accounting Errors Hit Hertz Hard" caught auto industry analyst Abby Devins's attention. Devins recalled that Hertz had hinted in March about the possibility of having to restate its 2011 financial statements, but by June the situation appeared worse than previously anticipated. "Hertz Global Holdings, Inc.," read the article, "would have to restate and correct results from the past three years, according to a regulatory filing Friday that indicated more widespread accounting problems at the auto-rental company than had been thought."[1] The article also mentioned that Hertz's stock had closed down about 9% in Friday's trading.

Keenly aware that car rental companies like Hertz provided a significant source of steady demand for automotive manufacturers, Devins was curious whether Hertz's accounting issues could be related in some way to its large rental fleet and what impact this might have on the company's future vehicle acquisition plans.

Car Rental Industry

As of 2013, the U.S. car rental industry totaled approximately $36 billion in revenue, which was divided between leisure travelers, business travelers, and leasing, with rentals taking place both at airport and off-airport locations (**Exhibit 1**). Since the majority of car rental demand came from leisure and business travel, the industry suffered during the 2008-09 recession, with revenue growth plummeting into negative territory (**Exhibit 2**). Revenue growth resumed, however, as the subsequent economic recovery began to take hold.

[1] Michael Calia, "Accounting Errors Hit Hertz Hard," *The Wall Street Journal*, June 7-8, 2014.

This case was prepared by Senior Lecturer Christopher Noe, Lauren Pully, MBA 2015, and Cate Reavis, Associate Director, Curriculum Development.

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