

A-201: financial accounting study guide flashcard



**ASSIGN
BUSTER**

Chapter 1 Financial Accounting A system through which managers report financial information about an economic entity to a variety of individuals who use this information for various decision making purposes. The process of identifying, recording, summarizing, and reporting economic information to decision makers. Managers of Companies Must Understand 2 Things: 1) Economic Consequence Perspective: Considering and understanding how such events affect the financial statements. 2) User Orientation:

Managers must also know how to read, evaluate, and analyze financial statements. The Annual Report: 1) The Auditor's Report - A short letter written by the auditor that describes the activities of the audit and comments on the financial position and operations of the company. Contains 3 things: 1) States that the statements were prepared in conformity with GAAP. 2) Presents fairly the company's financial condition and operations. 3) Confirms that the statements resulted from an effective internal control system.) The Management Letter - Normally states that the management is responsible for the preparation and integrity of the financial statements. Most contain references to GAAP, ethical and social responsibilities, the quality and reliability of the company's internal control system, the independent audit, and the audit committee of the board of directors. The 4 Financial Statements Generally only interested in the company's future prospects because the future is what interests you the most. The past of often a poor indicator of the future. The Footnotes

Descriptions and schedules that further explain the numbers on the financial statements. These are audited by an independent auditor and are considered part of the financial statements. The Financial Statements 1) The

Balance Sheet Indicates the financial condition of a business as of a given point of time. The Basic Accounting Equation: $\text{Assets} = \text{Liabilities} + \text{Stockholder Equity}$

1) Assets - Represent items that will bring future economic benefit to the company. Current Assets: Cash, Marketable Securities, Accounts Receivable, Inventory, Pre-Paid Expenses.

Non-Current Assets: Long-Term Notes Receivable, Long-Term Investments, Property/Plant/Equipment NET of Depreciation, Intangibles (i. e. goodwill). 2)

Liabilities - A probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Current Liabilities: Accounts Payable, Accrued Expenses, Unearned Income, Taxes Payable, Current Maturities of Long-Term Debt. Non-Current Liabilities: Long-Term Debt (Bonds Payable).) Shareholder's Equity -

Consists of Contributed Capital & Earned Capital. Contributed Capital: The original investment in the company. Preferred Stock, Common Stock (Contributed Capital), Additional Paid in Capital. Earned Capital/Retained Earnings: Represents funds earned by the company that the shareholders (through the board of directors) have chosen to reinvest in the company, called Retained Earnings. 2) The Income Statement Financial Statement prepared on an accrual basis, indicating the performance of a company during a particular period (usually a quarter or year).

Revenues - Expenses = Net Income 1) Revenues - Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combo of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing

major or central operations. Revenues from sales are recorded when products are shipped. Revenues from services are estimated in proportion to the completion of the service. 2) Expenses - The outflow of assets or the creation of liabilities in an effort to generate revenues for a company.

Ex) COGS, salaries, interest, advertising, taxes, utilities, depreciation. Some involve cash outflow, many do not however: Expenses can also be accrued (e. g. salaries, wages, interest) or the result of cost expirations (e. g. depreciation, amortization). Include Selling & Admin. Expenses and estimates of uncollectible receivables and depreciation on the equipment. 3) Statement of Retained Earnings Explains the changes in the shareholders' equity items (Common Stock and Retained Earnings) from one year to the next. * Beginning Retained Earnings * + Net Income * - Dividends Paid * = Ending Retained Earnings

The amount in the Ending Retained Earnings goes onto the Balance Sheet under " Retained Earnings" and is the Beginning Retained Earnings for the next period. 4) Statement of Cash Flows Summarizes the increase and decrease in CASH over a period of time. * Beginning Cash Balance (should equal the " Cash" account on Bal. Sheet.) * +/- Cash from Operating Activities * +/- Cash from Investing Activities * +/- Cash from Financing Activities * = Ending Cash Balance * Operating Activities: Activities associated w/ acquisition (buy inventory) and sale of company's products and services. Also interest received or paid.

Investing Activities: Involve the management of a company's long-term assets - primarily purchases and sales of fixed assets (esp. land and

equipment) and investments in equity securities. Financing Activities: The cash collections and payments related to the company's capital sources. Involves collection of capital through equity or debt issuances and any related payments such as dividends, debt payments, treasury stock purchases, cash borrowing, loan payments. Cash proceeds from and cash principal payments on short and long term liabilities. Debt Investments vs. Equity Investments: Debt Investment

If one were to loan money to a company, they would be making a debt investment and would become one of the company's creditors: requiring that the company signs a loan contract specifying 1) Maturity Date 2) Annual Interest Rate 3) Collateral 4) Any other debt restrictions you wish to impose. As a creditor, you would be interested in the company's ability to meet interest and principal loan payments, their cash management record, and ability to generate cash over the period of the loan. Creditors Have: 1) Preference for payment 2) Preference in the event of a liquidation and 3) Secured returns in the form of interest.

Equity Investment Rather than loaning money to a company, one may purchase equity in the company and become one of the owners, also known as Shareholders. Returns are primarily in the form of stock appreciation and dividends (which is at the discretion of the Board of Directors), whereas Creditors are paid under contract. Shareholders elect their Board of Directors annually to represent their interests Consists of at least quarterly meetings to set policies, declare dividends, and review performance and compensation of upper management.

Shareholders are interested in all 4 Financial Statements, but most specifically the income statement b/c dividends are usually declared based on % of income Shareholders have 1) Voting rights and 2) Potential for dividend income and increased share (stock) value. Corporate Governance Mechanisms encouraging management to report in good faith to - and act in the interest of - the shareholders. Extremely necessary b/c management and auditors face conflicting goals, but 3 factors influence managers and auditors to act professionally: 1) Professional Reputation 2) Legal Liability and 3) Ethics (it's the right thing to do. Profit-Seeking Entities Any company, business, or firm that prepares financial statements - They are referred to as a Company and are often divided into segments which provide their own financial statements. Consolidated Financial Statements The total dollar amounts on the Financial Statements consist of multiple companies, all of which are owned by the one company reporting the statements. Ex) The Limited Inc. owns Victoria Secret and more, but are all one statement. Subsidiaries The individual companies that are grouped together on the Consolidated Financial Statements prepare their own Financial Statements. Entities that are not established to make profits (school districts, counties, cities) also prepare financial statements. Industry A classification of a group of companies based on the similarity of their operations, product lines, and/or customers. 3 Basic Categories: 1) Manufacturing Firms - Acquire raw materials and convert them into goods sold either to customers, usually through retailers, or to other manufacturers who used them as raw materials. Ex) General Motors, IBM, PepsiCo. 2) Retail Firms - Purchase

goods from manufacturers and sell them to consumers. Ex) Wal-Mart, Kohl's, Lowe's, Toys R Us, J.

C. Penny. 3) Service Firms - Include both General Service Firms (AT&T, Fed-Ex, H&R Block), Financial Firms (Citicorp, American Express), and Internet Firms (Google). The Standard Industrial Classification (SIC) Index provides specific industry classification on a 1 to 4 digit code - the more digits, the more specific. Contracts: Debt Covenants vs. Management Compensation
Debt Covenants: Included in debt contracts, often requiring management to maintain certain levels of financial performance or position to help ensure that management will be able to make debt repayments when they come due.

Violations can mean the company has to pay back the loan in full.

Management Compensation Contracts: Base management pay on certain net income or stock price goals, which can encourage desirable management decision making. Financial Reporting Regulations and Standards Securities and Exchange Commission (SEC) Created in 1934 by the U. S. Congress to implement and enforce the Securities Act of 1933 and the Securities Exchange Act of 1934. Securities Act of 1933 - Requires any company that raises capital through public equity and debt exchanges (NYSE) to file a registration statement (Form S-1) w/ the SEC.

Securities Exchange Act of 1934 - Stated that companies w/ equity and/or debt securities listed on the public security markets (" listed companies") must: 1) Annually file Form 10-K (audited financial reports) 2) Quarterly file Form 10-Q (unaudited quarterly financial statements) 3) Annually provide

audited financial reports to the shareholders. Annual Reports published by major U. S. companies must include: 1) Audited Balance Sheets for 2 Most Recent years. 2) Audited Statements of Income, Shareholders' Equity, and Cash Flows for the 3 Most Recent years.) Footnotes, Independent Auditor's Letter, Management Letter, Management Discussion & Analysis, Letter to Shareholders from high-up officer, Description of the Business, etc...

Financial Accounting Standards Board (FASB) The professional body currently responsible for establishing financial accounting standards. Established the Generally Accepted Accounting Principles (GAAP), which defines the standards for reporting to shareholders. The Form 10-K must be prepared in conformance with GAAP and auditors attest to whether these standards have been followed in the preparation of the financial statements.

GAAP is increasingly more controversial b/c of how costly the reports can be for companies. Accounting Policymaking Process: Congress, The White House, Govt. agencies, and the Public influence the Policymakers (SEC, FASB) and the result is GAAP which sets the standard for Actual Accounting Practices. These practices, in turn, create costs and benefits to investors, creditors, managers, auditors, and influences the public. Independent Auditors Most large U. S. Companies are audited by one of the " Big 4" Accounting Firms, who provide audit report and/or an opinion on the Financial Statements.

The " Big 4" are: 1) PricewaterhouseCoopers 2) Deloitte & Touche 3) Ernst & Young 4) KPMG. The Standard Audit Report - Typically 3 Paragraphs: 1) Financial Statements & Internal Controls were audited, but responsibility for preparing the reports rests in the hands of the Management. 2) Auditor

conducted the audit in accordance with the standards set forth by the Public Company Auditor Oversight Board (PCAOB). 3) The Conclusion; usually stating that everything is in accordance with GAAP, but this standard audit opinion is not always rendered.

Board of Directors and Audit Committee The Board of Directors: 1) Elected annually by shareholders, oversees management to ensure that it acts in interest of shareholders which involves at least quarterly meetings. Normally comprised of both company officers & nonmanagement reps. has the power to hire and fire the officers and determine form & amount of pay. 2) The Board of Directors appoints a subcommittee of outside directors called the Audit Committee - which works w/ management to choose an auditor, and it monitors the audit to ensure it's thorough & independent.) However, even with the amount of control the Audit Committee has, management still pays the audit fees and ultimately decides whether the auditing firm is hired again. Sarbanes-Oxley Act: Passed by Congress in 2002, it requires the principal executive and financial officers to certify that the financial reports have been reviewed, do not contain untrue statements or omit important information, and fairly present the company's financial condition and performance. It also places additional responsibilities on management and the auditor to ensure adequate internal controls are in place.

Management must also file an annual report on internal controls over financial reporting, and the external auditor must attest to and report on management's assessment of internal controls. This act places heavy emphasis on the quality of a company's internal control system and significantly increases the auditor's role in ensuring that the control system

meets high standards. While most countries in the world have their own accounting rules, there are 2 primary financial reporting systems: GAAP & The International Financial Reporting Standards (IFRS).

IFRS is established by the International Accounting Standards Board (IASB) and is represented in well over 100 countries. GAAP and IFRS are gradually moving towards a potential adoption which would make one universal Financial Reporting System.

Chapter 2 Flow of Capital

- 1) Operating Activities: Managing the operating assets, which includes activities related to the production and sale of goods and services (e. g. sales, receivables, inventory, and payables management).
- 2) Investing Activities: Acquiring and disposing of producing assets, the assets used to produce and support the goods and services provided (e. . buildings, equip, know-how).
- 3) Financing Activities: Raising capital through equity or debt issuances and the related payments to capital providers such as debt repayment, dividends, and share repurchases.

The Classified Balance Sheet: A balance sheet in which the asset and liability accounts are grouped into classifications:

- 1) Current Assets
- 2) Long-Term Investments
- 3) Property, Plant, and Equipment
- 4) Intangible Assets
- 5) Current Liabilities
- 6) Long-Term Liabilities.

Assets: Assets Are Divided Into 4 Categories In Order of Liquidity:

- 1) Current Assets - Expected to be converted into cash within one year.

Cash - Currency the company has access to as of the current date: It can be in a bank account or on the company premise as petty cash, but should be separated from cash that is restricted (such as a ' compensating balance' that occurs when a bank loans a company money but requires they maintain a certain balance while the loan is outstanding, would be in the footnotes).

Short-Term Investments - Stocks (equity investment in other companies), Bonds (debt investment in govt. or other companies), and similar investments. These securities are readily marketable and intended to be sold within one year.

Often companies buy these securities to earn income w/ unused cash and the dollar value is the total selling price (market value) of securities as of balance sheet date. Accounts Receivable - The amount of money a company expects to collect from its customers. Arise from sales of products or services that customers have yet to pay. "Credit Sales" or "Sales on Account" Dollar amount on Balance Sheet = Total Amount of Receivables Owed - Uncollectibles (What is not expected to be received). Inventory - Items or products on hand that company intends to sell. Cost of Acquiring (Purchasing or Producing) it or the cost of replacing it as of the balance sheet date, whichever is lower. Pre-Paid Expense - Expenses that have been paid by a company before the corresponding right or service is actually used. (Insurance Premium, Rent...) Asset b/c it represents a benefit to be enjoyed in the future, but is not an Income Statement Expense until it is used. DO NOT create future cash inflows. 2) Long-Term Investments - Acquired by companies to provide benefits for periods of time usually extending beyond one year.

Long-Term Notes Receivable - Company receivables that are evidenced by Promissory Notes - Contracts (formal, legally enforceable documents) that state the face value of the receivable, date it is due, and interest payments. The date it is due is called the Maturity Date - which is beyond one year. However, if Maturity Date is w/in 1 year, it is a Current Asset. Arise b/c

companies receive notes in exchange for sale of expensive items. Land - May be purchased and held as a long-term investment. Investments In Debt & Equity Securities - Listed as Long-Term Investment when they are not intended to be sold in the near future.) Property, Plant, & Equipment - Assets acquired for use in day-to-day operations Property - Represents the land on which the company conducts its operations. It is carried on Balance Sheet as the original price & is not adjusted. Plant and Equipment - Represents the physical structures that a company owns and uses in its operations. Plant - Includes the value of factory, office buildings, and warehouse. Equipment - Includes machinery, vehicles, furniture, and similar items The dollar amounts of these accounts equal the original cost of the asset MINUS Accumulated Depreciation. Acquisition Cost - Accum.

Depreciation = Net Book Value 4) Intangible Assets - Have NO physical substance. In most cases, they represent legal rights to the use or sale of valuable names, items, processes, or information. Includes patents as well. Goodwill - Most common of Intangible Assets, it is the cost of purchasing another company over and above the total market price of that company's individual assets and liabilities. Intangible Assets are carried on the Balance Sheet at Net Book Value - Meaning that the dollar amount is the cost of the acquiring the intangible asset MINUS by Accumulated Amortization (it's usefulness over time).

Liabilities: This section of the Balance sheet is divided into 2 Categories which are also listed in order of liquidity. These dollar amounts are very important to users who are interested in the timing of a company's future cash obligations, which is important when assessing whether a company can

meet its debts when they come due. 1) Current Liabilities - Obligations expected to be paid (or services expected to be performed) w/ the use of assets listed in the current asset section of the Balance Sheet. Accounts Payable - Obligations to a company's suppliers for merchandise purchases made on account.

Wages Payable - Obligations to a company's employees for earned but unpaid wages as of the balance sheet date. Interest Payable and Short-Term Notes Payable - Dollar amounts owed to creditors, often banks and other financial institutions. Income Taxes Payable - Amounts owed to the government for taxes assessed on a company's income. Current Maturities of Long-Term Debts - Portions of long-term liabilities that are due in the current period. These often arise when the principal amounts of long-term liabilities are due in installments over time.

Unearned / Deferred Revenues - Represent services yet to be performed by a company for which cash payments have already been collected. 2) Long-Term Liabilities - Obligations expected to require payment over a period of time beyond the current year. Usually evidenced by formal contracts. Long-Term Notes Payable - Obligations on loans that are normally due more than 1 year beyond the balance sheet date. Usually involve either direct borrowing from financial institutions or arrangements to finance the purchase of assets. Bonds Payable - Notes that have been issued for cash to a large number of debt investors (bondholders).

Mortgage Payables - Obligations that are secured by real estate and are usually owed to financial institutions. Shareholders Equity 1) Contributed

Capital - A measure of the assets that have been contributed directly to the company by its owners. Can be made by purchasing equity securities issued by the company, contributing cash or noncash assets, or providing services.

This investor contribution is exchanged for ownership interests in the company (shares of stock). These ownership interests can be bought and sold freely (Stock Market), but such transactions have NO EFFECTS on the company's balance sheet.) Earned Capital (primarily Retained Earnings)

Retained Earnings - A measure of the assets that have been generated through a company's operating activities, but not paid out to shareholders (dividends). Not in the form of cash - It is simply a measure of the amount of the assets appearing on the balance sheet that have been provided by profitable operations. Large Balance of R. E. - Usually a positive sign b/c it indicates that the company has been profitable in the past and has chosen to reinvest those profits. Negative/Small Balance of R. E. Young companies often report negative Retained Earnings b/c it takes several years to become profitable. Also some very successful companies report low levels of Retained Earnings b/c they pay large dividends. Corporation vs. Partnership (Proprietorship): Corporation A legal entity that is separate and distinct from its owners. CAN be taxed and sued, and shareholders are legally liable only for the amount of their original contribution. Partnership (Proprietorship) Is NOT a legal entity. It CANNOT be taxed or sued. The legal liability of the owners (partners/proprietors) is not limited to their original contribution.

Differences are reflected in differences in the equity sections of their balance sheets. Corporation - " Shareholders' Equity" section draws distinctions between Contributed Capital and Retained Earnings. Partnership - " Owners'

Equity” section makes NO distinction b/w Contributed Capital and Retained Earnings. Consists of separate accounts for each partner. The Income Statement: Measures operating performance over a particular period – the activities associated with the acquisition and sale of the company’s inventories or services.

Operating Revenues: Represents the inflow of assets or decrease in liabilities due to a company’s operating activities over a period of time. 1) Sales – Most common Revenue Account, it represents a measure of asset increase (usually in the form of Cash or Accounts Receivable) due to selling a company’s product or inventories. 2) Fees Earned / Service Revenue – The revenue account that is reflected by companies that provide a service rather than selling a product. Operating Expenses: Represents the periodic and usual outflow of assets (or creation of liabilities) required to generate operating revenues.) Cost of Goods Sold – Represents the original cost of the inventory items (purchase price or cost of manufacturing) that are sold to generate sales revenue. Retail Companies: The remaining expense categories contain accounts reflecting the decrease in assets (or creation of liabilities) due to: Commission to Salesperson, Salaries, Wages, Insurance, Advertising, Rentals, Utilities, Property Tax, Equipment Maintenance, Depreciation of Plant and Equipment, and Amortization of Intangible Assets. Manufacturing Companies:

Typically include only Selling and Administrative expenses. Other Revenues and Expenses (other gains and losses): Usually contains Revenues and Expenses from activities that are not central to a company’s operations (usually small \$) 1) Other Revenues – Interest on bank accounts, rent

collected on rental of excess warehouse space, and book gains recognized when assets are sold for amounts that exceed those costs. 2) Other Expenses - Interest on outstanding loans and book losses recognized when assets other than inventory are sold for amounts that are less than original costs.

The Statement of Shareholders' Equity (Retained Earnings): Explains the changes in the Contributed Capital and Retained Earnings over a period. Represents a summary of the activity in the accounts that keep track of the shareholders' investment in the company. Shareholders' Investment increases when capital is collected from the sale (issuance) of equity securities (Contributed Capital) and when profits are reinvested in business. Dividends paid to shareholders reduce their investment in the company
Equation: Beginning Retained Earnings + Net Income - Dividends = End R.

E. Chapter 3 The Economic Entity Assumption The financial statements refer to entities that are distinct from both their owners and all other economic entities. Important in determining the methods to account for consolidated financial statements, investments in equity securities, and business segments. Personal assets and liabilities of the company owners are NOT included in the financial statements. Consolidated financial statements are common. For example, G. E. owns NBC and while NBC publishes its own separate financial statements, G. E. includes the assets and liabilities of NBC (a Subsidiary of G. E.) in their Consolidated Balance Sheet. The Fiscal Period Assumption The operating life of an economic entity can be divided into time periods over which timely performance measures can be developed and applied. The SEC requires publically traded companies to submit the Form
<https://assignbuster.com/a-201-financial-accounting-study-guide-flashcard/>

10-Q (unaudited, quarterly financial statements) and the Form 10-K (audited, annual financial stmt.) Companies must choose the dates of their reporting cycles - Most major US companies report on the Calendar Year, whereas some report on their Fiscal Year.

Macy's reports their financial statements on the Fiscal Year, ending on January 31 after the Christmas season to be more meaningful. Shorter Periods (Quarters) are more timely. Longer Periods (Annual) are more reliable. The Going Concern Assumption Follows logically from the fiscal period assumption in that if we assume that an entity's life can be divided into fiscal periods, we must further assume that its life extends beyond the current period. In other words, the life of the entity is assumed to be Indefinite.

FASB defines ' Assets' as " Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. " The Stable Dollar Assumption The performance and financial position of the entity can be measured in terms of a monetary unit that maintains constant purchasing power across fiscal periods. The value of \$1 is stable over time and throughout the accounting period. GAAP ignores inflation, meaning that the stable dollar assumption is one instance in which the financial statements are based on an unrealistic assumption.

The IFRS requires financial statements to be adjusted for inflation. The 4 Basic Assumptions of Financial Accounting believes that we have assumed the existence of a separate, measurable business entity (economic entity), whose infinite life (going concern) can be broken down into fiscal periods

(fiscal period) and whose transactions can be measured in stable dollars (stable dollar). A business entity operates in 2 general markets: 1) Input Market: Purchases inputs for its operations (materials, labor, etc...) Input Market Values (prices) are normally less than Output Market Prices.) Output Market: Where the business sells its outputs (services or inventories) One entity's output market may be another entity's input market. Valuation Base - The values used to determine the dollar amount of an entity's Assets and Liabilities on the Balance Sheet. The 4 Valuation Bases: 1) Present Value: A technique used to place a value, as of the present day, on a set of future cash flows. It is computed by discounting future cash flows at an interest rate that reflects a company's cost of capital. Discounted future cash flows from input and output markets. 2) Fair Market Value (FMV):

The dollar amount at which an item can be sold - Exchanged for cash.

Current sales price in output market. Short Term Investments 3)

Replacement Cost: The current price a company would have to pay in the input market to replace an existing asset while maintaining operations at the present value. The current cost to replace in input market. 4) Original Cost (Historical): The dollar amount incurred to acquire an asset (investment) or bring it to sellable (inventory) or serviceable (long-lived asset) condition.

Historical cost in input market. Valuation Bases Used on the Balance Sheet
Face Value:

A specific form of FMV, it reflects the cash expected to be received or paid in the near future. Cash and all current liabilities, and the Statement of Cash Flows. Net Realizable Value: Another form of FMV, it reflects the amount of cash expected to be collected from the outstanding accounts. Accounts

<https://assignbuster.com/a-201-financial-accounting-study-guide-flashcard/>

Receivable. Lower-of-cost-or-Market Rule: Ensures that the dollar value of this account is not overstated, illustrating that under certain circumstances Replacement Costs are found on Balance Sheet. Inventories are valued at Original Cost or Replacement Cost, whichever is lower. Balance Sheet Valuations: Assets:

Current Assets: Cash: FMV Short-Term Investments: FMV Accounts Receivable: FMV Inventory: L. C. M. Prepaid Expenses: OC - Adjusted Long-Term Investments: Long-Term Notes Receivable: PV Land: OC - Unadjusted Securities: OC - Unadjusted Property, Plant, and Equipment: Property: OC - Unadjusted Plant: OC - Adjusted Equipment: OC - Adjusted Intangible Assets: Patent: OC - Adjusted Trademark: OC - Adjusted Liabilities and Stockholders Equity: Current Liabilities: Accounts Payable: FMV Wages Payable: FMV Interest Payable: FMV Short-Term Notes Payable: FMV Other Payables: FMV Unearned Revenue: FMV Dividends Payable: FMV Long-Term Liabilities: Long-Term Notes Payable: PV Bonds Payable: PV Mortgage Payable: PV The 4 Principles of Accounting Measurement: Principle of Objectivity: Perhaps the most important and pervasive principle of accounting measurement, states that financial accounting information MUST be verifiable and reliable. Requires that the value of transactions be objectively determined and backed by documented evidence. Present Value is used on the financial statements only in those cases where future cash flows can be objectively determined. Contractual agreements (N.

R. , N. P. , etc.) Original Costs can be objectively verified and supported by documented evidence. They are reliable, can be audited at reasonable cost,

and do not violate principle of objectivity. Matching Principle: States that performance is measured by matching efforts against benefits in the time period in which the benefits are realized. Matching Principle is applied by first recognizing revenues and then matching against those revenues the expenses required to generate them. Net Income on the Income Statement is the result of matching expenses against revenues in the time period when revenues were realized.

If revenue will be recognized in a future period: Cost is recorded as an Asset, or Capitalized. Cash received is recorded as a Liability (Deferral, or Unearned Rev.) Principle of Revenue Recognition: The Production Sales Cycle: 1) Order 2) Production 3) Transfer to Buyer 4) Payment Determine the point in the operating cycle when revenue is recorded. The most common point of revenue recognition is Step 3, the Transfer to buyer. 4 Criteria Must Be Met Before Revenue Can Be Recorded In Income Stmt. : 1) The company has completed a significant portion of the production and sales effort.

Seller has done everything in order to receive revenue. 2) The amount of revenue can be objectively measured. 3) The major portion of the costs has been incurred, and the remaining costs can be reasonably estimated. (Post sale costs) 4) The eventual collection of the cash is reasonably assured.

Principle of Consistency: States that although there is considerable choice among accounting methods, companies should choose a set of methods and use them from one period to the next. Consistency helps financial statement users to make useful comparisons across time.

Change in accounting methods is rare but can occur. However, change is not easily granted and when approved the effects of change are clearly disclosed: 1) The financial effect of the change was reported on the Income Stmt. 2) The change was described in the footnotes. 3) An entire paragraph in the audit report was devoted to describing the changes. The 2 Exceptions To The Basic Principles: Materiality: Only those transactions dealing with dollar amounts large enough to make a difference to financial statement users need be accounted for in a manner consistent with the Principles of Financial Accounting.

The dollar amounts of some transactions are so small that the method of accounting has virtually no impact on the financial statements and, thus, no effect on the related evaluations and control decisions. In such cases, the least costly method of reporting is chosen, regardless of method suggested by Principles. Dollar amount is referred to as immaterial. Misstatement is extremely small and would have no bearing on the decisions of those using financial statements. Ex) Costs of capitalizing and depreciating the purchase price of the trash can simply exceed the benefits it would provide.

Conservatism: When in doubt, financial statements should: Understate Assets and Revenue Overstate Liabilities and Expenses Only when there is significant uncertainty about the value of a transaction should the most conservative alternative be chosen. Does NOT suggest that the financial statements should be intentionally understated. GAAP vs. IFRS: IFRS tends to allow management more alternatives when choosing accounting methods in a given circumstance and tends to require fewer disclosures. Why IFRS is

attractive to US companies, but why SEC has been slow to allow IFRS for US Stock Market.

IFRS includes provisions to adjust financial statements for the effects of inflation. Departure from Stable Dollar Assumption in US. IFRS allows management to somewhat substantially restate the value of fixed assets to market value, representing a much less strict interpretation of the principle of objectivity. In 2002, reached agreement on the " Short-term Convergence Project. " However, issues above are still being discussed. Chapter 4

Example Transaction: The company performed services and collected \$5000 from customer. Assets = Liabilities + Equity Cash +5000 = + Fees Earned 5000

Example Transaction: The company received \$8000 cash for services to be performed next year. Assets = Liabilities + Equity Cash +8000 = Unearned Revenue +8000 + 0 Statement of Cash Flows: Operating Section: Rent, Day-to-day operating expenses, and Interest On Loan. Cash (inc.): Cash provided from the operations of the company and receipt of interest income. Cash (decr.): Cash used in operations of company and payment of interest expense. Investing Section: SELL Bond, BUY Stock. Cash (inc.): Cash provided from the sale of long term assets (investments, fixed assets).

Cash (decr.): Cash used to purchase long term assets. Financing Section: ISSUE Bond, if paying back loan in FULL, Raise Money. Cash (inc.): Cash received from equity issuances (common stock) and long term borrowings (notes payable, bonds payable) Cash (decr.): Cash used to repay long term borrowings, to repurchase stock, or to pay dividends to shareholders. Journal

Entries Provide a more efficient way to represent relevant and measurable economic events, and their content and structure indicate how such events affect the accounting equation. Debit: Account has increased.

To debit an account simply means to place the dollar amount assigned to it on the left side of the journal entry. LEFT SIDE! Credit: Account has decreased. To credit an account means to place it on the right side of the journal entry. RIGHT SIDE! ALWAYS INDENTED. Balance Sheet Debits and Credits (Assets, Liabilities, and Equity): * Assets =| * Liabilities + Equity| * Left Side (DEBITS)| * Right Side (CREDITS)| * Normal Balance is DEBITS| * Normal Balance is CREDITS| * Increased by DEBITS| * Increased by CREDITS| Decreased by CREDITS| * Decreased by DEBITS| Ex) Equipment, Retained Earnings, Patent, Common Stock, Dividend Payable, Accumulated Depreciation, Supplies Inventory, Accounts Receivable, Land, Interest Payable, Unearned Revenue. Income Statement Debits and Credits (Revenue, Expenses, Dividends Declared): * Expenses & Dividends| * Revenues| * DECREASES Equity (R. E.)| * INCREASES Equity (R. E.)| * Normal Balance is DEBITS| * Normal Balance is CREDITS| * Increased by DEBITS| * Increased by CREDITS| Decreased by CREDITS (very rare)| * Decreased by DEBITS (very rare)| Ex) Fees Earned, Wages Expense, COGS, Prepaid Expense, Gain on Sale of Land, Rent Revenue, Insurance Expense. SUMMARY OF ACCOUNTS & DEBITS/CREDITS ON PG. 67 OF COURSE PACKET. Periodic Adjustments Accrual System of Accounting - System of accounting that recognizes revenues and expenses when assets and liabilities are created or discharged b/c of operating activities. Differs from cash flow

accounting, which reflects only cash inflows and outflows, and is the basis upon which the statement of cash flows is prepared.

Statements prepared under Accrual Accounting (Income Statement) are designed to measure earning power. The Matching Principle Matching - Efforts of a period (expenses) should be matched against benefits of the same period (revenues). Required by GAAP, it is 1 of 4 Primary Principles of Financial Accounting. The Matching Principle and Asset Capitalization: Current Period: Cost is incurred to generate Revenue. What period will the Revenue be earned? Current Period: Recognize cost as expense in current period on the Income Statement. Future Period: Capitalize cost in Current Period as an ASSET on Balance Sheet.

Convert Asset to an Expense in the future period when revenue is earned. Accrual Accounting (GAAP, Matching Principle): Recognizing revenue when earned and expense when incurred, regardless of when cash is received or paid. Adjusting Journal Entries (AJE's) Needed to record the proper amount of revenue and expense in each accounting period. Necessary to achieve Accrual Accounting and to satisfy the Matching Principle. Recorded at the end of the accounting period (for financial stmt. Purposes only). Adjusting entries Never Involve Cash. Entries will always include a Balance Sheet and Income Statement account.

Classified as Accrual or Deferral entries: Accrual entries ("to build up") Deferral entries to ("put off until later"). REVENUE when EARNED EXPENSE when INCURRED Accrued Expenses: Ex) Employees worked the last week of December earning \$100, 000, but will not be paid until January. The

necessary adjusting entry as of 12/31/08 is: Wages Expense 100, 000 Wages Payable 100, 000 Note: Wage expense must be recorded in December even though the cash has not been paid. The liability is accrued (recorded) b/c the company still owes these wages to the workers.

Accrued Revenues: Ex) During December 2008, Johnson Inc. earned \$75 interest income that will not be received until January 2009. The necessary adjusting entry as of 12/31/08 is: Interest Receivable 75 Interest Income 75 Note: The interest income should be accrued (recorded) at year-end for financial statement purposes. Deferred Expense: Ex) During 2008, Jones Inc purchased office supplies costing \$3000. The office supplies were recorded as an asset when purchased. At 12/31/08, the company realized that it had not used \$2000 of these supplies.

The necessary adjusting entry as of 12/31/08 is: Supplies Expense 1000 Supplies Inventory 1000 Note: Because these supplies had a value beyond this accounting period the supplies were recorded as an asset. When the supplies are later used, the Asset (Supplies Inventory) will be reduced and the Expense will be recorded. Pre-Paid Rent, Anything Pre-Paid, Depreciation to any asset Except Land!!! Deferred Revenue: Ex) On December 15, 2008 Johnson Inc. received 8000 from a customer for work to be completed in 2009.

The necessary adjusting entry as of 12/15/08 is: Cash 8000 Unearned Revenue 8000 The necessary adjusting entry in 2009 when the work is performed is: Unearned Revenue 8000 Fees Earned 8000 Note: Because the revenue was not yet earned when the cash was received in 2008, the

company deposited the check in the bank, increasing its cash balance and also recorded Unearned Revenue. Unearned Revenue is a Liability b/c the company still owes the services to the customer.

Revenue will be recorded when the services are performed. Accruals are when a business incurred an expense BEFORE paying cash. Accruals are when a business earned revenue BEFORE receiving cash. Deferrals are when a business incurred an expense AFTER paying cash. Deferrals are when a business earned revenue AFTER receiving cash. Closing Entries Nominal (temporary) accounts are used to accumulate the effect of transactions for only one accounting period. They include: Revenues (Sales and such) Expenses Gains Losses Dividends Declared These accounts must be “closed” at the end of the accounting period.

At the end of the accounting period these balances are “closed” and transferred to Retained Earnings! The Ending Balance in these accounts MUST BE ZERO! (after all closing entries are made). Revenues / Gains: Revenue and Gain accounts have CREDIT BALANCES! To close these accounts, you must DEBIT the accounts and CREDIT Ret. Earnings!! Expenses / Losses: Expense and Loss accounts have DEBIT BALANCES! To close these accounts, you must CREDIT the accounts and DEBIT Ret. Earnings!! Dividends Declared: The Dividends Declared account has a DEBIT BALANCE! To close this account, you must CREDIT Div. Declared and DEBIT Ret.

Earnings! A final step is to always make sure that ALL temporary accounts have a ZERO balance! Appendix A The Time Value of Money: 1 dollar today is

worth more than 1 dollar tomorrow. Financial accounting statements rely heavily on the concept of present value. Providing measures of present value is the ultimate goal of financial accounting. Interest: The Price of Money The price of money is called " interest" and is usually expressed as a percentage rate over a certain period of time. $\$ \text{ Amount of Interest} = \text{Percentage Rate} * \text{Amount of Money Borrowed (Principal)}$. Interest = Rental Fee for using money. Time Value

The difference between the value of a dollar today and the value of a dollar in the future is called the Time Value of Money. In a world where money has a price, a dollar today is worth more than a dollar at some point in the future.

Ex) Interest Rate = 10%, place \$1 in bank today and in 1 year you have \$1.10.

10. The Time Value of a dollar is \$0.10. The Size of Time Value - Large or Small? 1) First factor is the Price of Money, the Interest Rate. The higher the interest rate, the greater the time value of money. 2) Second factor is the Length of the Time Period. The longer the time period, the greater the time value of money.

Inflation In Inflation, the prices of today's goods are less than the prices for the same goods in the future. In an Inflationary Environment, 2 reasons that \$1 today is more than \$1 tomorrow: 1) The rental price charged for using the dollar (time value). 2) The erosion of purchasing power of the dollar in the future (inflation). Time Value Computations: Future Value: The dollar amount greater than the amount originally invested at given interest rate. Simple Interest: \$1 invested at a 10% per year interest rate will grow to \$1.10 (\$1*1.10) at the end of one year. Compound Interest:

Used to compute the future value of \$1 at the end of more than one period, given a 10% interest rate. That is, in the 2nd year, the 10% interest is applied to both the original \$1 principal and the \$0.10 interest earned the 1st year. Ex) Future value of \$1 at the end of 2 years, given a 10% interest rate compounded annually is equal to \$1.21. Table Factors: When computing the future value, the Table Factor is the intersection of the Interest Rate and the Number of Periods. In general, the Future Value calculation is: $\text{Future Value} = A(1 + i)^n$ Where: A = Money Amount (Principal) i = Annual Interest Rate * n = Number of Periods Future Value of Ordinary Annuities: Annuity: A flow of cash payments of equal amounts paid at periodic intervals. Ordinary Annuity (Annuity in Arrears): Annuity payments that are made at the end of each period. Ex) A 5 year ordinary annuity shows \$100 payments made at the end of each year for 5 years. To find an ordinary 5 year annuity of \$100 given a 10% interest rate compounded annually at the end of 5 years: Use the table for future value of an ordinary annuity by finding the intersection of 5 Periods & 10% Interest Rate (6.0) and multiply that number (6.10) by the amount of the periodic annuity payment (\$100). Future Value of an Annuity Due: Annuity Due: Annuities that are paid at the beginning of each period rather than at the end. Frequently found in lease agreements that require payments in advance. Only difference is that Annuity Due payments come 1 period earlier and thus earn one period more of interest than Ordinary Annuities. Present Value: The value NOW of a payment to be received in the future. \$1 is the Present Value of \$1.10 received 1 year in the future, given a 10% interest rate. Simple Interest Factor:

Future Value * $[1 / (1 + i)]$ Or, $PV = \$1.10 * [1 / (1.10)]$ Compounded

Interest: $PV = FV * [1 / (1 + i)^n]$ Computing an Implicit Rate of Return:

Company plans to invest \$1000 in a project expected to produce cash receipts of \$300 per year (assume at the end of each year) for 5 years. The Implicit Rate of Return (i) can be computed by first finding the table factor and then finding that interest rate on that table where the period of time matches your table factor. $PV = FV * (\text{Table Factor}; n = \text{years}, I = \text{interest rate})$
 $1000 = 300 * (\text{Table 5 "PV of an ordinary annuity;" } n = 5, I = ?$

Rearranging, $\text{Table Factor} = 1000 / 300 * \text{Table Factor} = 3.33$ On Table 5, a 15 % Interest Rate over a 5 year period leads to a table factor of 3.33.

Computing an Implicit Interest Rate: Can be computed on Notes Payable and Receivable. Company purchases property w/ fair market value of \$100,000, paying for it by signing a note payable requiring cash payments of \$20,000 at the beginning of each year for 6 years. $PV = FV * (\text{Table Factor}; n = \text{years}, I = \text{interest rate})$
 $100,000 = 20,000 * (\text{Table 6 "PV of an annuity due;" } n = 6, I = ?$ Rearranging, $\text{Table Factor} = 100,000 / 20,000 * \text{Table Factor} = 5.$

00 On Table 6, an 8 % interest rate over a 6 year period leads to a table factor of 5.00. Chapter 5 Primary Purposes of the Financial Statements: 1)

Help investors and Creditors influence and monitor the business decisions of the company's managers. 2) Help Predict company's Future Earnings and Cash Flows. Financial Accounting Numbers and Management Control:

Shareholders: Have incentives to encourage management to act in ways that maximize future dividend payments and stock appreciation.

Depends on earning power & long-term profitability - Must maintain high levels of earning power. Common method - Base management's pay on

reported income (incentives). Creditor: Concerned about companies not being able to meet loan obligations because: Paid to shareholders in form of dividends. Pledged to other creditors. Mismanaged. To reduce this probability, creditor may restrict certain business decisions as a condition of the loan. Written into the loan and expressed in accounting #'s. Financial Accounting Numbers as Prediction Aids: Report on PAST events, they are neither predictions nor forecasts.

However, past events are indicative of the future, they can be used to make predictions about a company's future earnings and cash flows. Have been used in statistical models to predict bankruptcy. According to FASB, the main objective of financial accounting is: " To help present and potential investors and creditors and other users in assessing the amount, timing, and uncertainty of future cash flows. " Framework For Using Financial Statements To Predict Future Earnings & Cash Flows: The Balance Sheet provides a measure of a company's value at a given point in time - Its Book Value (Assets - Liabilities).

However, Book Value is FAR from True Value, primarily because the financial statements are BACKWARD looking. Book Value + Adjustments for: 1) Business Environment 2) Unrecorded Events 3) Management Bias = TRUE VALUE Unrecorded Events: Financial Statements leave out important current and historical information, which is relevant to assessing True Value. Most of assets are carried at historical cost, rather than current market prices, and there is much doubt about usefulness of historical costs for decisions. GAAP ignores Inflation and are not published in a timely manner.

Management Bias: 5 Elements of Financial Statement Analysis: 1) Assessing the Business Environment: Can quickly gain a sense of a company's operations and how other experts view its future prospects is to access investment services (Moody's, Value Line, Dun & Bradstreet, and Standard & Poor's) These ratings reflect a company's future prospects within its business environment and have a direct bearing on its ability to issue debt w/ reasonable terms. 2) Reading and Studying the Financial Statements and Footnotes: 1) The Audit Report:

Serves as the Accounting profession's " Seal of Approval" - Stating whether and to what extent the info fairly reflects financial position. Standard Audit Report: Rendered after reviewing the financial records of a company, it states that financial statements fairly reflect the financial position & operations of the company & internal control system is reasonably effective. States that all necessary tests were conducted to conform to GAAP. In such cases, reader can be reasonably assured info is credible. Only companies traded on public stock exchanges are legally required to be audited by a CPA.

There are many more companies that are NOT publically traded and these companies may or may not choose to be audited, but most do NOT. 2) Significant Transactions: Earnings Persistence: Refers to the extent to which an income statement item reported in the current period can be expected to reflect future income levels. High Persistence - Expected to relate closely to future income amounts and be useful in predicting them. Low Persistence - Normally ' one-time' nonrecurring events. 3) Financial Statements and

Footnotes: One goal of assessing a company's business environment is to identify key items on the financial statements.

Retail - Success depends on quality of inventory management. Inventory, Accounts Payable, COGS, and the related footnotes are particularly important financial statements. Financial - Bank loans Millions/year, making collectables important. Software Man. - Invest in R&D, an income stmt. Expense account. It is important to recognize that the nature of the company's operations normally determines where the analysis should be focused. 3) Assessing Earnings Quality: Refers to the extent to which net income reported on the I. S. differs from True Earnings. Strategies to "manage" reported accounting numbers: 1) Overstating the Performance - Strategy in which management attempts to depict a more favorable picture of the financial statements by overstating the company's financial performance and condition. Sometimes used by young, fast, growing aggressive companies to attract much needed capital. Also used when companies face financial difficulties. 2) Taking A Bath - Strategy that recognizes excessive losses or expenses in a single period(s) that are already very poor, in hopes that these losses may be less obvious.

Recognizing losses in one period means they won't have to be recognized in future periods, which in turn may improve F. S. 's. 3) Creating Hidden Reserves - Conservative method that is used in years of extremely GOOD performance, it can help to "smooth" reported earnings over time.

Recognizing accounting losses in the current period ensures that reported earnings in that period are not too high and guarantees that the loss will not have to be recognized in future periods when reported earnings may be less

impressive.) Employing Off-Balance-Sheet Financing - Strategy designed to depict a company as less reliant on debt than in actually is. Ex) Choose accounting method so that debt need not be reported on the balance sheet.

4) Analyzing the Financial Statements 1) Comparisons Across Time: Financial Accounting Numbers are more meaningful if compared across time. At a minimum, GAAP requires financial statements of the current and preceding years to be disclosed side by side in reports. Required for 3 Years - Income Stmt. , Stmt. Of Cash Flow, Stmt. RE. Required for 2 Years - Balance Sheet.

Not necessarily uncommon to provide info for more than required amount of years - develop 'feel' for company's activities, etc. 2) Comparison Within The Industry: Comparison to similar companies. 3) Comparisons within the Financial Statements: Common Size Financial Statements: Simply a matter of computing ratios in which income statement or balance sheet items act as numerators and sales or total assets serve as denominators. Ratio Analysis: Computing additional ratios using 2 or more financial statement numbers is also a common and useful practice. There are no hard-and-fast rules for the computations of ratios.

Income Statement numbers are compared to Balance Sheet numbers - and since Income Statement refers to a period of time and the balance sheet refers to a specific point in time, it is usually best to compute an average for the balance sheet number. The 5 Categories of Ratios: 1) Profitability Ratios: Asses performance, normally measured in terms of some measure of earnings as a percent of some level of activity or investment. Designed to measure earning power. 1) Return on Equity: Compares the profits

generated by a company to the investment made by the company's shareholders.

Measure of efficiency w/ which the stockholders' investment is being managed. As the ratio increases management is viewed more efficient. R. O.

$E = \text{Net Income} * \text{Average Stockholders' Equity}$. 2) Return on Assets:

Broader, compares the returns to both shareholders and creditors to total assets, the total resources provided by shareholders & creditors. For every

dollar generated in assets, what to Net Income? R. O. A = {Net Income +

[Interest Expense (1 - Tax Rate)]} * Average Total Assets 3) Return on

Sales / Profit Margin:

Ratio provides an indication of a company's ability to generate and market

profitable products and control its costs. It reflects the number of cents in

profit for every dollar of sales. P. M. = {Net Income + [Interest Expense (1 -

Tax Rate)]} * Net Sales * 2) Leverage Ratios: Using borrowed funds to

generate returns for the shareholders. Leverage is desirable because it creates returns for the company's shareholders without using any of their

money, but increases risk by committing company to future cash obligations.

1) Common Equity Leverage:

Compares the return available to the shareholders to the returns available to all capital providers. High levels - Indicate that shareholders are receiving a

large portion of the total returns generated by the company. Returns are the result of company 1) not using leverage or 2) using leverage very effectively.

Common Equity Leverage = Net Income * {Net Income + [Interest Expense

(1 - Tax Rate)]} 2) Capital Structure Leverage: Measures the extent to which

a company relies on borrowing (liability) Incr. above 1 as liabilities in the capital structure increase, vise versa.

High Levels - Company is using leverage - large potential earning power and high levels of risk. Capital Structure Leverage = Average Total Assets *

Average Shareholders' Equity Debt/Equity Ratio = Average Total Liabilities *

Average Shareholders' Equity 3) Long-Term Debt Ratio: Measures the importance of long-term liabilities as a source of asset financing. % of assets accounted for with debt. Long-Term Debt Ratio = Long-Term Liabilities *

Total Assets * 3) Solvency Ratios:

Refers to a company's ability to meet its debts as they come due. 1) Current Ratio: Compares current assets to current liabilities as of balance sheet date. Measures solvency in the sense that current assets, for the most part, can be used to meet current liabilities. If ratio INCREASES: Current Liab.

DECREASES, Current A. GOOD. Current Ratio = Current Assets * Current

Liabilities 2) Quick Ratio: Similar to Current Ratio, except it provides a more stringent test of a company's solvency position. Current Assets which are not immediately convertible to cash (ex.

Inventories & Pre-Paid Expenses) are EXCLUDED from numerator. It is just the MOST Liquid of Currents (Cash, S. T. Investments, A/R) Quick Ratio = (Cash + Marketable Securities + Net Accts. Rec.) * Current Liabilities 3)

Interest Coverage Ratio: Compares the annual funds available to meet interest to the annual interest expense. Income before taxes and interest is used in numerator b/c they can be used to pay interest. How many times over we can cover interest with income. Increasing Levels signal that the

company is becoming more solvent. Interest Coverage = $(\text{Net Income} + \text{Tax Exp. Interest Exp.}) \div \text{Interest Expense} \times 4$) Asset Turnover Ratios (ALL can be converted to 'days' by: $365 / \text{Ratio}$): Typically computed for Total Assets, A/R, Inventory, Fixed Assets. Measure the speed with which assets move through operations, or the number of times during a given period that assets are acquired, used, and replaced. Can be divided by 365 days to determine the # of days, on average, that it takes for given assets to be turned over. In general - HIGH levels indicate efficient asset management (a company is using a relatively low level of assets to generate returns for shareholders).

However, in some situations, low assets investment can constrain profitability. 1) Receivables Turnover: Reflects the # of times the trade receivables were recorded, collected, and recorded again during the period. Measures the effectiveness of the credit-granting and collection activities of a company. How many times per year we clear Accounts Receivable. HIGH - Often suggests effective credit-granting and collection activity LOW - Can indicate late payments & bad debts, probably due to credit being granted to poor-risk customers and/or ineffective collection.

VERY HIGH - Not always desirable; may indicate overly stringent credit terms, leading to missed sales and lost profits. Receivables Turnover = $\text{Sales} \div \text{Average Accounts Receivable}$ 2) Inventory Turnover: Measures the speed with which inventories move through operations. Compares amount of inventory carried by company to the volume of goods sold during the period, reflecting how quickly inv. are sold. How many times per year we clear Inventory. INCREASE - Normally desirable b/c profit (and often cash) is usually realized each time inv. s sold & cost is often associated w/ carrying it.

HIGH turnover - Can indicate that inventory levels are too low, giving rise to lost sales and profits due to items being out of stock. Inventory Turnover = $\text{Cost of Goods Sold} \div \text{Average Inventory}$ 3) Fixed Assets Turnover: Measures the speed with which Fixed Assets are used up. Compares average level of Fixed Assets to the sales for the year, that is the level of Fixed Asset investment necessary to generate the annual sales volume. Fixed Assets Turnover = $\text{Sales} \div \text{Average Fixed Assets}$ 4) Total Asset Turnover: Measures the speed with which all assets are used up in operations, aggregating the turnover measures of the component assets (e. g. , A/R, Inventory, and Fixed Assets). It provides an overall measure of asset management efficiency. Total Asset Turnover = $\text{Sales} \div \text{Average Total Assets}$ 5) Other Ratios: 1) Earnings per Share: Perhaps the best known of all ratios, largely b/c the financial press often treat it as the primary measurement of a company's performance.

Measures profitability strictly from standpoint of common shareholder.

Assesses profitability relative to the # of common shares outstanding. GAAP

- This ratio must appear on face of I. S. & calculated complexly Earnings per

Share = $\text{Net Income} \div \text{Average \# of Common Shares Outstanding}$ 2) Price /

Earnings (P/E) Ratio: Used by analysts to assess the investment potential of

common stocks. By relating the price of a company's common stock to its

earnings, this ratio reflects the stock market's confidence that current

earnings will lead to cash inflows in the future.

Price / Earnings (P/E) Ratio = $\text{Market Price per Share} \div \text{Earnings per Share}$

Chapter 6 The Current Asset Classification: Current Asset: Any asset that is

intended to be converted into cash within one year or the company's

<https://assignbuster.com/a-201-financial-accounting-study-guide-flashcard/>

operating cycle, whichever is longer. Operating Cycle: The time it takes a company to convert cash to inventory (purchase or manufacture inventory), sell the inventory, and collect cash from the sale. The time periods for current asset classification differ widely from company to company. (Ex. Grocery chains: Short cycle.

Boeing company: Long cycle.) However, the accounts included in the current asset section of the balance sheets of all companies are virtually the same.

They are: Cash, Short-Term Investments, Short-Term Accounts and Notes Receivable, Inventories, and Pre-Paid Expenses. Measures Using Current

Assets: Working Capital, Current Ratio, & Quick Ratio (Solvency Ratios): 1)

Working Capital = Current Assets - Current Liabilities 2) Current Ratio =

Current Assets / Current Liabilities Internet Companies: Carry large amounts of cash & short-term investments... Relying very little on short-term debt

financing (+2.). Lowes: Large cash & S. T. Investment balances, large inventory of hardware goods, and low level of accounts payable (1. 27).

AT&T: Invest heavily in PP&E, financing w/ short & long-term debt. Carry low

Current Ratio b/c operations generate \$ to meet debts. 3) Quick Ratio =

(Cash + Short-term Investment + Short-term Rec.) * Current Liabilities The

Economic Consequences of Solvency Ra