

Chapter 5 Topic 3
Interpreting an Income Statement and Balance Sheet
 We learned how to prepare the two of the most important statements.
 Now, we must understand what they say to readers.

Nov 23-12:04 PM

Basic Accounting Principles: broad accounting guidelines followed by professional accountants in all countries
 Review of Generally Accepted Accounting Principles (GAAPs)
 - we have seen 5 of at least 10
Revenue Principle: revenue must be recognized at the time when the sale of goods or services is made, and not when the cash is received from the customer. (assumes you can define revenue)
Expense Principle: expense must be accounted for when it is incurred, and not when the cash payment is made. (assumes you can define expense)

Nov 23-12:09 PM

Matching Principle: Revenues recognized during one accounting period must be matched with expenses incurred during the same accounting period.
 On the basis of this recognition, the net income or net loss can be calculated. The accounting period may be any designated length up to one year.
Objectivity Principle: Before a transaction can be recorded, it must have occurred. Physical proof or evidence is required to prove that a transaction took place, and such evidence is called a source document.
Cost Principle: 1) all assets must be recorded on the basis of how much was paid to get those assets.
 2) these same costs must be kept in the asset accounts even if the so-called market or current value has gone up.

Nov 23-10:40 PM

EXPLAINING SPECIFIC ACCOUNTING PRINCIPLES
Specific Accounting Principles: more specific accounting guidelines followed by accountants in a particular country.
 In Canada there are 3 accounting bodies
 1) Canadian Institute of Chartered Accountants (CICA) CA } Now called
 2) Society of Management Accountants of Canada CMA } CPA
 3) Certified General Accountants Association of Canada CGA }
 All follow the CICA Handbook, published by the CICA, which contains more specialized guidelines.

Nov 23-10:53 PM

CICA Handbook: published by the Canadian Institute of Chartered Accountants, containing specific guidelines for use in Canada.
 Since they refer to financial reporting requirements, these guidelines are often referred to as financial reporting principle

Nov 24-8:57 AM

Guidelines learned to date:

- Financial statements should be prepared in such form and use such words and classifications that readers can easily understand the information being reported.
- Assets - classified under at least two categories: Current and Fixed
- Main items making up current assets should be reported separately, for example, cash, marketable securities, accounts receivable.
- Fixed assets should be recorded by major category: for example, land, building, and machinery.
- The cost value of Fixed Assets should be disclosed on every balance sheet.
- If the assets of the business are promised as security against liabilities, the nature of such assets should be disclosed. - the readers of the balance sheet should know which assets have been pledged as security against which debts

Nov 24-9:45 AM

Guidelines continued:

- Liabilities reported on the balance sheet should be classified under at least two headings: current and long term.
- Current liability section reports all debts payable within one year from the date of the balance sheet, for example: bank loan payable, accounts payable, other loans payable, taxes payable and current payments of long term debt
- If any of the liabilities are secured, they should be stated separately and the fact that they are secured should be indicated

Nov 24-9:58 AM

Guidelines continued:

- Any long-term debt obligations payable within a year out of current funds should be included in current liabilities.
- The income statement should report at least the following items: the main sources of revenue earned by the business for a specific accounting period, the major expenses incurred for the same period, and the net income or net loss for the period.
- The financial statements of an unincorporated business (sole proprietorship) should clearly indicate the name of the business and, when necessary, the name of the owner.
- Any "salary" paid to the owner of a single proprietorship should be considered part of the payment of the net income to the owner. Such "salaries" should be accounted for in a separate drawings account.

Keep in mind other countries may follow different principles.

Nov 24-10:19 AM

WHAT AN INCOME STATEMENT SAYS

- every income statement follows the matching principle: revenue earned for the period are matched with expenses incurred for the same period
 - two elements - Revenue and Expense
- the heading tells the reader
 1. The name of the business
 2. The name of the statement
 3. The length of the accounting period for which revenue and expenses have been matched.

** accounting period has ended. (not ending)

Nov 29-9:47 AM

WHAT AN INCOME STATEMENT SAYS

- Reports the main and secondary source(s) of revenue earned by the business during the accounting period.
- **Main or Primary Source of Revenue:** regular operations of the business that brings in revenue
 - Example - Dental Practice - fees for services rendered - Professional Fees Earned
- **Secondary source of revenue:** a source of revenue which is not part the regular operations of business, usually an investment.
 - Example - The dental office may also have money invested in Canada Savings Bonds. The interest earned would be a secondary source of revenue for the dental office.
 - dividends earned from investing in stocks
 - rental revenue earned from renting part of the firm's land or bu

Nov 29-8:08 PM

What an income statement says (Continued)

- Various terms are used by business to describe their main source of revenue. The nature of the main business will give you a hint. Service firms sell services, main source depends on what their services are.

Realtor	Commission	Commissions Earned
Profession such as doctors, lawyers, accountants, dentists	Charge Fees for services	Fees Earned
Retailers/Wholesalers	Buys and sells a good	Sales Revenue or Sales

Nov 29-8:26 PM

What an income statement says (Continued)

- What is revenue?
 - Revenue principle defines the main source of business revenue as the inflow of assets (cash or Accts. Rec.) from a sale of goods or services.
 - When is the revenue recognized. *(at the time of sale)*
- Example:**
 - Oct. 1 Dr. D. performed dentals services such as cleaning and examining Jane Doe's teeth.
 - Oct. 30 Jane Doe paid the dental bill.
 - When is the revenue recognized??? *Oct 1st*

Nov 29-8:39 PM

What an income statement says (Continued)
 Every source of revenue should be traced back to a source document
 The reader must have confidence that all revenues reported are accurate.
 What gives the reader that confidence?
Auditors: specialized accountants who conduct an examination of the accounting records and other supporting evidence of a business

Nov 29-8:47 PM

What an income statement says (Continued)
 - The expense principle gives the meaning of expenses and guides accountants in deciding when to record expenses in accounting.
 - **Business Expenses** - costs of operating a business
 Example: telephone in a dentist office, helps bring in revenue
 In the language of accounting that cost is "used up" and so becomes expired.
Expired Costs: expenses to be matched against revenue in the income statement
 All expired costs, therefore are business expenses.

Nov 29-8:52 PM

What an income statement says (Continued)
 - The expense principle not only defines an expense but tells readers when those expenses are to be accounted for.
 Expenses are recorded when incurred not when paid.
 - All expense transactions must be recorded in accordance with the objectivity principle. The income statement is based on this principle, since all reported expenses can be traced to source documents

Nov 29-9:36 PM

What an income statement says (Continued)
 - the result of matching revenues with related expenses - **the net income or net loss** - may be considered the most important piece of information reported by the income statement.

Income Statement	net result	net income
Earning Statement or Statement of Earnings	net result	net earnings
Years ago **rare in today's accounting practice		
Profit and Loss Statement	net result	net profit

Nov 29-9:41 PM

What an income statement says (Continued)
Important to remember net income is related to the matching principle.
 Net income is made up of more revenue than matched expenses.
 If revenue refers to the inflow of assets and expenses to expired costs, net income means that the business has increased the \$\$ amount of assets during the accounting period.
 so...
 If a net loss is the result, this means that the total dollar amount of assets must have decreased during the accounting period.

Nov 29-9:48 PM

WHAT AN INCOME STATEMENT DOES NOT SAY
 - it does not predict net income for any future period.
 It is a matching of revenues and related expenses for a period that has ended. It is a historical report.
 The future is uncertain, cannot rely on a single years report as an indication of future results.
 Comparing past accounting periods, 5 or 10 year periods, one may be able to predict with greater confidence the future of the business
 Management may try to predict by examining a budgeted income statement.

Nov 29-9:55 PM

What an income statement does not say (Continued)

Income Statement: a historical statement reporting the matching of revenues with related expenses for a period that has ended.

Budgetted Income Statement: a statement estimating future revenues matched with future expenses in order to predict net income or net loss for some future accounting period

Nov 29-10:01 PM

What an income statement does not say (Continued)

- An income statement even if well prepared, reports only a fair approximation of net income for an accounting period.

Example: Advertising Expense in December - \$1000
December Sales - \$10,000

Do we know for sure that the \$10 000 sales in December is a result of \$1 000 spend on advertising in December.

Perhaps, part is a result of November's advertising, or perhaps the advertising will result in January sales.

Nov 29-10:05 PM

What an income statement does not say (Continued)

- An income statement **does not** report the so-called "true profit" - it reports the profit for the accounting period.

True Profit: the difference between total funds invested over the life of the business and funds realized from sale of the business

Example: Total investment in a business over 20 years - \$100 000
Total withdrawals for person use (drawings) 240 000
After 20 years sold the business for 160 000

True Profit = \$160 000 + \$240 000 - \$100 000
= \$300 000

Owner's do not need this "true profit" but periodic information on the progress of the business, that is why income statements are prepared. At least yearly, may be quarterly or even monthly.

Nov 29-10:13 PM

What an income statement does not say (Continued)

- Net incomes **does not** mean cash - it is the excess of revenue over related expenses for a specific time period

- cash has very little to do with determining net income

revenue - inflow of cash
expenses - outflow of cash

... but cash can be used for other things such as purchasing assets, investments

... sometimes there is no outflow in the current accounting period

.... some expenses there is no outflow of cash

Nov 29-10:05 PM

In summary, an income statement reports mainly the following information:

- the source of revenue earned for a given accounting period
- those expenses which are related to the revenue for the same accounting period
- the result of matching the two -- the net income or net loss

Nov 29-10:39 PM

In accounting

- expenses **must** be treated as expired costs
- net income **must** always be regarded as the **net increase to owner's equity** as a result of having revenues greater than their related expenses for a given accounting period.

Nov 29-10:13 PM

WHAT A BALANCE SHEET SAYS

- First line provides the name of the business.
It identifies the **accounting entity** (the business or unit distinct from its owner(s) for accounting purposes)
- Detailed summary of assets and claims against the assets, as at a particular date.
These details come from the accounts in the *General Ledger*
- Information about the financial position of the firm with regard to its ability to pay current debts.
Look at J. Emery Real Estate - current liabilities vs current assets

Nov 29-10:41 PM

What a balance sheet says (continued)

- Gives the reader a view of the firm's financial position to carry on business operations.
Analyze fixed assets. What is the value of fixed assets J Emery Real Estate has to assist in revenue making activities?
- Strength of the owner's claim against the assets.
J. Emery Real Estate
Total Assets \$ 128 065
Creditors \$ 24 000 or 19%
J. Emery \$ 104 065 or 81%
- Must remember claims of creditors must always be satisfied before the owner's claim

Nov 29-10:51 PM

What a balance sheet says (continued)

- In accordance with specific guidelines in the CICA Handbook, a balance sheet tells the reader which debts are secured
- In accounting, any liability that is reported as secured has one or more assets pledged as the security. In accordance with the CICA Handbook, a balance sheet will report which assets have been pledged
- A balance sheet can say other things to readers, but it is out of the scope of this course.

Nov 29-10:59 PM

WHAT A BALANCE SHEET DOES NOT SAY

- It does not provide details of how profits were made by the business. These details are found in the ??? *Income Statement*
- Claims of creditors or owners against specific assets
The claims are **against the assets in general** - the total assets only
- "Capital" under Owner's Equity must not be interpreted as cash. The meaning of **capital** should be restricted only to **investment**.
- does not reveal how the invested money was used
- ** Does not report the so-called market value, current value or worth of any business.
Some readers believe total assets presents CASH. Easy to put a \$ value on current assets. Fixed assets, not so easy, they are purchased to produce revenue not to be converted into cash.

Nov 29-11:04 PM

What a balance sheet does not say (continued)

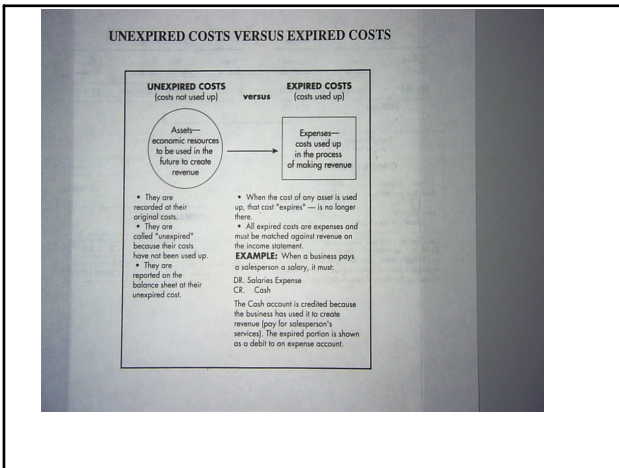
- Topic 2 - Cost Principle
- \$\$ amounts listed on the Balance Sheet do not indicate the price at which assets could be sold.
- Value:** in accounting, the cost of the asset not its present value or worth
- CICA Handbook tells us all fixed assets are reported "**at cost**"

Nov 29-11:15 PM

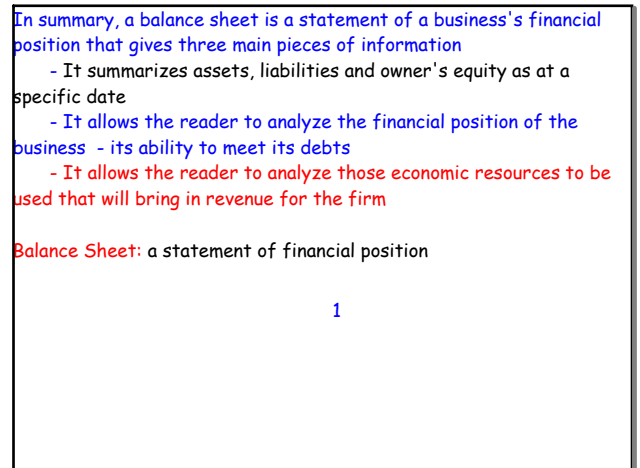
What a balance sheet does not say (continued)

- If assets are reported on the balance sheet at costs and are still usable to produce revenue, then at least part of the costs must not have been used up - in other words, they are **unexpired costs**.
- Unexpired Costs:** assets carried forward in the balance sheet to be expired in some future accounting period.

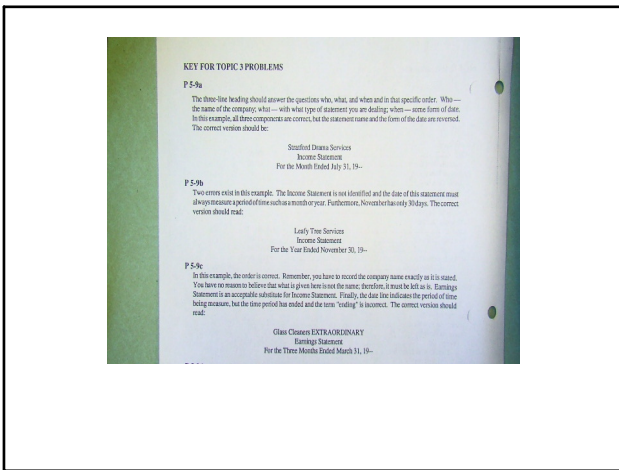
Nov 30-8:53 AM



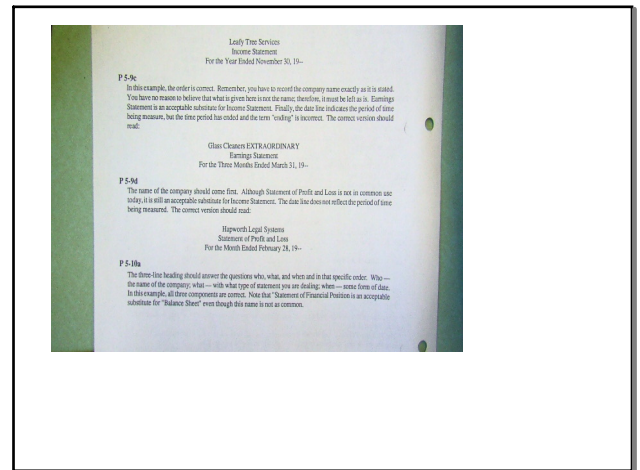
Nov 12-3:31 PM



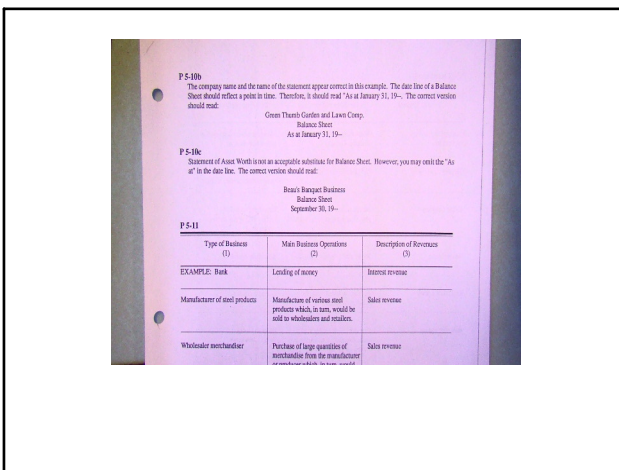
Nov 29-11:15 PM



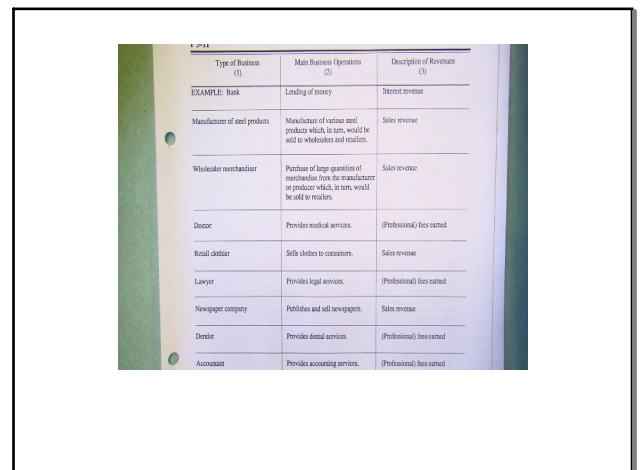
Dec 19-9:23 AM



Dec 19-9:24 AM



Dec 19-9:25 AM



Dec 19-9:25 AM

Type of Business (1)	Main Business Operations (2)	Description of Revenues (3)
Mortgage and savings corporation	Offers mortgages and also invests customers' savings.	Mortgage and interest revenue Investment revenue
Telephone company	Provides telephone services.	Local service revenue Long distance service revenue
Airline company	Transportation service of passengers, freight and express, and mail.	Passenger fees earned Freight and express revenue Mail revenue
Movie theater	Shows movie films, sells refreshments.	Admission revenue Concession revenue
Rail estate agency	Boys and girls real estate for different consumers.	Commissions earned
Insurance agency	Provides protection against death, fire, theft, also invests customers' savings.	Premium fees earned Investment revenue

P 5-12a
Bird's View Touring Co.
Income Statement
For the Four Months Ended May 31, 19--

Dec 19-9:26 AM

Insurance agency	Provides protection against death, fire, theft, also invests customers' savings.	Premium fees earned Investment revenue
P 5-12a Bird's View Touring Co. Income Statement For the Four Months Ended May 31, 19--		
Revenues:		
Touring Fees Earned	\$34,600.00	
Chapering Fees Earned	5,500.00	
Total Revenues		\$41,100.00
Expenses:		
Telephone Expense	\$ 125.00	
Fuel Expense	2,900.00	
Plane Maintenance Expense	1,800.00	
Insurance Expense	800.00	
Hanger Rental Expense	400.00	
Utilities Expense	130.00	
Wages Expense	750.00	
Office Supplies Expense	250.00	
Total Expenses		6,615.00
Net Income (Loss)		\$34,485.00

Dec 19-9:26 AM

Assets		
P 5-12b Bird's View Touring Co. Balance Sheet As at May 31, 19--		
Current Assets:		
Cash		\$ 10,000.00
Canada Savings Bonds		3,000.00
Accounts Receivable		600.00
Office Supplies on Hand		750.00
Total Current Assets		\$ 14,350.00
Fixed Assets (at cost):		
Land (security for mortgage payable)		\$1,000.00
Office building (security for mortgage payable)		57,750.00
Equipment		97,000.00
Tour Equipment		1,400.00
Total Fixed Assets		157,150.00
Total Assets		\$171,500.00
Liabilities		
Current Liabilities:		
Bank Loan Payable	\$ 4,000.00	
Accounts Payable	3,600.00	
Current portion of mortgage payable	2,800.00	
Total Current Liabilities		\$ 10,400.00
Long-Term Liabilities:		
11.5% Mortgage Payable, due in 25 years (secured by land and office building)	\$29,000.00	
Less: current portion	(1,200.00)	
Total Long-Term Liabilities		27,800.00
Total Liabilities		\$ 38,200.00
Owner's Equity		
I. Partners, Capital	\$89,665.00	
Add: Net Income for four months	54,635.00	
Total Owner's Equity		133,295.00
Total Liabilities and Owner's Equity		\$171,500.00

Dec 19-9:27 AM

Liabilities		
P 5-12b Bird's View Touring Co. Balance Sheet As at May 31, 19--		
Current Liabilities:		
Bank Loan Payable	\$ 4,000.00	
Accounts Payable	3,600.00	
Current portion of mortgage payable	2,800.00	
Total Current Liabilities		\$ 10,400.00
Long-Term Liabilities:		
11.5% Mortgage Payable, due in 25 years (secured by land and office building)	\$29,000.00	
Less: current portion	(1,200.00)	
Total Long-Term Liabilities		27,800.00
Total Liabilities		\$ 38,200.00
Owner's Equity		
I. Partners, Capital	\$89,665.00	
Add: Net Income for four months	54,635.00	
Less: Withdrawals for four months	(124,150.00)	
Total Owner's Equity		133,295.00
Total Liabilities and Owner's Equity		\$171,500.00

P 5-12c
 (i) The total Current Assets of Bird's View Touring Co. is \$14,350.00.
 (ii) The total Current Liabilities of Bird's View Touring Co. is \$10,400.00.
 (iii) The percentage claim the creditors have on Total Assets is equal to $\frac{\$40,000}{\$171,500} = 23.33\%$.
 (iv) The residual claim of the owners is $\$171,500 - \$40,000 = \$131,500.00$. Note: This is the same figure as the Total Owner's Equity figure from the Balance Sheet.

Dec 19-9:27 AM