The Role Of Accounting In Business

Chapter Objectives

1. Define accounting and identify uses of its information
2. Understand the three basic financial statements
3. Understand cash-basis vs. accrual
4. Evaluate a company’s performance
5. Discuss career opportunities in accounting and its future

Stakeholders

• “…parties who are interested in the activities of the business because they’re affect by them…”

Accounting

• “…measuring and summarizing business activities, interpreting financial statements, and communicating the results to management and other decision makers.”

Fields of Accounting

• Management Accounting – provides information to decision makers inside the organization to help operate the business
• Financial Accounting – furnishes information to individuals and groups inside/outside the organization to assess the firm’s financial performance

Management Accounting

• “…provides… reports… tailored to the needs of individual managers… (in a) relevant, accurate, timely… format… (to aid) in making decisions.”
Financial Accounting

• Statements
  - Income Statement
  - Balance Sheet
  - Statement of Cash Flows

• Generally Accepted Accounting Principles

Users Of Accounting Information

- Owners & Managers
- Government Agencies
- Other Users
- Investors & Creditors

The Functions of Financial Statements

- Income Statement – Shows sales/expenses and if made a profit
- Balance Sheet – Indicates assets/liabilities and amount invested in company
- Statement of Cash Flows – Shows how much cash in and out of firm

Income Statement

- Revenues and Expenses
- Cost of Goods Sold
- Operating Expenses
- Gross Profit
- Net Income

Stress-Buster Income Statement

<table>
<thead>
<tr>
<th>Stress-Buster Company</th>
<th>Income Statement</th>
<th>Month Ended September 30, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (100 X $10)</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Less Cost of goods sold (100 X $6)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Gross profit (100 X $4)</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>Less Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>240</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Table rental</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Net income (profit)</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

Proposed Income Statement #1

<table>
<thead>
<tr>
<th>Stress-Buster Company</th>
<th>Income Statement</th>
<th>Month Ended September 30, 20X1</th>
</tr>
</thead>
<tbody>
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<td>400</td>
<td></td>
</tr>
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<td>Less Operating expenses</td>
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<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>240</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Table rental</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Net income (profit)</td>
<td>$200</td>
<td></td>
</tr>
</tbody>
</table>
Proposed Income Statement #2

<table>
<thead>
<tr>
<th>Stress-Buster Company Income Statement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Month Ended September 30, 20X1</td>
<td></td>
</tr>
<tr>
<td>[if Sales Increase to 150 units]</td>
<td></td>
</tr>
<tr>
<td>Sales (150 x $10)</td>
<td>$1,500</td>
</tr>
<tr>
<td>Less Cost of goods sold (150 x $6)</td>
<td>900</td>
</tr>
<tr>
<td>Gross profit (150 x $4)</td>
<td>600</td>
</tr>
<tr>
<td>Less Operating expenses</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>240</td>
</tr>
<tr>
<td>Advertising</td>
<td>40</td>
</tr>
<tr>
<td>Total rental</td>
<td>20</td>
</tr>
<tr>
<td>Net income (profit)</td>
<td>300</td>
</tr>
</tbody>
</table>

Breakeven Analysis

• “…total sales revenue must exactly equal all your expenses…”

$ Fixed Costs
$ Variable Costs
$ Contribution Margin Per Unit
$ Breakeven Point In Units

Proposed Income Statement #3

<table>
<thead>
<tr>
<th>Stress-Buster Company Income Statement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Month Ended September 30, 20X1</td>
<td></td>
</tr>
<tr>
<td>[At breakeven level of sales = 75 units]</td>
<td></td>
</tr>
<tr>
<td>Sales (75 x $10)</td>
<td>$750</td>
</tr>
<tr>
<td>Less Cost of goods sold (75 x $6)</td>
<td>450</td>
</tr>
<tr>
<td>Gross profit (75 x $4)</td>
<td>300</td>
</tr>
<tr>
<td>Less Operating expenses</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>240</td>
</tr>
<tr>
<td>Advertising</td>
<td>40</td>
</tr>
<tr>
<td>Total rental</td>
<td>20</td>
</tr>
<tr>
<td>Net income (profit)</td>
<td>0</td>
</tr>
</tbody>
</table>

Balance Sheet

• “…tells what you have (and where it came from) at a specific point in time…”

- Assets – Business resources
- Liabilities – Debts owed to outside entities
- Owner’s Equity – Amount invested

Accounting Equation

\[ \int \frac{x + 5}{x^2 - 2x - 3} \, dx \]

\[ \int \frac{5}{3} \, dx = \int \frac{2}{x-3} \, dx - \int \frac{1}{x+1} \, dx \]

\[ = 2 \ln |x-3| - \ln |x| \]

\[ = \ln \left| \frac{(x-3)^2}{x+1} \right| + C \]

• Assets = Liabilities + Owner’s Equity

Stress-Buster Balance Sheet

<table>
<thead>
<tr>
<th>Stress-Buster Company Balance Sheet As of September 1, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Liabilities and Owner’s equity</td>
</tr>
<tr>
<td>Liabilities</td>
</tr>
<tr>
<td>Owner’s equity</td>
</tr>
<tr>
<td>Total Liabilities and Owner’s equity</td>
</tr>
</tbody>
</table>
Stress-Buster
Balance Sheet #2

Stress-Buster Company
Balance Sheet
As of September 30, 20X1

Assets
- Cash (original $600 plus $100 earned) $700
- Liabilities and Owner's equity
  - Liabilities $400
  - Owner's equity ($200 invested by owner plus $100 profits retained) $300
  - Total Liabilities and Owner's equity $700

Accrual Accounting
• “...accountant records a transaction when it occurs...”

- Account Receivable
- Account Payable
- Inventory

Classified Balance Sheet

Assets
- Current - Convert to cash within a year
- Long-Term - Intend to hold for more than a year

Liabilities
- Current - Pay off within a year
- Long-Term - Not due for more than a year

College Shop
Balance Sheet

The College Shop
Balance Sheet
As of January 1, 20X6

Assets
- Current assets
  - Cash $10,000
  - Account receivable $50,000
  - Inventory $75,000
- Long-term assets
  - Furniture, fixtures, and equipment $150,000
  - Total Assets $235,000

Liabilities
- Current liabilities
  - Accounts payable $15,000
  - Accrued liabilities $20,000
  - Total Current liabilities $35,000
- Long-term liabilities
  - Note payable due in 5 years $100,000
  - Owner's equity $102,000
  - Total Liabilities and Owner's equity $337,000

College Shop
Income Statement

The College Shop
Income Statement
Year Ended December 31, 20X5

Sales $450,000
Cost of goods sold 230,000
Gross profit 220,000
Operating expenses
  - Rent and utilities 30,000
  - Salaries and wages 75,000
  - Depreciation 30,000
  - Total Operating expenses 135,000
  - Operating income 85,000
  - Interest expense 10,000
  - Income before taxes 75,000
  - Income taxes 15,000
  - Net income 60,000

End-of-Year
Balance Sheet

The College Shop
Balance Sheet
As of December 31, 20X5

Assets
- Current assets
  - Cash $10,000
  - Account receivable $50,000
  - Inventory $60,000
  - Total Current assets $120,000
- Long-term assets
  - Property, plant, and equipment $150,000
  - Accumulated depreciation 50,000
  - Total Long-term assets $100,000
  - Total Assets $220,000

Liabilities
- Current liabilities
  - Accounts payable $15,000
  - Accrued liabilities 10,000
  - Total Current liabilities $25,000
- Long-term liabilities
  - Note payable due in 5 years $100,000
  - Owner's equity $102,000
  - Total Liabilities and Owner's equity $337,000
Statement Of Cash Flows

“...tells... where cash came from and where it went.”

Activities:
- Operating
- Investing
- Financing

Cash Flow Statement

The College Shop
Cash Flow Statement
As of December 31, 20X6

Cash inflows from Operating activities: $45,000
Cash outflows from Financing activities: $5,000
Increase in cash during the year: $40,000

Comparative Income Statement

The College Shop
Comparative Income Statement
Years Ended December 31, 2007 and 2008

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Cost of goods sold</th>
<th>Gross profit</th>
<th>Operating income</th>
<th>Less Operating expenses</th>
<th>Operating income</th>
<th>Less Interest</th>
<th>Less Income taxes</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$900,000</td>
<td>$213,000</td>
<td>$687,000</td>
<td>$180,000</td>
<td>$10,000</td>
<td>$170,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>2008</td>
<td>$900,000</td>
<td>$225,000</td>
<td>$675,000</td>
<td>$30,000</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Income Statement With Vertical Percentage Analysis

The College Shop
Comparative Income Statement
Years Ended December 31, 2007 and 2008

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Cost of goods sold</th>
<th>Gross profit</th>
<th>Operating income</th>
<th>Less Operating expenses</th>
<th>Operating income</th>
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<td>$170,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Amount</td>
<td>Percent</td>
<td>Amount</td>
<td>Percent</td>
<td>Amount</td>
<td>Percent</td>
<td>Amount</td>
<td>Percent</td>
<td>Amount</td>
<td>Percent</td>
</tr>
<tr>
<td>Sales</td>
<td>100.00%</td>
<td>Sales</td>
<td>100.00%</td>
<td>Sales</td>
<td>100.00%</td>
<td>Sales</td>
<td>100.00%</td>
<td>Sales</td>
<td>100.00%</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>23.67%</td>
<td>Cost of goods sold</td>
<td>24.70%</td>
<td>Cost of goods sold</td>
<td>22.92%</td>
<td>Cost of goods sold</td>
<td>22.92%</td>
<td>Cost of goods sold</td>
<td>22.92%</td>
</tr>
<tr>
<td>Gross profit</td>
<td>76.33%</td>
<td>Gross profit</td>
<td>75.30%</td>
<td>Gross profit</td>
<td>77.08%</td>
<td>Gross profit</td>
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<td>Gross profit</td>
<td>77.08%</td>
</tr>
<tr>
<td>Operating income</td>
<td>20.00%</td>
<td>Operating income</td>
<td>20.00%</td>
<td>Operating income</td>
<td>20.00%</td>
<td>Operating income</td>
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<td>20.00%</td>
</tr>
<tr>
<td>Less Operating expenses</td>
<td>11.11%</td>
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</tr>
<tr>
<td>Operating income</td>
<td>88.89%</td>
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<td>88.89%</td>
</tr>
<tr>
<td>Less Interest</td>
<td>2.22%</td>
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<td>Less Interest</td>
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<tr>
<td>Less Income taxes</td>
<td>1.11%</td>
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<td>1.11%</td>
<td>Less Income taxes</td>
<td>1.11%</td>
</tr>
<tr>
<td>Net income</td>
<td>96.67%</td>
<td>Net income</td>
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<td>Net income</td>
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<td>96.67%</td>
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Ratio Analysis

- % Profit Margin
- % Management Efficiency
- % Management Effectiveness
- % Financial Condition

Gross Profit Margin

- % Gross Profit Margin
  - Sales
Interest Coverage

Interest Coverage = Operating Income / Interest Expense

Basic Things to Succeed

- Good profit on each item
- Move inventory
- Good return on investment
- Watch cash

Challenges To Accounting Profession

- Arthur Andersen
- Enron
- Sarbanes-Oxley Act
- Public Accounting Oversight Board

Careers In Accounting

- "People Profession"
- Skills
  - Analytical
  - Interpersonal
  - Communication
- Job Prospects
  - Certified Public Accountants - Audits
  - Private Accountants - Controller
  - Certified Management Accountants