



Key Accounting Terms

- Accounting equation
- Revenue and expenses
- Capital and withdrawals
- Fixed cost and variable cost



Accounting Equation

Assets=Liabilities + Owner's Equity

A = L + OE



Transactions

 Any business event or activity that involves monetary value



Accounts



 Used to record and summarize business transactions





Revenue and Expenses

 Becomes a portion of owner's equity



- Revenue
 - Money earned from selling goods or services
 - Increases owner's equity



Revenue and Expenses

- Expense
 - Cost of goods or services that a business buys and uses to earn revenue
 - Decreases owner's equity



Revenue and Expenses

- Result in net profit or net loss
 Revenue Expenses
- Incorporated as
 - Assets = Liabilities + Owner's Equity + Revenue - Expenses
 A = L + OE + R - E



Capital and Withdrawals

• Determines the owner's equity

- Capital
 - Owner's investment
 - Increases owner's equity
- Withdrawals
 - When an owner withdraws assets



Fixed and Variable Costs

- Fixed costs do not vary with the amount of activity in a business
 - Property taxes, administration salaries, etc.



- Variable costs vary with the activity
 - Cost of direct material, direct labor and variable overhead, etc.



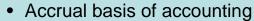
Accounting Records

- Chart of Accounts
 - · Detailed list of all accounts
 - Coded according to respective class of accounts
 - Assets:1
 - Liabilities: 2
 - Owner's equity: 3
 - Revenue: 4
 - Expenses: 5



Cash Basis and Accrual Basis

- Cash basis of accounting
 - Records transaction only when money is realized or paid
 - Does not accurately reflect period profit/loss



- Records transaction when revenue is earned or expense is incurred, not strictly when money has changed hands
- Presents a truer picture of period profitability/loss



Financial Statements Financial statements:



Income Statements



- Balance Sheet
- Cash Flow Statement
- Statement of Stockholder's Equity







Types of Expenses

- Cost of goods sold
 - Cost of products sold in an accounting period
- Cost of goods sold = Beginning inventory
 + Purchases Ending inventory
- Manufacturing cost of goods sold = Direct Material + Direct Labor + Variable Overhead + "Allocated" Factory Overhead



Types of Expenses

- Operating expenses
 - Expenditures that are necessary for the daily operations of a business
 - Marketing expenses
 - Administrative expenses
 - Other general expenses
 - Depreciation
 - Depletion



Types of Expenses (cont.)

- Interest expenses
 - Result of the financial structure of a business
 - Incurred if a company has taken a loan to support its asset investment
- Income tax (Federal, state & local)



Profit and Loss

- Gross profit on sales
 - Gross profit on sales = Total revenue
 Cost of goods sold
- Operating profit
 - Operating profit = Gross profit on sales – Operating expenses
- EBIT (Earnings Before Interest and Taxes)
 - EBIT = Operating profit + Other revenue
 - Other revenue: Dividends, Interest, etc.



Profit and Loss (cont.)

- Income before taxes
 - Income before taxes = EBIT Interest expenses
- Net profit or Net loss
 - Net profit or Net loss = Income before taxes – Income taxes



Interpret Income Statements

- Ratios used to interpret Income
 - Net operating margin
 - Profit margin on sales



Net Operating Margin

- Net Operating Margin = Operating profit/sales
- Expressed in percentage



 Compared to previous years' percentage to determine financial health



Profit Margin on Sales

- Profit Margin on Sales = Net Profit/Sales
- Expressed in percentage



- Financial health determined by comparing this percentage with the percentages of:
 - Previous years
 - Other companies



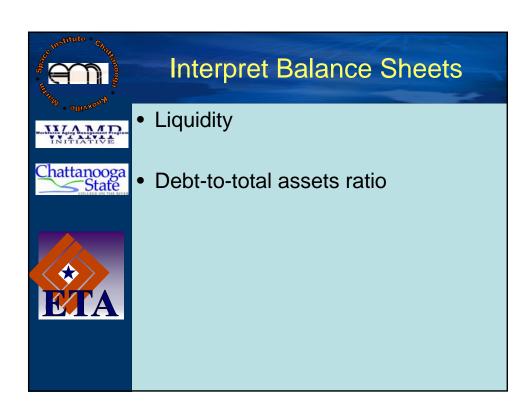
Inadequate Level of Gross Profit on Sales

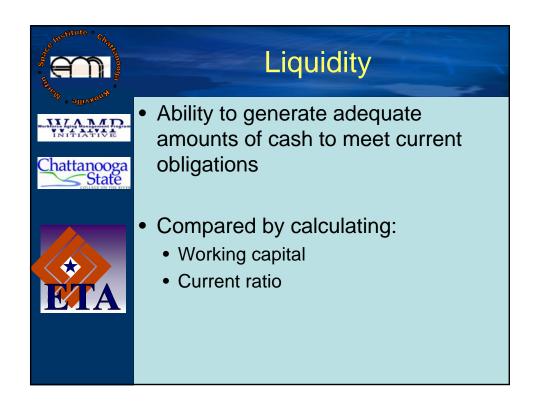
- The reasons could be:
 - Product volume
 - Price structure
 - Product costs



Balance Sheet

- Owner's equity
 - Capital Stock
 - Preferred
 - Common
 - · Retained earnings







Working Capital

- Working Capital = Current Assets –
 Current Liabilities
- Value should be neither too small nor too large



Current Ratio



 Reflects whether a company has sufficient current resources to meet obligations



- Current Ratio = Current Assets / Current Liabilities
- Expressed as a decimal
- Value should not be below 1



Debt-to-Total-Assets Ratio

- Debt-to-Total Assets Ratio = Total Liabilities / Total Assets
- Indicates:
 - · Liabilities per \$1 of assets
 - Measure ability to absorb a reduction in assets without hindering its ability to pay creditors
- Value should be low



Cash Flow Statement

- Includes three categories of accounts:
 - Operating activities
 - Investing activities
 - Financing activities



Operating Activities

- Cash inflows and outflows that relate to daily operations
- Generally result from purchase and sale of product or service
- Example:
 Collecting
 - Collecting from customers
 - · Collecting interest and dividends
 - Paying suppliers
 - Paying employees
 - Paying interest and tax



Investing Activities

 Involve the acquisition and sale of long-term assets

- Example:
 - Purchasing stocks
 - Selling fixed assets
 - Selling debt or stocks
 - Loaning money
 - Purchasing fixed assets



Financing Activities

 Result from issuance and repayment of long-term liabilities and capital stock



- Example:
 - Issuing stock certificates
 - Buying back your own stock
 - Issuing loans
 - Making loan payments



Fundamentals of Budgeting

- Budgeting is the process of planning and controlling the financial activities for an upcoming accounting period by:
- EVITA I
- Analyzing present performance
- Setting objectives for improving its future financial health



Importance of Budgeting

- Outlines a plan for managers and employees
- Fortifies effective pricing and spending efforts
- BenefitsRequires planning
 - Enhances communication
 - Reinforces accountability
 - Identifies problems
 - Motivates employees



Analyze Financial Statements

- Methods of analysis
 - Horizontal analysis
 - Trend analysis
 - · Vertical analysis
 - Ratio analysis



Horizontal Analysis

- Analyzes month-to-month or year-toyear changes for each line item on a financial statement
- Determines the method, the reason, and the outcome of change



Trend Analysis

- Analyzes changes for three or more years
 - Shown in dollar amount and percentage
 - With first year as base year and subsequent years as percentage of base year amount



Vertical Analysis

- Concentrates on the relationships between various items in the same period
- Top-down budgeting



Ratio Analysis

- Studies relationships between multiple items on financial statements
- Identifies strong and weak areas
- Compares business operations of similar companies



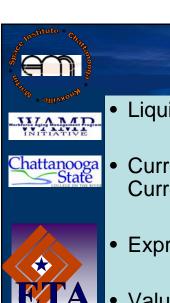
Information Provided by Ratio Analysis

- Liquidity ratios
 - Determine a company's ability to generate cash
- Activity ratios
 - Evaluate how well a company uses its assets
- Leverage ratios
 - Determine a business's ability to meet its long-term obligations
- Profitability ratios
 - · Determine returns for investors



Information used in Budgeting

- Working Capital
- Current ratio
- Acid test
- Inventory turnover ratio
- Days sales outstanding
- Total assets turnover ratio
- Debt-to-total-assets ratio
- Times-interest-earned ratio
- Net operating margin
- Profit margin on sales



Current Ratio

- Liquidity ratio
- Current Ratio = Current Assets / Current Liabilities
- Expressed as a decimal
- Value should not be below 1
- Generally 2:1 satisfactory



Acid Test or Quick Asset Rate

- More Restrictive
- Cash, marketable securities and accounts receivable to current liabilities



Inventory Turnover Rate

- Activity ratio
- Calculates the frequency of inventory to be sold out and restocked, per year
- Inventory Turnover Ratio = Cost of Goods Sold / Average Inventory
 - Average Inventory = (Beginning Inventory + Ending Inventory) / 2
- Value should be high



Days Sales Outstanding

- Activity ratio
- Indicates the length of time a business must wait after making a sale before receiving cash



- Days Sales Outstanding = Accounts Receivable / Average Sales Per Day
 - Average Sales Per Day = Annual Sales / 360
- · Value should be low



Total Assets Turnover Ratio

- Activity ratio
- Indicates a business's ability to generate sales in relation to its total assets
- Total Assets Turnover Ratio = Sales / Total Assets
- Value should be high



Total Debt-to-Total Assets Ratio

- Leverage ratio
- Indicates a company's
 - · Liabilities per \$1 of assets
 - Ability to absorb a reduction in assets without hindering its ability to pay creditors
- Total Debt-to-Total-Assets Ratio = Total Liabilities / Total Assets
- · Value should be low



Times-Interest-Earned Ratio

- Leverage ratio
- Measures ability to meet its annual interest payments



- Times-Interest-Earned Ratio = Operating Profit / Interest Charges
- Value should be high



The Profit Margin on Sales

- Profitability ratio
- Indicates how satisfactory business activities have been



- Profit Margin on Sales = Net Profit / Sales
- Value should be high



The Break-Even Point

- Occurs when
 - Total sales = Total expenses, with nothing left over for profit
 - Operating income = zero



Break-Even Point = Total Fixed
 Operating Expenses / Contribution
 Profit Margin per unit



The Break-Even Example

Fixed Cost = \$2,000,000

R = \$100 VC = \$60/unit

Profit Contribution

PC = \$100-\$60 = \$40/unit

BE = $\frac{$2,000,000}{$40}$ = $\frac{50,000 \text{ units}}{}$

at 50,000 units

R = 50,000 (\$100) = \$5,000,000

VC = 50,000 (\$60) = \$3,000,000 FC = = \$2,000,000

Total Cost \$5,000,000

Profit 0



Budget Objectives

- Relevant
 - To your business's vision
- Measurable
 - In quantitative terms
- Realistic
 - Challenging but not impossible



Monitor Performance

- Record the actual performance of the business on "pro forma" statements
- To compare actual performance with the budgeted amount



"Pro Forma" Financial Statements

- Forward-looking documents
- Created when setting a budget
- Used to establish the projected financial activity for an upcoming accounting period
- Used only for internal purposes and not viewed by external parties

IMXMPLE, INC. Income Statement For year ending 12/31/04 (01/01/04 – 12/31/04)	
Sales	\$12,000,000
Cost of Goods Sold	7,000,000
Gross Profit on Sales	5,000,000
Operating Expenses	
Selling \$300,000	
Gen & Adm 400,000	
Dep & Depl <u>500,000</u>	
Total Operating Expenses	<u>1,200,000</u>
Operating Profit	3,800,000
Other Revenue	
Dividends & Interest	<u>20,000</u>
Earnings before Int. & Taxes	3,820,000
Other Expenses _	
Interest Expense	500,000
Income Before Taxes	3,320,000
Provision for all taxes	1,200,000
Net Profit for year	<u>\$2,120,000</u>



Accounting Equation

Total Assets =
Total Liabilities + Total Equity

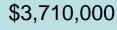
\$18,610,000 = \$8,789,000 + \$9,821,000 \$18,610,000 = \$18,610,000



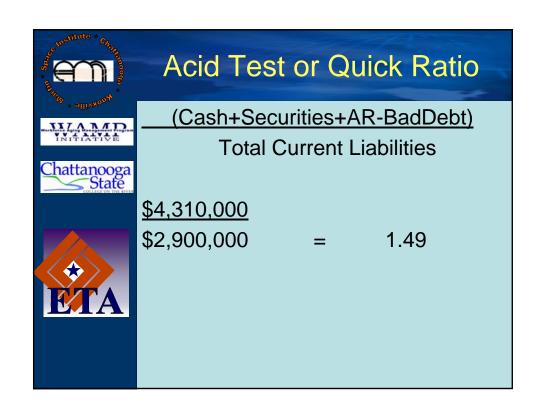
Working Capital

Current Assets - Current Liabilities

\$6,610,000 - \$2,900,000 =

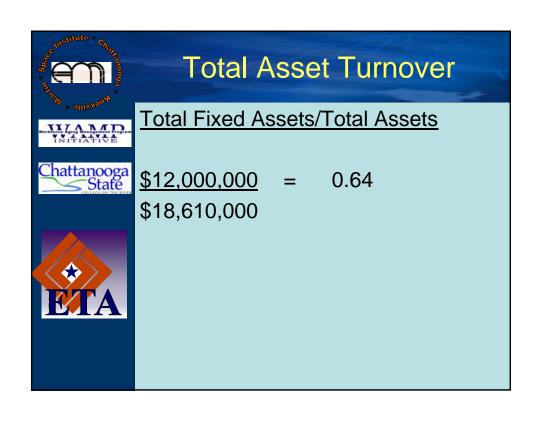


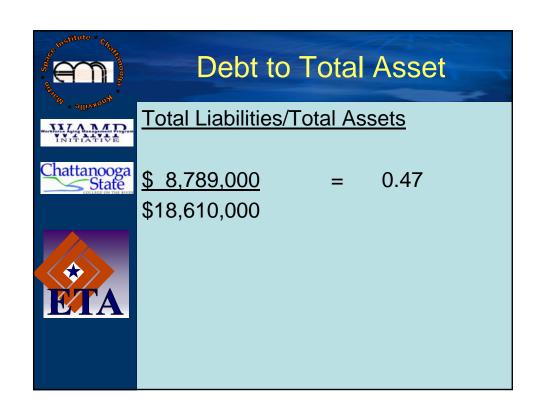














		Balar	MPLE, INC. nce Sheet 12/31/04	
ASSETS Current Assets Cash Mkt. Sec Acct Rec Less Allocated (Bad Debt)	\$3,250,000 40,000	\$400,000 700,000 3,210,000	LIABILITIES Current Liabilities Acct payable Notes payable Accrued Lin Taxes payable	\$500,000 300,000 400,000 1,200,000
Inventory		2,300,000	Div. payable	_500,000
Total Current Assets		6,610,000	Total Current Liabilities	2,900,000
Fixed Assets Real Estate Equipment Less Dept.	4,000,000 1,000,000	9,000,000 3,000,000	Long Term Liabilities Bonds Debentures	4,000,000 _1,889,000
Total Fixed Assets		12,000,000	Total Long Term	5,889,000
Total Assets		\$18,610,000	Total Liabilities	\$8,789,000
			OWNER Stock Preferred Common Additional Retained Earnings Total Equity	S EQUITY 1,000,000 4,000,000 4,000,000 821,000 \$9,821,000

