Objectives and Game Plan

- Understand some key concepts of Financial Accounting
- Appreciate the differences between cash basis and accrual accounting
- Develop a mental model for classifying types of accruals
- Practice the basic bookkeeping model
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- Understand some key concepts of Financial Accounting
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Key Conflict: Relevance v. Reliability

Example: How should we value one-of-a-kind assets, like one of Intel’s wafer fabrication plants?
Key Conflict: Relevance v. Reliability

Example: How to value one-of-a-kind assets?

• Financial accounting stresses Reliability: Verifiable and objective information.

• However, we will see that there is ample room for managerial judgment when applying “objective rules.”
Important Financial Accounting Concepts

- Consistency: Across time
- Comparability: Across firms
- Conservatism: “anticipate no profit, but anticipate all losses”
- Materiality: Benefit/cost trade-off

Revenue Recognition

Matching Principle: Matching Efforts (costs) with Benefits (revenue)

Further, we will make assumptions about the Economic Entity, its ability to survive as a Going Concern, and the Fiscal Period (which need not be the calendar year)
The Balance Sheet Equation

Assets = Liabilities + Shareholders’ Equity

Assets “own” - Liabilities “owe” = Shareholders’ Equity “owners’ share of the business” (book value, residual claim)
Objectives and Game Plan

- Understand some key concepts of Financial Accounting

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Accounting in a Single-Period World is “Easy”

Example: Shipping Expeditions in the 15th Century
- Ship sold at end of voyage: finite project life
- No information available until ship returns
- Income is simply difference between cash out and cash in
Accounting in a Multiperiod World is “Difficult”

- No pre-determined end to firm's life; a firm is going concern
- Cash invested and generated at multiple points in time
- Monitoring by external investors requires them to evaluate investments and retain/reward management at particular points in time
- Therefore: Accrual accounting; the hope is that it allows performance measurement and monitoring at particular points in time, independent of when cash effects occur.
Principles of Accrual Accounting

► An attempt to measure *firm performance* in a particular period regardless of when cash is exchanged

► Revenue Recognition:
  • Earnings process substantially complete
  • Cash collection reasonably assured

► The Matching Principle for Expenses:
  • Match *efforts* to the benefits generated
  • Capitalize expenditures that will benefit future periods, expense as benefits are realized
  • Recognize liabilities when efforts benefiting the current period require cash payment in the future
Objectives and Game Plan

- Understand some key concepts of Financial Accounting
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# Cash Collection v. Revenue Recognition

## Prior Period

<table>
<thead>
<tr>
<th>Cash received concurrent with earning revenue</th>
<th>+ Cash (A) = + Revenue (SE) → Income Statement</th>
</tr>
</thead>
</table>

## Current Period

<table>
<thead>
<tr>
<th>Cash received before earning revenue</th>
<th>- Deferred Revenue (-L) + Revenue (SE) → Income Statement</th>
</tr>
</thead>
</table>

## Subsequent Period

<table>
<thead>
<tr>
<th>Cash received after earning revenue</th>
<th>+ Accounts Receivable (A) = + Revenue (SE) → Income Statement + Cash (A) - A/R (-A) = 0</th>
</tr>
</thead>
</table>

Note: Deferred Revenue can also be called Advances from Customers. Both names signify that cash has been received for a service or product that hasn't been delivered.

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**Session 2**

15.5.15 2003
## Cash Payment v Expense Recognition

<table>
<thead>
<tr>
<th></th>
<th>Prior Period</th>
<th>Current Period</th>
<th>Subsequent Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid <em>concurrent with</em> using resource to generate revenue</td>
<td>- Cash (-A) = + Expense (-SE) ➔ Income Statement</td>
<td>- Cash (-A) = + Expense (-SE) ➔ Income Statement</td>
<td></td>
</tr>
<tr>
<td>Cash paid <em>before</em> using resource to generate revenue</td>
<td>- Cash (-A) + Productive Asset (A) = 0</td>
<td>- Productive Asset (-A) = + Expense (-SE) ➔ Income Statement</td>
<td></td>
</tr>
<tr>
<td>Cash paid <em>after</em> using resource to generate revenue</td>
<td>0 = + Accrued Liability (L) + Expense (-SE) ➔ Income Statement</td>
<td>- Cash (-A) = - Accrued Liability (-L)</td>
<td></td>
</tr>
</tbody>
</table>

Note: The "Productive Asset" could be inventory, Prepaid Insurance, PP&E, etc. In the case of PP&E, we would reduce the value of the asset through the contra-asset Accumulated Depreciation. The "Accrued Liability" could be Accounts Payable, Accrued Wage Expense, Interest Payable, etc.
Temporary v Permanent Accounts

Permanent Accounts:
- Appear on the Balance Sheet
- Start each period with the ending balance from the prior period

Temporary Accounts:
- Appear on the Income Statement
- Start each period with a balance of $0
- Are closed at the end of the period to the Income Summary to compute Net Income for the period
Handling Temporary Accounts in the Balance Sheet Equation (BSE) Format

Net Income = Revenues - Expenses + Gains - Losses


Therefore...

• Revenues and Gains ultimately Increase Ret. Earn.
• Expenses and Losses ultimately Decrease Ret. Earn.
• We’ll record Income Statement components directly to the Permanent Account, Retained Earnings, with a note about the reason
• Recognize that this is a short-cut around the use of Temporary Accounts
Objectives and Game Plan

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Exercise E4-19: Peters Company

See Example E4-19: Peters Company on pages 163-4 in the course textbook.
Exercise E4-19: Peters Company (continued)

\[ \text{Cash} + \ AR + \text{PPRent} + \text{Inv} = \ AP + \text{WgsPble} + \text{CC} + \text{RE} \]

<table>
<thead>
<tr>
<th>BB</th>
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<tbody>
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<td>4a</td>
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<td>5</td>
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</tr>
</tbody>
</table>

EB

\[ \text{Total Assets} = \]

\[ \text{Liab} + \text{SE} = \]
## Exercise E4-19: Peters Company (continued)

<table>
<thead>
<tr>
<th>Performance Measure</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Cash Flow from Operations</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Key Points

- Relevance of Accounting Measures depends on the decision context

- Most relevant measures are sometimes the least reliable: a major trade-off in accounting

- Accrual Accounting attempts to measure performance, regardless of when cash is affected
  
  • Tables on *Cash Collection v. Revenue Recognition* slides provide a framework for thinking about the accrual process

- Balance Sheet Equation (BSE) as a tool for understanding events' impacts on the Financial Statements