

Transaction Analysis

Cash vs. Accrual Accounting

Accrual accounting based on GAAP

- Realization principle
 - o Record revenue when:
 - 1. The earnings process is complete or virtually (when goods are sold/services performed) complete
 - 2. There is reasonable certainty as to the collectability of the asset received
 - o It is not necessary to receive cash in order to record revenue
 - o The receipt of cash doesn't always indicate that a revenue has been earned
 - o Record revenue independent of exchange of cash
 - o It is required that the receipt of cash be relatively assured in order to record revenue
- Problem #1
- The Matching Principle
 - o Record expenses when:
 - 1. The same accounting period that the related revenue is earned in
 - The determining factor in the timing of recording expenses is the generation of revenue not the payment of cash
 - For most expenses, it is difficult to trace to a specific revenue so they recorded, when they are incurred
- Problem #2
- Cash accounting does not follow GAAP
 - o Record revenues when cash is received
 - o Record expenses when cash is paid
- Problem #3
- Accrual accounting must be used by all companies who sell stock to the public
- Cash accounting can be used by any company who doesn't sell stock to the public
- Cash accounting is also used by individuals to account for their personal finances
- If a company who does not sell stock to the public attempts to get a bank loan, they are typically required to present their financial statements using accrual accounting
- This is usually required because cash accounting can be easily manipulated and thus could lead to misleading financial statements
- Account - place where all increases and decreases in financial statement are recorded
- Analyze accounts using a T-account
 - o 1. Top (heading) → place account name
 - o 2. Left side - debit

- o 3. Right side - credit
- Example #4
- Accounting transactions - economic events that require recording in the financial statements
 - o Transactions are recorded in the financial statements because they result in a change to assets, liabilities, and/or equity accounts
 - o Not all activities represent transactions
- Ledger - all the accounts of the company taken together (think of the ledger as all the T-accounts of the company)
- Journal - the place where all accounting transactions are initially recorded
- Journal entry - the means used to record transactions in the journal
- Notice debts always = credits
- Double-entry accounting - every transaction must be recorded with at least one credit and one debit with the total dollar debits = total dollar credits
- Posting - process of transferring credit and debit accounts from the journal ledger
 - o Posting the T-accounts allows us to determine the ending balance in each account
- Double-entry system - effects two or more accounts
- Example #5
- Gains - a gain is recorded when you sell an asset other than inventory for more than it cost
 - o You are not in the business of selling these assets - they are not part of your inventory
 - o The gain = selling price - cost
 - o A gain is classified as a revenue account
- Losses - a loss is recorded when you sell an asset other than inventory for less than it cost
 - o You are not in the business of selling these assets - they are not part of your inventory\
 - o The loss = cost - selling price
 - o A loss is classified as an expense account
- New account - dividends
 - o Payments by corporation to stockholders
 - o *Not an expense account*
 - o Dividends are classified as a contra equity account since it reduces equity

Accounting Cycle Basic Steps

- 1. Record transactions in the journal (use journal entries)
- 2. Post debit and credit amounts from the journal to the ledger

- 3. Prepare a trial balance
 - o Trial balance - a list of accounts and their balances at a given time
 - The primary purpose of a trial balance is to prove debits = credits after posting
 - If debits and credits do not agree, the trial balance can be used to uncover errors in journalizing a post
 - o *The total debits must equal the total credits*
 - Errors can occur and trial balance agrees
 - o Incorrect accounts or amounts used in journalizing or posting
 - o A journal entry is not recorded
- 4. From trial balance, prepare financial statements
- Financial statement analysis - involves the examination of both the relationships among financial statement numbers and the trends in those numbers over time
 - o Purposes:
 - o 1. Use the past performance of a company to predict how it will do in the future
 - o 2. Evaluate the performance of a company with an eye toward identifying problem areas
- Financial ratios - relationships between financial statements amounts
 - o Ratios are used by creditors and investors to help them make decisions
 - o Specifically these ratios aid users in deciding whether or not to invest in or loan money to a company
- Note - a single ratio by itself is not very meaningful, they provide meaningful information when they can be compared with same bench mark (needs to be a comparison)
 - o Typical benchmarks or Comparison Points
 - 1. Other companies that operate in the same industry
 - 2. Industry averages
 - 3. Past years (trend analysis)
- Two ratios to be discussed:
 - o 1. Working capital = current assets - current liabilities
 - o 2. Current ratio = current assets/current liabilities
- Both of these are referred to as liquidity ratios
- Liquidity ratios - measure the short-term ability of the company to its debts as they come due
 - o Who cares? Short-term creditors such as bankers and suppliers
- Both ratios give a user a feel for the company's ability to pay their debts when their due, one ratio is in the form of a dollar and the other in form of "# of times"
- Effects of transactions on the liquidity ratios
 - o Assume working capital is positive and the current ratio is greater than 1