



BACHELOR  
of ECONOMICS



**Thammasat University  
Faculty of Economics  
Bachelor of Economics (International Program)**

**AC 201**  
Fundamental Accounting

**Semester 1/2016**

**Course Materials**

**Topics:**

Chapter 3 Operating Decisions and  
the Accounting System

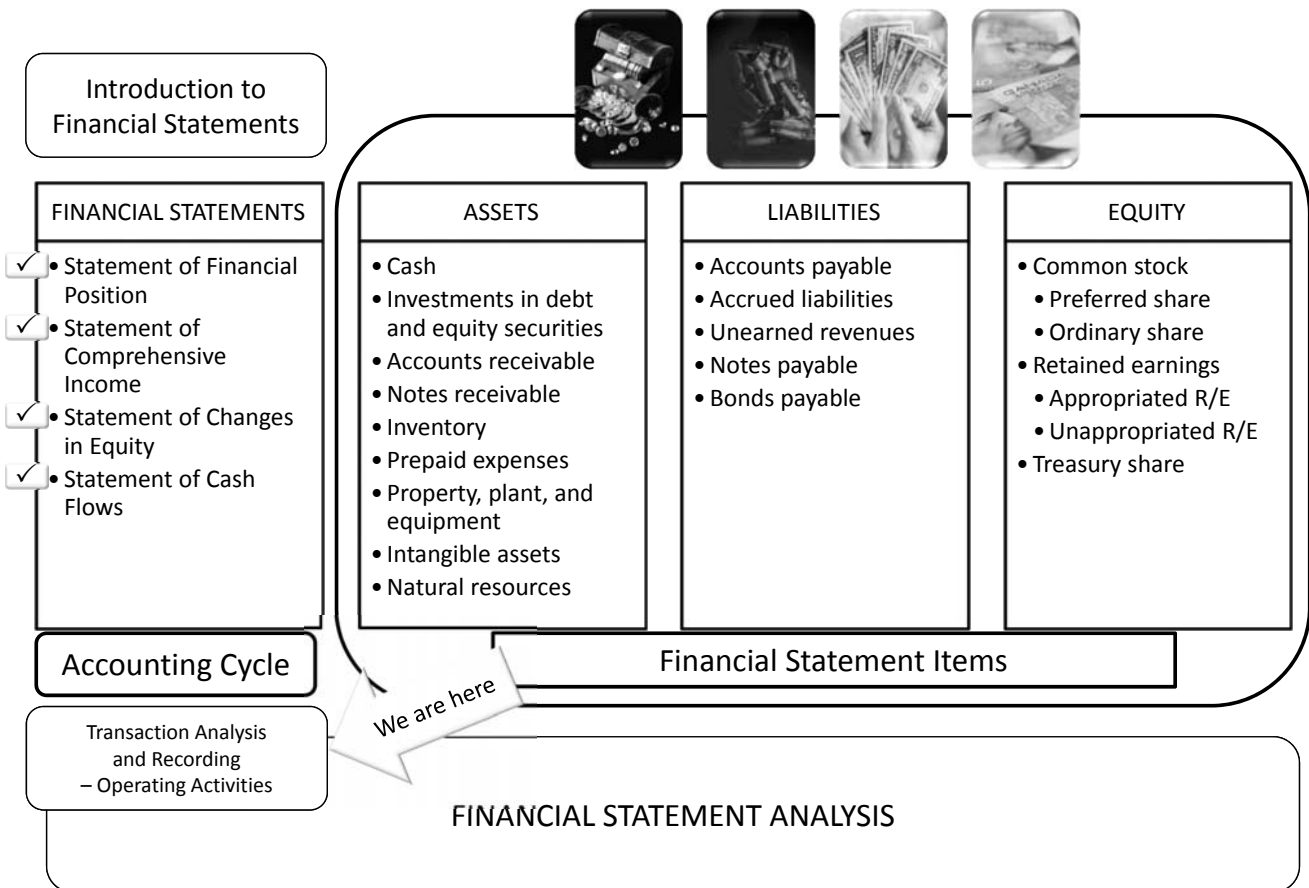
**Session:**

Session #3

**Instructor:**

Ajarn Santana Singhasaneh





AC201 Fundamental Accounting



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## CHAPTER 3: OPERATING DECISIONS AND THE ACCOUNTING SYSTEM

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## How do Business Activities Affect the Statement of Income ?



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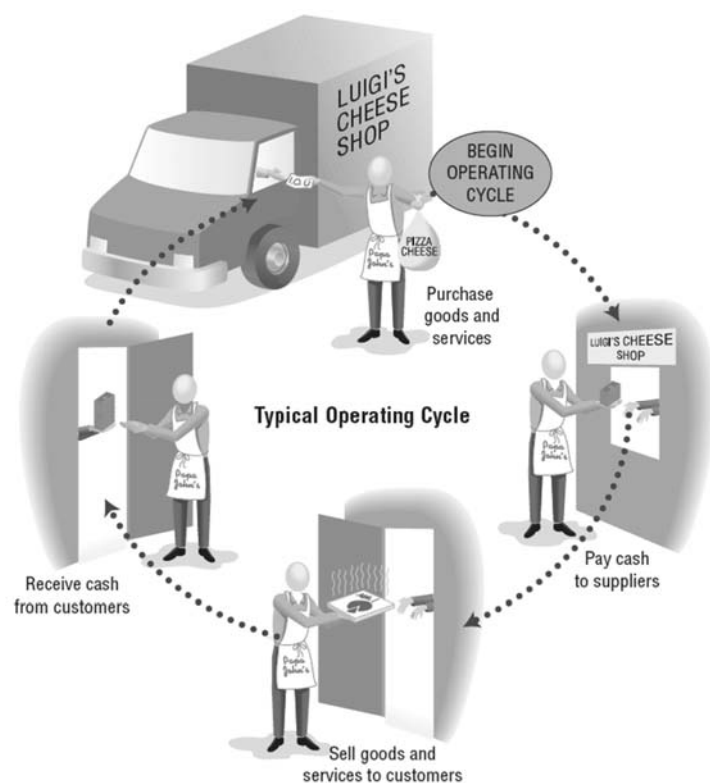


## The Operating Cycle

### Operating (Cash-to Cash) Cycle:

is the time it takes to receives goods or services from suppliers, to pay cash to suppliers, to sell them to customers, and to collect cash from customers.

**Time-Period Assumption:**  
To measure and report financial information periodically, we assume that the long life of a company can be cut into shorter periods.



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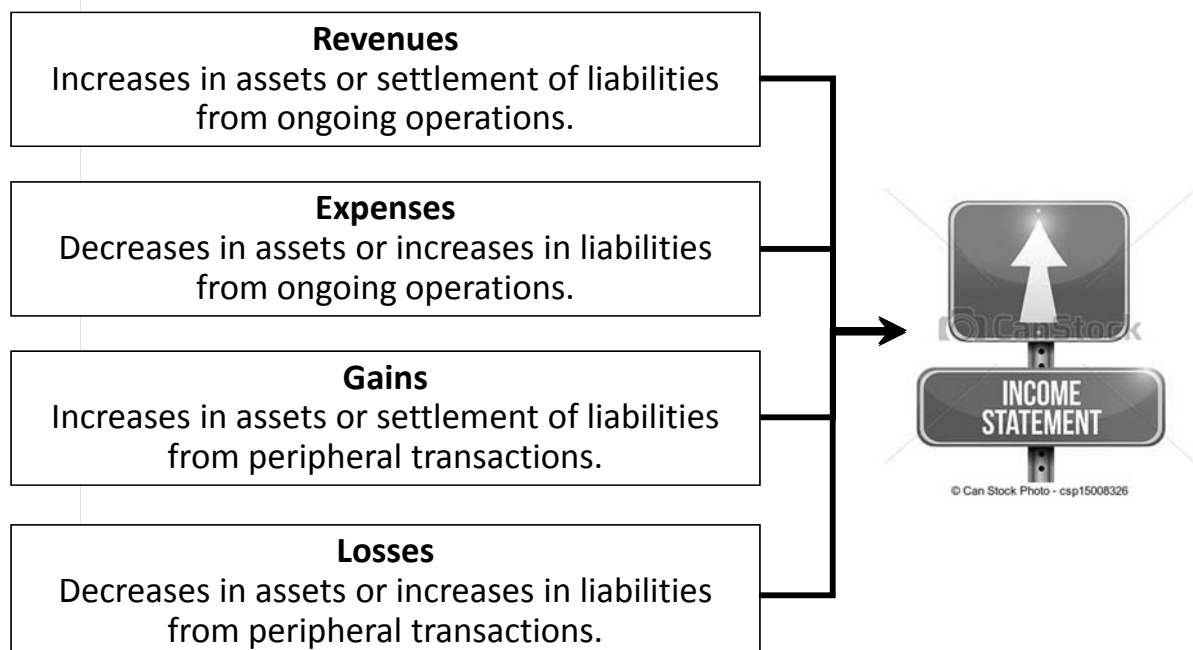
## The Operating Cycle

Issues arise in reporting periodic income to users:

1. **Recognition Issues:** *When* should the effects of operating activities be recognized (recorded)?
2. **Measurement Issues:** *What amounts* should be recognized ?



## Elements of the Statement of Income



PAPA JOHN'S INTERNATIONAL, INC.  
**Consolidated Statement of Income**  
**For the Year Ended December 31, 2008**  
(dollars in thousands)

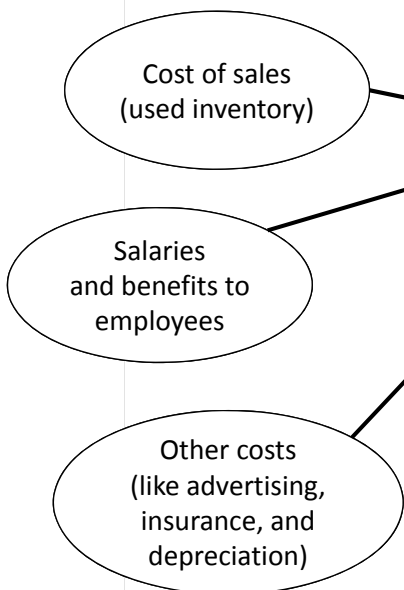
<b>Operating Revenues</b>				
Restaurant sales revenue	\$ 996,000	}		
Franchise fee revenue	136,000			
<b>Total revenues</b>	<b>1,132,000</b>			
<b>Operating Expenses</b>				
Cost of sales	483,000	}	<i>Operating activities (central focus of the business)</i>	
Salaries expense	193,000			
Rent expense	35,000			
Advertising expense	49,000			
General and administrative expenses	100,000			← <i>Includes insurance, repairs, utilities, and fuel expenses</i>
Depreciation expense	33,000			
Other operating expenses	172,000			
<b>Total expenses</b>	<b>1,065,000</b>			
<b>Operating Income</b>	<b>67,000</b>	← <i>Subtotal of operating revenues minus operating expenses</i>		
<b>Other Items</b>				
Investment income	1,000	}	<i>Peripheral activities (not the main focus of the business)</i>	
Interest expense	(8,000)			
Loss on restaurants sold	(3,000)			
<b>Income before Income Taxes</b>	<b>57,000</b>	← <i>Subtotal of all revenues minus all expenses except taxes</i>		
Income tax expense	20,000			
<b>Net Income</b>	<b>\$ 37,000</b>			
<b>Earnings per Share</b>	<b>\$ 1.32</b>	← <i>= \$37,000,000 Net Income ÷ 28,100,000 Average Number of Shares Outstanding (from Papa John's annual report)</i>	7	



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PAPA JOHN'S INTERNATIONAL, INC.  
**Consolidated Statement of Income**  
**For the Year Ended December 31, 2008**  
(dollars in thousands)

Papa John's  
Primary Operating Expenses



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<b>Net Income</b>	<b>\$ 37,000</b>	
<b>Earnings per Share</b>	<b>\$ 1.32</b>	



## International Perspective: Statement of Income Differences



As indicated in Chapter 2, under IFRS, the income statement is usually titled the Statement of Operations. There is also a difference in how expenses may be reported:

	GAAP	IFRS
<b>Presentation of Expenses</b> <ul style="list-style-type: none"> <li>Similar expenses are reported, but may be grouped in different ways</li> </ul>	Public companies categorize expenses by <b>business function</b> (e.g., production, research, marketing, general operations).	Companies can categorize expenses by either <b>function or nature</b> (e.g., salaries, rent, supplies, electricity).

In addition, foreign companies often use account titles that differ from U.S. companies. For example, GlaxoSmithKline (a U.K. pharmaceutical company), Parmalat (an Italian food producer of milk, dairy products, and fruit-based beverages), and Unilever (a U.K. and Netherlands-based company supplying food, home, and personal care products such as Hellman's mayonnaise, Dove soap, and Popsicle treats) use the term *turnover* to refer to sales revenue, *finance income* for income from investments, and *finance cost* for interest expense. BMW Group, on the other hand, reports *revenues* and uses *financial result* for the difference between income from investments and interest expense. All four companies follow IFRS.

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## How are Operating Activities Recognized and Measured ?



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## How Are Operating Activities Recognized and Measured?

### Cash Basis Accounting:

records only **CASH** transactions. Cash receipts are treated as revenues, and cash payments are treated as expenses.

### Accrual Basis Accounting:

records the impact of business transactions on the entity's assets and liabilities **in the period in which those transactions occur**, even if the resulting cash receipts or payments occur in a prior or future period.



## How Are Operating Activities Recognized and Measured?

### Cash Basis Accounting

**Revenues** are recorded when cash is received and **Expenses** are recorded when cash is paid.

#### Income Measurement

Revenues [= cash receipts]  
- Expenses [= cash payments]  
Net income [cash basis]

Earn = to receive as return for effort and especially for work done or services rendered

### Accrual Basis Accounting

**Revenues** are recorded when earned and **Expenses** are recorded when incurred, regardless of the timing of cash receipts or payments.

#### Income Measurement

Revenues [= when earned]  
- Expenses [= when incurred]  
Net income [accrual basis]



## Example: Cash Basis v/s Accrual Basis Accounting

- During 2014, Canine Consulting billed its client for \$55,000 for its services. On December 31, 2014, it had received \$2,500, with the remaining \$52,500 to be received in 2015. Total expenses during 2014 were \$34,000 with \$33,000 of these costs not yet paid at December 31, 2014. Determine net income for the year 2014 under both method.

### Cash Basis: Income Measurement

Revenues	2,500	[= cash receipts]
- Expenses	(1,000)	[= cash payments]
<u>Net income</u>	<u>1,500</u>	[cash basis]

### Accrual Basis: Income Measurement

Revenues	55,000	[= when earned]
- Expenses	(34,000)	[= when incurred]
<u>Net income</u>	<u>21,000</u>	[accrual basis] ✓

Accrual basis accounting allows for a **BETTER** measure of a company's economic measurement

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## How Are Operating Activities Recognized and Measured?

### Accrual Basis Accounting ✓

In accrual basis accounting, revenues and expenses are recognized (recorded) when the transaction that causes them occurs, **NOT** necessarily when cash is received or paid.

**Revenues** are recorded when earned,  
**Expenses** are recorded when incurred,  
regardless of the timing of cash receipts or payments.

Two basic accounting principles that determine **when** revenues and expenses are recorded:

1. Revenue realization principle
2. Expense matching principle

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## Accrual Basis: Revenue Realization Principle



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## Revenue Realization Principle

Under the Revenue Realization Principle,  
**ALL 4 criteria** must be met for **REVENUE** to be **RECOGNIZED**.

1. Delivery has occurred or services have been rendered;
2. There is persuasive evidence of an arrangement for customer payment;
3. The price is fixed or determinable; and
4. Collection is reasonably assured.

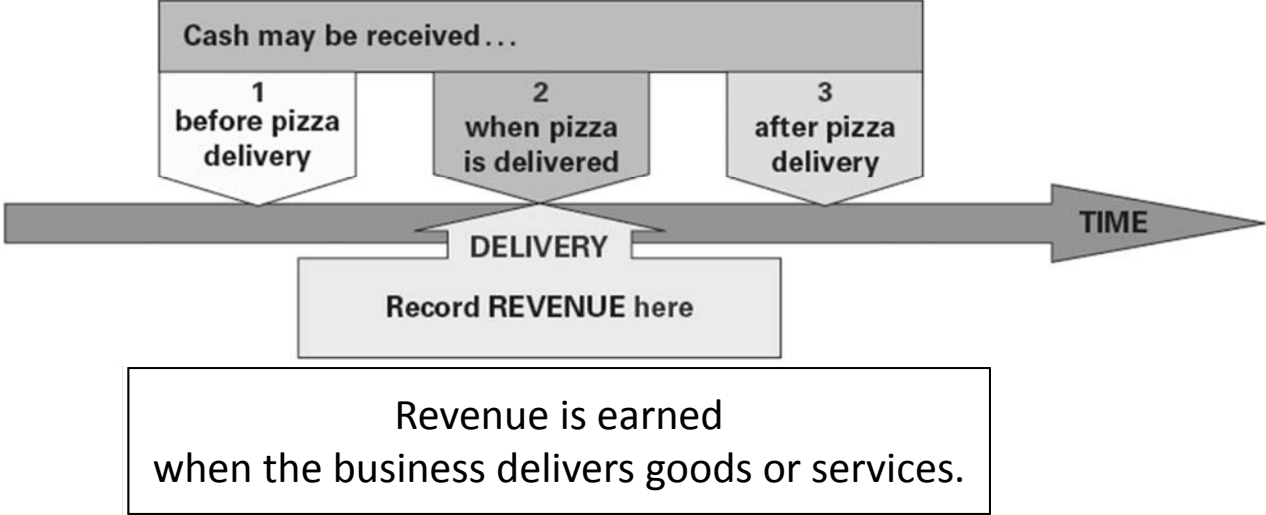
For most businesses, these conditions are met  
**at the point of delivery of goods or services**,  
regardless of when cash is received.

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# Revenue Realization Principle

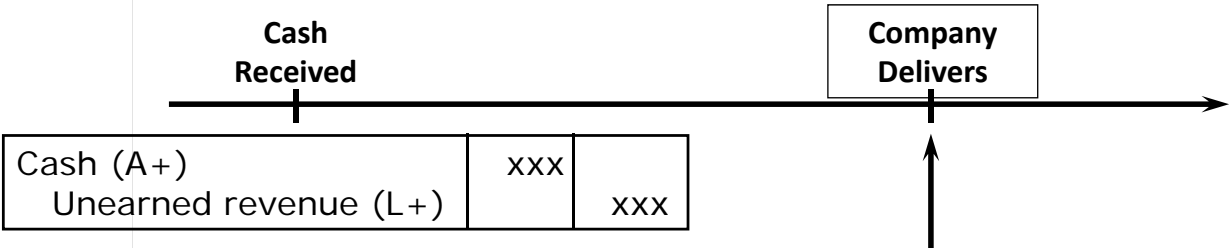
## Recording Revenues v/s Cash Receipts



# 1. Cash Received BEFORE Revenue is Earned (1)

If cash is received **BEFORE** the company delivers goods or services, a liability account **UNEARNED REVENUE** is recorded.

When the company delivers the goods or services, **UNEARNED REVENUE** is reduced and **REVENUE** is recorded.



**Unearned revenue:**  
A liability representing a company's obligation to provide goods or services to customers in the future.

**Revenue will be recorded when earned.**

Unearned revenue (L-)	xxx	
Service revenue (REV+)		xxx



## 1. Cash Received BEFORE Revenue is Earned (2)

**UNEARNED REVENUE:**

Some businesses collect cash from customers before earning of revenue. This create a liability called “unearned revenue.”

**Example:** On August 1, ABC Company received \$16,000 cash for its services to be provided to a customer during the following 3 months. The company noted that it had provided \$10,000 worth of services in the month of August.

When cash is received {

Date	Account Title & Explanation	Debit	Credit
Aug 1	Cash (A+)	16,000	
	Unearned revenue (L+)		16,000

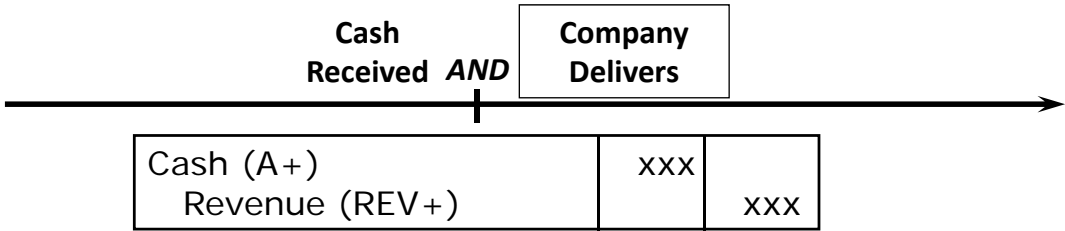
When revenue is earned {

Date	Account Title & Explanation	Debit	Credit
Aug 31	Unearned revenue (L-)	10,000	
	Service revenue (REV+, E+)		10,000



## 2. Cash Received WHEN Revenue is Earned

When cash is received **ON** the date the **REVENUE** is earned, the following entry is made:

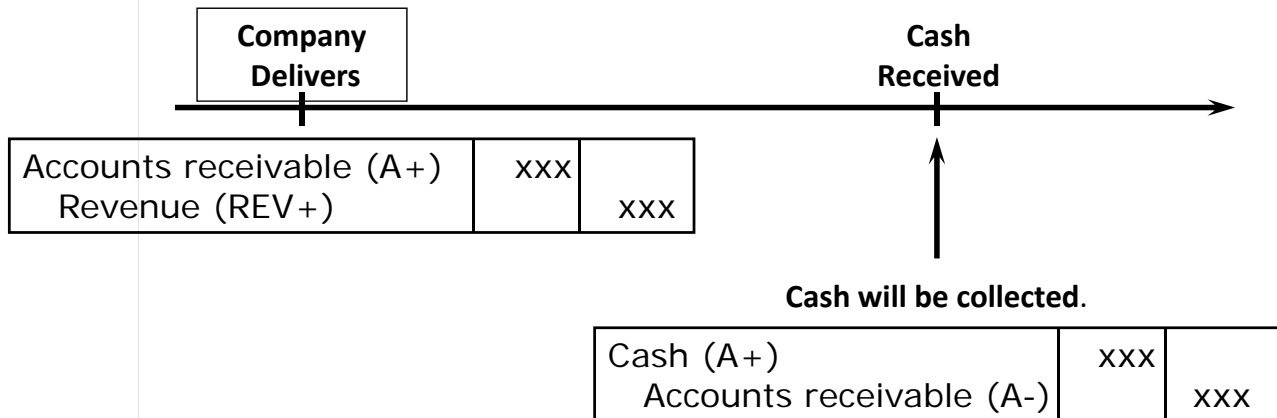




### 3. Cash Received AFTER Revenue is Earned (1)

If cash is received **AFTER** the company delivers goods or services, an asset account **ACCOUNTS RECEIVABLE** is recorded.

When the cash is received the **ACCOUNTS RECEIVABLE** is reduced.



### 3. Cash Received AFTER Revenue is Earned (2)

**ACCOUNTS RECEIVABLE:**

Businesses may earn revenue before they receive the cash. A revenue that has been earned but not yet collected is called accounts receivable.

**Example:** On August 4, ABC Company delivered merchandise of \$7,100 to a customer on account. On September 3, the customer paid the amount in full.

When revenue is earned	<b>Date</b>	<b>Account Title &amp; Explanation</b>	<b>Debit</b>	<b>Credit</b>
	Aug 4	Accounts receivable (A+)	7,100	
		Sales revenue (REV+, E+)		7,100

When cash is received	<b>Date</b>	<b>Account Title &amp; Explanation</b>	<b>Debit</b>	<b>Credit</b>
	Sep 3	Cash (A+)	7,100	
		Accounts receivable (A-)		7,100

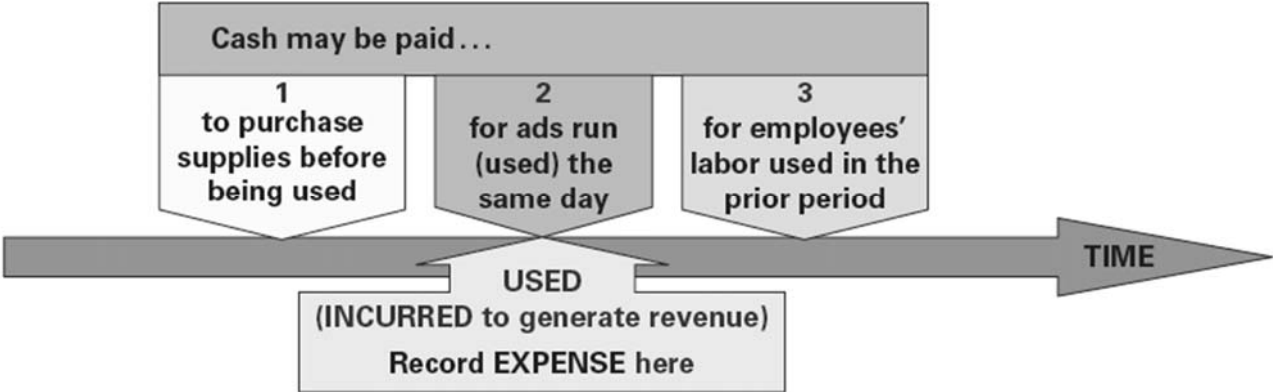


## Accrual Basis: Expense Matching Principle



## Expense Matching Principle

### Recording expenses v/s cash payments



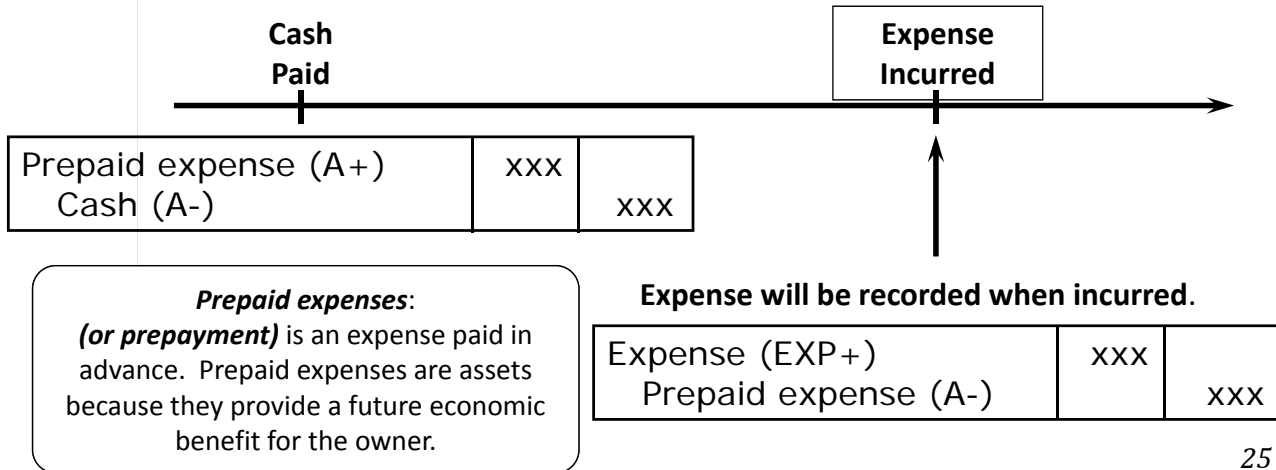
**EXPENSES** are **RECOGNIZED**  
when they are incurred in generating revenue,  
regardless of when cash is paid.



## 1. Cash is Paid BEFORE Expense is Incurred (1)

If cash is paid **BEFORE** the company receives goods or services, an asset account, **PREPAID EXPENSE** is recorded.

When the expense is incurred **PREPAID EXPENSE** is reduced and an **EXPENSE** is recorded.



## 1. Cash is Paid BEFORE Expense is Incurred (2)

Typical assets and their related expense accounts include. . .

CASH PAID FOR (ASSETS)	As USED over time becomes	EXPENSE
Prepaid rent	—————>	Rent expense
Prepaid insurance	—————>	Insurance expense
Supplies	—————>	Supplies expense
Building & equipment	—————>	Depreciation expense



# 1. Cash is Paid BEFORE Expense is Incurred (3)

**PREPAID EXPENSES:**

Companies pay rent (or insurance) in advance. This prepayment creates an asset for the renter (or insurer), who can use the rented item (or be covered by the insurance policy) in the future.

**Example:** On August 1, ABC Company paid \$3,000 cash for 3 months' store rent. ↖ \$1,000 per month

When cash is paid {

Date	Account Title & Explanation	Debit	Credit
Aug 1	Prepaid rent (A+)	3,000	
	Cash (A-)		3,000

When expense is incurred {

Date	Account Title & Explanation	Debit	Credit
Aug 31	Rent expense (EXP+, E-)	1,000	
	Prepaid rent (A-)		1,000



Prepaid rent & Rent expense				
	August x1	Septeber x1	October x1	
Prepaid rent at beginning of month	3,000	2,000	1,000	
Add increase during month	-	-	-	
Less <u>used up</u> during month	(1,000)	(1,000)	(1,000)	
Prepaid rent at end of month	<u>2,000</u>	<u>1,000</u>	<u>-</u>	
Rent <u>expense</u> (EXP)	1,000	1,000	1,000	



# 1. Cash is Paid BEFORE Expense is Incurred (4)

**SUPPLIES:**

Supplies are another type of prepaid expense. Companies purchase supplies for use in their operations. During the period, some supplies (assets) are used up and become expenses.

**Example:** On August 1, ABC Company paid \$900 cash for office supplies. On August 31, records showed that \$250 of office supplies was used up during the month.

When cash is paid {

Date	Account Title & Explanation	Debit	Credit
Aug 1	Supplies (A+)	900	
	Cash (A-)		900

When expense incurred {

Date	Account Title & Explanation	Debit	Credit
Aug 31	Supplies expense (EXP+, E-)	250	
	Supplies (A-)		250



Supplies & Supply expense				
	<u>August x1</u>	<u>Septeber x1</u>	<u>October x1</u>	
Supplies at beginning of month	900	650	850	
Add purchase during month	-	100	-	
Less <u>used up</u> during month	(250)	(300)	400	
Supplies at end of month	<u>650</u>	<u>850</u>	<u>450</u>	
Supply <u>expense</u> (EXP)	→ 250	300	400	



# 1. Cash is Paid BEFORE Expense is Incurred (5)

## BUILDING & EQUIPMENT:

Building & equipment are long-lived tangible assets. They have finite useful lives and the passage of time reduces their usefulness. This decline is an expense. Depreciation is the process of allocating cost of building equipment to expense over their useful lives.

**Example:** On August 1, ABC Company paid \$14,400 cash for office equipment. The equipment is estimated to last 6 years.

When cash is paid {

Date	Account Title & Explanation	Debit	Credit
Aug 1	Office equipment (A+)	14,400	
	Cash (A-)		14,400

When expense incurred {

Date	Account Title & Explanation	Debit	Credit
Aug 31	Depreciation expense (EXP+, E-)	200	
	Accumulated depreciation (XA+)		200

← Contra asset account

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## If Accumulated Depreciation account is NOT used

[Depreciation expense is directly charged to the asset account.]

	Aug 1, x1	Dec 31, x1	Dec 31, x2	Dec 31, x3	Dec 31, x4	Dec 31, x5	Dec 31, x6	Aug 1, x7
Office equipment (A)	14,400	13,400	11,000	8,600	6,200	3,800	1,400	-
Depreciation expense (EXP)	-	1,000	2,400	2,400	2,400	2,400	2,400	1,400

## When Accumulated Depreciation account is used

[Depreciation expense is charged to the **contra-asset account**.]

	Aug 1, x1	Dec 31, x1	Dec 31, x2	Dec 31, x3	Dec 31, x4	Dec 31, x5	Dec 31, x6	Aug 1, x7
Office equipment	14,400	14,400	14,400	14,400	14,400	14,400	14,400	14,400
Less Accumulated depreciation -		<u>1,000</u>	<u>3,400</u>	<u>5,800</u>	<u>8,200</u>	<u>10,600</u>	<u>13,000</u>	<u>14,400</u>
Office equipment-net	<u>14,400</u>	<u>13,400</u>	<u>11,000</u>	<u>8,600</u>	<u>6,200</u>	<u>3,800</u>	<u>1,400</u>	<u>-</u>
Depreciation expense	-	1,000	2,400	2,400	2,400	2,400	2,400	1,400





### 3. Cash is Paid AFTER Expense is Incurred (2)

**ACCRUED EXPENSES/ACCOUNTS PAYABLE:**

Businesses incur expenses before they pay cash. Examples include salary expense where the company's payable grows as the employees work. In effect, a liability is accrued.

**Example:** The payday of the month falls on Sunday, August 31. The salary of \$2,600 will be paid on Monday, September 1.

When expense Incurred	<b>Date</b>	<b>Account Title &amp; Explanation</b>	<b>Debit</b>	<b>Credit</b>
	Aug 31	Salary expense (EXP+, E-)	2,600	
		Accrued salary expense (L+)		2,600
When cash is paid	<b>Date</b>	<b>Account Title &amp; Explanation</b>	<b>Debit</b>	<b>Credit</b>
	Sep 1	Accrued salary expense (L-)	2,600	
		Cash (A-)		2,600



### A Question of Ethics

**Management's Incentives to Violate Accounting Rules**



Investors in the stock market base their decisions on their expectations of a company's future earnings. When companies announce quarterly and annual earnings information, investors evaluate how well the companies have met expectations and adjust their investing decisions accordingly. Companies that fail to meet expectations often experience a decline in stock price. Thus, managers are motivated to produce earnings results that meet or exceed investors' expectations to bolster stock prices. Greed may lead some managers to make unethical accounting and reporting decisions, often involving falsifying revenues and expenses. While this sometimes fools people for a short time, it rarely works in the long run and often leads to very bad consequences.

Fraud is a criminal offense for which managers may be sentenced to jail. Samples of fraud cases, a few involving faulty revenue and expense accounting, are shown below. Just imagine what it must have been like to be 65-year-old Bernie Ebbers or 21-year-old Barry Minkow, both sentenced to 25 years in prison for accounting fraud.

The CEO	The Fraud	Conviction/Plea	The Outcome
<b>Bernard Madoff, 71</b> Madoff Investment Securities	Scammed \$50 billion from investors in a Ponzi scheme in which investors receive "returns" from money paid by subsequent investors.	Confessed, December 2008	Sentenced to 150 years
<b>Bernie Ebbers, 65</b> Worldcom	Recorded \$11 billion in operating expenses as if they were assets.	Convicted, July 2005	Sentenced to 25 years
<b>Sanjay Kumar, 44</b> Computer Associates	Recorded sales in the wrong accounting period.	Pleaded guilty, April 2006	Sentenced to 12 years
<b>Martin Grass, 49</b> Rite Aid Corporation	Recorded rebates from drug companies before they were earned.	Pleaded guilty, June 2003	Sentenced to 8 years
<b>Barry Minkow, 21</b> ZZZZ Best	Made up customers and sales to show profits when, in reality, the company was a sham.	Convicted, December 1988	Sentenced to 25 years

Many others are affected by fraud. Shareholders lose stock value, employees may lose their jobs (and pension funds, as in the case of Enron), and customers and suppliers may become wary of dealing with a company operating under the cloud of fraud. As a manager, you may face an ethical dilemma in the workplace. The ethical decision is the one you will be proud of 20 years later.



## The Expanded Transaction Analysis Model



$$A = L + SE$$

Assets		=	Liabilities		+	Stockholders' Equity	
Debit (+)	Credit (-)		Debit (-)	Credit (+)		Debit (-)	Credit (+)
Accounts have debit balances				Accounts have credit balances			Accounts have credit balances

Common Stock	
Debit (-)	Credit (+)
	Investments by owners

Retained Earnings	
Debit (-)	Credit (+)
Dividends declared	Net income

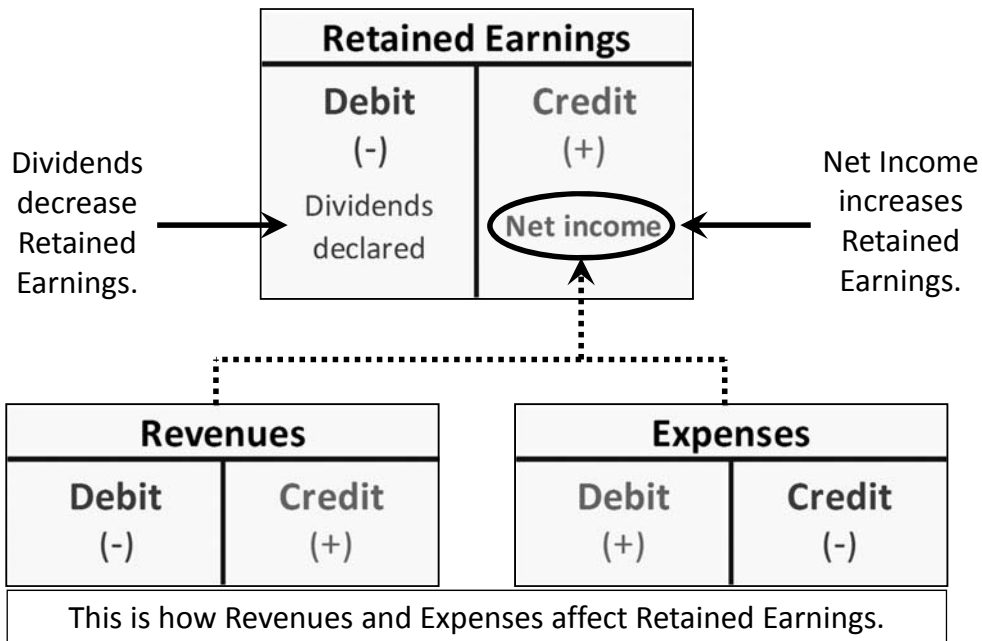
This is how Revenues and Expenses affect Retained Earnings.

Revenues	
Debit (-)	Credit (+)

Expenses	
Debit (+)	Credit (-)



## Expanded Transaction Analysis Model



## Analyzing Some of Papa John's Transactions

- (a) Papa John's restaurants sold pizza to customers for \$36,000 cash and sold \$30,000 in supplies to franchised restaurants, receiving \$21,000 cash with the rest due on account.

	Debit	Credit
(a) Cash (+A) [\$36,000 + \$21,000].....	57,000	
Accounts Receivable (+A) .....	9,000	
Restaurant Sales Revenue (+R, +SE) .....		66,000
<b>Assets</b>	<b>=</b>	<b>Liabilities +</b>
Cash                    +57,000		<b>Stockholders' Equity</b>
Accounts Receivable + 9,000		Restaurant Sales Revenue (+R) +66,000

Equality checks:

1. Debits \$66,000 equal Credits \$66,000,
2. The accounting equation is in balance.



### Analyzing Some of Papa John's Transactions

(b) The cost of the dough, sauce, cheese, and other supplies for the restaurant sales in (a) on the previous screen was \$30,000.

		<u>Debit</u>	<u>Credit</u>
(b) Cost of Sales (+E, -SE) .....		30,000	
Supplies (-A) .....			30,000
<u>Assets</u>		=	<u>Liabilities</u>
		+	<u>Stockholders' Equity</u>
Supplies	-30,000		Cost of Sales (+E) -30,000

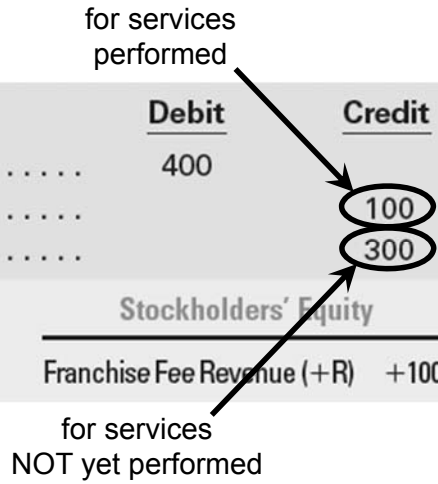
- Equality checks:
1. Debits \$30,000 equal Credits \$30,000,
  2. The accounting equation is in balance.



### Analyzing Some of Papa John's Transactions

(c) Papa John's sold new franchises for \$400 cash, earning \$100 immediately by performing services for franchisees; the rest will be earned over the next several months.

		<u>Debit</u>	<u>Credit</u>
(c) Cash (+A) .....		400	
Franchise Fee Revenue (+R, +SE) .....			100
Unearned Franchise Fees (+L) .....			300
<u>Assets</u>		=	<u>Liabilities</u>
		+	<u>Stockholders' Equity</u>
Cash	+400		Unearned Franchise Fees +300
			Franchise Fee Revenue (+R) +100



- Equality checks:
1. Debits \$400 equal Credits \$400,
  2. The accounting equation is in balance.



## Analyzing Some of Papa John's Transactions

- (d) In January, Papa John's paid \$7,000 for utilities, repairs, and fuel for delivery vehicles, all considered general and administrative expenses incurred during the month.

	<u>Debit</u>	<u>Credit</u>
(d) General and Administrative Expenses (+E, -SE) . . . .	7,000	
Cash (-A) . . . . .		7,000

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
Cash -7,000				General and Administrative Expenses (+E) -7,000

Equality checks:

1. Debits \$7,000 equal Credits \$7,000,
2. The accounting equation is in balance.



## Papa John's Statement of Financial Position Accounts

+ Cash (A) -				+ Accounts Receivable (A) -				+ Supplies (A) -			
Bal.	13,000			Bal.	24,000			Bal.	17,000		
(a)	57,000	7,000	(d)	(a)	9,000	12,800	(i)	(e)	29,000	30,000	(b)
(c)	400	9,000	(e)	Bal.	<u>20,200</u>			Bal.	<u>16,000</u>		
(h)	4,000	14,000	(f)								
(i)	15,500	9,000	(g)								
(k)	1,000	10,000	(j)								
Bal.	<u>41,900</u>										

+ Prepaid Expenses (A) -				+ Property and Equipment (A) -				- Accounts Payable (L) +			
Bal.	10,000			Bal.	200,000			(j)	10,000	29,000	Bal.
(g)	9,000					1,000	(h)			20,000	(e)
Bal.	<u>19,000</u>			Bal.	<u>199,000</u>					<u>39,000</u>	Bal.

- Unearned Franchise Fees (L) +			
	6,000		Bal.
	300		(c)
	<u>6,300</u>		Bal.



## Papa John's Statement of Income Accounts

Beginning balances start at zero.

<b>– Restaurant Sales Revenue (R) +</b>	<b>– Franchise Fee Revenue (R) +</b>	<b>– Gain on Sale of Land (R) +</b>
0 Bal.	0 Bal.	0 Bal.
66,000 (a)	100 (c)	3,000 (h)
66,000 Bal.	2,700 (i)	3,000 Bal.
66,000 Bal.	2,800 Bal.	3,000 Bal.
<b>– Investment Income (R) +</b>	<b>+ Cost of Sales (E) –</b>	<b>+ Salaries Expense (E) –</b>
0 Bal.	Bal. 0	Bal. 0
1,000 (k)	(b) 30,000	(f) 14,000
1,000 Bal.	Bal. 30,000	Bal. 14,000
1,000 Bal.	30,000	14,000
<b>+ General and Administrative Expenses (E) –</b>		
Bal. 0		
(d) 7,000		
Bal. 7,000		
7,000		

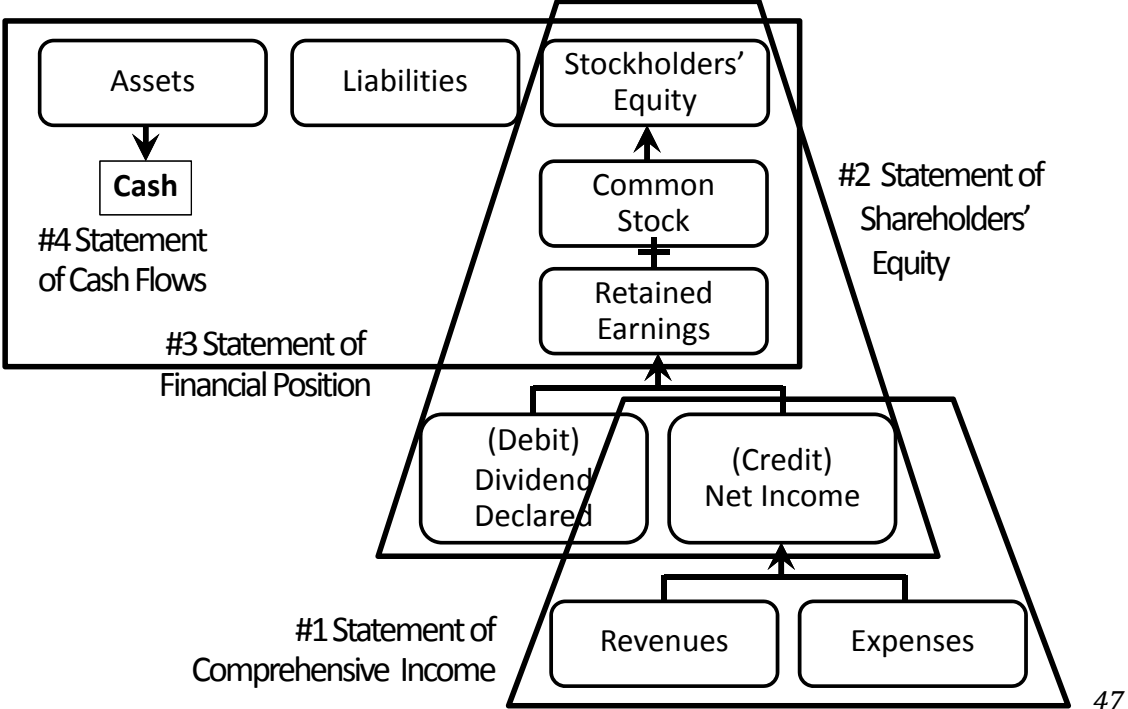


## How is the Statement of Income Prepared and Analyzed ?





## How is the Statement of Income Prepared and Analyzed ?



## How is the Statement of Income Prepared and Analyzed ?

Statement	Formula
#1 Income Statement	Revenues – Expenses = Net Income
#2 Statement of Stockholders' Equity	$\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends Declared} = \text{Ending Retained Earnings}$ $\text{Beginning Common Stock} + \text{Stock Issuances} - \text{Stock Repurchases} = \text{Ending Common Stock}$ <p style="text-align: right;">Ending Stockholders' Equity</p>
#3 Balance Sheet	$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ <p style="text-align: center;">(includes Cash)</p>
#4 Statement of Cash Flows	$\begin{aligned} &\text{Cash provided by (or used in) Operating Activities} \\ &+/- \text{Cash provided by (or used in) Investing Activities} \\ &+/- \text{Cash provided by (or used in) Financing Activities} \\ &\hline &\text{Change in Cash} \\ &+ \text{Beginning Cash} \\ &\hline &\text{Ending Cash} \end{aligned}$



# 1. Statement of Comprehensive Income

PAPA JOHN'S INTERNATIONAL, INC.  
Consolidated Statement of Income (before adjustments)  
For the Month Ended January 31, 2009  
(dollars in thousands)

<b>Operating Revenues</b>	
Restaurant sales revenue	\$66,000
Franchise fee revenue	2,800
Total revenues	68,800
<b>Operating Expenses</b>	
Cost of sales	30,000
Salaries expense	14,000
General and administrative expenses	7,000
Supplies expense	0
Rent expense	0
Insurance expense	0
Utilities expense	0
Depreciation expense	0
Other operating expenses	0
Total expenses	51,000
<b>Operating Income</b>	17,800
<b>Other Items</b>	
Investment income	1,000
Interest expense	(0)
Gain on sale of land	3,000
Income before Income Taxes	21,800
Income tax expense	0
<b>Net Income</b>	<b>\$21,800</b>
<b>Earnings per Share (for the month)</b>	<b>\$ 0.78</b>

Note:  
Normally, accounts with zero balances are not included on formal statements. However, we include them here to indicate that there are numerous expenses and revenues to be determined and recorded in the adjustment process described in Chapter 4.

\$21,800,000 unadjusted net income divided by approximately 28,100,000 shares (from Papa John's annual report) 49



# 2. Statement of Shareholders' Equity

PAPA JOHN'S INTERNATIONAL, INC.  
Consolidated Statement of Stockholders' Equity (before adjustments)  
Month Ended January 31, 2009  
(dollars in thousands)

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance, December 31, 2008	\$7,000	\$123,000	\$130,000
Additional stock issuances	2,000		2,000
Net income (prior to adjustments)		21,800	21,800
Dividends declared		(3,000)	(3,000)
Ending balance, January 31, 2009	<u>\$9,000</u>	<u>\$141,800</u>	<u>\$150,800</u>

The net income (\$21,800) comes from Statement of Comprehensive Income we just prepared.



### 3. Statement of Financial Position

PAPA JOHN'S INTERNATIONAL, INC. Consolidated Balance Sheet (before adjustments) January 31, 2009 (dollars in thousands)	
<b>ASSETS</b>	
<b>Current Assets</b>	
Cash	\$ 41,900
Accounts receivable	20,200
Supplies	16,000
Prepaid expenses	19,000
Other current assets	13,000
<b>Total current assets</b>	<u>110,100</u>
Investments	2,000
Property and equipment (net)	199,000
Notes receivable	11,000
Intangibles	77,000
Other assets	36,000
<b>Total Assets</b>	<u><b>\$435,100</b></u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>	
<b>Current Liabilities</b>	
Accounts payable	\$ 39,000
Dividends payable	3,000
Accrued expenses payable	71,000
<b>Total current liabilities</b>	<u>113,000</u>
Unearned franchise fees	6,300
Notes payable	138,000
Other long-term liabilities	27,000
<b>Total liabilities</b>	<u>284,300</u>
<b>Stockholders' Equity</b>	
Common Stock	9,000
Retained earnings	141,800
<b>Total stockholders' equity</b>	<u>150,800</u>
<b>Total liabilities and stockholders' equity</b>	<u><b>\$435,100</b></u>

} From the Statement of  
Stockholders' Equity

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### 4. Statement of Cash Flows

<b>Operating activities</b>	<b>Effect on Cash Flows</b>
Cash received: Customers	+
Interest and dividends on investments	+
Cash paid: Suppliers	-
Employees	-
Interest on debt obligations	-
Income taxes	-
<b>Cash Flows from Operating Activities</b>	<u><b>Total</b></u>



## 4. Statement of Cash Flows

Direct approach to preparing operating cash flows.

	Effect on Cash Flows
<b>Operating activities</b>	
Cash received: Customers	+
Interest and dividends on investments	+
Cash paid: Suppliers	-
Employees	-
Interest on debt obligations	-
Income taxes	-
<b>Cash Flows from Operating Activities</b>	<u>Total</u>
<b>Investing Activities</b>	
Purchase of property, plant or equipment	-
Purchase of other long-term assets	-
Sale of property, plant or equipment	+
Sale of other long-term assets	+
<b>Cash Flows from Investing Activities</b>	<u>Total</u>
<b>Financing Activities</b>	
Issuance of long-term debt	+
Issuance of common stock	+
Dividends paid	-
Repurchase of long-term debt	-
Repurchase of contributed capital	-
<b>Cash Flows from Financing Activities</b>	<u>Total</u>
Net increase or (decrease) in cash	
Beginning balance in cash account	
Ending balance in cash account	

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## Total Asset Turnover Ratio

$$\text{Total Asset Turnover Ratio} = \frac{\text{Sales (or Operating) Revenues}}{\text{Average Total Assets}}$$

$$(\text{Beginning total assets} + \text{ending total assets}) \div 2$$

Papa John's Total Asset Turnover Ratio for 2008 (dollars in thousands):

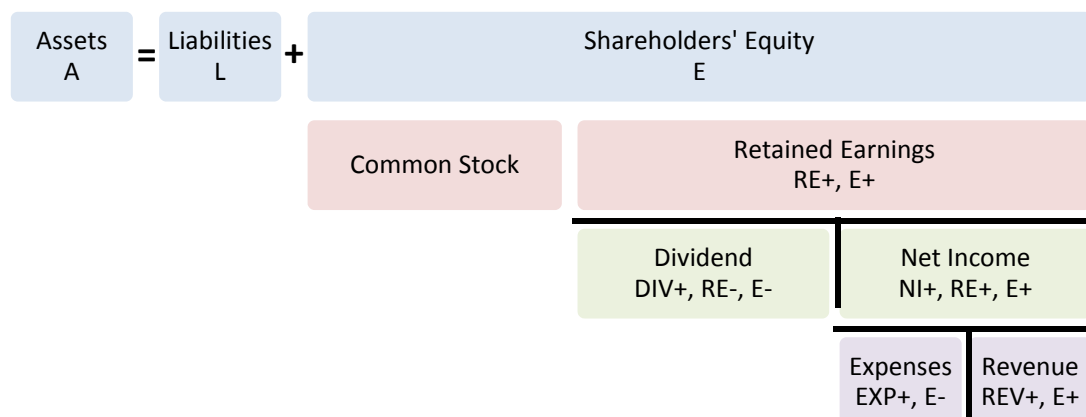
$$\frac{\$1,132,000}{(\$402,000 + \$386,000) \div 2} = 2.87$$

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## CHAPTER 3: OPERATING DECISIONS AND THE STATEMENT OF COMPREHENSIVE INCOME

### The Accounting Equation

$$A = L + E$$



### CHAPTER 3 - EXERCISE

The statement of financial position of Tabor Hill Designers Inc. as of January 31, 2014 is as follows.

TABOR HILL DESIGNERS INC.  
**Statement of Financial Position**  
As of January 31, 2014

<b>Assets</b>	
Current assets	
Cash	\$ 3,100
Supplies	<u>900</u>
Total current assets	4,000
Property, plant and equipment	<u>21,000</u>
Total assets	<u>\$ 25,000</u>
<b>Liabilities &amp; Stockholders' Equity</b>	
Current liabilities	
Notes payable	\$ <u>15,000</u>
Total current liabilities	<u>15,000</u>
Stockholders' Equity	
Common Stock	10,000
Retained earnings	<u>-</u>
Total stockholders' equity	<u>10,000</u>
Total liabilities & stockholders' equity	<u>\$ 25,000</u>

During February 2014, Tabor Hill Designers Inc. entered into the following transactions. Analyze each of the following transactions and prepare the journal entry required to record the related transaction.

- a. On February 3, provide website design services for \$40,000 cash.
- b. On February 7, provide website design services to Acme Company, for \$20,000 on account. The company expects Acme to pay in the future.
- c. On February 14, collect \$18,000 cash from Acme Company for service provided on Feb 7.
- d. On February 16, sell a \$1,000 gift certificate for cash.
- e. On February 21, customer redeems (uses) a \$1,000 gift certificate for website design services.
- f. On February 25, paid employees \$16,000 cash for their wages earned.
- g. On February 28, paid \$3,000 cash for insurance covering 1 year from March 1, 2014 through February 28, 2014.
- h. On February 28, paid \$9,000 cash in advance for office rent for a six-month period starting March 1, 2014.
- i. On February 28, received \$250 telephone bill for previous month, to be paid next month.
- j. On February 28, received \$500 utility bill for this month and made cash payment immediately.

**Step 1:** Analyze the transactions to determine the accounts (at least two) that are affected.

**Step 2:** Journalize (record) the transactions.

The company uses the following general ledger accounts.

- |                               |                  |                   |
|-------------------------------|------------------|-------------------|
| Cash                          | Accounts payable | Common stock      |
| Accounts receivable           | Notes payable    | Retained earnings |
| Supplies                      | Unearned revenue | Design revenue    |
| Prepaid expenses              |                  | Wage expense      |
| Property, plant and equipment |                  | Utilities expense |
|                               |                  | Telephone expense |

- a. On February 3, provide website design services for \$40,000 cash.

GENERAL JOURNAL				
Date		Account Titles and Explanation	Debit	Credit
Feb	3	Cash (A+)	40,000	
		Design Revenue (REV+, E+)		40,000
		To record design service revenue earned.		

Ensure the equation still in balance and debits = credits

Assets	=	Liabilities	+	Stockholders' Equity
Cash (A+)                    +40,000				Retained Earnings            +40,000 (Design Revenue) (REV+, E+)

- b. On February 7, provide website design services to Acme Company, for \$20,000 on account. The company expects Acme to pay in the future.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- c. On February 14, collect \$18,000 cash from Acme Company for service provided on Feb 7.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- d. On February 16, sell a \$1,000 gift certificate for cash.  
 [Gift certificate is a voucher given as a present that is exchangeable for a specified cash value of goods or services from a particular place of business.]

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- e. On February 21, customer redeems (uses) a \$1,000 gift certificate for website design services.  
 [Redeem = to exchange for goods.]

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- f. On February 25, paid employees \$16,000 cash for their wages earned.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- g. On February 28, paid \$3,000 cash for insurance covering 1 year from March 1, 2014 through February 28, 2015.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- h. On February 28, paid \$9,000 cash in advance for office rent for a six-month period starting March 1, 2014.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- i. On February 28, received \$250 telephone bill for previous month, to be paid next month.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

- j. On February 28, received \$500 utility bill for this month and made cash payment immediately.

GENERAL JOURNAL			
Date	Account Titles and Explanation	Debit	Credit

**Step 3:** Post the transactions to T-accounts to determine the ending balances of each of the accounts.

The following T-accounts set forth the ending balances of the accounts of Tabor Hill Designers as of January 31, 2014. Post each of the February 2014 journal entries to the T-accounts.

Assets				Liabilities				Stockholders' Equity					
+ Cash -				- Accounts Payable +				- Common Stock +					
BegBal	3,100					BegBal	0			BegBal	10,000		
EndBal						EndBal				EndBal			
+ Accounts Receivable -				- Notes Payable +				- Retained Earnings +					
BegBal	0					BegBal	15,000			BegBal	0		
EndBal						EndBal				EndBal			
+ Supplies -				- Unearned Revenue +				- Design Revenue +					
BegBal	900					BegBal	0			BegBal	0		
EndBal						EndBal				EndBal			
+ Prepaid Expenses -				+ Wage Expense -				+ Utilities Expense -					
BegBal	0					BegBal	0			BegBal	0		
EndBal						EndBal				EndBal			
+ Property, Plant & Equipment -				+ Telephone Expense -				+ Telephone Expense -					
BegBal	21,000					BegBal	0			BegBal	0		
EndBal						EndBal				EndBal			

**Step 4:** Prepare the Statement of Income, Statement of Stockholders' Equity, and Statement of Financial Position for Tabor Hill as of and for the month ended February 28, 2014.

Use the ending balances from the T-accounts on previous exercise to prepare (1) Statement of Comprehensive Income; (2) Statement of Stockholders' Equity; and (3) Statement of Financial Position for Tabor Hill as of and for the month ended February 28, 2014. (\*Ignore income tax expense.)

TABOR HILL DESIGNERS INC.  
**Statement of Income**  
**For the month ended February 28, 2014**

Revenues:		
Design revenues		
Expenses:		
Wages expenses		
Utilities expenses		
Telephone expenses		
Total expenses		
Pretax income		
Less: Income tax expense*		-
Net income		

TABOR HILL DESIGNERS INC.  
**Statement of Stockholders' Equity**  
**For the month ended February 28, 2014**

	Common Stock	Retained Earnings	Total Stockholders' Equity
Balance, January 31, 2014			
Contribution from stockholders			
Net income			
Dividend			
Balance, February 28, 2014			

TABOR HILL DESIGNERS INC.  
**Statement of Financial Position**  
**As of February 28, 2014**

<b>Assets</b>	
Current assets	
Cash	
Accounts receivable	
Supplies	
Prepaid expenses	
Total current assets	
Property, plant and equipment	
Total assets	
<b>Liabilities &amp; Stockholders' Equity</b>	
Current liabilities	
Accounts payable	
Notes payable	
Unearned revenue	
Total current liabilities	
Stockholders' Equity	
Common stock	
Retained earnings	
Total stockholders' equity	
Total liabilities & stockholders' equity	