

Busi 293 Notes

Chapter Three

Operating Decisions and the Statement of Earnings

How well is a company performing?

In order to address this question we have to understand what the company does in the normal course of its business. What qualitative and quantitative measures are available to provide meaningful information?

How often is such information required? - daily, weekly, monthly, quarterly, semi-annually or annually?

The advent of computers has allowed companies to record, summarize and report information very quickly. Most entities have monthly reporting deadlines.

Different businesses have different operating cycles - defined as the length of time between payment of suppliers and employees and the collection of cash from customers.

The **periodicity** assumption assumes that we can break the results of an entity into shorter periods. Management cannot wait a whole year before analyzing operations. Changes need to be made throughout the year. Ongoing financial information is imperative.

In this chapter the focus is on the Statement of Earnings. There are two items to keep in mind as we work through this chapter. First when should items be recognized (**Recognition**) in the Statement of Earnings and at what amount (**Measurement**)?

In previous chapters we indicated that the Statement of Earnings provided the reader with a summary of revenues and expenses. In this chapter we are going to expand that our presentation of the Income Statement into:

- Results of continuing operations
- Results of discontinued operations
- Earnings per share

Continuing operations advises the reader of the earnings that are expected to continue - this has **predictive value**.

Discontinued operations, in simplest terms, represents results that are not expected to reoccur. If this were not disclosed separately, the reader might mistakenly assume past results would continue unchanged. An example of discontinued operations occurs when an entity decides to close down a segment of its operations. Multi-national companies often operate in many industries and decide to close or sell an unprofitable segment. The details of discontinued operations will be discussed in Intermediate Accounting.

Please refer to textbook Reference A for an example of a classified Statement of Earnings.

A brief description of each of the key components is presented on the next page.

Sales – revenue earned from the ongoing operations of the business.

Cost of sales – the cost of the products sold

Gross Margin (Profit) is the difference between Sales and Cost of goods sold. This is an important item for most retail operations. Management watches this line very closely.

Operating costs represent the expenses incurred in the normal course of business – e.g. salary expense, hydro, rent etc. Companies have flexibility in presenting this information.

Earnings (loss) from operations equals gross margin less operating expenses.

Other Income/Expenses - Items which are not central to continuing operations such as investment income, rental income, or interest expense or loss on disposal of assets are usually shown after operating profit.

Earnings before income taxes - sum of all income minus expenses except taxes and results of investments in associated companies.

Income tax expense - this is a cost of running a business and therefore properly shown on the income statement.

Earnings for the year - earnings from continuing operations.

Earnings per share - another closely monitored ratio, discloses the amount of earnings earned by each share. As discussed before, it is calculated by dividing profit by the weighted average number of common shares outstanding during the year.

Discontinued operations – profit/loss from discontinued operations and the gain/loss on the disposal of the assets of the discontinued segment. Discontinued operations is shown net of the related tax effect.

Please refer to textbook Reference B for an example of how discontinued operations are presented on the Statement of Earnings.

Measurement Issues

There are two methods of measuring earnings:

Cash Basis

- records revenues only when cash is received
- records expenses only when cash is paid

This approach is not GAAP and therefore is not widely used. Do you see that management could manipulate earnings simply by delaying or speeding up cash payments or receipts?

Accrual Basis

- records revenues when it is earned
- records expenses when they are incurred to earn the related revenue

The accrual basis is widely used and conforms to GAAP. Notice that the receipt or expenditure of cash is irrelevant.

Revenue Recognition Principle

Revenue should be recorded when the following conditions are have been satisfied:

- The selling entity has transferred to the buyer the significant risks and rewards of ownership of the goods? This is usually the transfer of legal title.
- The selling entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
- The amount of revenue can be measured reliably.
- It is probable that the economic benefits associated with the transaction will flow to the selling entity.
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Please refer to textbook Reference C which provides an excellent summary of when companies recognize revenue. All companies must disclose their revenue recognition policies in the notes to the financial statements.

Should cash be received from a customer before these criteria are satisfied, the amount should be recorded as a liability which is usually recorded as deferred or unearned revenue.

Matching Principle

GAAP requires that expenses be matched to the revenue recognized in the period. Do you see that the accrual basis of accounting uses the matching principle while the cash basis does not adhere to this principle?

Recall the Accounting Equation: accounting equation:

Assets = Liabilities + Shareholders' Equity

Shareholders' Equity may be expanded as follows:

Assets = Liabilities + Share Capital + Retained Earnings + Other Components

Share capital represents permanent investments by shareholders

Retained Earnings represents net earnings (loss) earned by a company since inception less dividends declared since inception. It represents, as the name indicates, the net earnings of an entity which have been retained and not distributed to the shareholders.

Other components are items required by IFRS and are beyond the expectations in Introductory Accounting.

Analyzing Transactions

The starting point to record transactions is to understand what accounts and elements of the financial statements have been affected. Please refer to textbook Reference D which provides you with examples of transactions, the related journal entries, their effect on the accounting equation and the preparation of a Statement of Earnings.

Please refer to textbook Reference E which illustrates the use of T-Accounts. I suggest you spend time reviewing and understanding these examples.

Please refer to textbook Reference F which briefly discusses cash flows. Although covered in Chapter 5 (done near the end of this course), please notice that earnings per the Statement of Earnings do not equal cash flow from operations. The key point here is that a company which reports earnings may experience cash flow problems. This is because of timing differences - items being recognized for accounting purposes in a different period than the related cash receipt or payment.

RATIOS

Two ratios are discussed at the end of chapter 3:

Total Asset Turnover ratio – measures the efficiency of utilizing company assets

Calculation

= Sales (or Operating) Revenue/ Average total assets
(Notice that average assets is (beginning + ending assets)/2)

The higher the number the more effective management has been in using the entity's assets. Again make comparisons between years and with competitors.

Return on Assets ratio – measures how well management used the assets to generate a return.

Calculation

= $\frac{\text{Net Earnings} + \text{Interest Expense (net of tax)}}{\text{Average total assets}}$

By adding back the after-tax cost of interest, you are eliminating the cost of financing and therefore presenting a more realistic earnings figure which was generated by the company's assets. You are focusing on the earnings regardless of how the assets were financed.