

Accounting Principles

Critical to Success

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Basic Accounting You Need to Know

- Assets, Liabilities, Equity, Income, & Expenses
 - Assets
 - Includes what you have and what people owe you.
 - Liabilities
 - What your company owes to other people.
 - Equity
 - The difference between what you have and what you owe.
 - $\text{Equity} = \text{Assets} - \text{Liabilities}$ or $\text{Assets} = \text{Liabilities} + \text{Equity}$.
 - Income
 - What your sales & other revenues are.
 - Expenses
 - What your bills & other expenses are.

The Measurement of Performance

- ➔ Balance Sheet
- ➔ Income Statement
- ➔ Statement of Cash



Financial Statements

- Basic Principles to Remember
 - Accrual vs. Cash Basis
 - Double Entry System
 - GAAP / IFRS
 - Historical Cost Basis
 - Matching Concept
 - Consistency
 - Going Concern

Financial Statements

- Chart of Accounts
 - What is right for your business?
 - Structure it for your own business model
 - Get it right the first time!
 - Management vs. tax account vs. DCAA structure
 - Design it to capture profitability points
 - Design it to measure Breakeven easily
 - Variable and Fixed Costs separation
- Internal Control
 - Important in any size business
 - Must be given some thought

Balance Sheet – Assets

A Particular Point in Time

➤ Current Assets

- Cash
- Accounts Receivable
 - Less: Allowances – Bad Debts & Discounts
- Inventory
 - Less: Reserve for Obsolescence
- Pre-Paid Expenses
- Other Short Term Assets

➤ Non-Current Assets

- Security Deposits
- Fixed Assets
 - Less: Accumulated Depreciation
- Goodwill
- Other Non-Current Assets

Balance Sheet – Assets

A Particular Point in Time

- Total Assets = Current Assets + Non Current Assets
- Historical Cost Concept
- Liquidity Order – Top to Bottom
- Depreciation is Simply a Cost Allocation Method
- Working Capital Investment
 - Current Assets – Current Liabilities

Balance Sheet – Liabilities

A Particular Point in Time

- Current Liabilities
 - Accounts Payable
 - Accrued Expenses
 - Current Portion of Long Term Debt
 - Other Current Liabilities
- Non Current Liabilities
 - Long Term Debt (More than 12 Months)
 - Bank Debt
 - Capital Leases – from a bank or vendor
 - Friend's or Relative's Loan
 - Other Long Term Liabilities

Balance Sheet – Liabilities

A Particular Point in Time

- Total Liabilities = Current + Long Term Debt
- Listed in Order of Liquidity
- Important When Assessing Risk
 - ENRON – Off Balance Sheet Debt

Balance Sheet – Liabilities

A Particular Point in Time

- Does Not Include Interest Portion of Debt
- Does Not Include Liabilities for Operating Leases
- Usually Does Not Include Building or Office Lease

Balance Sheet – Equity

A Particular Point in Time

➤ Equity

- Stock at Par or Stated Value
- Paid in Capital
 - Stock + Paid in Capital = Amount Invested
- Retained Earnings
 - Earnings (or Losses) Re-Invested in the Business
- Current Year Earnings
 - Equals Net Income from Income Statement

Balance Sheet – Equity

A Particular Point in Time

➤ Equity

- Measures Amount of Net Capital Invested and Retained
- Represents Book Value *(which has limited value)*
 - Stock + Paid in Capital = Amount Invested
- Usually Shows Number of Shares Outstanding
- Does Not Measure Performance

XYZ BALANCE SHEET 12-31-11

ASSETS

CASH	100
ACCOUNTS RECEIVABLE	200
LESS ALLOWANCE FOR BAD DEBTS	(20)
NET ACCOUNTS RECEIVABLE	180
INVENTORY	600
LESS ALLOWANCE FOR OBSOLESCENCE	(75)
NET INVENTORY	525
PREPAID EXPENSES	10
TOTAL CURRENT ASSETS	815
UNDEPOSITED FUNDS	50
FIXED ASSETS	
PROPERTY, PLANT & EQUIPMENT	800
CONSTRUCTION IN PROCESS	50
TOTAL GROSS FIXED ASSETS	850
LESS ACCUMULATED DEPRECIATION	(300)
NET FIXED ASSETS	550
TOTAL ASSETS	<u>1,415</u>

XYZ BALANCE SHEET 12-31-11

LIABILITIES

ACCOUNTS PAYABLE	200
ACCRUED EXPENSES	100
CURRENT PORTION OF LTD	75
TOTAL CURRENT LIABILITIES	375
BANK DEBT	350
CAPITAL LEASES	25
TOTAL LIABILITIES	750

EQUITY

COMMON STOCK	500
RETAINED EARNINGS	100
CURRENT EARNINGS	65
TOTAL EQUITY	665
TOTAL LIABILITIES & EQUITY	<u>1,415</u>

Income Statement

A Particular Period in Time

- Creation of Goods or Services by a Company During a Specific Interval of Time
- Monthly, Quarterly and Annual Periods
- Measures the Performance of a Business

Income Statement

A Particular Period in Time

- Sales or Revenues
 - Decreased by Returns, Allowances
- Cost of Sales includes
 - Variable Costs (controllable costs)
 - Materials / Labor – prime cost
 - Other Variable
 - Other Relevant Fixed Costs
- Allows calculation of Contribution Margin

Income Statement

A Particular Period in Time

- Sales & Marketing Expenses
- Administration Expenses
- Gross Margin Less SG&A Expenses =
Operating Earnings
- Other Expenses / Income
 - Interest
 - Misc. Expenses / Income
- Pre-Tax Income

Income Statement

A Particular Period in Time

- Tax Provision – can be managed
 - State & Federal Based on Income
- Net Income – Is this the “bottom line”?
Add Back Depreciation & Amortization
- Operating Cash Flow
 - Represents amount of cash generated during this period in time from operations

Income Statement

A Particular Period in Time

“Reported earnings plus depreciation and other non-cash charges less the amount of capitalized expenditures for plant and equipment and additional working capital.

We consider this figure, not the GAAP figure, to be the relevant item for valuation purposes.”

Warren Buffet
Berkshire Hathaway
Annual Reports

XYZ INCOME STATEMENT TWELVE MONTHS ENDED 12-31-11

GROSS SALES	1,600
SALES RETURNS & ALLOWANCES	(200)
NET SALES	1,400
COST OF SALES: VARIABLE	
MATERIALS	200
DIRECT LABOR	300
OTHER VARIABLE COSTS	100
TOTAL VARIABLE COSTS	600
CONTRIBUTION MARGIN	800
%	57%
FIXED LABOR & OVERHEAD	300
TOTAL COST OF SALES	900
GROSS MARGIN	500
%	36%

XYZ
INCOME STATEMENT
TWELVE MONTHS ENDED 12-31-11

GROSS SALES	1,600
SELLING EXPENSE	125
ADMINISTRATION EXPENSE	180
TOTAL EXPENSES	305
OPERATING INCOME	195
INTEREST EXPENSE	45
OTHER EXPENSE	15
INCOME BEFORE TAX	135
PROVISION FOR INCOME TAX	70
NET INCOME	<u>65</u>

Statement of Cash

A Particular Period in Time

- This Statement is Important to Small Business Because...
 - It Shows Cash Generated From Operations and
 - Cash Used for Investments and
 - Cash Used or Received From Financing
 - Sustainable Cash Flow

You Can See Your Beginning Period Cash Balance and How You Arrived at Your Ending Period Cash Balance

Statement of Cash

A Particular Period in Time

- Net Income...*then add*
- Non Cash Items - Depreciation / Amortization
- *Plus/Minus* Working Capital Increases / Decreases
- *Equals* Cash From Operations...*then subtract*
- Investments - Fixed Assets
- Financing - Increases / Decreases in Debt
- *Equals* Net Increase / Decrease in Cash for the Period

XYZ

STATEMENT OF CASH

TWELVE MONTH PERIOD ENDED 12-31-11

NET INCOME	65
ADD: NON CASH EXPENSES:	
DEPRECIATION	100
CHANGES IN ASSETS & LIABILITIES	
INCREASE IN ACCOUNTS RECEIVABLE	(50)
INCREASE IN INVENTORY	(30)
INCREASE IN PREPAID EXPENSES	(10)
INCREASE IN ACCOUNTS PAYABLE	20
DECREASE IN ACCRUED EXPENSES	(15)
TOTAL CASH PROVIDED BY OPERATIONS	80
CASH FLOWS USED FROM INVESTING ACTIVITIES:	
PROPERTY, PLANT & EQUIPMENT	(50)

XYZ
STATEMENT OF CASH
TWELVE MONTH PERIOD ENDED 12-31-11

CASH FLOWS FROM FINANCING ACTIVITIES	
NET INCREASE IN BANK DEBT	75
PAYMENT OF CAPITAL LEASES	(10)
TOTAL CASH PROVIDED BY FINANCING ACTIVITIES	65
INCREASE IN CASH FOR THE PERIOD	<u>95</u>
BEGINNING CASH BALANCE	5
ENDING CASH BALANCE	100

DCAA – SBIR/R&D Contracts

Areas of Emphasis & Audit Interests

- Internal control systems & management policies,
- Accuracy and reasonableness of cost representations,
- Adequacy and reliability of records/accounting systems,
- Financial capability, and
- Contractor compliance with contractual provisions such as the Cost Principles the “Cost Accounting Standards Clause” and the Truth in Negotiations Act.

The extent of DCAA's involvement is determined by the type of contract that will be awarded. Generally, most DCAA efforts on firm-fixed price type contracts take place during the proposal stage rather than in the incurred cost stage. The reverse is true for flexibly priced contracts.

DCAA – SBIR/R&D Contracts

Accumulation of Costs

1. Proper segregation of direct costs from indirect costs.

DCAA will review the accounting system to determine if direct costs are segregated from indirect costs. **Direct costs** are defined in FAR 31.202 as any cost that can be identified specifically with a particular final cost objective (e.g., a contract). An example would be labor specifically identified to the contract, or materials purchased specifically for the contract.

DCAA – SBIR/R&D Contracts

Accumulation of Costs

2. Identification and accumulation of direct costs by contract
3. A logical and consistent method for the allocation of indirect costs to cost objectives.
4. Accumulation of costs under general ledger control
5. A timekeeping system that identifies employees' labor by cost objectives.

DCAA – SBIR/R&D Contracts

Accumulation of Costs

6. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives
7. Interim (at least monthly) determination of costs charged to a contract through routine posting to books of account
8. Exclusion from costs charged to Government contracts of amounts that are not allowable pursuant to FAR Part 31 or other contract provisions

DCAA – SBIR/R&D Contracts

Accumulation of Costs

9. Identification of costs by contract line item and units (as if each unit or line item was a separate contract) if required by the proposed contract.
10. Segregation of pre-production costs from production costs.

Techniques for Making Financial Decisions

- Statements Are Your Responsibility
- Management Reports
 - Sales vs. Budget, Breakeven vs. Plan, Est. Cash Flow vs. Plan
- Determine What Drives Cash Flow - Products / Services
- Low Cost Producer Is Still Important – *do cost accounting*
- Variable vs. Fixed Costs – contribution margins & capacity utilization
- The Budget – Where Do You Start?
- Analyze the Numbers – RATIO ANALYSIS