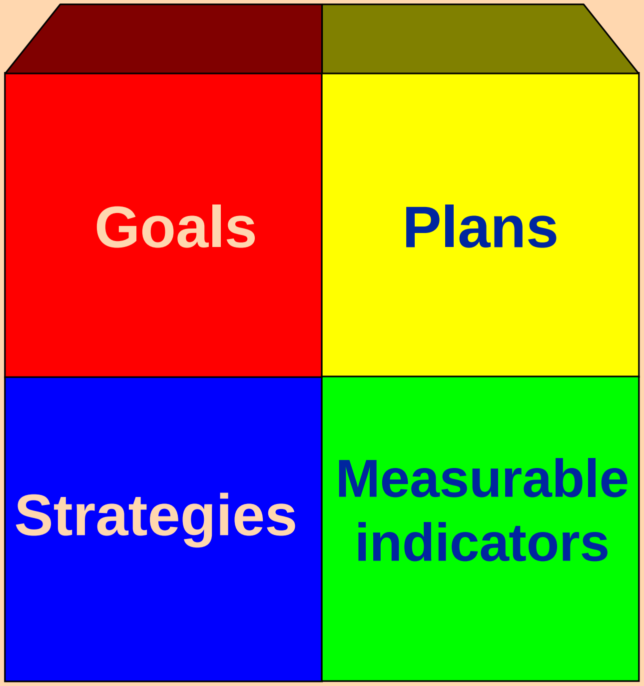
Chapter 3

Operating Decisions and the Income Statement

Business Background

Businesses develop . . .



The goals include elements of income.

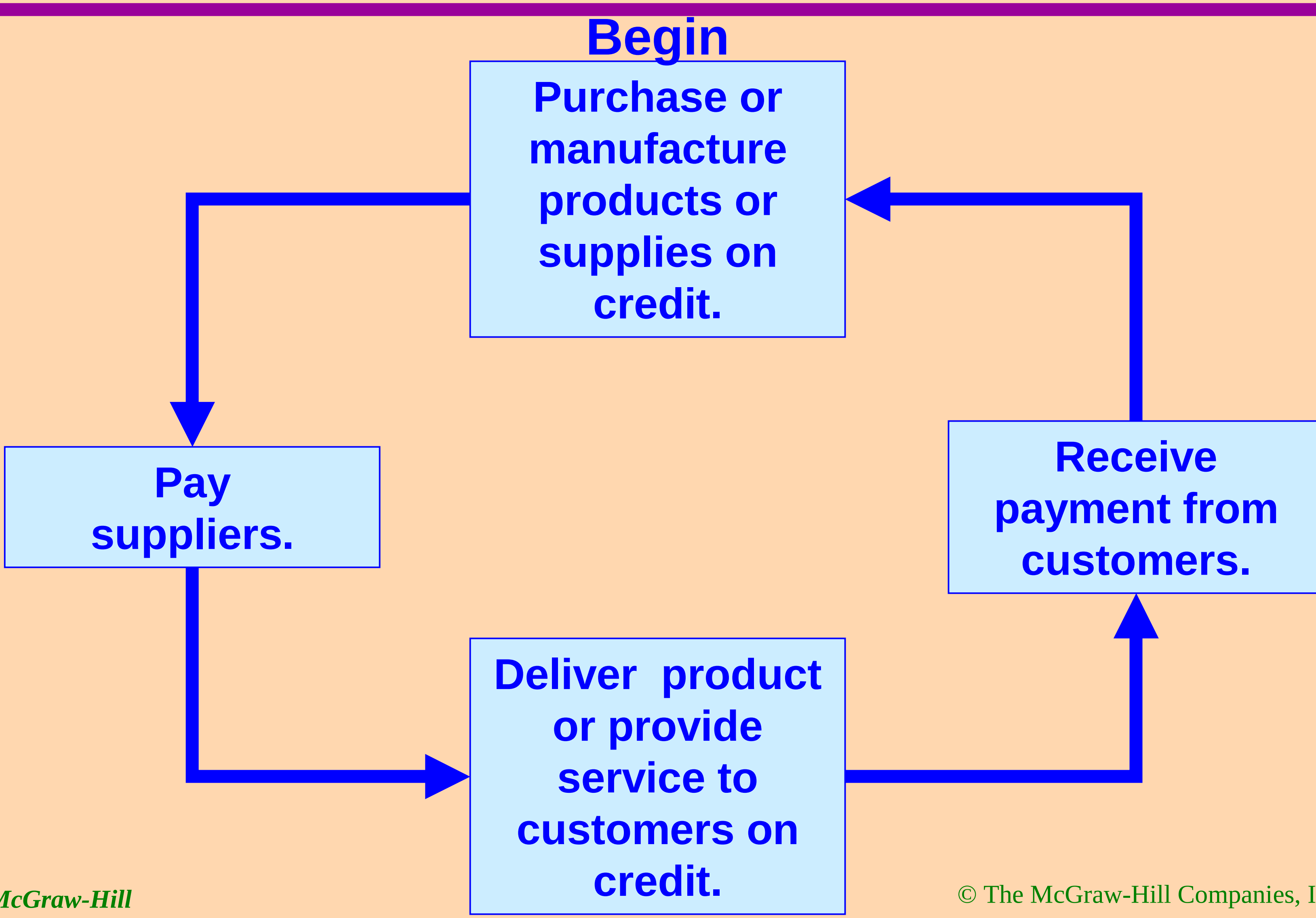
Business Background

What business activities affect the income statement?

How are these activities recognized and measured?

How are these activities reported on the income statement?

The Operating Cycle

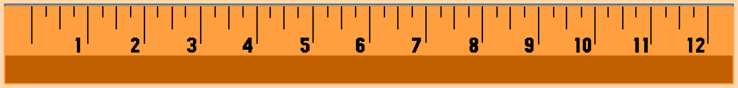


Underlying Accounting Assumptions

Time Period: The long life of a company can be reported over a series of shorter time periods.

Recognition Issues : When should the effects of operating activities be recognized (recorded)?

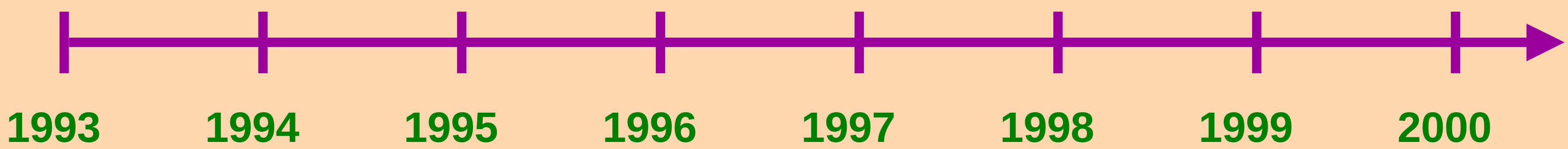
Measurement Issues: What amounts should be recognized?



The Time Period Assumption

To meet the needs of decision makers, we report financial information for relatively short time periods (monthly, quarterly, annually).

Life of the Business



Annual Accounting Periods

Elements on the Income Statement

Revenue
Increases in assets or settlement of liabilities from ongoing operations.

Expense
Decreases in assets or increases in liabilities from ongoing operations.

Gains
Increase in assets or settlement of liabilities from peripheral transactions.

Losses
Decreases in assets or increases in liabilities from peripheral transactions.

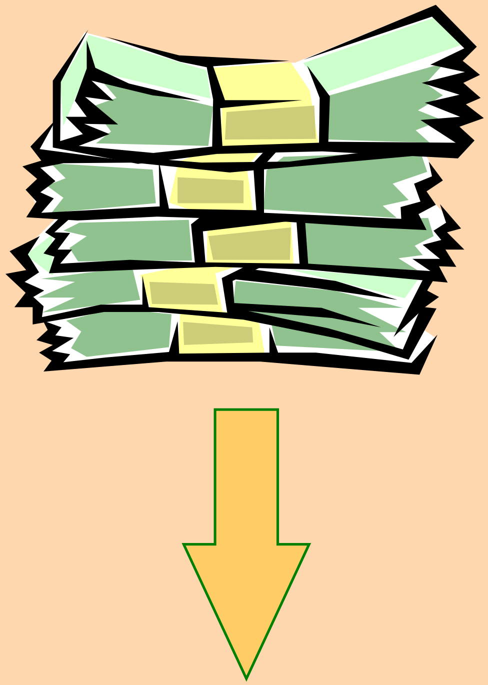
Papa John's Primary Operating Activities

- Sell pizza
- Sell franchises
- Sell supplies and equipment to franchisees

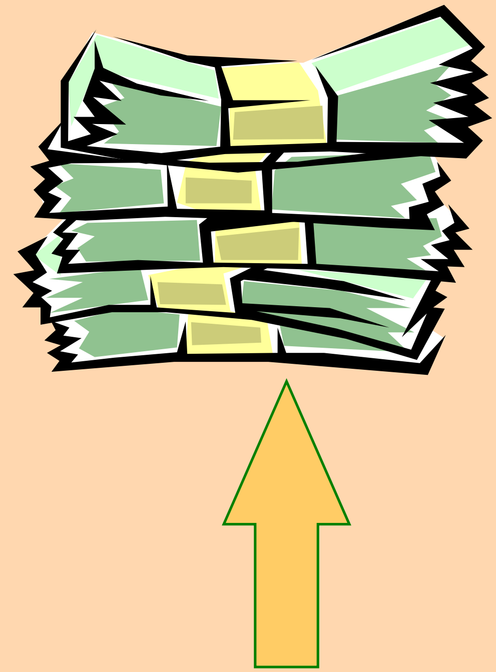
PAPA JOHN'S INTERNATIONAL, INC. AND SUBSIDIARIES
Consolidated Statement of Income
For the Year Ended December 27, 1998
(In thousands)

Revenues:	
Restaurant sales	$ 324,900
Franchise royalties and development fees	38,500
Commissary, equipment and other sales	306,400
Investment income	4,400
Total revenues	674,200
Costs and expenses:	
Restaurant expenses:	
Cost of sales	87,500
Salaries and benefits	87,000
Advertising and related costs	28,400
Occupancy costs and other operating expenses	58,500
	261,400
Commissary, equipment and other expenses:	
Cost of sales	240,700
Salaries, benefits, and other operating expenses	39,500
	280,200
General and administrative expenses	50,500
Depreciation and amortization	19,400
Other costs and expenses	5,300
Total costs and expenses	616,800
Income before income taxes	57,400
Income tax expense	22,200
Net income	$ 35,200

Cash Basis Accounting



Revenue is recorded when cash is received.

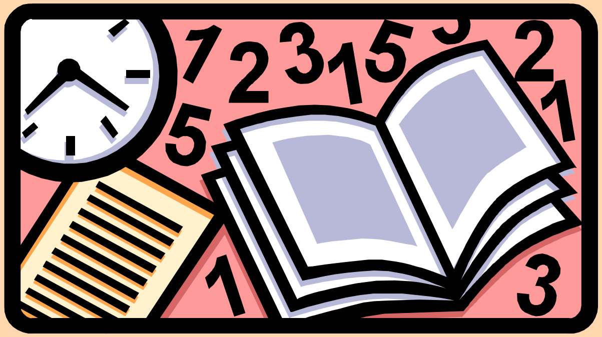


Expenses are recorded when cash is paid.

Accrual Accounting

Assets, liabilities, revenues, and expenses should be recognized when the transaction that causes them occurs, not necessarily when cash is paid or received.

Required by GAAP.

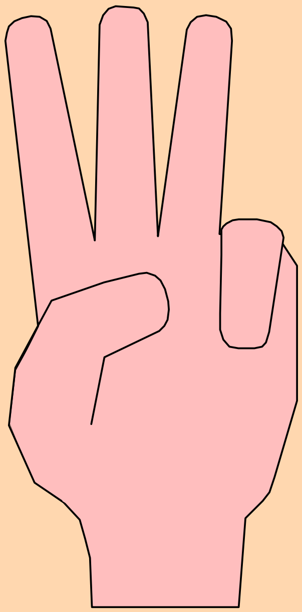


Principles Affecting Income Determination

❶Revenue Principle

❷Matching Principle

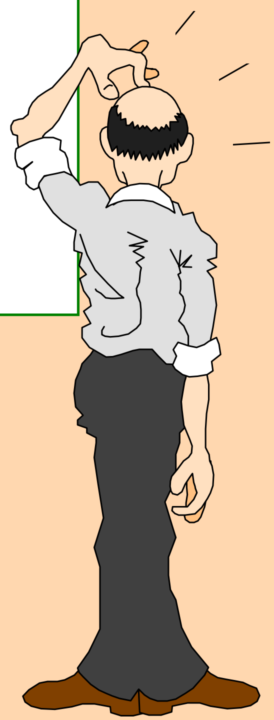
❸Cost Principle



The Revenue Principle

Recognize revenues when . . .

- **Earnings process is complete or nearly complete.**
- **An exchange transaction takes place.**
- **Collection is reasonably assured.**



The Revenue Principle

Typical liabilities that become revenue when earned include . . .

CASH COLLECTED (Goods or services due to customers)	over time will become	REVENUE (Earned when goods or services provided)
Rent collected in advance	→	Rent revenue
Unearned air traffic revenue	→	Air traffic revenue
Deferred subscription revenue	→	Subscription revenue

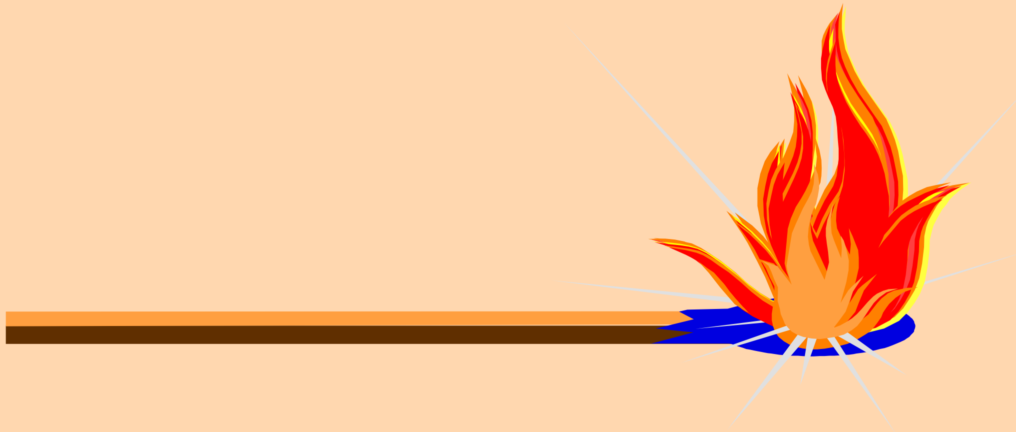
The Revenue Principle

Assets reflecting revenues earned but not yet received in cash include . . .

CASH TO BE COLLECTED (Owed by customers)	and already earned as	REVENUE (Earned when goods or services provided)
Interest receivable	→	Interest revenue
Rent receivable	→	Rent revenue
Royalties receivable	→	Royalty revenue

The Matching Principle

Resources consumed to earn revenues in an accounting period should be recorded in that period, regardless of when cash is paid.



The Matching Principle

Typical assets and their related expense accounts include. . .

CASH PAID FOR	as used over time becomes	EXPENSE
Supplies inventory	→	Supplies expense
Prepaid insurance	→	Insurance expense
Buildings and equipment	→	Depreciation expense

The Matching Principle

Typical liabilities and their related expense accounts include . . .

CASH TO BE PAID	and already incurred as	EXPENSE
Salaries payable	→	Salaries expense
Interest payable	→	Interest expense
Property taxes payable	→	Property tax expense

A = L + SE

ASSETS	
Debit for Increase	Credit for Decrease

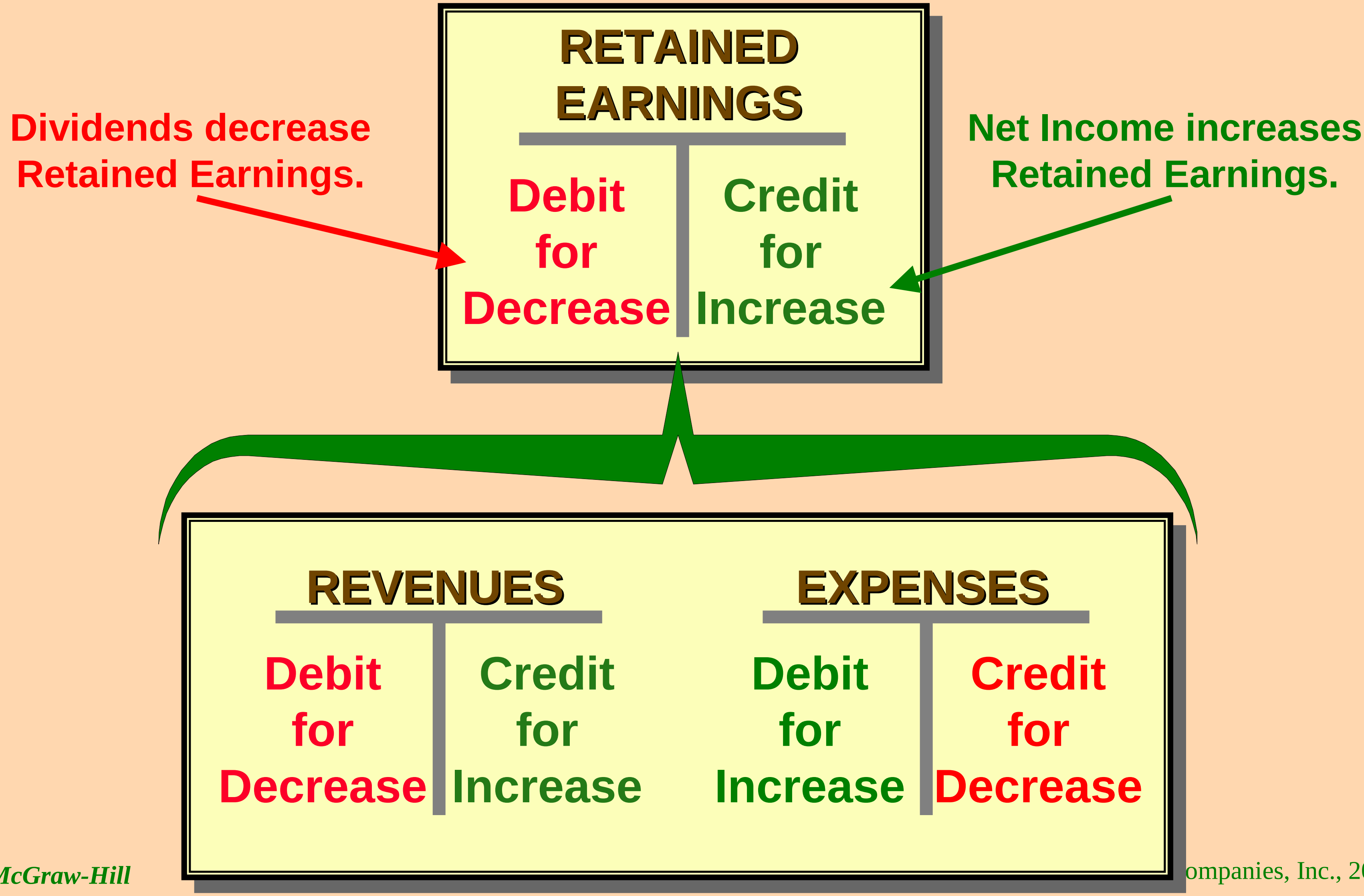
LIABILITIES	
Debit for Decrease	Credit for Increase

CONTRIBUTED CAPITAL	
Debit for Decrease	Credit for Increase

RETAINED EARNINGS	
Debit for Decrease	Credit for Increase

Next, let's see how Revenues and Expenses affect Retained Earnings.

The Expanded Transaction Analysis Model



Transaction Analysis Rules

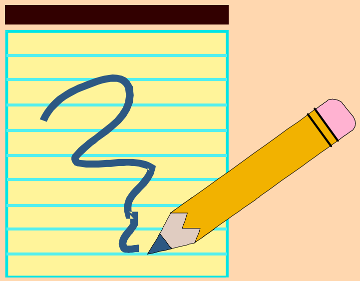
Let's apply the complete transaction analysis model to some of Papa John's transactions.

All amounts are in thousands of dollars.

Papa John's sold 25 franchises for $400 cash. The company earned $175 immediately. The rest will be earned over several months.

Identify & Classify the Accounts

1. Cash (asset)
2. Franchise royalties and development fees (revenue)
3. Unearned franchise and development fees (liability)



Determine the Direction of the Effect

1. Cash increases.
2. Franchise royalties and development fees increase.
3. Unearned franchise and development fees increase.

Papa John's sold 25 franchises for $400 cash. The company earned $175 immediately. The rest will be earned over several months.

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	400		Unearned franchise and development fees	225		Franchise royalties and development fees	175

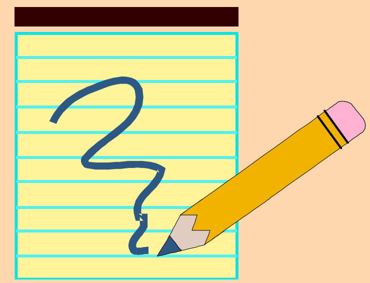
GENERAL JOURNAL Page 1

Date		Description	Debit	Credit
		Cash	400	
		Unearned franchise and development fees		225
		Franchise royalties and development fees		175

The company received $35,200 for pizza sales. The cost of the pizza ingredients for those sales was $9,600.

Identify & Classify the Accounts

1. Cash (asset)
2. Restaurant sales revenue (revenue)
3. Cost of sales- restaurant (expense)
4. Inventories (asset)



Determine the Direction of the Effect

1. Cash increases.
2. Restaurant sales revenue increases.
3. Cost of sales- restaurant increases.
4. Inventories decrease.

The company received $35,200 for pizza sales. The cost of the pizza ingredients for those sales was $9,600.

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	35,200				Restaurant sales revenue	35,200
Inventory	(9,600)				Cost of sales	(9,600)

GENERAL JOURNAL — **Page 1**

Date		Description	Debit	Credit
		Cash	35,200	
		Restaurant sales revenue		35,200
		Cost of sales - restaurant	9,600	
		Inventories		9,600

End of Chapter 3