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chapter 3

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Operating Decisions and the Accounting System

Chipotle Mexican Grill's philosophy of "Food with Integrity" guides its operating decisions. "Food with Integrity" entails finding and serving high-quality sustainably and organically raised food. It also includes showing respect for animals, the environment, and people involved in the operations. The company keeps operations simple, offering a few menu items (burritos, burrito bowls, tacos, and salads). Within these items, customers can choose from four meats, two types of beans and rice, and a variety of additional items such as salsa, guacamole, cheese, and lettuce—creating hundreds of options. The focused menu allows Chipotle to concentrate on the source of the food items, a challenging activity given the smaller and often costlier market for organic meats, produce, and dairy products. Anticipating changes in these food costs and sources is critical to determining menu prices and controlling costs.

To control quality and increase efficiency, the company purchases key ingredients such as meat, beans, and tortillas from a small number of suppliers and other raw materials from approved sources. Twenty-two independently owned and operated regional distribution centers purchase from these suppliers and then deliver the items as needed to the Chipotle restaurants in each region.

Learning Objectives

After studying this chapter, you should be able to:

- 3-1 Describe a typical business operating cycle and explain the necessity for the time period assumption. p. 100
- 3-2 Explain how business activities affect the elements of the income statement. p. 102
- 3-3 Explain the accrual basis of accounting and apply the revenue realization and expense matching principles to measure income. p. 105
- 3-4 Apply transaction analysis to examine and record the effects of operating activities on the financial statements. p. 111

3-5 Prepare a classified income statement. p. 121

3-6 Compute and interpret the net profit margin ratio. p. 122

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FOCUS COMPANY:

Chipotle Mexican Grill

IT'S MORE THAN MEAT,
GUACAMOLE, AND TORTILLAS

www.chipotle.com

The second highest cost for Chipotle, as with most restaurants, is hiring and developing employees. The food is prepared from scratch on stoves and grills, not with microwaves and other automated cooking techniques. Each employee is trained in all aspects of food preparation—from grilling, to making fresh salsa, to cooking rice—and creating a positive interactive experience for customers. The company has numerous incentives to develop strong leadership, with nearly 98 percent of managers promoted from within the company.

Chipotle also competes using marketing strategies. Chipotle spends less on expensive national advertising campaigns than larger restaurant chains and much more on strategic promotional activities to make connections with neighborhoods to explain how Chipotle is different. Most activities are innovative, such as the award-winning two-minute animated video “Back to the Start” that aired during the 2012 Grammy Awards; the Cultivate Chicago festival featuring indie bands, artisanal food, wine producers, and high-profile chefs; and the Chipotle Truck, which travels to various locations, including new store openings, and sells almost a full menu of Chipotle items from the food trailer. As stated in its 2011 annual report:

Collectively, these efforts and our excellent restaurant teams have helped us create considerable word-of-mouth publicity, with our customers learning about us and telling others, allowing us to build awareness with relatively low advertising expenditures, even in a competitive category, and to differentiate Chipotle as a company that is committed to doing the right things in every facet of our business.

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UNDERSTANDING THE BUSINESS

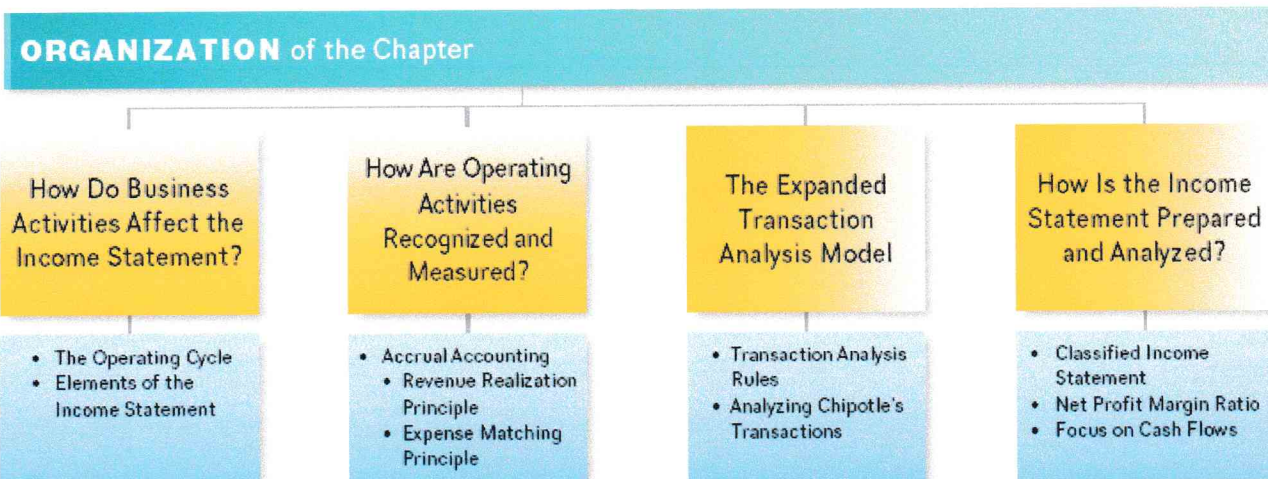
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The restaurant industry is extremely competitive. For example, in February 2012, McDonald's Corporation announced a requirement that suppliers need to phase out stalls that restrict the movement of pregnant pigs, a change made in direct response to Chipotle's TV video on its ethical stance aired at the Grammy Awards. Taco Bell announced in July 2012 the creation of a Cantina Bell™ menu featuring “gourmet” food items such as the Cantina Burrito and Cantina Bowl. Jack in the Box, Inc., is expanding its Qdoba Mexican Grill chain to compete in the fast-casual segment of the industry that is dominated by Mexican restaurants.

Restaurants have to manage economic downturns and shifts in consumer tastes for healthier food choices while facing the competition. Based on their projections of these forces, companies set goals for their performance. Published income statements provide the primary basis for comparing projections to the actual results of operations. To understand how business plans and the results of operations are reflected on the income statement, we need to answer the following questions:

1. How do business activities affect the income statement?
2. How are business activities measured?
3. How are business activities reported on the income statement?

In this chapter we focus on Chipotle's operating activities that involve the sale of food to the public. The results of these activities are reported on the income statement.



HOW DO BUSINESS ACTIVITIES AFFECT THE INCOME STATEMENT?

LEARNING OBJECTIVE 3-1

Describe a typical business operating cycle and explain the necessity for the time period assumption.

The Operating Cycle

The long-term objective for any business is to **turn cash into more cash**. If a company is to stay in business, this excess cash must be generated from operations (that is, from the activities for which the business was established), not from borrowing money or selling long-lived assets.

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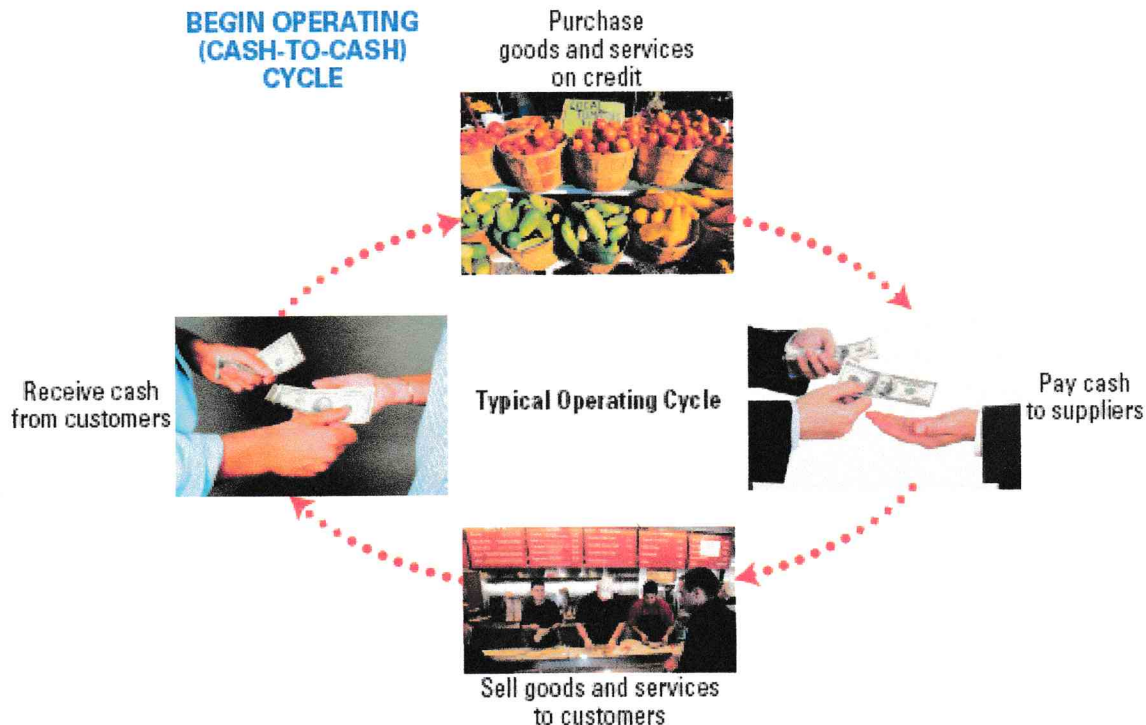
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The **OPERATING (CASH-TO-CASH) CYCLE** is the time it

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takes for a company to pay cash to suppliers, sell goods and services to customers, and collect cash from customers.

Companies (1) acquire inventory and the services of employees and (2) sell inventory or services to customers. The **operating (cash-to-cash) cycle** begins when a company receives goods to sell (or, in the case of a service company, has employees work), pays for them, and sells to customers; it ends when customers pay cash to the company. The length of time for completion of the operating cycle depends on the nature of the business.



The operating cycle for Chipotle is relatively short. It spends cash to purchase fresh ingredients, prepares the food, and sells it to customers for cash. In some companies, inventory is paid for well before it is sold. Toys R Us, for example, builds its inventory for months preceding the year-end holiday season. It borrows funds from banks to pay for the inventory and repays the loans with interest when it receives cash from customers. In other companies, cash is received from customers well after a sale takes place. For example, furniture retailers often allow customers to make monthly

payments over several years. Shortening the operating cycle by creating incentives that encourage customers to buy sooner and/or pay faster improves a company's cash flows.

The **TIME PERIOD ASSUMPTION**

indicates that the long life of a company can be reported in shorter time periods.

Until a company ceases its activities, the operating cycle is repeated continuously. However, decision makers require information periodically about the company's financial condition and performance. As indicated in the conceptual framework in Exhibit 2.1, to measure income for a specific period of time, accountants follow the **time period assumption**, which assumes that the long life of a company can be reported in shorter time periods, such as months, quarters, and years.¹ Two types of 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?

Before we examine the rules accountants follow in resolving these issues, however, let's examine the elements of the income statement that are affected by operating activities.

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EXHIBIT 3.1

Chipotle Mexican Grill's
Income Statement

Operating activities
(central focus
of business)

Peripheral activities
(not central
focus
of business)

CHIPOTLE MEXICAN GRILL, INC.	
Consolidated Statement of Income*	
For the Year ended December 31, 2011	
(in thousands of dollars, except per share data)	
Restaurant sales revenue	\$2,269,500
Restaurant operating expenses:	
Food, beverage, and packaging	738,700
Salaries and wages	543,100
Occupancy	147,300
Other operating expenses	259,700
General and administrative expenses	149,400
Depreciation expense	74,900
Total operating expenses	<u>1,913,100</u>
Income from operations	356,400
Other items:	
Investment income	2,100
Interest expense	(2,900)
Gain (loss) on disposal of assets	<u>(5,800)</u>
Income before income taxes	349,800
Income tax expense	134,800
Net income	<u>\$ 215,000</u>
Earnings per share	<u>\$ 6.89</u>

*The information has been adapted from actual statements and simplified for this chapter.

EXPLANATIONS

Includes used supplies

Includes rent, insurance, and utilities

Includes advertising and maintenance

Includes management training

Also called Provision for Income Taxes

= \$215,000,000 Net Income ÷ 31,217,000 weighted average number of common stock shares outstanding

Elements of the Income Statement

LEARNING OBJECTIVE 3-2

Explain how business activities affect the elements of the income statement.

Exhibit 3.1 shows a recent income statement for Chipotle, simplified for the purposes of this chapter. It has multiple subtotals, such as **operating income** and **income before income taxes**. This format is known as **multiple step** and is very common.² In fact, you can tell if a company uses the multiple-step format if you see the Operating Income (also called Income from Operations) subtotal. As we discuss the elements of the income statement, also refer to the conceptual framework outlined in Exhibit 2.1.

Operating Revenues

REVENUES are increases in assets or settlements of liabilities from ongoing operations.

Revenues are defined as increases in assets or settlements of liabilities from **ongoing operations** of the business. Operating revenues result from the sale of goods or services. When Chipotle sells tacos to consumers, it has **earned** revenue. When revenue is earned, assets, usually Cash or Accounts Receivable, often increase. Sometimes if a customer pays for goods or services in advance, a liability account, usually Unearned (or Deferred) Revenue, is created. At this point, no revenue has been earned. There is simply a receipt of cash in exchange for a promise to provide a good or service in the future. When the company provides the promised goods or services to the customer, then the revenue is recognized and the liability eliminated.

Many companies generate revenues from a variety of sources. For example, General Motors reports revenues from its automotive sales as well as from providing financing to customers. In the restaurant industry, many companies, such as McDonald's Corporation, have company-owned stores but also sell franchise rights. The franchisor (seller) reports revenues from both

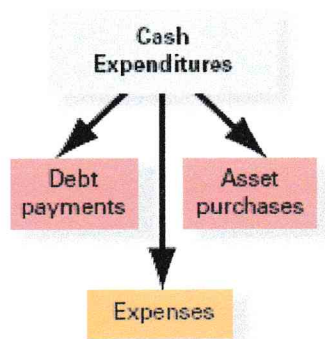
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the sales of food in company-owned stores and the fees from franchisees. Chipotle does not sell franchises. Therefore, the company generates revenue from one source—sales of food orders to customers—that is reported in the **Restaurant Sales Revenue** account.

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Operating Expenses



EXPENSES are outflows or the using up of assets or increases in liabilities from ongoing operations incurred to generate revenues during the period.

Some students confuse the terms **expenditures** and **expenses**. An expenditure is any outflow of cash for any purpose, whether to buy equipment, pay off a bank loan, or pay employees their wages. **Expenses** are outflows or the using up of assets or increases in liabilities from **ongoing operations** incurred to generate revenues during the period. Therefore, **not all cash expenditures are expenses, but expenses are necessary to generate revenues.**

Chipotle's employees make and serve food. The company uses electricity to operate equipment and light its facilities, and it uses food and paper supplies. Without incurring these expenses, Chipotle could not generate revenues. Expenses may be incurred before, after, or at the same time as cash is paid. When an expense is incurred, assets such as Supplies decrease (are used up) **or** liabilities such as Wages Payable or Utilities Payable increase. The following are Chipotle's primary operating expenses:

Restaurant Operating Expenses:

- **Food, Beverage, and Packaging Expense.** In Chipotle's restaurant operations, any food ingredients or beverage and packaging supplies that are used to produce and sell meals are expensed as they are used. For Chipotle, this is its largest expense at \$738,700,000 in 2011. In companies with a manufacturing or merchandising focus, Cost of Goods Sold (or Cost of Sales) representing the cost of inventory used in generating sales is usually the most significant expense.
- **Salaries and Wages Expense.** When employees work and generate sales for Chipotle, the company incurs an expense, although wages and salaries will be paid later. Salaries and Wages Expense of \$543,100,000 is Chipotle's second largest expense. In purely service-

oriented companies in which no products are produced or sold, the cost of having employees generate revenues is usually the largest expense. For example, Federal Express reported \$9.365 billion in salaries expense for the year ended May 31, 2012.

- **Occupancy Expense.** Renting facilities, insuring property and equipment at the stores, and using utilities are typical expenses related to occupying facilities. Usually, rent and insurance are paid before occupying the facilities, but utilities are paid after occupying the facilities.
- **Other Operating Expenses.** These expenses include advertising and marketing costs and repair and maintenance of store facilities.

General and Administrative Expenses: General and Administrative Expenses include costs of renting headquarters facilities, executive salaries, and training managers. These are typically expenses that are not directly related to operating stores.

Depreciation Expense: When a company uses buildings and equipment to generate revenues, a part of the cost of these assets is reported as an expense called Depreciation Expense. Chapter 8 discusses methods for estimating the amount of depreciation expense.

Operating revenues less operating expenses equals **Operating Income** (also called Income from Operations)—a measure of the profit from central ongoing operations.

Other Items

Not all activities affecting an income statement are central to ongoing operations. Any revenues, expenses, gains, or losses that result from these other activities are not included as part of operating income, but are instead categorized as Other Items. Typically, these include the following:

- **Investment Income** (or **Investment Revenue**, **Interest Revenue**, or **Dividend Revenue**). Using excess cash to purchase stocks or bonds in other companies is an investing activity for Chipotle, not the central operation of making and selling fresh Mexican food. Therefore, any interest or dividends earned on investments in other companies are not included as operating revenue.

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Interest Expense. Likewise, since borrowing money is a financing activity, any cost of using that money (called interest) is not an operating expense. Except for financial institutions, incurring interest expense and earning investment income are **not** the central operations of most businesses, including Chipotle. We say these are peripheral (normal but not central) transactions.

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GAINS are increases in assets or decreases in liabilities from peripheral transactions.

LOSSES are decreases in assets or increases in liabilities from peripheral transactions.

- **Gain (Loss) on Disposal of Assets.** Companies sell property, plant, and equipment from time to time to maintain modern facilities. They also sell investments as needed. Selling these assets for more than the original purchase price does not result in earning revenue because the transaction is not the central operating focus for the business. **Gains** result in an increase in assets or decrease in liabilities from a **peripheral** transaction. **Losses** are decreases in assets or increases in liabilities from **peripheral** transactions. In 2011, Chipotle reported a loss of \$5,800,000.

Income Tax Expense

Adding and subtracting other items to operating income gives a subtotal of **Income before Income Taxes** (or pretax income). Income Tax Expense (also called **Provision for Income Taxes**) is the last expense listed on the income statement before determining net income. All profit-making corporations are required to compute income taxes owed to federal, state, and foreign governments. Income tax expense is calculated as a percentage of pretax income determined by applying the tax rates of the federal, state, local, and foreign taxing authorities. Chipotle's effective tax rate in 2011 was 38.5 percent (\$134,800,000 in income tax expense divided by \$349,800,000 in income before income taxes). This indicates that, for every dollar of income before taxes that Chipotle made in 2011, the company paid nearly \$0.39 to taxing authorities.

Earnings per Share

Corporations are required to disclose earnings per share on the income statement or in the notes to the financial statements. This ratio is widely used in evaluating the operating performance and profitability of a company. At this introductory level, we can compute earnings per share simply as net income divided by the weighted average number of shares of stock outstanding (Net Income ÷ Weighted Average Number of Shares of Stock Outstanding). Please note, however, that the calculation of the ratio is actually much more complex and beyond the scope of this course. Instead, we used the actual number computed by Chipotle. For 2011, Chipotle reported \$6.89 in earnings for each share of stock owned by investors.



INTERNATIONAL PERSPECTIVE



Income Statement Differences

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

In addition, foreign companies often use account titles that differ from those used by 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

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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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GlaxoSmithKline
Parmalat



Unilever

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HOW ARE OPERATING ACTIVITIES RECOGNIZED AND MEASURED?

CASH BASIS

Income Measurement

Revenues (= cash receipts)
– Expenses (= cash payments)
<u>Net Income (cash basis)</u>

CASH BASIS ACCOUNTING

records revenues when cash is received
and expenses when cash is paid.

You probably determine your personal financial position by the cash balance in your bank account. Your financial performance is measured as the difference between your cash balance at the beginning of the period and the cash balance at the end of the period (that is, whether you end up with more or less cash). If you have a higher cash balance, cash receipts exceeded cash disbursements for the period. Many local retailers, medical offices, and other small businesses use **cash basis accounting**, in which revenues are recorded when cash is received and expenses are recorded when cash is paid, regardless of when the revenues are earned or the expenses incurred. This basis produces net operating cash flow information which is often quite adequate for organizations that do not need to report to external users. The following table illustrates the application of cash basis accounting for the first three years of a new business. Cade Company:

Cade Company Income Statements	Year 1	Year 2	Year 3	Total
Sales on credit	\$ 60,000	\$60,000	\$60,000	\$180,000
Cash receipts from customers	\$ 20,000	\$70,000	\$90,000	\$180,000
Cash disbursements for:				
Salaries to employees	(30,000)	(30,000)	(30,000)	(90,000)
Insurance for 3 years	(12,000)	(0)	(0)	(12,000)
Supplies	(3,000)	(7,000)	(5,000)	(15,000)
Net operating cash flows	\$(25,000)	\$33,000	\$55,000	\$ 63,000

In this illustration, \$60,000 in sales was earned each year by Cade Company. However, because the sales were on account, customers spread out their payments over three years. Salaries to employees were paid in full each year. Insurance was prepaid at the beginning of the first year for equal coverage over the three years. Supplies were purchased on credit and used evenly over the three years. However, the company paid part of the first year purchases in the second year.

Using cash basis accounting may lead to an incorrect interpretation of future company performance. Simply looking at the first year, investors and creditors might interpret the negative cash flows as a problem with the company's ability to generate cash flows in the future. However, the other two years show positive cash flows. Likewise, performance over time appears uneven, when in actuality it is not. Sales were earned evenly each year, although collections from customers were not. The years in which insurance and supplies were paid for are not the same as the years in which these resources were used.

LEARNING OBJECTIVE 3-3

Explain the accrual basis of accounting and apply the revenue realization and expense matching principles to measure income.

Accrual Accounting

ACCRUAL BASIS ACCOUNTING

records revenues when earned and expenses when incurred, regardless of the timing of cash receipts or payments.

Financial statements created under cash basis accounting normally postpone or accelerate recognition of revenues and expenses long before or after goods and services are produced and delivered (when cash is received or paid). They also do not necessarily reflect all assets or liabilities of a company on a particular date. For these reasons, cash basis financial statements are not very useful to external decision makers. Therefore, generally accepted accounting principles require **accrual basis accounting** for financial reporting.

In accrual basis accounting, revenues and expenses are recognized when the transaction that causes them occurs, not necessarily when cash is received or paid. That is, **revenues are recognized when they are earned and expenses when they are incurred.**

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Using the same information for Cade Company, we can apply the accrual basis of accounting.

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ACCRUAL BASIS
Income Measurement
 Revenues (= when earned)
 – Expenses (= when incurred)
 Net Income (accrual basis)

Cade Company Income Statements	Year 1	Year 2	Year 3	Total
Sales revenue (earned)	\$60,000	\$60,000	\$60,000	\$180,000
Expenses (resources used or incurred):				
Salaries expense	(30,000)	(30,000)	(30,000)	(90,000)
Insurance expense	(4,000)	(4,000)	(4,000)	(12,000)
Supplies expense	(5,000)	(5,000)	(5,000)	(15,000)
Net income	\$21,000	\$21,000	\$21,000	\$ 63,000

Regardless of when cash is received, Cade Company reported revenues when earned. Likewise, the company used insurance coverage and supplies evenly over the three years, despite prepaying the entire amount of insurance at the beginning of the first year and paying part of the first year's purchases in the second year. The \$21,000 net income in the first year is a better predictor of future cash flows and performance than net operating cash flows reported under cash basis accounting. The two basic accounting principles that determine when revenues and expenses are recorded under accrual basis accounting are the **revenue realization principle** and the **expense matching principle**.

Revenue Realization Principle

The **REVENUE REALIZATION PRINCIPLE** states that revenues are recognized when (1) goods or services are delivered, (2) there is persuasive evidence of an arrangement for customer payment, (3) the price is fixed or determinable, and (4) collection is reasonably assured.

Under the **revenue realization principle**, four criteria or conditions must normally be met for revenue to be recognized. If **any** of the following criteria are **not** met, revenue normally is **not** recognized and cannot be recorded.

1. **Delivery has occurred or services have been rendered.** The company has performed or substantially performed the acts promised to the customer by providing goods or services.
2. **There is persuasive evidence of an arrangement for customer payment.** In exchange for the company's performance, the customer has provided cash or a promise to pay cash (a receivable).
3. **The price is fixed or determinable.** There are no uncertainties as to the amount to be collected.
4. **Collection is reasonably assured.** For cash sales, collection is not an issue since it is received on the date of the exchange. For sales on credit, the company reviews the customer's ability to pay. If the customer is considered creditworthy, collecting cash from the customer is reasonably likely.

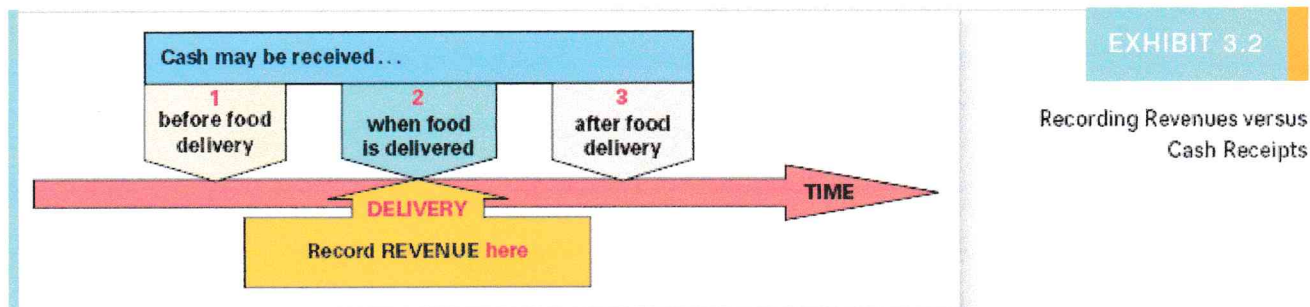
These conditions normally occur when the title, risks, and rewards of ownership have transferred to the customers. For most businesses, these conditions are met at the point of delivery of goods or services, **regardless of when cash is received.**

Although businesses expect to receive cash in exchange for their goods and services at the time of delivery, the timing of cash receipts from customers does not dictate when businesses report revenues. Instead, the key to determining when to report revenue is whether the business has done what it promised to do. Exhibit 3.2 illustrates that revenue is earned when the business delivers goods or services, although cash can be received from customers (1) in a period **before** delivery, (2) in the **same** period as delivery, or (3) in a period **after** delivery. Let's see how to handle each of these cases.

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- 1** Cash is received *before* the goods or services are delivered. Chipotle sells gift cards to customers for cash in exchange for the promise to provide future food orders. Since Chipotle has not at that point delivered food, it records **no revenue**. Instead it creates a liability account (Unearned Revenue) representing the amount of food service owed to the customers. Later, when customers redeem their gift cards and Chipotle delivers the food, it earns and records the revenue while reducing the liability account since it has satisfied its promise to deliver.

On receipt of a \$100 cash deposit:

Cash (+A)	100	
Unearned Revenue (+L)		100

On delivery of ordered food:

Unearned Revenue (-L)	100	
Restaurant Sales Revenue (+R, +SE) ...		100

- 2** Cash is received *in the same period* as the goods or services are delivered. As is a typical timing of cash receipts and revenue recognition in the restaurant industry, Chipotle receives cash from most customers within a few minutes of them receiving their food. Chipotle delivers the food to the customer as ordered in exchange for cash, **earning revenue** in the process.

On delivery of ordered food for \$12 cash:

Cash (+A)	12	
Restaurant Sales Revenue (+R, +SE) ...		12

- 3** Cash is received *after* the goods or services are delivered. When a business sells goods or services on account, the revenue is earned when the goods or services are delivered, not when

cash is received at a later date. Let's assume to boost business, Chipotle delivers food when ordered by select customers, such as departments at area colleges or businesses, that pay for the food order when Chipotle bills them at the end of the month, not when the customers receive the food. When delivered, Chipotle records both Restaurant Sales Revenue and the asset Accounts Receivable, representing the customer's promise to pay in the future for past food deliveries. When the customer pays its monthly bill, Chipotle will increase its Cash account and decrease Accounts Receivable.

On delivery of ordered food for \$50 on account:		
Accounts Receivable (+A)	50	
Restaurant Sales Revenue (+R, +SE) ...		50
On receipt of cash after delivery:		
Cash (+A)	50	
Accounts Receivable (-A)		50

Companies usually disclose their revenue recognition practices in the financial statement note titled Significant Accounting Policies. The following excerpt from Note 1 to recent financial statements describes how Chipotle recognizes its revenue:

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition

Revenue from restaurant sales is recognized when food and beverage products are sold . . . The Company recognizes revenue from gift cards when: (i) the gift card is redeemed by the customer; or (ii) the Company determines the likelihood of the gift card being redeemed by the customer is remote (gift card breakage) . . . The determination of the gift card breakage rate is based upon Company-specific historical redemption patterns.



REAL WORLD EXCERPT
Annual Report

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PAUSE FOR FEEDBACK

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We just learned the **revenue realization principle's** criteria: (1) The company delivers goods or performs services, (2) there is persuasive evidence of an arrangement with the customer, (3) the price is fixed or determinable, and (4) collection is reasonably assured. Regardless of when cash is received, revenue is earned and recorded when these criteria are met.

SELF - STUDY QUIZ

Complete this quiz now to make sure you can apply the principle. The following transactions are samples of typical monthly operating activities of Papa John's International, Inc. (dollars in thousands) that makes and delivers pizza and sells franchises. If revenue is to be recognized in **January**, indicate the title of the revenue account and the amount of revenue to be recognized. For account titles, name the revenue account based on the nature of the transaction. For example, sales to customers are Restaurant Sales Revenue and sales of franchisees are Franchise Fee Revenue.

ACTIVITY	REVENUE ACCOUNT TITLE	AMOUNT OF REVENUE RECOGNIZED IN JANUARY
(a) In January, Papa John's company-owned restaurants sold food to customers for \$32,000 cash.		
(b) In January, Papa John's sold new franchises for \$625 cash, providing \$400 in services to these new franchisees during January; the remainder of services will be provided over the next three months.		
(c) In January, Papa John's received \$210 in cash from customers as deposits on large orders to be delivered in February.		
(d) In January, Papa John's delivered \$1,630 to select customers on account; the customers will pay when billed at the end of January.		
(e) In January, customers paid \$1,200 on account to Papa John's from December deliveries of pizza.		
(f) In January, Papa John's delivered \$385 to customers who provided deposits in December.		

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no end-of-period adjustments have been made yet to reflect all revenues earned and expenses incurred during the quarter. Therefore, the trial balance is **unadjusted** until adjustments are made, as we discuss in Chapter 4.

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CLASSIFIED INCOME STATEMENT

The following classified income statement is presented to highlight the structure **but note that, because it is based on unadjusted balances, it would not be presented to external users.**

CHIPOTLE MEXICAN GRILL, INC. Consolidated Statement of Income UNADJUSTED For the Quarter ended March 31, 2012 (in thousands of dollars)	
Restaurant sales revenue	\$619,300
Restaurant operating expenses:	
Food, beverage, and packaging	0
Salaries and wages	138,600
Occupancy	10,000
Other operating expenses	48,600
General and administrative expenses	49,300
Depreciation expense	0
Total operating expenses	<u>246,500</u>
Income from operations	372,800
Other items:	
Investment income	4,700
Interest expense	(0)
Gain (loss) on disposal of assets	<u>(1,300)</u>
Income before income taxes	376,200
Income tax expense	0
Net income	<u>\$376,200</u>

When comparing this statement with Chipotle's 2011 income statement in Exhibit 3.1, we notice that the income from operations above (\$372,800) is higher for just the first quarter of 2012 than for all of 2011 (\$356,400). Obviously, numerous adjustments are necessary to revenues and expenses. We would not want to use the information for analysis until it has been adjusted. However, we can analyze the 2011 financial statements using the net profit margin ratio to determine how effective Chipotle's management is at generating profit.

KEY RATIO ANALYSIS



Net Profit Margin

After you have completed your answers, check them with the solutions at the bottom of the page.

Solutions to SELF-STUDY QUIZ

Revenue Account Title	Amount of Revenue Recognized in January
(a) Restaurant Sales Revenue	\$32,000
(b) Franchise Fee Revenue	\$ 400
(c) No revenue earned in January	—
(d) Restaurant Sales Revenue	\$ 1,630
(e) No revenue earned in January	—
(f) Restaurant Sales Revenue	\$ 385

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The 2011 ratio for Chipotle using actual reported amounts (in Exhibit 3.1) is (dollars in thousands):

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$$\frac{\$215,000}{\$2,269,500} = 0.0947 \text{ or } 9.47\%$$

COMPARISONS OVER TIME Chipotle Mexican Grill, Inc.			COMPARISONS WITH COMPETITORS Panera Bread, Inc. Fiesta Restaurant Group, Inc.	
2011	2010	2009	2011	2011
0.0947	0.0975	0.0835	0.0746	0.0201

INTERPRETATIONS

In General Net profit margin measures how much of every sales dollar generated during the period is profit. A rising net profit margin signals more efficient management of sales and expenses. Differences among industries results from the nature of the products or services provided and the intensity of competition. Differences among competitors in the same industry reflect how each company responds to changes in competition (and demand for the product or service) and changes in managing sales volume, sales price, and costs. Financial analysts expect well-run businesses to maintain or improve their net profit margin over time.

Focus Company Analysis Chipotle's net profit margin decreased slightly between 2010 and 2011 to 9.47 percent, but increased over the three-year period of 2009 to 2011. As indicated by management in the annual report, the primary changes were in higher food costs, primarily avocados, beef, chicken, and dairy, which grew at a rate (32 percent) higher than the growth in sales revenue (24 percent). Acquiring "Food with Integrity" (naturally raised, free of preservatives and growth hormones) is challenging and costlier than using traditional food products and sources. On the other hand, labor and occupancy costs grew at a lower rate than sales due to higher average sales per restaurant. Chipotle's management did a better job of generating revenues and controlling labor and occupancy costs in 2011.

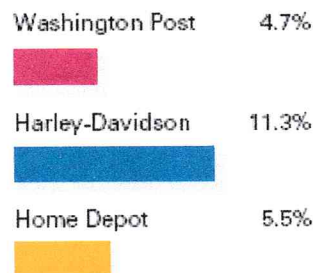
Panera Bread and Fiesta Restaurant Group each had a lower net profit margin than Chipotle. Chipotle's is nearly 27 percent higher than Panera Bread's. This may suggest that Chipotle has greater effectiveness in generating sales, mostly by a high growth in establishing 150 new restaurants and higher menu prices while controlling costs. Panera, on the other hand, opened about 78 new company-owned restaurants and sold 10 additional franchises. Differences in business strategies explain some of the wide variation in the ratio analysis.

A Few Cautions The decisions that management makes to maintain the company's net profit margin in the current period may have negative long-run implications. Analysts should perform additional analysis of the ratio to identify trends in each component of revenues and expenses. This involves dividing each line on the income statement by net sales. Statements presented with these percentages are called **common-sized income statements**. Changes in the percentages of the individual components of net income provide information on shifts in management's strategies.

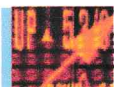
LEARNING OBJECTIVE 3-6

Compute and interpret the net profit margin ratio.

Selected Focus Companies'
Net Profit Margin
Ratios for 2011



FINANCIAL ANALYSIS



New Revenue Recognition Standard

The FASB and IASB are collaborating on a new revenue recognition accounting standard. By the time you read this, a new standard should be in place. The good news is that the core revenue recognition principle that we discuss in this chapter will not change. **Companies will recognize revenue when goods and services are transferred to customers in an amount they expect to receive.** The major changes we will see relate to complex contracts that require transfer of multiple goods or services, such as when Dell sells computers and a one-year warranty together in a single sale. For these types of sales contracts, companies will determine the separate obligations and split the sales price among them. They will then recognize each part of the revenue when they have provided each promised good or service. Accounting for complex sales transactions will be covered in your intermediate accounting course.

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FOCUS ON CASH FLOWS



Operating Activities

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In this chapter, we focus on cash flows from operating activities: **cash from** operating sources, primarily customers, and **cash to** suppliers and others involved in operations. The accounts most often associated with operating activities are current assets, such as Accounts Receivable, Inventories, and Prepaid Expenses, and current liabilities, such as Accounts Payable, Wages Payable, and Unearned Revenue.

As discussed in Chapter 2, companies report cash inflows and outflows over a period of time in their **statement of cash flows** that is divided into three categories:

- **O** - Operating activities primarily with customers and suppliers, and interest payments and earnings on investments.
- **I** - Investing activities include buying and selling noncurrent assets and investments.
- **F** - Financing activities include borrowing and repaying debt, including short-term bank loans, issuing and repurchasing stock, and paying dividends.

Only transactions affecting cash are reported on the statement. An important step in constructing and analyzing the statement of cash flows is identifying the various transactions as operating, investing, or financing. Let's analyze the Cash T-account for Chipotle's transactions in this chapter, adding to transactions (a)—(f) from Chapter 2. Refer to transactions (g)—(q) illustrated earlier in the chapter, and remember, **if you see Cash in a transaction, it will be reflected on the statement of cash flows.**

		+ Cash (A) -			
		1/1/12	401,200		
From investors	+ F (a)	62,300	55,100	(c)	- I For noncurrent assets
From bank	+ F (b)	2,000	400	(d)	- F To bank
			60,400	(e)	- I For investment in other companies
From customers	+ O (i)	615,300	167,700	(g)	- O For supplies
From asset disposal	+ I (l)	10,600	86,000	(h)	- O For prepaid assets
From customers	+ O (m)	3,300	49,300	(j)	- O For training
From investments	+ O (p)	4,700	230,100	(k)	- O To employees
From customers	+ O (q)	15,400	37,200	(n)	- O To suppliers
			58,600	(o)	- O For utilities and maintenance
			<u>370,000</u>		



PAUSE FOR FEEDBACK



As we discussed, every transaction affecting cash can be classified either as an operating, investing, or financing effect.

Operating effects relate to receipts of cash from customers, payments to suppliers (employees, utilities, and other suppliers of goods and services for operating the business), and any interest paid or investment income received.

Investing effects relate to purchasing/selling investments or property and equipment or lending funds to/receiving repayment from others.

Financing effects relate to borrowing or repaying banks, issuing stock to investors, repurchasing stock from investors, or paying dividends to investors.

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SELF - STUDY QUIZ

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Mattel, Inc., designs, manufactures, and markets a broad variety of toys (e.g., Barbie, Hot Wheels, Fisher-Price brands, and American Girl dolls) worldwide. Indicate whether these transactions from a recent statement of cash flows were operating (O), investing (I), or financing (F) activities and the direction of their effects on cash (+ for increases in cash; – for decreases in cash):

TRANSACTIONS	TYPE OF ACTIVITY (O, I, OR F)	EFFECT ON CASH FLOWS (1 OR 2)
1. Purchases of property, plant, and equipment		
2. Receipts from customers		
3. Payments of dividends		
4. Payments to employees		
5. Receipts of investment income		

After you have completed your answers, check them with the solutions at the bottom of the next page.

DEMONSTRATION CASE

This case is a continuation of the Terrific Lawn Maintenance Corporation case introduced in Chapter 2. In that chapter, the company was established and supplies, property, and equipment were purchased. Terrific Lawn is now ready for business. The balance sheet at April 7, 2014, based on the first week of investing and financing activities (from Chapter 2) is as follows:

TERRIFIC LAWN MAINTENANCE CORPORATION

Balance Sheet

April 7, 2014

Assets

Current Assets:

Cash	\$ 3,800
Notes receivable	1,250
Total current assets	5,050
Equipment	4,600
Land	3,750
Total assets	\$13,400

Liabilities and Stockholders' Equity

Current Liabilities:

Short-term notes payable	\$ 400
Total current liabilities	400
Long-term notes payable	4,000
Total liabilities	4,400

Stockholders' Equity:

Common stock (\$0.10 par)	150
Additional paid-in capital	8,850
Total stockholders' equity	9,000
Total liabilities and stockholders' equity	\$13,400

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The additional following activities occurred during the rest of April 2014:

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- a. Purchased and used gasoline for mowers and edgers, paying \$90 in cash at a local gas station.
- b. In early April, received from the city \$1,600 cash in advance for lawn maintenance service for April through July (\$400 each month). The entire amount was recorded as Unearned Revenue.
- c. In early April, purchased \$300 of insurance covering six months, April through September. The entire payment was recorded as Prepaid Expenses.
- d. Mowed lawns for residential customers who are billed every two weeks. A total of \$5,200 of service was billed in April.
- e. Residential customers paid \$3,500 on their accounts.
- f. Paid wages every two weeks. Total cash paid in April was \$3,900.
- g. Received a bill for \$320 from the local gas station for additional gasoline purchased on account and used in April. The bill will be paid in May.
- h. Paid \$700 principal and \$40 interest on notes owed to XYZ Lawn Supply.
- i. Paid \$100 on accounts payable.
- j. Collected \$1,250 principal and \$12 interest on the note owed by the city to Terrific Lawn Maintenance Corporation.

Required:

1.
 - a. On a separate sheet of paper, set up T-accounts for Cash, Accounts Receivable, Notes Receivable, Prepaid Expenses, Equipment, Land, Accounts Payable, Short-term Notes Payable, Longterm Notes Payable, Unearned Revenue (same as deferred revenue), Common Stock, Additional Paid-in Capital, Retained Earnings, Mowing Revenue, Interest Revenue, Wages Expense, Fuel Expense, and Interest Expense. Beginning balances for the balance sheet accounts should be taken from the preceding balance sheet. Beginning balances for operating accounts are \$0. Indicate these balances on the T-accounts.
 - b. Analyze each transaction, referring to the expanded transaction analysis model presented in this chapter.
 - c. On a separate sheet of paper, prepare journal entries in chronological order and indicate their effects on the accounting model (Assets = Liabilities + Stockholders' Equity). Include the equality checks: (1) Debits = Credits, and (2) the accounting equation is in balance.
 - d. Enter the effects of each transaction in the appropriate T-accounts. Identify each amount with its letter in the preceding list of activities.
 - e. Compute balances in each of the T-accounts.
2. On the Cash T-account, identify each transaction as O for operating activity, I for investing activity, or F for financing activity.
3. Use the amounts in the T-accounts to prepare an unadjusted classified income statement for Terrific Lawn Maintenance Corporation for the month ended April 30, 2014. (Adjustments to accounts will be presented in Chapter 4.)

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+ Prepaid Expenses (A) –		+ Equipment (A) –		+ Land (A) –	
Beg.	0	Beg.	4,600	Beg.	3,750
(c)	300		<u>4,600</u>		<u>3,750</u>
	<u>300</u>				

Liabilities

– Accounts Payable (L) +			– Short-term Notes Payable (L) +			– Unearned Revenue (L) +		
	0	Beg.		700	Beg.		0	Beg.
(i)	100	(g)					1,600	(b)
	<u>220</u>			<u>700</u>			<u>1,600</u>	

– Long-term Notes Payable (L) +		
	4,000	Beg.
(h)	700	
	<u>3,300</u>	

Stockholders' Equity

– Common Stock (SE) +			– Additional Paid-in Capital (SE) +			– Retained Earnings (SE) +		
	150	Beg.		8,850	Beg.		0	Beg.
	<u>150</u>			<u>8,850</u>			<u>0</u>	

Revenues

– Mowing Revenue (R) +			– Interest Revenue (R) +		
	0	Beg.		0	Beg.
	5,200	(d)		12	(j)
	<u>5,200</u>			<u>12</u>	

Expenses

+ Wages Expense (E) –		+ Fuel Expense (E) –		+ Interest Expense (E) –	
Beg.	0	Beg.	0	Beg.	0
(f)	3,900	(a)	90	(h)	40
	<u>3,900</u>	(g)	320		<u>40</u>
			<u>410</u>		

2. Cash flow activities identified (O = operating, I = investing, and F = financing):

		+ Cash (A) -					
		Beg.	3,800				
	From customers	(b)	1,600	90	(a)	-0	For fuel
	From customers	(e)	3,500	300	(c)	-0	For insurance
\$12 for interest	+0; \$1,250 for principal	(j)	1,262	3,900	(f)	-0	To employees
				740	(h)	-0	\$40 for interest; -F \$700 for principal
				100	(i)	-0	To suppliers
			<u>5,032</u>				

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3. Income Statement:**Page 129**

TERRIFIC LAWN MAINTENANCE CORPORATION	
Unadjusted Income Statement	
For the Month Ended April 30, 2014	
Mowing revenue	\$5,200
Operating expenses:	
Wages expense	3,900
Fuel expense	410
Total operating expenses	4,310
Income from operations	890
Other items:	
Interest revenue	12
Interest expense	(40)
Income before taxes	862
Income tax expense	0
Net income	<u>\$ 862</u>

To be computed and recorded after adjustments are made to revenue and expense accounts (Chapter 4)

CHAPTER TAKE-AWAYS**3-1. Describe a typical business operating cycle and explain the necessity for the time period assumption. p. 100**

- The operating cycle, or cash-to-cash cycle, is the time needed to purchase goods or services from suppliers, sell the goods or services to customers, and collect cash from customers.
- Time period assumption—to measure and report financial information periodically, we assume the long life of a company can be cut into shorter periods.

3-2. Explain how business activities affect the elements of the income statement. p. 102

- Elements of the income statement:
 - a. Revenues—increases in assets or settlements of liabilities from ongoing operations.
 - b. Expenses—decreases in assets or increases in liabilities from ongoing operations.
 - c. Gains—increases in assets or settlements of liabilities from peripheral activities.
 - d. Losses—decreases in assets or increases in liabilities from peripheral activities.

3-3. Explain the accrual basis of accounting and apply the revenue realization and expense matching principles to measure income. p. 105

In accrual basis accounting, revenues are recognized when earned and expenses are recognized when incurred.

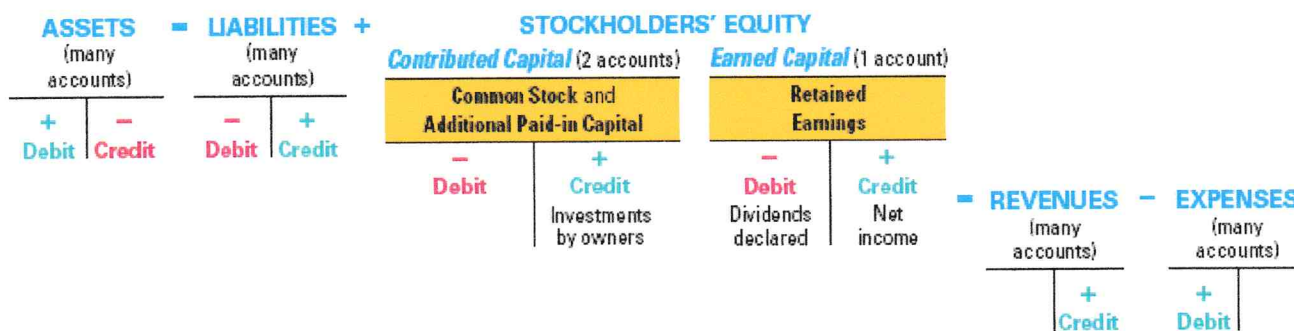
- Revenue realization principle—recognize revenues when (1) delivery has occurred, (2) there is persuasive evidence of an arrangement for customer payment, (3) the price is fixed or determinable, and (4) collection is reasonably assured.
- Expense matching principle—recognize expenses when they are incurred in generating revenue.

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Apply transaction analysis to examine and record the effects of operating activities on the financial statements. p. 111 **Page 130**

The expanded transaction analysis model includes revenues and expenses:



Prepare a classified income statement. p. 121

Until the accounts have been updated to include all revenues earned and expenses incurred in the period (due to a difference in the time when cash is received or paid), the financial statements are unadjusted:

- Classified income statement—net income is needed to determine ending Retained Earnings; classifications include Operating Revenues, Operating Expenses (to determine Operating Income), Other Items (to determine Pretax Income), Income Tax Expense, Net Income, and Earnings per Share.

Compute and interpret the net profit margin ratio. p. 122

The net profit margin ratio ($\text{Net Income} \div \text{Net Sales [or Operating Revenues]}$) measures the profit generated per dollar of sales (operating revenues). The higher the ratio, the more effective the company is at generating revenues and/or controlling costs.

In this chapter, we discussed the operating cycle and accounting concepts relevant to income determination: the time period assumption, definitions of the income statement elements (revenues, expenses, gains, and losses), the revenue realization principle, and the expense matching principle. The accounting principles are defined in accordance with the accrual basis of accounting, which requires revenues to be recorded when earned and expenses to be recorded when incurred in the process of generating revenues. We expanded the transaction analysis model introduced in Chapter 2 by adding revenues and expenses and prepared an unadjusted classified income statement. In Chapter 4, we discuss the activities that occur at the end of the accounting period: the adjustment process, the preparation of adjusted financial statements, and the closing process.

KEY RATIO

Net profit margin ratio measures the profit generated per dollar of sales (operating revenues). A high ratio suggests that a company is generating revenues and/or controlling expenses effectively. The ratio is computed as follows (p. 122):

$$\text{Net Profit Margin Ratio} = \frac{\text{Net Income}}{\text{Net Sales (or Operating Revenues)}}$$

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FINDING FINANCIAL INFORMATION

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Balance Sheet

Current Assets

Cash
Short-term investments
Accounts and notes receivable
Inventory (goods to be sold)
Supplies
Prepaid expenses

Noncurrent Assets

Long-term investments
Property and equipment
Intangibles

Current Liabilities

Accounts payable
Notes payable
Accrued expenses payable
Unearned revenue

Noncurrent Liabilities

Long-term debt

Stockholders' Equity

Common Stock
Additional paid-in capital
Retained earnings

Income Statement

Revenues (operating)

Sales (from various operating activities)

Expenses (operating)

Cost of goods sold (used inventory)
Rent, wages, depreciation, insurance, etc.

Operating Income

Other Items
Interest expense
Investment income
Gains on sale of assets
Losses on sale of assets

Pretax Income

Income tax expense

Net Income

Earnings per Share

Statement of Cash Flows

Operating Activities

+ Cash from customers
+ Cash from interest and dividends
- Cash to suppliers
- Cash to employees
- Interest paid
- Income taxes paid

Notes

Under Summary of Significant Accounting Policies
Description of the company's revenue recognition policy.

KEY TERMS

Accrual Basis Accounting p. 105
Cash Basis Accounting p. 105
Expense Matching Principle p. 109
Expenses p. 103
Gains p. 104
Losses p. 104
Operating (Cash-to-Cash) Cycle p. 101
Revenue Realization Principle p. 106
Revenues p. 102
Time Period Assumption p. 101

QUESTIONS

1. Describe a typical business operating cycle.
2. Explain what the time period assumption means.
3. Write the income statement equation and define each element.
4. Explain the difference between

- a. Revenues and gains.
 - b. Expenses and losses.
5. Define **accrual accounting** and contrast it with cash basis accounting.
 6. What four criteria must normally be met for revenue to be recognized under accrual basis accounting?
 7. Explain the expense matching principle.
 8. Explain why stockholders' equity is increased by revenues and decreased by expenses.

? ANALYTICAL QUESTION

How effective is management in generating profit on every dollar of sales?

% RATIO AND COMPARISONS

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales (or Operating Revenues)}^{\dagger}}$$