Seminar 2:
Accounting Cycle
Accrual Accounting I

Learning Objectives

- Identify steps in the accounting cycle
- Explain the accounting principles and assumptions
- Identify the categories of a classified statement of financial position
- Explain what are current assets and the types of current assets
  - Cash
  - AR
  - Inventory
  - prepaid expenses

The nature of accounting revisit …

Identification	Measurement	Recording	Communication
Transactions →	Quantification in $ terms →	Recording classification summarisation →	Accounting reports Analysis and interpretation

The Accounting Cycle

Steps in the cycle

1. Recognise & record transactions
2. Prepare financial statements

Start of new period

Accounting Records

Source documents

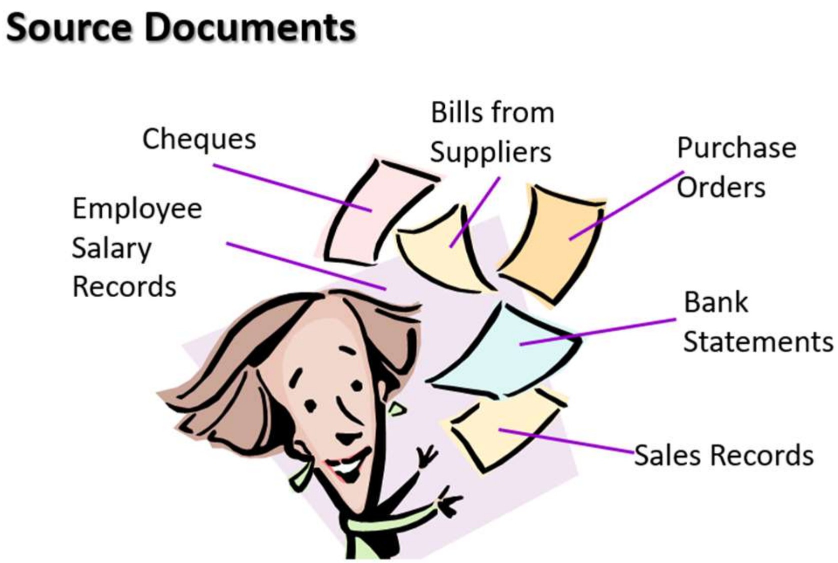
Financial statements

The Accounting Cycle: Transactions

- Types of transactions
  - External transactions
  - Internal transactions
  - Non-transaction events
- Transactions of a business entity

The Accounting Cycle: Source Documents

- Provides written evidence of a transaction
- Serves to control the entity’s resources
  - tax invoice to guests/customers (from point-of-sale systems, property management systems)
  - purchase orders issued to suppliers
  - Invoices from suppliers
  - credit card slips



Expanded Accounting Cycle

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1. Recognise & record transactions
2. Journalise transaction
3. Post to ledger accounts
4. Prepare trial balance of GL
5. Prepare financial statements

Source documents

General journal

General ledger

Trial balance

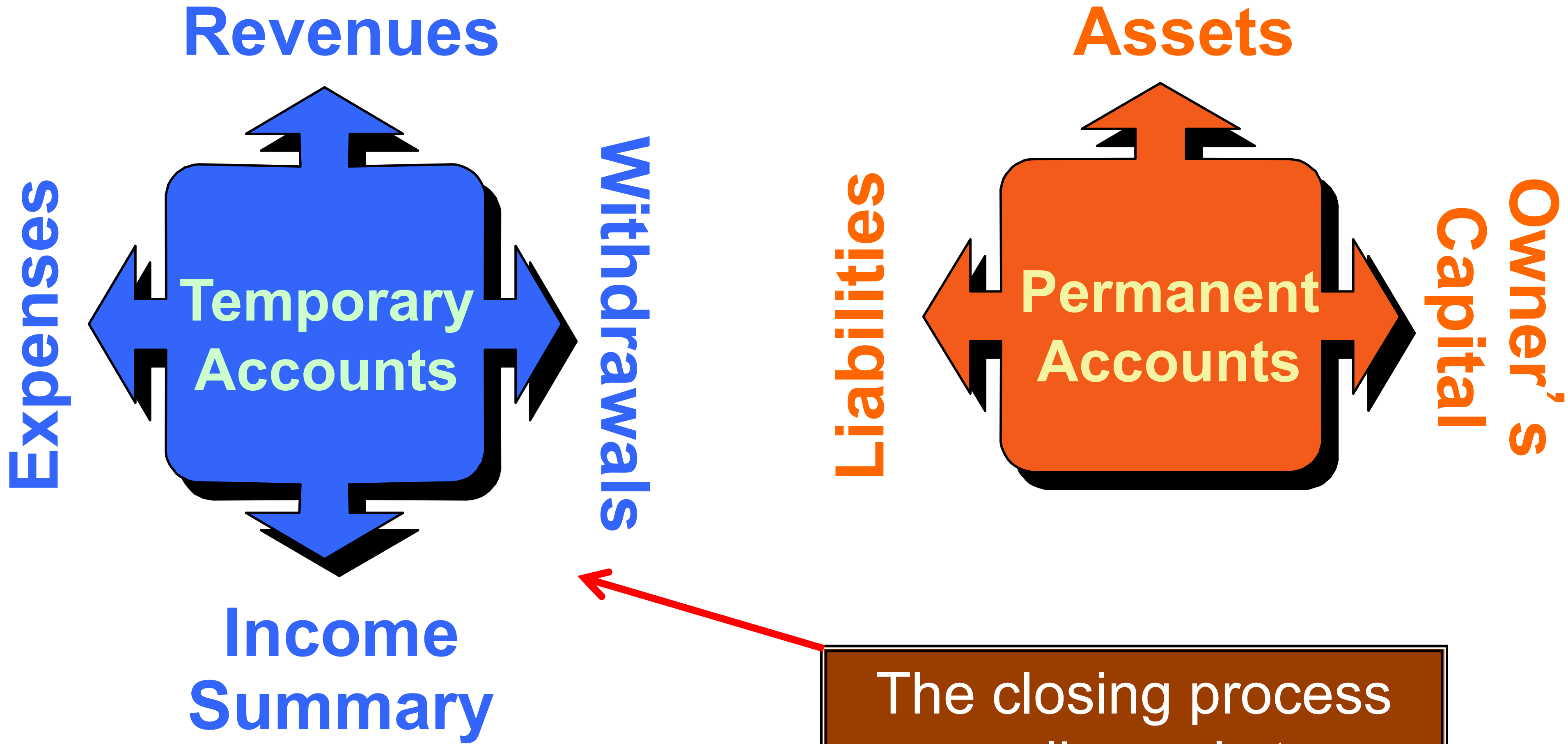
Financial statements

Chart of Accounts

- Complete listing of ledger account titles and ID numbers
- Will reveal:
  - Nature of the organisation
  - Nature of activity
  - Types of revenue and expenses

Balance Sheet Accounts					
Assets		**Liabilities**		**Shareholders' Equity**	
101	Cash	201	Accts. payable	301	Share capital
111	Accts. receivable	231	Notes payable	311	Dividends
141	Office supplies			312	Retained earnings
151	Office furniture	**Income Statement Accounts**			
191	Land	**Revenues**		**Expenses**	
		401	Service revenue	501	Rent expense
				502	Salary expense
				503	Utilities expense

Temporary and Permanent Accounts

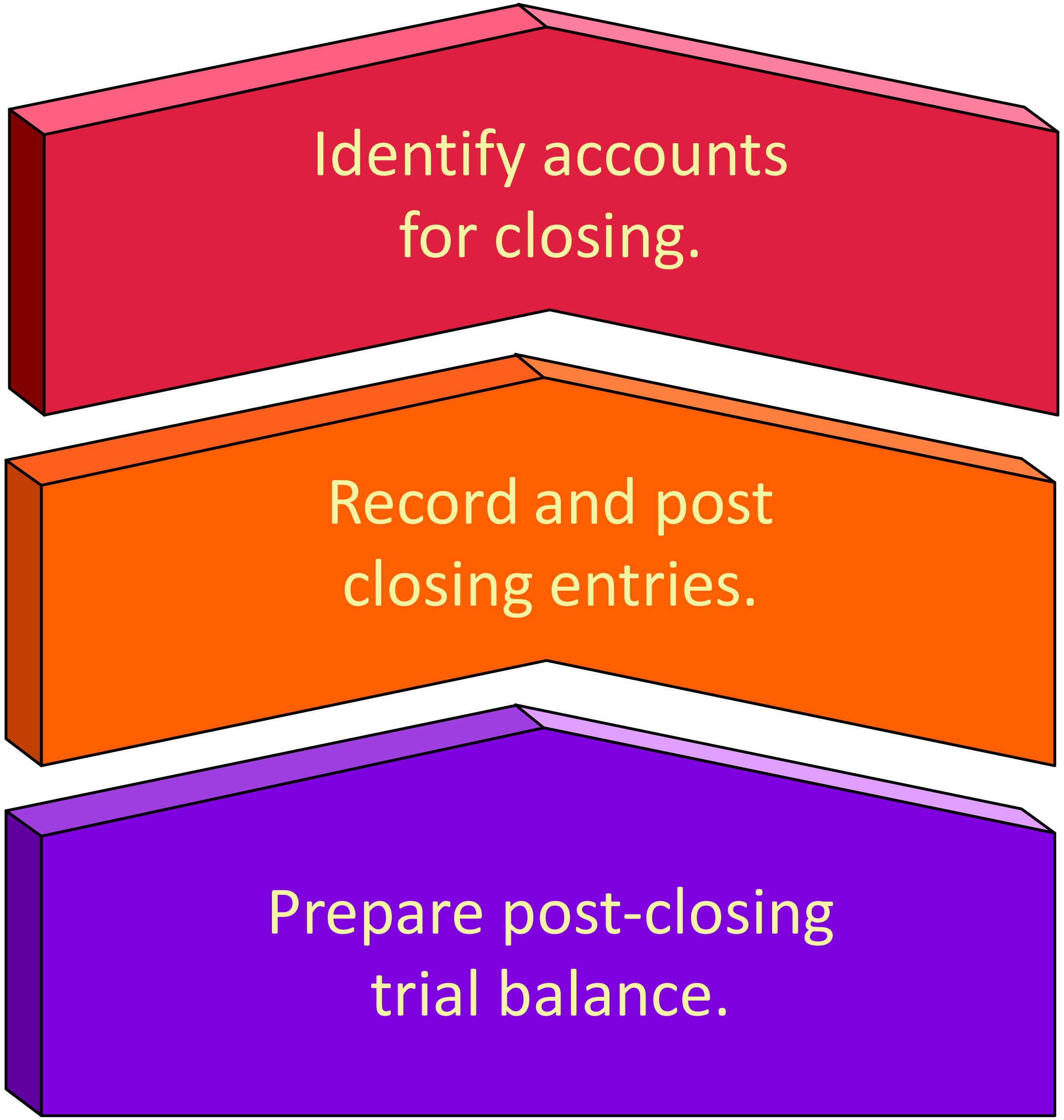


The closing process applies only to temporary accounts.

Recording Closing Entries

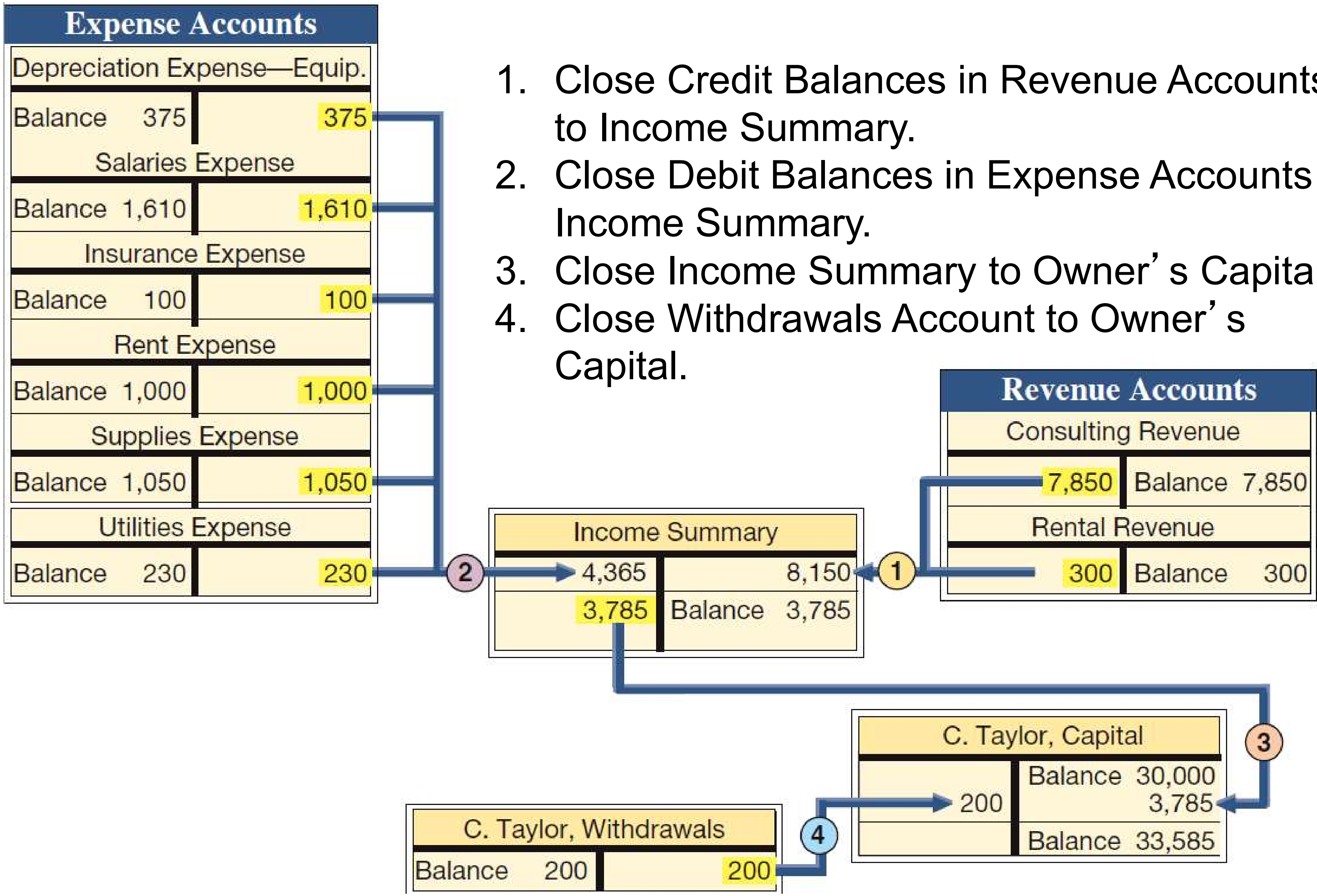
1. Resets revenue, expense and withdrawal account balances to zero at the end of the period.

2. Helps summarize a period’s revenues and expenses in the Income Summary account.

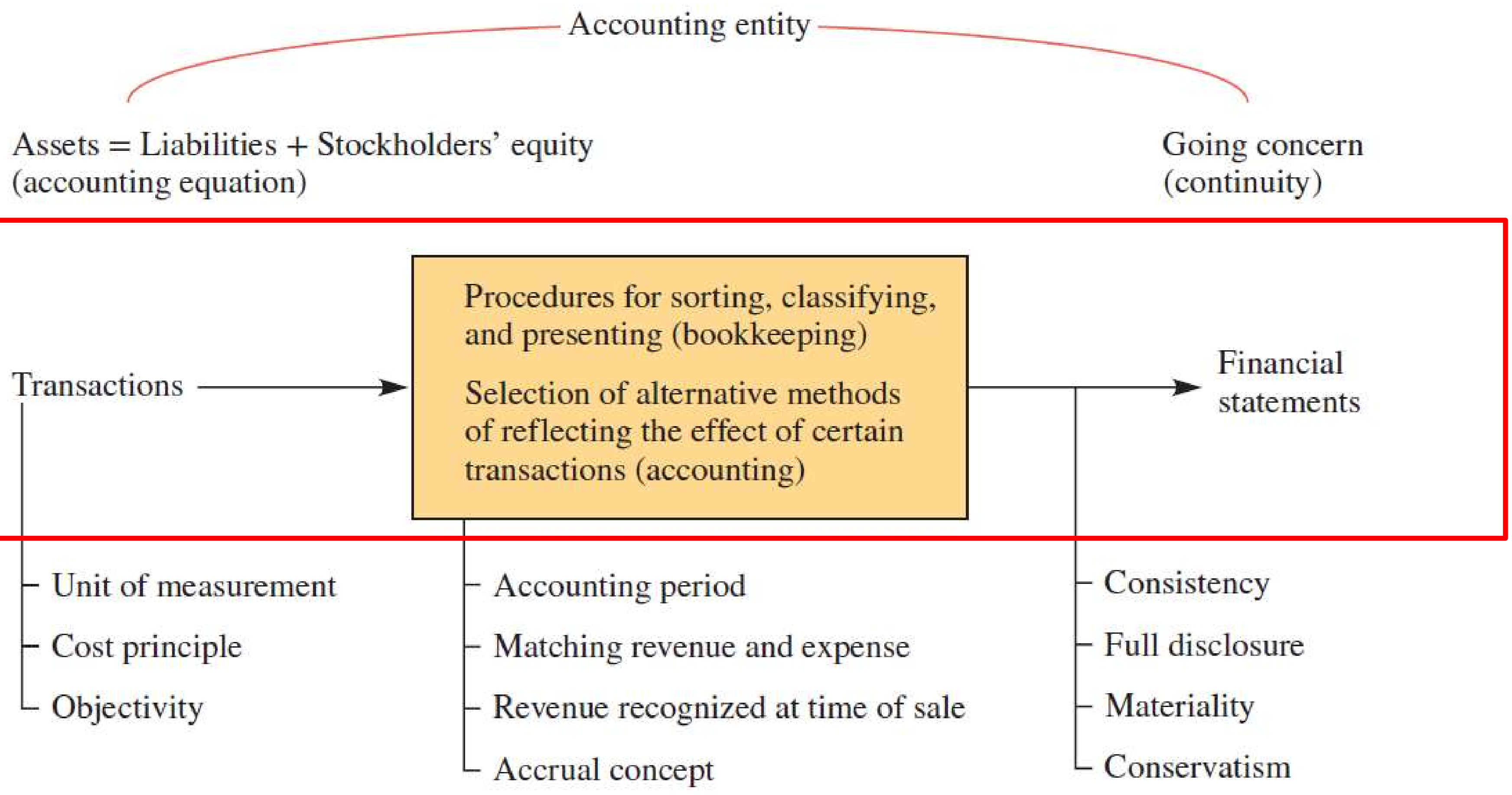


Summary of the Closing Process

1. Close Credit Balances in Revenue Accounts to Income Summary.
2. Close Debit Balances in Expense Accounts to Income Summary.
3. Close Income Summary to Owner’s Capital.
4. Close Withdrawals Account to Owner’s Capital.



Accounting Concepts and Principles



Concepts and Principles of Accounting

Accounting equation

Assets = Liabilities + Stockholders' equity

Accounting Entity

Every economic entity can be separately identified and accounted for.

Going Concern Concept

The presumption that the entity will continue to operate in the future—that it is not being liquidated.

Concepts and Principles of Accounting

Unit of Measurement

Only transactions denominated in dollars (currency) are recorded in the accounting records.

Cost Principle

Transactions are recorded at their original cost to the entity as measured in dollars.

Objectivity

Any given transaction must be recorded in the same way in all situations (based on solid evidence)

Concepts and Principles of Accounting

Accounting Period

The period of time selected for reporting results of operations and changes in financial position

Matching revenue and expense (Matching Principle)

All expenses incurred to generate that period's revenues are to be deducted from the revenues earned.

Revenue is recognized at the time of sale.

When the title to the product being sold passes from the seller to the buyer or when the services involved in the transaction have been performed

Accrual Accounting

Recognize revenue at the point of sale and recognize expenses when incurred, even though the cash receipt or payment may occur at another time.

Concepts/Principles Related to Financial Statements

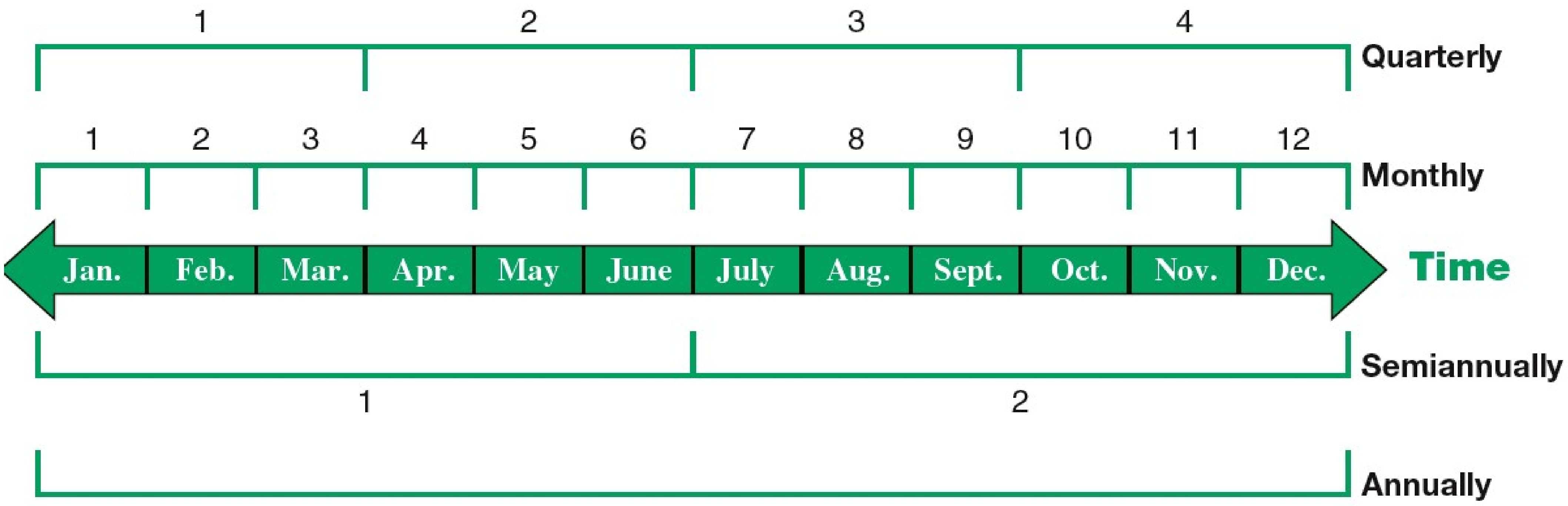
Consistency
Provides meaningful trend comparisons over several years

Full Disclosure
Circumstances and events that make a difference to financial statement users should be disclosed.

Materiality
The benefit of increased accuracy should outweigh the cost of achieving the increased accuracy.

Conservatism
When in doubt, make judgments and estimates that result in lower profits and asset valuations.

The Accounting Period



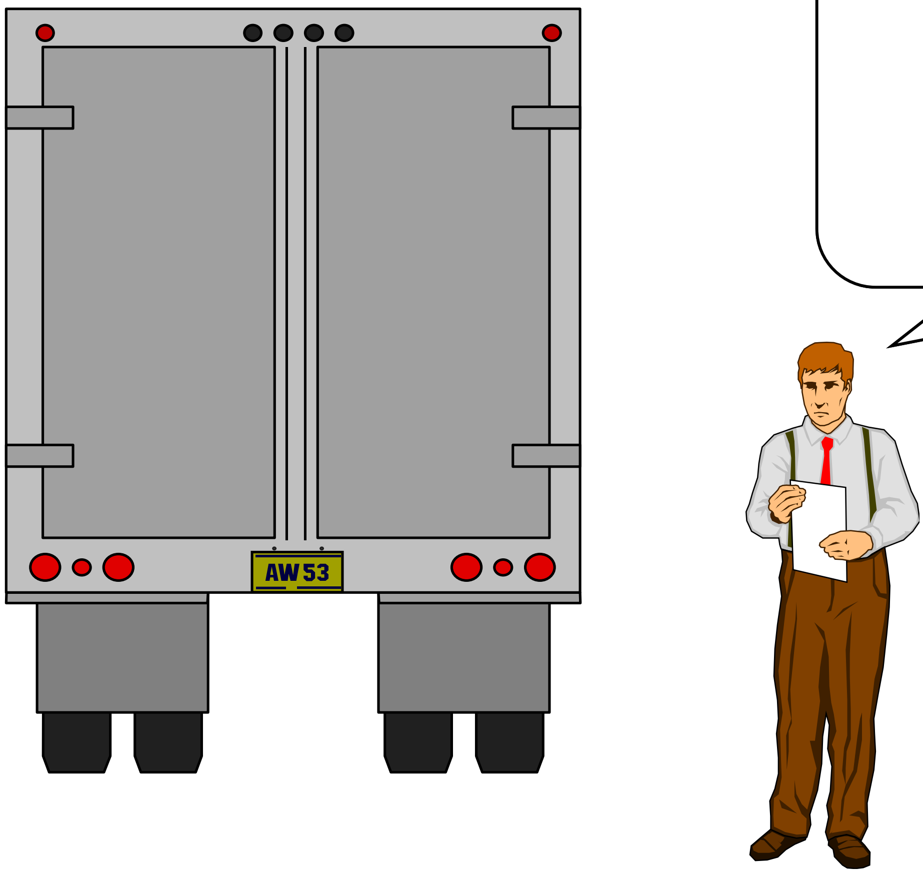
Accrual Accounting Vs. Cash Flows

Revenue Recognition + Matching Principle

Accrual accounting recognizes:	***Cash flow*** recognizes:
Revenue *when revenue is earned,* at the point of sale of services or products	Revenue *when payment is received* for services rendered or products sold
Expenses *when they are incurred*	Expenses *when they are paid*

Revenue Recognition Principle

We have delivered the product to our customer, so I think we should record the revenue earned.



Cash vs Non-cash Transactions

Cash transactions	Non-cash transactions
Collecting payments from customers	Sales on account / credit
Receiving cash from interest earned	Purchases of inventory on account
Paying salaries, rent, and other expenses	Accrual of expenses incurred but not yet paid
Borrowing money	Depreciation expense
Paying off loans	Usage of prepaid rent, insurance, and supplies
Issuing shares	Earning of revenue when cash was collected in advance

Accrual Basis versus Cash Basis

Accrual Basis

Revenues are recognized when earned and expenses are recognized when incurred.

Cash Basis

Revenues are recognized when cash is received and expenses are recorded when cash is paid.

Non-GAAP

Accrual Basis versus Cash Basis

FastForward paid $2,400 for a 24-month insurance policy beginning December 1, 2015.

Insurance Expense 2015			
Jan	Feb	Mar	Apr
$ -	$ -	$ -	$ -
May	Jun	Jul	Aug
$ -	$ -	$ -	$ -
Sep	Oct	Nov	Dec
$ -	$ -	$ -	$ 2,400

On the cash basis, the entire $2,400 would be recognized as insurance expense in 2015. No insurance expense from this policy would be recognized in 2016 or 2017, periods covered by the policy.

Accrual Basis versus Cash Basis

Insurance Expense 2015

Jan	Feb	Mar	Apr
$ -	$ -	$ -	$ -
May	**Jun**	**Jul**	**Aug**
$ -	$ -	$ -	$ -
Sep	**Oct**	**Nov**	**Dec**
$ -	$ -	$ -	$ 100

Insurance Expense 2016

Jan	Feb	Mar	Apr
$ 100	$ 100	$ 100	$ 100
May	**Jun**	**Jul**	**Aug**
$ 100	$ 100	$ 100	$ 100
Sep	**Oct**	**Nov**	**Dec**
$ 100	$ 100	$ 100	$ 100

Insurance Expense 2017

Jan	Feb	Mar	Apr
$ 100	$ 100	$ 100	$ 100
May	**Jun**	**Jul**	**Aug**
$ 100	$ 100	$ 100	$ 100
Sep	**Oct**	**Nov**	**Dec**
$ 100	$ 100	$ 100	$ -

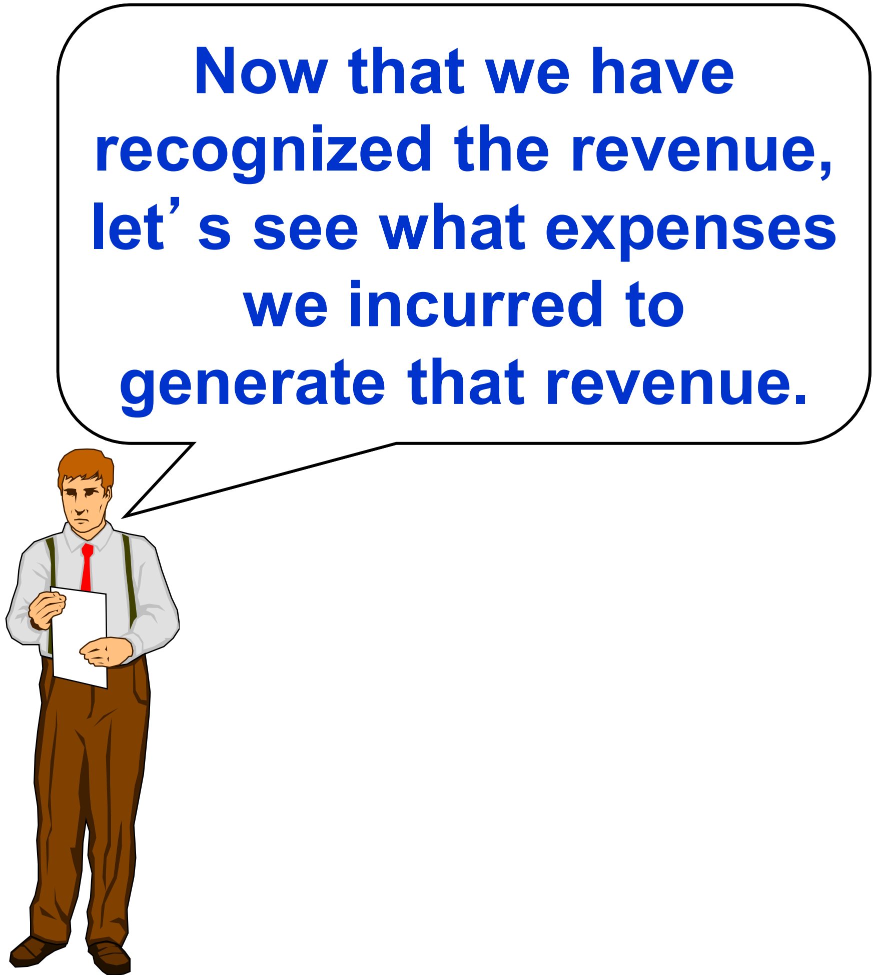
On the accrual basis, $100 of insurance expense is recognized in 2015, $1,200 in 2016, and $1,100 in 2017. The expense is matched with the periods benefited by the insurance coverage.

Recognizing Revenues & Expenses

Revenue Recognition Principle

Matching Principle

Summary of Expenses	
Rent	$1,000
Gasoline	500
Advertising	2,000
Salaries	3,000
Utilities	450
and	. . . .



Classified Statement of Financial Position

Categories of a Classified Statement of Financial Position	
Assets	Liabilities and Equity
Current assets	Current liabilities
Noncurrent assets	Noncurrent liabilities
Long-term financial assets	Equity
Property, plant and equipment	
Intangible assets	

Current items are those expected to come due (both collected and owed) within the longer of one year or the company's normal operating cycle.

SNOWBOARDING COMPONENTS
Statement of Financial Position
January 31, 2015

Assets

Current assets		
Cash	$ 6,500	
Short-term investments	2,100	
Accounts receivable, net	4,400	
Merchandise inventory	27,500	
Prepaid expenses	2,400	
Total current assets		$ 42,900

Current assets are expected to be sold, collected, or used within one year or the company’s operating cycle.

Accounts payable	$ 15,300	
Wages payable	3,200	
Notes payable	3,000	
Current portion of long-term liabilities	7,500	
Total current liabilities		$ 29,000
Noncurrent liabilities (net of current portion)		150,000
Total liabilities		179,000

Equity

T. Hawk, Capital		164,800
Total liabilities and equity		$343,800

SNOWBOARDING COMPONENTS
Statement of Financial Position
January 31, 2015

Assets

Current assets		
Cash	$ 6,500	
Short-term investments	2,100	
Accounts receivable, net	4,400	
Merchandise inventory	27,500	
Prepaid expenses	2,400	
Total current assets		$ 42,900
Long-term financial assets	67,500	

Long-term financial assets or investments are expected to be held for more than one year or the operating cycle.

Accounts payable	$ 15,300	
Wages payable	3,200	
Notes payable	3,000	
Current portion of long-term liabilities	7,500	
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Total current assets		$ 42,900
Long-term financial assets	67,500	
Property, plant and equipment, net	223,400	

Property, plant and equipment are tangible long-term assets used to produce or sell products and services.

Wages payable	3,200	
Notes payable	3,000	
Current portion of long-term liabilities	7,500	
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Total current assets		$ 42,900
Long-term financial assets	67,500	
Property, plant and equipment, net	223,400	
Intangible assets	10,000	
Current portion of long-term liabilities	7,500	
Total current liabilities		$ 29,000
Noncurrent liabilities (net of current portion)		150,000
Total liabilities		179,000
Equity		
T. Hawk, Capital		164,800
Total liabilities and equity		$343,800

Intangible assets are long-term resources used to produce or sell products and services and that lack physical form.

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SNOWBOARDING COMPONENTS
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Total liabilities and equity		$343,800

Current liabilities are obligations due within the longer of one year or the company’s operating cycle.

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Total liabilities		179,000
Equity		
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Total liabilities and equity		$343,800

Noncurrent liabilities are obligations not due within the longer of one year or the company's operating cycle.

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Statement of Financial Position
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Equity		
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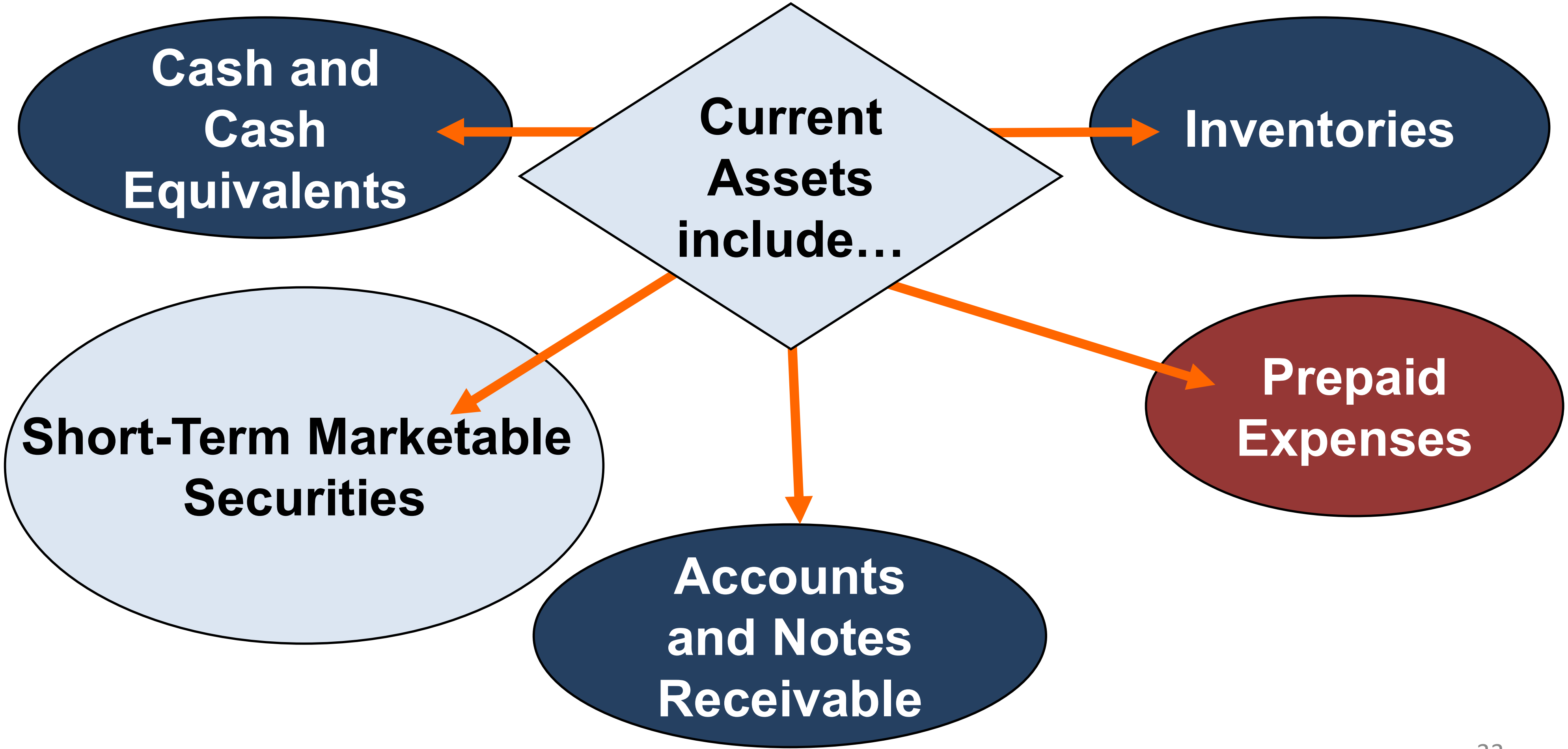
Equity is the owner's claim on the assets.

What Are Current Assets?

Current assets include cash and other assets that are expected to be converted to cash or used up within one year, or an operating cycle, whichever is longer.



Cash and Cash Equivalents

Cash includes...

- Money on hand in change funds
- Petty cash funds
- Undeposited receipts
- Checking and savings accounts

Cash Equivalents include. . .

- U.S. Treasury securities
- Money market mutual funds
- Bank certificates of deposit
- Commercial paper

Accounts Receivable (AR)

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A receivable is an amount due from another party (customers). Also known as Debtors.

ABC Ltd Accounts Receivable Subsidiary Ledger for year ended December 31, 2019					
Account: M. Williams Inc.		No. 20503			
Date	Particulars	Ref.	Debit	Credit	Balance (Dr)
Dec-01	Opening Balance				$ 150,000
Dec-05	Sales Journal	32	$ 325,000		$ 475,000
Dec-10	Cash Receipts	30		$ 225,000	$ 250,000

ABC Ltd Accounts Receivable Subsidiary Ledger for year ended December 31, 2019					
Account: T. George Inc.		No. 20792			
Date	Particulars	Ref.	Debit	Credit	Balance (Dr)
Dec-01	Opening Balance				$ 353,000
Dec-18	Cash Receipts	30		$ 353,000	0

A company must also maintain a separate account for each customer that tracks how much that customer purchases, has already paid, and still owes.

Sales on Credit

On July 1, TechCom had a credit sale of $950 to CompStore and a collection of $720 from RDA Electronics from a prior credit sale.

General Ledger

Accounts Receivable				
Date	PR	Debit	Credit	Balance
June 30		3,000		3,000
July 1		950		3,950
July 1			720	3,230

Accounts Receivable Ledger

RDA Electronics				
Date	PR	Debit	Credit	Balance
June 30		1,000		1,000
July 1			720	280

CompStore				
Date	PR	Debit	Credit	Balance
June 30		2,000		2,000
July 1		950		2,950

TechCom
Schedule of Accounts Receivable

RDA Electronics............	$ 280
CompStore..................	2,950
Total..........................	$3,230

When sales completed, revenue and AR _________.

When AR collected, AR _______ and _______________.

Bad Debts/Uncollectible Accounts

If a company makes credit sales to customers, some accounts inevitably will turn out to be uncollectible.

Credit managers must **estimate** the probable **bad debts expense** (or **uncollectible accounts expense**) of the firm.

Aging of Receivables Method

Classify each receivable by how long it is past due.

Each age group is multiplied by its estimated bad debts percentage.

Estimated bad debts for each group are totaled.

Example of Aging of Receivables Method

MUSICLAND
Schedule of Accounts Receivable by Age
December 31, 2015

Customer	Totals	Not Yet Due	1 to 30 Days Past Due	31 to 60 Days Past Due	61 to 90 Days Past Due	Over 90 Days Past Due
Carlie Abbott...............	$ 450	$ 450				
Jamie Allen.................	710			$ 710		
Chavez Andres.............	500	300	$ 200			
Balicia Company..........	740				$ 100	$ 640
Zamora Services.........	1,000	810	190			
Total receivables*......	$50,000	$37,000	$6,500	$3,700	$1,900	$ 900
Percent uncollectible.....		× 2%	× 5%	× 10%	× 25%	× 40%
Estimated uncollectible..	$ 2,270	$ 740	$ 325	$ 370	$ 475	$ 360

Bad Debts/Uncollectible Accounts

When the amount of accounts receivable estimated to be uncollectible has been determined, a valuation adjustment can be recorded to reduce the carrying value of the asset and recognize the bad debt expense.

Balance Sheet	Income Statement
Assets = Liabilities + Stockholders' equity	← Net income = Revenues − Expenses
− Allowance for Bad Debts	− Bad Debts Expense

Balance Sheet Presentation

Accounts Receivable
Less: Allowance for Bad Debts
Net realizable value of accounts receivable

The net realizable value is the amount of accounts receivable that the business expects to collect.

Writing Off an Uncollectible Account Receivable

When an account is determined to be uncollectible, it should be written off against the allowance account.

The effect of this entry on the financial statements follows:

Balance Sheet	Income Statement
Assets = Liabilities + Stockholders' equity	← Net income = Revenues – Expenses
– Accounts Receivable + Allowance for Bad Debts	

Writing Off an Uncollectible Account Receivable

The presentation of the Allowance for Bad Debts in the current asset section of the balance sheet (using assumed amounts) is as follows:

Accounts receivable.	$10,000
Less: Allowance for bad debts	(500)
Net accounts receivable	$ 9,500

Assume that $100 of the accounts receivable was written off. The balance sheet presentation now would be:

Accounts receivable	$9,900
Less: Allowance for bad debts.	(400)
Net accounts receivable.	$9,500

Inventories

For merchandising and manufacturing firms, the sale of inventory in the ordinary course of business provides the major, ongoing source of operating revenue. Inventories represent the most significant current asset for such firms.

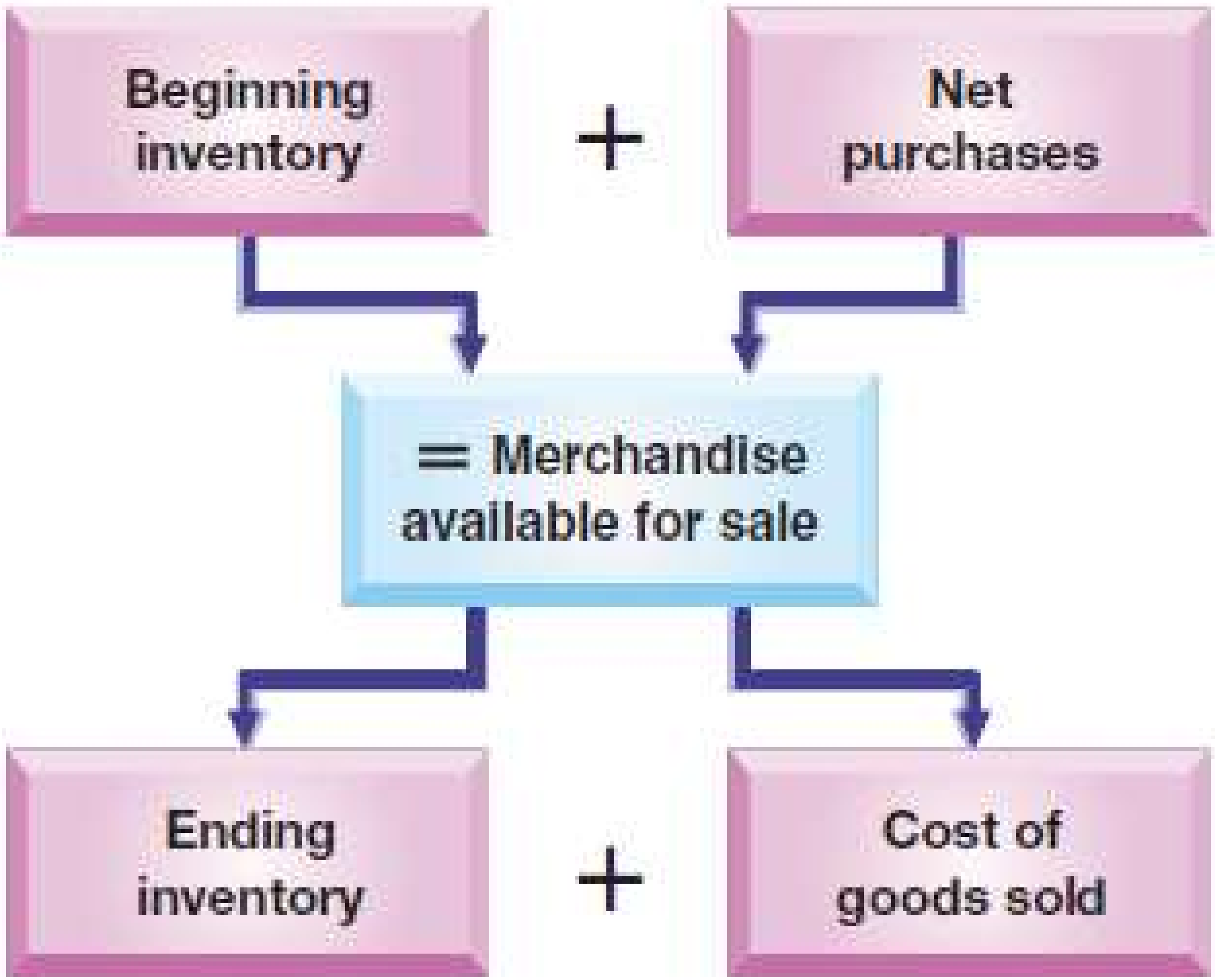
For service organizations, inventories consist mainly of office supplies and other items of relatively low value that will be used up within the organization, rather than being offered for sale to customers.

Effects of Purchase and Sale Transactions on the Financial Statements

Balance Sheet	Income Statement
Assets = Liabilities + Stockholders' equity	← Net income = Revenues − Expenses
Purchase of inventory: + Inventory + Accounts Payable	
Recognize cost of goods sold: − Inventory	− Cost of Goods Sold

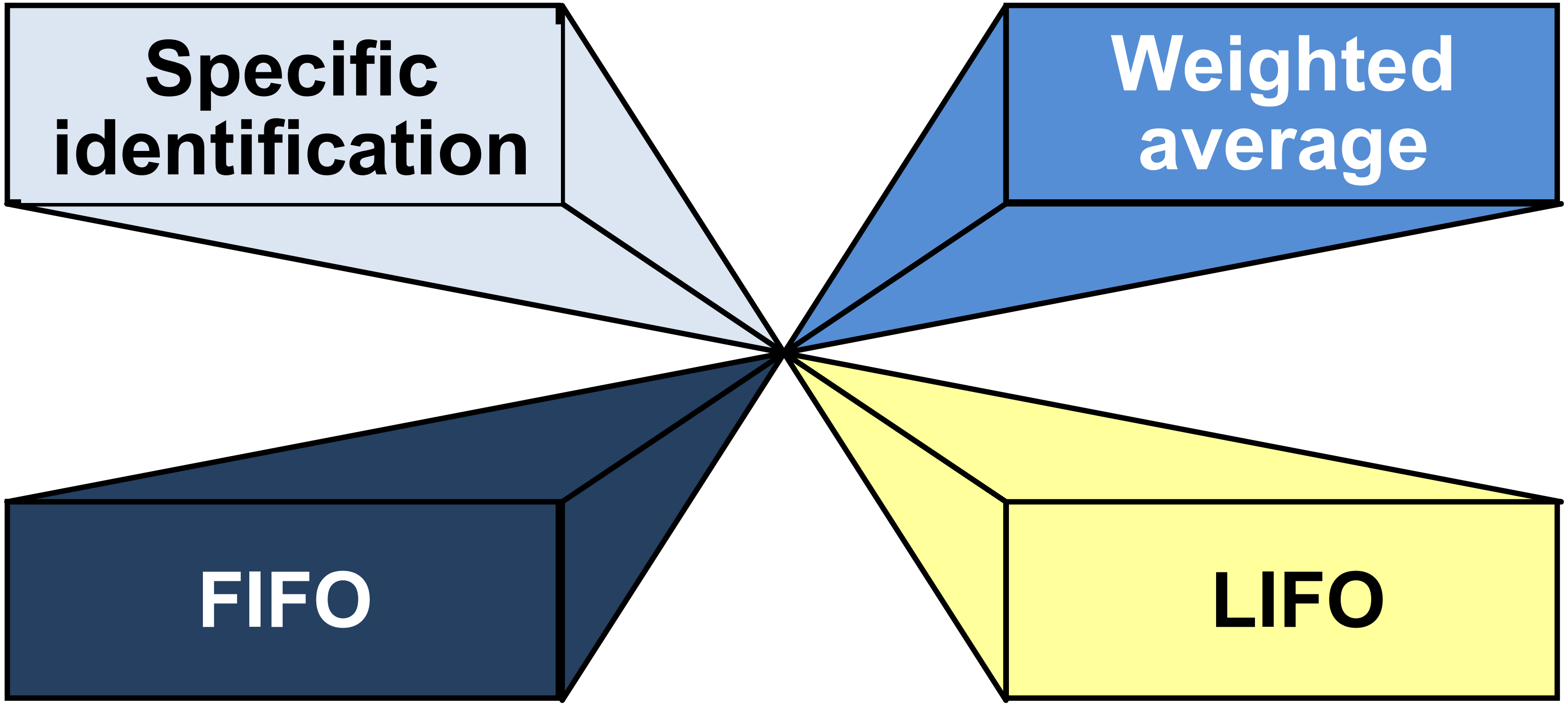
When sold

Inventory Systems



Inventory Cost Flow Assumptions

We use one of these inventory valuation methods to determine the cost of goods sold.



Specific Identification

When an item is sold, the cost of that specific item is determined from the firm's records, and that amount is transferred from the Inventory account to Cost of Goods Sold.

Weighted Average

Involves calculating the average cost of the items in beginning inventory plus purchases made during the year

Cost of Goods Available for Sale during the Year ÷ Units Available for Sale during the Year

First-In, First-Out (FIFO)

The first-in, first-out (FIFO) method assigns the oldest costs to the cost of goods sold and the recent costs to ending inventory.

Oldest Costs → Costs of Goods Sold

Recent Costs → Ending Inventory

Financial Statement Effects of Costing Methods

Because prices change, inventory methods nearly always assign different cost amounts.

TREKKING COMPANY For Month Ended August 31	Specific Identification	FIFO	Weighted Average Cost
Income Statement			
Sales	$ 6,050	$ 6,050	$ 6,050
Cost of goods sold	**4,582**	**4,570**	**4,622**
Gross profit	1,468	1,480	1,428
Expenses	450	450	450
Income before taxes	1,018	1,030	978
Income tax expense (30%)	305	309	293
Net income	**$ 713**	**$ 721**	**$ 685**
Statement of financial position			
Inventory	**$1,408**	**$1,420**	**$1,368**

Inventory Accounting System Alternatives

Periodic Inventory System

A count of the inventory on hand is made periodically—frequently at the end of the fiscal year— and the cost of the inventory on hand is determined and subtracted from the sum of the beginning inventory and purchases to determine the cost of goods sold.

Perpetual Inventory System

A record is made of every purchase and every sale, and a continuous record of the quantity and cost of each item of inventory is maintained.

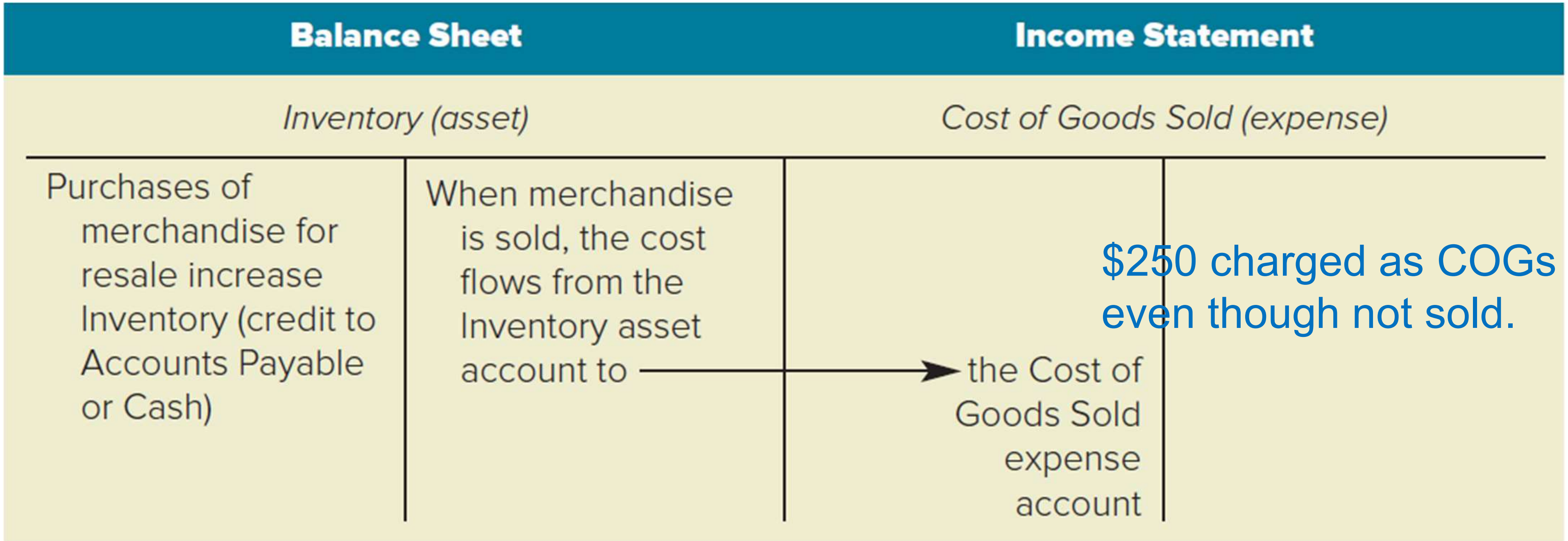
Inventory Errors / Discrepancy

Errors in the amount of ending inventory have a direct dollar-for-dollar effect on cost of goods sold and net income.

A merchandiser using a perpetual inventory system is usually required to make an adjustment to update the Merchandise Inventory account to reflect any loss of merchandise, including theft and deterioration to match with the physical quantity determined in a stock count.

Adjusting Entry for Inventory

Z-Mart's Merchandise Inventory account at the end of year 2015 has a balance of $21,250, but a physical count reveals that only $21,000 of inventory exists.



-$250 from Inventory to adjust to the value determined in a physical count value

So what is the impact to Profit/(Loss)?

Prepaid Expenses and Other Current Assets

Prepaid expenses are expenses that have been paid in the current fiscal period but that will not be subtracted from revenue until a subsequent fiscal period.

Examples:

Insurance

Rent

Prepaid Expenses and Other Current Assets

Prepaid insurance affects the financial statements in the following manner:

Balance Sheet	Income Statement
Assets = Liabilities + Stockholders' equity	← Net income = Revenues – Expenses
Payment of premium for the year: Cash -2400 Prepaid Insurance +2400	
Recognition of expense for one month Prepaid Insurance -100	Insurance Expense -100

An adjusting entry is recorded to bring an asset or liability account balance to its proper amount.

Every month, there should be an adjusting entry to reduce the prepaid insurance (Asset) and charge insurance expense (Income Statement) to recognize that one month of insurance coverage has been used up. This repeats until insurance coverage is over.