1 Accounting in Business

in the aggregate accumulate transactions of the same type over a certain period and report the data as one amount in the company's financial statements

accounting the entire process of identifying, recording, and communicating economic events (bookkeeping is part of recording only)

Who uses accounting data?

- **Internal users**
  Managerial accounting provides internal reports to help users make decisions about their companies
  - Management
  - Employees
- **External users** (investors and creditors, etc.)
  Financial accounting provides economic and financial information for investors, creditors, and other external users
  - Lenders
  - Investors
  - Competitors
  - Government agencies
    IRS: SEC:
  - The press

Measurement principles (used by IFRS)

- **[IMPT]** Follow trade-offs between **relevance** (makes a difference in decision making) and **faithful representation** (factual and accurate)
- **[IMPT]** Enhancing qualitative characteristics (**Comparability, Verifiability, Timeliness, Understandability**)
- **Historical cost** principle: record assets at their initial cost when it was purchased
- **Fair value** principle: assets and liabilities should be reported at fair value (price received to sell an asset or settle a liability)
  - Only used when asses are actively traded, otherwise rarely used
  - Also used when market value info is available for certain assets

Accounting assumptions

- **Monetary unit** assumption: include only data that can be expressed in money terms
- **Economic entity** assumption: activities of the entity are separate and distinct from the activities of its owner and all other economic entities
  - Proprietorship
    * owned by **one** person
    * the owner receives any profits and suffers any losses
    * the owner has **unlimited liability** (liable for all debts of business)
    * **no legal distinction** between the business as an economic unit and the owner
    * Accounting records of the business activities are kept **separate** from owner's personal records
  - Partnership
    * owned by **two or more** persons associated as partners
    * each owner has **unlimited personal liability**
    * for accounting purposes, partnership transactions are kept **separate** from personal activities
  - Corporation
    * **separate legal identity** under corporation law
    * ownership is divided into **transferable shares**: shareholders may transfer part or all of their ownership shares to other investors at any time
    * holders of shares enjoy **limited liability**
    * **Unlimited life**; ownership can be transferred without dissolving the corporation

1.1 The Basic Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Assets: A resource controlled by the entity in the *present* due to *past* event that will give rise to *future* benefits

- Cash
- Accounts Receivable
- Supplies
- Equipment

Liabilities: A *present* obligation arising from *past* event that is expected to lead to a *future* outflow of resources upon settlement

- accounts payable: purchase commodities/equipment on credit from suppliers
- note payable: money borrowed
- salaries/wages payable
- sales and real estate taxes payable
- **[IMPT]** Example: claim from an employee due to workplace accident which is highly likely to be settled in the future

Equity: the ownership claim on a company (residual equity after creditors' claims are satisfied)

- **Share capital-ordinary**: paid in by shareholders in exchange for the ordinary shares they purchase
- **Retained earnings**
  - Revenues
  - Expenses
  - Dividends: increase in net assets, available to distribute to shareholders

1.2 Financial Statements

1. **Income statement (IS)** presents the revenues and expenses and resulting net income or net loss for a specifi c period of time.
2. **Retained earnings statement** summarizes the changes in retained earnings for a specific period of time.
3. **Statement of financial position (SFP)** (sometimes referred to as a balance sheet) reports the assets, liabilities, and equity of a company at a specific date.
   - Current and noncurrent assets/liabilities (can be turned into cash/settled within 1 year?)
   - Preferably sorted from higher liquidity to lower

- **[IMPT]** Assets recorded at **cost/book value**, not market value
- **[IMPT]** Revenue vs Loss/Gain
- **[IMPT]** Notes Payable vs Accounts Payable
  Notes: usually cash
  Accounts: usually owed to suppliers

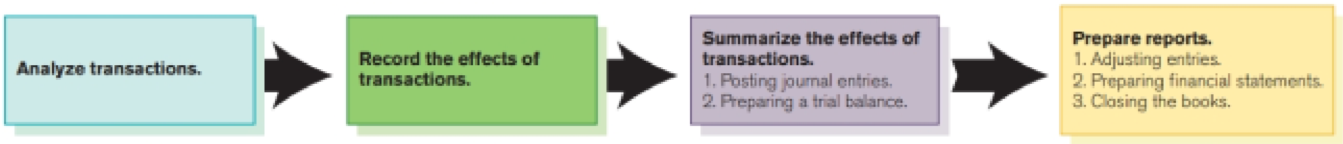
4. **Statement of cash flows (SCF)** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

$$\Delta Cash = CFO + CFI + CFF$$

5. **Statement of comprehensive income (SCI)** presents other comprehensive income items that are not included in the determination of net income

2 The Mechanics of Accounting

- **[IMPT]** **Prepaid rent** is an **asset**!
  The benefits are not going to happen now; but will happen in the future
- **[IMPT]** **Unearned revenue** is a **liability**
  Has to be settled in the future



	Assets		Liabilities	Equity		
				Revenues	Expenses	Dividends
↑	Dr.	=	Cr.	Cr.	Dr.	Dr.
↓	Cr.		Dr.	Dr.	Cr.	Cr.

3 Adjusting Accounts

Accrual Accounting can capture the value of the firm much better due to timeliness
Adjusting entries made at the end of a period do not involve cash
Each adjusting entry involves a balance sheet account and an account on the IS/SCI;

- **Unrecorded Receivables**: Amount that has not been paid but the work has been done/should be recognized (*e.g.* billing every 3 months)
- **Unrecorded Liabilities**: Expenses being incurred prior to being paid or recorded (*e.g.* interest payable, wages payable) in other words parts of expense is actually incurred due to the use of resources but it has not been paid
- **Prepaid Assets**: Payments that a company makes in advance for items charged to expense (*e.g.* insurance premium payment) and the asset slowly loses its value
- **Unearned Revenues**: Amounts received before the actual recognition of revenues, and work is slowly being done over time which decreases liability and increases revenue

Accumulated Depreciation: is a *Contra-asset* with normal balance of credit

- Note that for depreciation of PPE, PPE balance is not directly credited but instead Accumulated depreciation is credited (Less)

Allowance for bad debt: contra-asset for accounts receivable

	Assets		Liabilities	Equity		
				Rev.	Exp.	Div.
Unrecorded Receivables	Dr.	=		Cr.		
Unrecorded Liabilities			Cr.		Dr.	
Prepaid Expenses	Cr.				Dr.	
Unearned Revenues			Dr.	Cr.		

Steps to preparing Financial Statements

- Adjust journal entries
- Adjust trial balance (book not closed yet)
- Prepare financial statements
  1. IS → to calculate NI
  2. SCE → to calculate ΔRE

  $$RE_1 + NI - Dividends = RE_2$$

  3. SFP (Classified)
- Close book
  - Transfer nominal accounts to RE
- Post-closing trial balance

4 Problems in Financial Statements

1. Errors (unintentional mistakes)
   not entering/forgot to enter, entering wrong info/amount, entering wrong accounts
2. Disagreements on judgment
   Different parties have different judgments/estimates abt revenue accounts
3. Frauds ⇒ intentional in order to manipulate FS!
   - **Corruption**: misusing one's position for personal gains
   - **Asset Misappropriation**: Theft/embezzlement of company resources
   - **Financial Statements Fraud**: misreporting amounts to portray more favourable results

4.1 Fraud

The Fraud Triangle (Why people commit fraud)

1. Pressure
   pressure to meet financial/personal goals/attract investors
2. Opportunity
   Weak internal control/adequate means to commit fraud
3. Rationalization
   Justify action as unavoidable/necessary

4.2 Internal control System

Objectives:
- Ensure **reliable** and accurate financial records
- Properly account and **protect** assets
- Promotes **efficient** operations
- Adherence to company policies
- Compliance with laws and regulations

Internal Control Structure: the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved, some categories:
- The control environment - clear organizational structure establishes clear lines of authority and responsibility
- **Monitoring** - independent oversight of management through Board of Directors (BOD) & internal and external auditors
- Risk assessment
- Information and communication
- Control activities - used by management to meet objectives

Principles of Internal control (Control Activities/Procedures)
- **Preventive controls**: prevent problems from occurring
  - **Establish responsibilities** and **segregate duties** (do not make one party/department responsible for all/conflicting parts of the process)
  - Proper procedures for **authorizations** (different levels of authority)
  - **Separate recordkeeping** from **custody** of assets
- **Detective controls**: help catch problems that are occurring before problems become large
  - Maintain adequate records
    E.g. paying supplies using prenumbered checks
  - Regular and independent reviews
    evaluate effectiveness and promotes adherence

Limitations of internal control
- Human error/human fraud
- Costs must not exceed benefits (*e.g.* if internal control is too inefficient/high costs then it might not be good)

4.3 Auditors

Role of internal auditors
- Monitor operating results and financial records
- Evaluate internal controls
- Assist with increasing efficiency and effectiveness of operations
- Make sure that regulations are complied
- Detect fraud

Role of external auditors
- examine organisations' FS to determine if they are prepared and presented in accordance with accounting standards and free from misstatement
- Can only provide **reasonable assurance** that FS are presented fairly

4.4 Earnings Management

Objectives
- To meet internal targets
  motivate managers to increase revenues and figures
- To meet external expectations
  assurance for suppliers that they will receive payments, customers need to make sure that the company will be able to fulfill warranty obligations
- Income smoothing: to smooth out earnings / appear more stable
- Window dressing to appear more stable for bank loans or Initial Public Offering (IPO)

5 Cash

Major activities of a business
- Operating activities: selling products or services, buying inventory for resale, and incurring and paying for necessary expenses associated with the primary activities of the business
- Investing activities: purchase of assets for use in the business (occur less frequently and amounts involved are quite large)
- Financing activities: raising money to finance a business by means other than operations (debt and equity financing)

Internal Control of Cash
- Separating duties in handling of cash and accounting for cash
- Cash receipts are deposited daily in banks
- Except for small-amount payments, all payments are made with
- Prepare a bank reconciliation periodically: to compare with the cash balance in the company's accounting records

5.1 Cash Disbursement for Operating Activities

Purchases Discounts: x/10, n/30 means if the customer pays in 10 days, they will get x% discount but no discount when the customer pays in 30 days

5.1.1 Petty Cash Funds

Establishing the funds
- Petty Cash is an asset

Making payments from the fund
- No entry is recorded in the journal, but receipts are kept
- In general, Petty funds account in the ledger is not affected unless funds are established/size is increased

Replenishing the funds: Dr. expenses and Cr. cash
Cash Short and Over: to be adjusted in Dr. or Cr. depending on the discrepancy so that

$$\text{Cash} - \text{Expenses} = \text{Cash Over and Short}$$

6 Receivables

6.1 Accounts Receivable

Subsidiary accounts Individual accounts of customers under accounts receivable
e.g. *Accounts Receivable - Customer Name*

Expected Credit Loss Alternative names:
- Bad Debt Expense
- Accounts Receivable Impairment Loss
- Uncollectible Account Expense

Allowance for Bad Debts/Loss Allowance a Contra-asset (XA)
Allowance method is preferred under Accrual Accounting Principle as it accounts receivable can be paid by customers in 5 years? 10 years? which might be uncertain

$$\text{AR} - \text{Loss Allowance} = \text{Net AR}$$

How to estimate ending balance for Loss Allowance?
- Individual assessment → for customers with known credit problems
- Group assessment (*Provision matrix*)
  - **Provision matrix**
  - Aging accounts receivable → accounts who have not been paid for longer should have higher probability of not being paid
- Result is the ending balance of Loss Allowance Account

6.2 Notes Receivable

- **Maturity date**: due date; when it is expressed in terms of month, will include the date of issuance, but when expressed in terms of day, will not include the date of issuance but start counting for the day after
- **Interest Revenue**

$$\text{Interest Revenue} = \text{Face value} \times \text{Annual I/R} \times \text{time period (term)}$$

- To record customers who want to pay by notes, we record Dr. Notes Receivable and Cr. Accounts Receivable
- When customer makes payment: Dr. Cash and Cr. Notes Receivable + Interest Revenue
- To record **dishonored note receivable**: Dr. Accounts Receivable and Cr. Notes Receivable + Interest Revenue
  - Overall effect is an increase in Revenue by the amount equal to Interest Revenue

6.3 Foreign Currency Transaction

Might happen if transaction is conducted in different currencies (exchange rates fluctuate daily)
Foreign exchange loss/gain: A revenue/expense account that is adjusted according to exchange rates
How to avoid this?
- Denominate price in own currency (US Dollars) and the risk of exchange rate changes would have fallen on the Korean Company
- Locked in the price of foreign currency by entering into a forward contract with a foreign currency broker (Derivative contract)

6.4 Variable Consideration

Some examples
- Discounted price for all goods bought if the customer buys a specified quantity
- Return policy, but we do not know if the customer will return or not

Hence, it is estimated at the start and is periodically reassessed using expected value/most likely amount for estimation
- Use most likely amount if the outcome is yes/no
- Use estimation if there are different outcomes with probabilities

7 Financial Statement Analysis (FSA)

General areas of FSA:
- **Liquidity and efficiency**: able to meet short term obligations and efficiently generate revenues
- **Solvency**: able to meet long term obligations and generate future revenues
- **Profitability**: rewards for investors
- **Cash Flow**: manage cash inflow and outflow
- **Market Prospects**: generate positive market expectations

7.1 Return on Assets (ROA)

$$\text{ROA} = \frac{\text{Net profit}}{\text{Avg total assets}}$$

Measures *profitability*

7.2 Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Measures *solvency* and financial leverage (higher financial leverage ⇒ higher risk)

7.3 Profit Margin/Return on Sales

$$\text{Profit Margin} = \frac{\text{Net Income/Profit}}{\text{Net Sales}}$$

Profitability?: How much profit is generated every one dollar of sales?
- Measures future growth of the company
- Start-ups will usually have negative growth, but if it's decreasing in magnitude it's good

7.4 Accounts Receivable Turnover

$$\text{Accounts Receivable Turnover} = \frac{\text{Net Sales Revenue}}{\text{Average Accounts Receivable}}$$

Measures how well an organization is managing its accounts receivable (collecting receivables/cash, paying short-term loans to cover cash shortage)

$$\text{Average Collection Period} = \frac{365}{\text{Accounts Receivable Turnover}}$$

8 Exam stuff

- Record transactions: prepare journal entries
- prepare ledger: draw T-accounts
- on credit = on account
- Property Plant and Equipment: it's very broad and if we want to record in journal entry usually need specific accounts
- Write "not included in journal" when there's no exchange of goods/cash