

ACC531: Auditing and Assurance Services

Background-Part I

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This slide deck...

- includes background knowledge for auditing and assurance services.
- is not comprehensive.
- is also tested on the exam 1.

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1 Accounting for Business Decisions

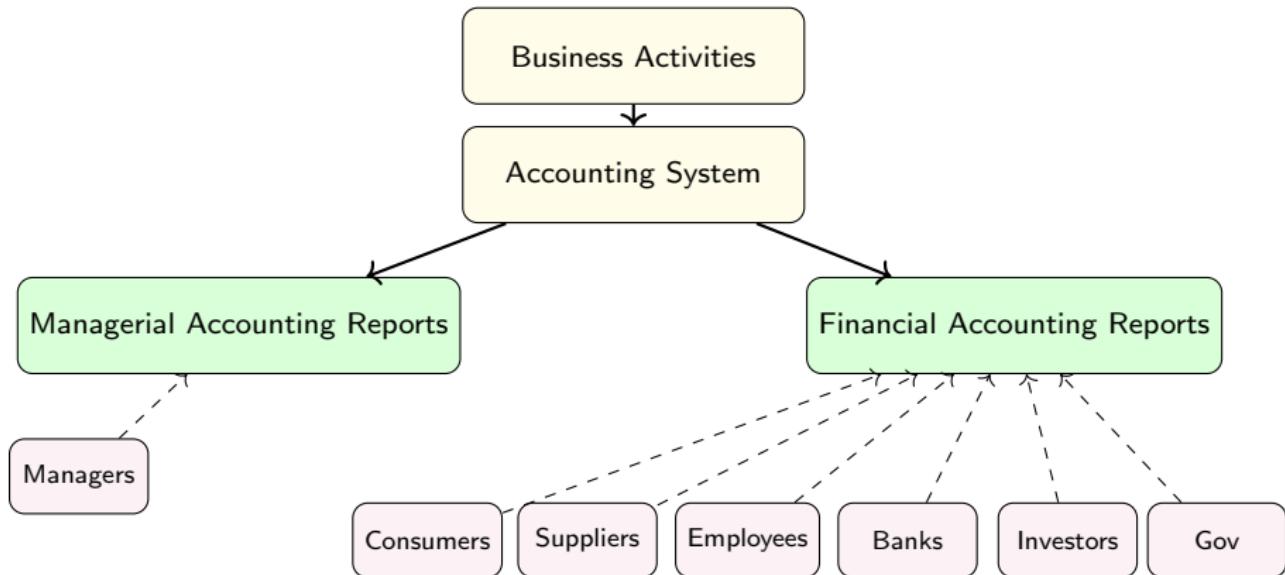
2 Basic Accounting Equation: $A = L + SHE$

- Transactions
- Assets
- Liabilities
- Shareholders' Equity

3 Accrual Accounting

- R, E, and NI
- Expansion of Accounting Equation
- Adjustments

- Accounting is the **language of business**.
- Accounting provides information for decision-making.



- **Managers:** Use accounting information to help run the business.
- **Consumers:** Decide whether to buy the business's products or services.
- **Suppliers:** Check if the business can pay for goods and services.
- **Employees:** Look at the business's finances for job security and pay.
- **Banks:** Decide whether to lend money to the business.
- **Investors:** Decide whether to buy or sell shares in the business.
- **Governments:** Use information to set taxes and check rules are followed.

Usefulness of Accounting

Accounting is used to help stakeholders make decisions.

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Basic Accounting Equation

- Assets (A) = Liabilities (L) + Stockholders' Equity (SHE)
(Resources) = (Sources of Resources)

Assets (A) **Resources** owned or controlled by a company that are expected to provide future economic benefits.

Liabilities (L) **Obligations** of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

SHE **Residual interest** in the assets of a company after deducting liabilities; represents the owners' claims on the business; **Defined by A - L.**

Transactions

Financial activities that involve the exchange of goods, services, or money.

- All transactions affect the basic accounting equation: A = L + SHE.
- Two types:
 - ▶ **Operating** activities: Affect NI (mainly covered in Ch3).
 - ▶ **Financing** and **Investing** activities: Do not affect NI (covered in Ch2).
- **Activities but not transactions:**
 - ▶ Promising to hire employees
 - ▶ Exchange of stocks between shareholders

Assets (A)

Resources owned by a company that are expected to provide future economic benefits.

Examples:

- Cash: \$10,000
- Equipment: \$20,000
- Inventory: \$10,000

EX 1. What assets do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Cash: \$60,000 (50,000 - 20,000 - 0 + 30,000)

Equipment: \$20,000

Total Assets: \$80,000

EX 2. What assets do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Cash: \$80,000 (50,000 - 0 - 0 + 30,000)

Equipment: \$20,000

Total Assets: \$100,000

Liabilities (L)

Obligations of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

Examples:

- Accounts Payable: \$10,000 (owed to suppliers)
- Salaries Payable: \$10,000 (owed to employees)
- Notes Payable: \$20,000 (owed to banks)

EX 1. What liabilities do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Salaries Payable: \$10,000

Accounts Payable: \$0

Total Liabilities: \$10,000

EX 2. What liabilities do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - on credit.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

Salaries Payable: \$10,000

Accounts Payable: \$20,000

Total Liabilities: \$30,000

Stockholders' Equity (SHE)

The residual interest in the assets of a company after deducting liabilities; represents the owners' claims on the business.

- SHE consists of 2 components:
 - ▶ Contributed Capital (a.k.a. Paid-in Capital or Common Stock)
 - ▶ Retained Earnings (a.k.a. Earned Capital)

Retained Earnings (Earned Capital, Equity)

The cumulative amount of net income retained in the business after dividends are paid.

Retained Earnings Equation

$$\text{End. RE} = \text{Beg. RE} + \text{Net Income} - \text{Dividends}$$

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1. Your company has sold a product to a customer on cash in December. The product was delivered and cash collected in December.

- Revenues: December.
- Cash inflows: December.

2. Your company has sold a product to a customer on cash in December. The product was delivered in December but cash collected in January.

- Revenues: December.
- Cash inflows: January.

Revenue Recognition Principle

Revenue is recognized when products & services are delivered, regardless of when cash is received.

How much revenue should Noodlecake recognize in September?

- ① In September, Noodlecake sold \$3,000 of apps online. Cash collected in September.
- ② Noodlecake issued three \$100 gift cards at the beginning of September. These gift cards have not been used at the end of September.
- ③ Noodlecake sold \$9,000 of apps in the App Store and on Google Play in September. Cash will be collected in October.

- Revenues: \$12,000 ($3,000 + 0 + 9,000$)
- Cash flow timing isn't important for revenue recognition.

Matching Principle

- Expenses should be recognized **in the same period as the revenues** they help to generate, regardless of when cash is paid. In other words,
- Expenses should be recognized when the resources are **used up** to generate the revenues.

EX. When to recognize expenses?

- ① Noodlecake bought \$1,000 of supplies in September.
- ② Noodlecake used up the supplies in October.

Answer: October.

How much expenses should Noodlecake recognize in September?

- ① Noodlecake wrote checks to employees totaling \$7,800 for wages related to hours worked in September.
- ② Noodlecake displayed online ads in Sep and received a bill for \$500 to be paid in October.
- ③ Noodlecake was notified by its bank that an automatic monthly payment of \$600 was transmitted to its utility company for electricity use in September.

- Expenses: $\$7,800 + \$500 + \$600 = \$8,900$
- Cash flow timing isn't important for expense recognition.
- Expenses should be recognized in the period when the goods or services are used up.

Net Income (NI)

Revenues - Expenses.

- Net Income is a measure of a company's profitability.
- Net Income is **NOT** an account.
- Net Income is **NOT** the same as cash flows from operating activities.

Expansion of Accounting Equation

$$\begin{aligned}A_t &= L_t + SHE_t \\A_t &= L_t + (CC_t + RE_t) \\A_t &= L_t + CC_t + (RE_{t-1} + NI_t - D_t) \\A_t &= L_t + CC_t + (RE_{t-1} + R_t - E_t - D_t) \\A_t + E_t + D_t &= L_t + CC_t + (RE_{t-1} + R_t)\end{aligned}$$

<i>A</i>	Assets
<i>L</i>	Liabilities
<i>SHE</i>	Stockholders' Equity
<i>CC</i>	Contributed Capital
<i>RE</i>	Retained Earnings
<i>R</i>	Revenues
<i>E</i>	Expenses
<i>NI</i>	Net Income
<i>D</i>	Dividends

Adjustments

- Adjustment journal entries (AJEs) are needed at the end of each reporting period to ensure that all of the accounts (A,L, SHE, R, and E) have the correct balance.
- Adjustments are required because of mismatch between the timing of the recognition of revenues or expenses and the timing of the payment of cash.
- Adjustments should be carefully checked at the end of each reporting period.

To figure out how much to adjust, we need to compare:

- where we were before the adjustment.
- where we are supposed to be after the adjustment.

EX. Adjustment to Prepaid Rent:

- Paid \$7,200 for September, October, and November's rent in advance.
- Recorded as **Prepaid Expense (Asset!)** initially.

How much do we need to adjust at the end of the september?

- Where we were before the adjustment: **\$7,200**.
- Where we are supposed to be after the adjustment: **\$4,800**.
→ We need to adjust **\$2,400**.

- ABC corp. purchased supplies for \$2,000 in January and used the half of them in February.

January:

Supplies (+A)	2,000
Cash (-A)	2,000

February (Adjustment Journal Entry):

Supplies Expense (+E)	1,000
Supplies (-A)	1,000

Due to the adjustment in February,

- The balance of Supplies becomes **\$1,000**.
- \$1,000 of Supplies are recognized as Supplies Expense.

Adjustments to Prepaid Expenses

- ABC corp. purchased a 12-months insurance plan (\$12,000) at the beginning of January.

January 1:

Prepaid Insurance (+A)	12,000
Cash (-A)	12,000

January 31 (Adjustment Journal Entry):

Insurance Expense (+E)	1,000
Prepaid Insurance (-A)	1,000

Due to the adjustment in January,

- The balance of Prepaid Insurance becomes **\$11,000**.
- \$1,000 of Prepaid Insurance are recognized as Insurance Expense.