COMM 293

MIDTERM REVIEW SESSION

SOLUTIONS

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1. Accounting foundation

Assets: reasonably assured that the entity will get future economic inflows
Historic cost principal – Assets are recorded at cost
Examples: PPE, A/R

Liabilities: entity will have future economic outflows due to events in the past
Examples: A/P, deferred revenue

Shareholder's equity:
1) Contributed capital: permanent investments by shareholders
2) Retained earnings: Earnings retained since inception of business

To remember the equation: in order for the economic inflows and outflows to balance each other out, you must either take a loan (liabilities) or raise money (SE) to gain access to the assets. Therefore, there is no "free lunch" in the double entry accounting.

Integrating the three elements
Accounting equation: Assets = Liabilities + Shareholder's equity

Main financial statements:
1. Balance sheet: A = L + SE
2. Income statement: Revenues – expenses = profit

3. Statement of cash flows: revenues and expenses do not equal to cash collected or paid. Therefore, we must prepare a statement of cash flows in accordance to the standards.

i) Operating activities: day to day operations
ii) Financing activities: how the management finances the business
iii) Investing activities: how was the available cash utilized by the management

Accounting standards:
ASPE: Used by private entities
IFRS: Used by public entities or private entities
Private entities have a choice between the two standards. However, public entities must use IFRS.

DEAD rule: Debit expenses, assets and dividends

PRACTICE

Classify the accounts to financial statements (i.e. B/S or I/S):

Allowance for doubtful accounts: B/S

Cost of goods sold: I/S

Intangibles: B/S

Accumulated depreciation: B/S

Land: B/S

Rent expense: I/S

Salaries: I/S

Prepaid expense: B/S

Inventory: B/S

Accounts payable: B/S

PRACTICE

Outline the two effects of each transaction on the equation (A = L + SE)

1) Purchased building for cash: Increase in assets and decrease in assets.

2) Purchased an equipment on account: Increase in assets and increase in liabilities

3) Received proceeds from customers: Increase in assets and increase in shareholder's equity

4) Incurred advertising expense of $5000 on account: increase in liabilities and decrease in shareholder's equity

2. Accounting Cycle

Step 1: Journal entries: Dr and Cr each transaction
→

Step 2: T-accounts: create a T account for each account such as equipment/supplies by summarizing all debits and credits

→
Step 3: Trial Balance: take the end balance of the T accounts

	T ACCOUNT		
	Cash		
JE #1	100	12	JE #3
JE #2	20		
Trial Balance -->	108		

3. Accrual accounting

Matching principle – Revenues and expenses are recognized when incurred (expenses must be matched with revenues)

2 types of journal entries:
Deferrals: Receipt of assets or payments of cash advance of revenue or expense recognition
Examples: Prepaid expenses, Unearned revenues
Accruals: Revenues earned or expenses incurred that have not been previously recorded
Examples: Sales on credit, interest, accrued wages

PRACTICE

1) Rihanna's company purchased a lipstick inventory of $100,000 on a note payable of three months on October 1. The note requires an interest of 10%. Provide the journal entry on October 31st.

100,000 x 10% x 1/12 = 833.33

On October 31st
Dr. Interest expense 833.33
  Cr. Interest payable 833.33

2) Cardi B performed one song worth $50 million for her agency without having billed them on November 31. Provide journal entry for, the queen, Cardi B.
Dr. Accounts receivable 50 million
  Cr. Revenue 50 million

3) Hydro BC purchased $5000 worth of supplies on November 1. An inventory count showed a balance of $2500 on December 31.

5000 - 2500 = cost of supplies used
Dr. Supplies expense 2500
  Cr. Supplies 2500

4) Debeers purchased a prepaid insurance for the potential breakdown of specific machinery for the duration of 2 years. The coverage cost is $120,000 for each year. Provide a journal entry for the month of August.

Dr. Insurance expense 10,000
Cr. Prepaid insurance 10,000

Consequences if not adjusted? Expenses are understated by 10,000 and net income is overstated by 10,000. Moreover, assets and SE will be overstated by 10,000.

5) Amazon collected $10 million worth of cash for the goods which have not been delivered to the customer yet. However, by August 1, it was able to deliver $1 million worth of goods. Provide initial and adjusting journal entry.

initial entry:
Dr. Cash $10 million
Cr. Unearned revenue $10 million

Adjusting entry
Dr. Unearned revenue $1 million
Cr. Revenue $1 million

4. Merchandising

Sales revenue
– COGS
= Gross profit
– Operating expenses
= Net income

Inventory systems:
1) Perpetual: continuous tracking where you compute and record COGS when it is sold
2) Periodic: tracking end of accounting period. You must only record revenue when the item is sold. COGS will be recorded at the end of the period.

Perpetual system
Best buy purchased $8000 worth of PS5 from Sony. Provide the journal entry.

PRACTICE

Purchasing inventory:
Dr. Inventory 8000
  Cr. Accounts payable 8000

Fright costs
FOB destination: Seller pays the freight costs
FOB shipping: Buyer pays the freight costs

Best buy incurred $1000 in freight costs to get the PS5 delivered from Sony. Provide the journal entry.
To record freight cost (FOB shipping):
Dr. Inventory 1000
  Cr. Cash 1000

Sony incurred $1000 in freight costs to deliver the PS5 to Best Buy to Vancouver locations.
To record freight cost (FOB destination):
Dr. Freight out (Delivery expense) 1000
  Cr. Cash 1000

Selling terms
3/15, n/30

What does each part mean?
1) 3 – Percentage (3%)
2) 15 – days (15 days)
3) n/30 – net 30 days (must be paid within 30 days)

What does the whole term mean?
The customer will obtain a 3% discount on the goods if the payment is made within 10 days of purchase/shipment or it has to be definitely paid within 30 days.

Purchase discount (reduces cost of inventory): when the buyer pays an invoice within the discount period, the amount of discount reduces the value of the inventory. This is because the companies record inventory at cost and by paying it within the discount period, they are able to reduce the "cost" of inventory that they purchase.

PRACTICE

Suppose Best buy purchased $100,000 worth of inventory from Sony for the new PS5. The terms are 2/10, n/30. Best buy pays the amount within the discount period. Provide the journal entry.

Dr. Accounts payable 100,000
Cr. Inventory 2000
Cr. Cash 98,000

After inspection of the inventory after payment, Best buy discovered that some of the PS5s were not functional. Therefore, they returned $1200 worth of inventory back to Sony. Provide journal entry.

Purchase allowance (returns or defects):
Dr. Accounts payable 1200
Cr. Inventory 1200

SUMMARY

	Inventory			
Freight in	1000	1200	Purchase return	
Purchase	108000	2000	Purchase discount	
	105800			

PRACTICE

Flip side: Sales returns and allowances

Suppose Toy manufacturer sold $100,000 worth of toys to Walmart. Toy inc has a markup of 20% on sales. Provide journal entries.
Sale of goods:
Dr. A/R 100,000
Cr. Sales revenue 100,000

Record COGS:
Dr. COGS 80,000
Cr. Inventory 80,000

Walmart returned $2,000 worth of toys as it did not meet the quality standards. Provide journal entry.
Sales returns and allowances (matching principle):

Journal entry #1:
Dr. Sales returns and allowances 2000
Cr. A/R 2000

Journal entry #2:
Dr. Inventory 1600
Cr. Cost of goods sold 1600

Let's consider the example above. Suppose Best buy purchased $100,000 worth of inventory from Sony for the new PS5. The terms are 2/10, n/30. Best buy pays the amount within the discount period. Provide the journal entry. This would be Sony's perspective.

Sales discount:
Dr. Cash 98,000
Dr. Sales discounts 2,000
  Cr. Accounts receivable 100,000

PERIODIC system: Journal Entries list for reference

Purchase inventory:
Dr. Purchases
  Cr. Accounts payable

Sale of goods:
Dr. Accounts receivable
  Cr. Sales revenue

Purchase discount:
Dr. Accounts payable
  Cr. Purchase discounts
  Cr. Cash

Purchase allowance/returns:
Dr. Accounts payable
  Cr. Purchase allowances and returns

5. Inventories

FIFO: Assumes that the earliest goods purchased are sold first
LIFO: Assumes that the latest goods purchased are sold first
Weighted average method: Cost of goods available for sale/units available for sale

Valuation method: lower of cost and market. Write up is not allowed. Write down when market value is lower than the cost of initial acquisition.

Formula for inventory turnover:
COGS/average inventory
average inventory = (beginning + ending inventory)/2
The number of times the average inventory is sold and replaced during a period (usually a year)

Which method would be better when the prices are rising, and the company wishes to pay lesser taxes?
LIFO. Therefore, IFRS prohibits the use of LIFO.

PRACTICE

		COGAS		
Date	Explanation	Units	Unit cost	Total cost
01-Jan	Beg inventory	50	9	450
15-Apr	Purchases	100	10	1000
25-Aug	Purchases	200	11	2200
20-Nov	Purchases	300	12	3600
		650		$ 7,250
Amount of sales	**250**			
Sales price	**$ 15**			
Average method	7250/650	$ 11.15		
	x total units	250		
	COGS	$ 2,788.46		

FIFO method	50*9+100*10+100*11
	2550

6. Accounts receivable

a. It is an asset on the balance sheet which represents the money due to a company in the short term
b. In order to call it an accounts receivable, we must be reasonably assured that entity will collect consideration in the future

Which accounting questions are we tackling here? State 2-3 questions.
Do we know if the consideration will be received for sure? How do we need to account for the "possibility" that some customers may not pay us? What if the customer paid after we determined that it would be uncollectible?

What are definitions and the uses of these accounts?
1. Allowance for doubtful accounts: As a contra asset, it reduces the asset balance (accounts receivable) temporarily to give us a realistic picture of how much of the amount will be converting into cash.

2. Bad debt expense: this refers to the outstanding bills that the company has determined to be uncollectible and must be written off.

Alternative way of thinking about bad debt expense: consider it the "cost of being in the business".

A. SALES METHOD

PRACTICE

Scenario: Cardi B decided to diversify her business portfolio. She entered the business of providing hydro for the city of Vancouver called "Water As Pure". She is expected to provide $5,000,000 worth of hydro to the city for FY 2020. Her accountant determined that they would be unable to collect 5% of the sales made this year.

Step 1: Record the sales
Dr. Accounts Receivable $5,000,000
Cr. Revenue $5,000,000

Step 2: Record the possibility of default (think 5% won't pay)

Dr. Bad debt expense $250,000 (5 Million x 5%)
Cr. Allowance for doubtful accounts $250,000

An uncool customer utilized $200 worth of hydro over several months and did not pay in time because she did not like her music and switched to Hydro BC.

Step 3: Record the actual default
Dr. Allowance for doubtful accounts - Uncool customer $200
Cr. Accounts receivable – uncool customer $200

But fortunately, more people found her cool and higher number of customers than initially expected paid for the hydro in the exact amount of $500. Essentially, $500 was written off thinking that it would not be paid but they ended up paying.

Step 4: Record the JE when the customers pay
Dr. Cash $500
Cr. Accounts receivable $500

Since the uncool person thought it was immoral to use Cardi B's services and not pay her, he decided to send her a cheque of $200.

Step 5: Record receipt when the A/R was previously written off but the amount becomes collectible

Dr. Accounts receivable $200
Cr. Allowance for doubtful accounts $200

Additional journal entries:
To record returns and allowances on the products:
Dr. Sales returns and allowances
Cr. A/R

When a company sells its "A/R" to another company:
Dr. Cash
Dr. Service charge expense
Cr. Accounts receivable

Points to remember for allowance for doubtful accounts: When there is a debit balance from the previous years, lower number of customers paid back than initially expected. When there is a credit balance from previous years, higher number of customers paid back than expected.

Key insight: by having an allowance for doubtful accounts and bad debt, we are ensuring that the asset balance on the balance sheet AND revenue on the income statement are not overestimated.

The similar accounting process is undertaken under the aging of accounts method.

B. AGING OF ACCOUNTS METHOD

An example of how to calculate the bad debt expense:

Age of accounts receivable	Accounts receivable	Probability of not collecting	Expected Uncollectible amount
	A	B	A x B
Current	100500	1%	1005
Past due - 1-30 days	1000	3%	30
Past due - 31-60 days	3000	10%	300
Past due - 61+ days	5500	40%	2200
		Total	$ 3,535

The total amount of $3,535 would be the bad debt expense in this case.

Formulas list:

Receivables turnover: Net credit sales/Average net accounts receivable

Average collection period: 365/Receivables turnover

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