

COMMERCE MENTORSHIP PROGRAM

# MIDTERM REVIEW SESSION

# COMM 293



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<http://cmp.cus.ca>

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# Chapter 1: Accounting in Action

# What is Accounting? (boring version)

- Recognizing, recording, communicating economic activities
- Interested users:
  - Internal (management)
  - External (shareholders)
- Different types:
  - Cost accounting
  - Audit
  - Tax
- Deliver financial info to concerned users

# What is Accounting? (better version)

- Language of financial information
- Words in a sentences = numbers in financials
- Wealth lies in financial literacy
- Reading numbers to get ahead
- Don't believe me... Warren Buffet

# Warran Buffet on Accounting

- [https://www.youtube.com/watch?v=rV3Etfww7EQ&ab\\_channel=InvestmentKnowledge](https://www.youtube.com/watch?v=rV3Etfww7EQ&ab_channel=InvestmentKnowledge)

# Financial vs Managerial Accounting

## **Financial Accounting**

- Collecting data for financial statements
- Emphasis on past
- External users
- Follow GAAP/IFRS

## **Managerial Accounting**

- Collecting data for business decision-making
- Emphasis on future
- Internal users
- Follow logic

# Assets

- Economic resources controlled by the company
- Result from past business events
- Expected future economic benefits
- Recorded at **historical cost**
  - The cost of acquisition
- Examples:
  - Accounts receivable
  - Inventory
  - PPE
  - Cash



# Liabilities

- Debts/firm obligations
- Result from past business events
- Expected future outflow of economic resources
- Examples
  - Accounts payable
  - Unearned revenue
  - Notes payable
  - Principal & interest payments

# Shareholders' Equity

## **Contributed capital**

- Permanent Investments for equity
- Common stock
- # & total value of shares issued

## **Retained Earnings**

- Consists of revenues, less expenses and dividends

## **Other**

- Changes in values of assets/liabilities

# The Accounting Equation

**Assets = Liabilities + Shareholders' Equity**

- Must always remain balanced
- Only 2 ways to acquire assets

Ex. 1) If Nike has \$900K in assets and \$300K in liabilities, what is the balance in SE?

**Example Corporation**  
**Balance Sheet**  
**December 31, 2020**

**ASSETS**

Current assets	
Cash and cash equivalents	\$ 2,200
Short-term investments	10,000
Accounts receivable - net	39,500
Other receivables	1,000
Inventory	31,000
Supplies	3,800
Prepaid expenses	1,500
Total current assets	<u>89,000</u>
Investments	<u>36,000</u>
Property, plant & equipment - net	
Land	5,500
Land improvements	6,500
Buildings	180,000
Equipment	201,000
Less: accumulated depreciation	<u>(56,000)</u>
Property, plant & equipment - net	<u>337,000</u>
Intangible assets	
Goodwill	105,000
Other intangible assets	<u>200,000</u>
Total intangible assets	<u>305,000</u>
Other assets	<u>3,000</u>
Total assets	<u><u>\$ 770,000</u></u>

**LIABILITIES**

Current liabilities	
Short-term loans payable	\$ 5,000
Current portion of long-term debt	15,000
Accounts payable	20,900
Accrued compensation and benefits	8,500
Income taxes payable	6,100
Other accrued liabilities	4,000
Deferred revenues	<u>1,500</u>
Total current liabilities	<u>61,000</u>
Long-term liabilities	
Notes payable	20,000
Bonds payable	375,000
Deferred income taxes	<u>25,000</u>
Total long-term liabilities	<u>420,000</u>
Total liabilities	<u>481,000</u>
Commitments and contingencies (see notes)	

**STOCKHOLDERS' EQUITY**

Common stock	110,000
Retained earnings	220,000
Accum other comprehensive income	9,000
Less: Treasury stock	<u>(50,000)</u>
Total stockholders' equity	<u>289,000</u>
Total liabilities & stockholders' equity	<u><u>\$ 770,000</u></u>

*The accompanying notes are an integral part of this statement.*

<b>Innovative Products, Inc.</b> <b>Income Statement</b> For Year Ending December 31, 2012		
<b>Sales</b>		\$50,00,000
Cost of Goods Sold		
Materials	8,00,000	
Labor	11,00,000	
Overhead	6,00,000	25,00,000
<b>Gross Margin</b>		<b>\$25,00,000</b>
<b>Operating Expenses</b>		
Selling Expenses	9,00,000	
Administrative Expenses	6,00,000	
Depreciation and Amortization	5,00,000	2000000
<b>Operating Income</b>		<b>\$5,00,000</b>
<b>Other Income &amp; Expenses</b>		
Interest Revenue	50000	
Interest Expense	-1,00,000	
Extraordinary items	2,00,000	1,50,000
<b>Income Before Tax</b>		<b>\$6,50,000</b>
Income Tax (at 35%)		\$2,27,500
<b>Net Income</b>		<b>\$4,22,500</b>



# Statement of Stockholders' Equity Example

	Common Stock	Additional Paid-in Capital	Retained Earnings
Balance, December 31, 20x4	\$ 80,000	\$160,000	\$130,000
Issuance of stock	20,000	65,000	
Net income			69,000
Cash dividends			(21,000)
Stock dividends – 8%	8,000	26,000	(34,000)
Purchase of treasury stock			
Sale of treasury stock		13,000	
Balance, December 31, 20x5	\$108,000	\$264,000	\$144,000

**Centerfield Sporting Goods**  
**Statement of Cash Flows for period ended December 31, 2019**

**Cash flows from operations**

Customer payments		2,000,000
Material purchases	-	640,000
Payroll costs	-	840,000
Other payments	=	<u>352,000</u>

**Total cash flows from operations** **168,000**

**Cash flows from investing**

Equipment purchase	-	40,000
		<u>-</u>

**Total cash flows from investing** **- 40,000**

**Cash flows from financing**

Loan payments	-	60,000
		<u>-</u>

**Total cash flows from financing** **- 60,000**

**Net change in cash** **68,000**

**Beginning cash balance** **92,000**

**Ending cash balance** **160,000**

# Generally Accepted Accounting Principles (GAAP)

- Universal set of accounting regulations
- In Canada:
  - Public companies follow International Financial Reporting Standards (IFRS)
  - Private companies can follow IFRS or ASPE
- In USA:
  - Comply with US GAAP
  - Regulated by the SEC



# Chapter 2: The Recording Process

# Accounting Equation – Expanded

- $\text{Assets} = \text{liabilities} + \text{SE}$
- $\text{SE} = \text{common stock} + \text{retained earnings (RE)}$
- $\text{RE} = \text{net income} - \text{dividends}$
- $\text{RE} = \text{revenues} - \text{expenses} - \text{dividends}$
- $\text{Assets} = \text{liabilities} + \text{common stock} + \text{revenues} - \text{expenses} - \text{dividends}$

# Transaction Analysis

- 1) Identify accounts involved
- 2) Determine direction of effect
- 3) Check that  $A = L + SE$  remains balanced
- Duality of effects
  - Every transaction affects min. 2 accounts

# Transaction Analysis – Examples

- 2) Nike issues \$4,000 of common shares to investors for cash.
- 3) Nike borrows \$12,000 from the bank with a 5-year note.
- 4) Nike buys \$8,000 in new equipment for making shoes. They pay \$1,000 in cash, and agree to a 3-year note for the balance.

# Journal Entries

- Method for analyzing transactions
- Recording as either “Debit” or “Credit”
  - ONLY signal left and right
- Summarize results of economic transactions

# Journal Entries – Examples

- 5) Nike issues \$4,000 of common shares to investors for cash.
- 6) Nike borrows \$12,000 from the bank with a 5-year note.
- 7) Nike buys \$8,000 in new equipment for making shoes. They pay \$1,000 in cash, and agree to a 3-year note for the balance.

# General Ledger

- Shows effects of multiple economic transactions
- Isolates balances for each individual account

# General Ledger – Examples

- 8) Nike issues \$4,000 of common shares to investors for cash.
- Nike borrows \$12,000 from the bank with a 5-year note.
- Nike buys \$8,000 in new equipment for making shoes. They pay \$1,000 in cash, and agree to a 3-year note for the balance.



# Debit and Credit Framework

<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Shareholders' Equity</b>			
<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Common Stocks</b>	+	<b>Retained Earnings</b>	
<b>Dr.</b>	<b>Cr.</b>	<b>Dr.</b>	<b>Cr.</b>	<b>Dr.</b>	<b>Cr.</b>	<b>Dr.</b>	<b>Cr.</b>
+	-	-	+	-	+	-	+
				<b>Revenues</b>	-	<b>Expenses</b>	-
				<b>Dr.</b>	<b>Cr.</b>	<b>Dr.</b>	<b>Cr.</b>
				-	+	+	-
						<b>Dividends</b>	
						<b>Dr.</b>	<b>Cr.</b>
						+	-

- Gain = economic benefit outside regular operations
- Loss = economic loss outside regular operations

# Debits and Credits for Journal Entries

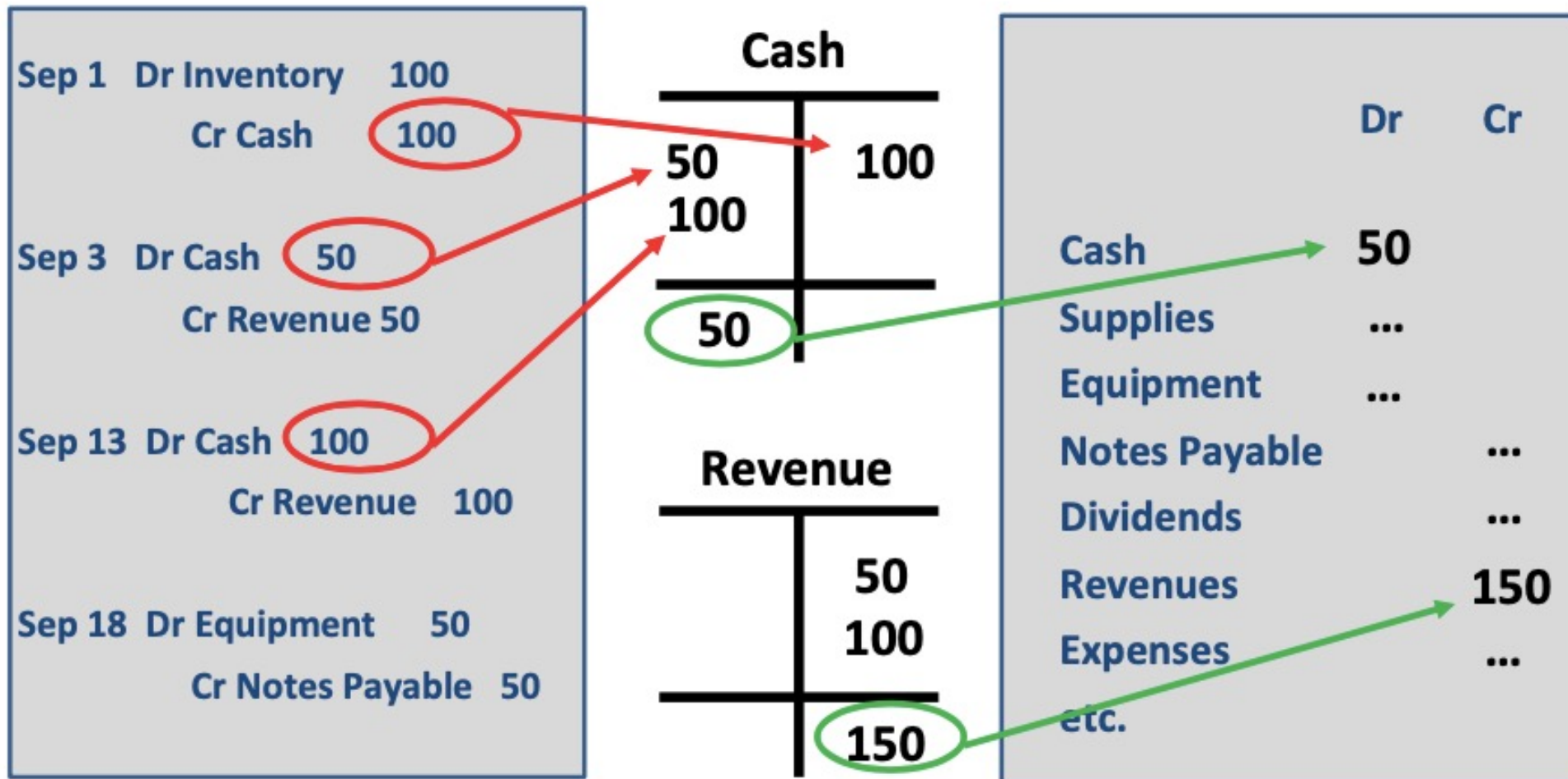
- **D.E.A.D**
- Debit expenses, assets, dividend increases
- Credit all other increases
- Debits = Credits ALWAYS

# Trial Balance

<b>MAGNIFICENT LANDSCAPING SERVICE</b> <b>Adjusted Trial Balance</b> <b>April 30, 2018</b>		
<b>Account Title</b>	<b>Debit</b>	<b>Credit</b>
Cash	\$2,950	
Accounts Receivable	575	
Office Supplies	40	
Prepaid Insurance	240	
Equipment	2,500	
Accumulated Depreciation: Equipment		\$ 35
Accounts Payable		28
Salaries Payable		420
Unearned Lawn Mowing Revenue		100
Common Stock		5,000
Dividends	1,000	
Lawn Mowing Revenue		2,350
Gas Expense	53	
Advertising Expense	35	
Depreciation Expense: Equipment	35	
Supplies Expense	85	
Salaries Expense	420	
	<u>\$7,933</u>	<u>\$7,933</u>

# Chapter 2 Summary

## ▶ Journal Entries   ▶ T-Accounts:   ▶ Trial Balance



# Chapter 3: Adjusting the Accounts

# Accounts Receivable vs Accounts Payable

## **AR**

- Records amounts for goods/services given on credit
- Money owed TO company
- Asset

## **AP**

- Records amounts for goods/services received on credit
- Money owed BY company
- Liability

# Methods of Measuring Income

## **Cash Basis**

- Revenues/expenses recorded at transfer of cash
- Not used often, not GAAP
- Can be manipulated by management

## **Accrual Basis**

- Revenues/expenses recorded as incurred
- Used most often, follows GAAP
- Independent of cash receipts timing

# Revenue Recognition Principle – Examples

- 1) Cash received BEFORE revenue is earned
  - Dr Cash
  - Cr Unearned revenue (liability)
- 2) Cash received WHEN revenue is earned
  - Dr Cash
  - Cr Sales revenue (retained earnings)
- 3) Cash received AFTER revenue is earned
  - Dr Accounts receivable
  - Cr Sales revenue



# Revenue Recognition Principle

- Revenues to be recorded when earned
- Independent of when cash is received/paid
- 9) Ex: Nike sold \$2,000 worth of merchandise on Jan 3<sup>rd</sup> , but cash payment was collected on Jan 22. When is revenue recognized?  
Journal entries:

# Expense Recognition Principle – Examples

- 1) Cash paid BEFORE expense is incurred
  - Dr Prepaid expense (asset)
  - Cr Cash
- 2) Cash paid WHEN expense is incurred
  - Dr Expense
  - Cr Cash
- 3) Cash paid AFTER expense is incurred
  - Dr Expense
  - Cr Expense payable

# Expense Recognition Principle

- Expenses to be recorded when earned
- Independent of when cash is received/paid
- 10) Ex: Nike's marketing team received a \$500 commission for the sale of merchandise on Jan 3<sup>rd</sup> , but it was paid out on Jan 20. When is the expense recognized? Journal entries:

# Two Kinds of Adjusting Entries

## **Deferrals**

- Receipt of assets/cash BEFORE incurring revenue/expense
- Ex. prepaid expenses, unearned revenues

## **Accruals**

- Receipt of assets/cash AFTER incurring revenue/expense
- Ex. accrued revenues/expenses

# Deferrals Example

11) Mike spent \$700 on Jan 1<sup>st</sup> to cover the month's rent fee. What are the journal entries on Jan 1<sup>st</sup> and Jan 31<sup>st</sup>?

# Accruals Example

- 12) Mike decided to open a car wash. On Jan 3, Bill came and received a \$30 car wash on credit. Next week on Jan 7, Bill sent an e-transfer to cover the cost of the car wash. What are the Jan 3 and Jan 7 journal entries for Mike and Bill?

# Depreciation

- Method for allocating cost of tangible asset
- Journal entry: Dr Depreciation Expense, Cr Accumulated Depreciation
- Depreciation expense for current (single) period
- Accumulated depreciation -> contra-asset account
  - Accounts for multiple periods of depreciation
- $\text{Depreciation expense} = \text{depreciable amount} / \text{useful life}$
- $\text{Depreciable amount} = (\text{cost of acquiring} - \text{residual value}) / \text{useful life}$

# Accumulated Depreciation vs Depreciation Expense

## **Accumulated Depreciation**

- Credit balance
- Contra-asset account, offsets assets on balance sheet
- Permanent account

## **Depreciation Expense**

- Asset depreciation for 1 period
- Appears on income statement
- Temporary account



# Adjusting Entries – Depreciation

- 13) Nike bought a company truck for \$98K on Jan 1, 2019. The truck has a useful life of 7 years and is expected to generate annual sales of \$300K with no residual value. Jan 1, 2016 journal entries:
- Adjusting entries on Dec 31, 2016 for depreciation:

# Book Value

- Book value = cost of depreciable asset – accumulated depreciation
- 14) Ex. Nike bought a company truck for \$98K on Jan 1, 2019. The truck has a useful life of 7 years and is expected to generate annual sales of \$300K with no residual value. Book value at Dec 31, 2021?

# Expenses Misstatement - Example

- Payments cover beyond current period
- 15) Ex. A business paid \$100,000 in salaries for 2 years at the start of their fiscal year. They recorded this journal entry:
  - Dr Salaries Expense    \$100,000
    - Cr Cash    \$100,000
- Adjusting journal entry at year end:

# Chapter 4: Completing the Accounting Cycle

# Purpose of Closing Process

- Balance sheet items roll-forward balances
- I/S items don't roll forward balances
- Must create 0 balance in temporary accounts
- Allocate net income/loss to retained earnings

# Permanent vs Temporary Accounts

## **Permanent Accounts**

- Assets
- Liabilities
- Shareholders' Equity

## **Temporary Accounts**

- Revenues
- Expenses
- Gains
- Losses
- Dividends declared

# Step 1) Closing Revenues to Income Summary

- 16) Ex. Nike has balances of \$7,000 in sales revenue, \$3,000 in service revenue and \$500 gain from investments.

## Step 2) Closing Expenses to Income Summary

- 17) Ex. Nike has balances of \$2,000 in COGS, \$1,500 in advertising, \$1,000 in office supplies, and \$500 in legal fees.



## Step 3) Close Income Summary to Retained Earnings

- 18) Income Summary has a balance of \$5,500

## Step 4) Close Dividends to Retained Earnings

- 19) Ex. Nike has a dividend balance of \$100

# Skipping Income Summary

## **Closing revenues:**

- Dr Revenues/Gains
- Cr Retained Earnings

## **Closing expenses:**

- Dr Retained Earnings
- Cr Expenses/Losses

## **Closing dividends:**

- Dr Retained Earnings
  - Cr Dividends

# Balance Sheet Classifications

- Current assets
  - Expected usage within 1 year
- Long-term investments
- PPE
- Intangible assets
- Current liabilities
  - Obligations due within 1 year
- Obligations paid after 1 year
- Accounts ordered by liquidity

# Operating Cycle

- Time period for inventory to turn to cash
- 1) Purchase inventory
- 2) Sell it on account
- 3) Collect payment from customers
- Approximately 1 year

# Chapter 5: Accounting for Merchandising Operations

# Merchandising Companies

- Product/goods oriented rather than services
- Retailers (sales direct to end-users)
  - Ex. Walmart, Superstore
- Wholesalers (sales to retailers)
  - Ex. Proctor & Gamble, General Mills
- Hold inventory as current asset
- COGS is total cost of goods (inventory) sold

# Perpetual vs Periodic Inventory Systems

## **Perpetual**

- Constant tracking of inventory changes
- Better control over inventory
- Real time reporting of profits
- Expensive to maintain
- Common for high-value goods

## **Periodic**

- Does not keep constant track of inventory changes
- COGS calculated only at the end
- Not always up to date
- Inventory adjusted end of period



# Cost of Goods Sold (COGS)

- Direct cost of goods acquired that were sold
- Cost incurred only if inventory is sold
- Essential in matching principle

# Perpetual Inventory – Delivery Costs

- If seller pays for delivery of inventory:
  - Dr Delivery Expense
  - Cr Cash/AP
  - No journal entries for buyer
- If buyer pays for delivery of inventory:
  - Dr Inventory
  - Cr Cash/AP
  - Included in overall cost of inventory

# Perpetual Inventory – Delivery Costs Example

- 20) Nike buys \$5,000 worth of clothes from XYZ on Jan 3 and pays \$500 delivery costs on credit. The journal entries for Nike:
- 21) If XYZ (the seller) takes care of the delivery costs, the journal entries for Nike and for XYZ are:

# Perpetual Inventory – Purchase Discounts

- Discount granted on sale of inventory
- Journal entries
  - Dr AP
  - Cr Inventory
  - Cr Cash

# Perpetual Inventory – Purchase Allowance

- Reduction in price due to item defect/wrong order
- Journal entries
  - Dr AP
  - Cr Inventory

# Perpetual Inventory – Purchase Return

- Customer returns item to merchandiser
- Journal entries
  - Dr AP
  - Cr Inventory

# Credit Terms

- Ex. Nike bought \$10,000 worth of clothes from XYZ on account with credit term 3/12, n/30
- Three-twelve, net thirty
- 3 % discount if paid within 12 days, else full balance in 30 days

# Credit Terms – Example

- 22) Ex. Nike bought \$40K clothes on account from XYZ on Feb 2 with credit terms 3/12 , n/30.
- Feb 2 journal entries for Nike:
- Assuming Nike pays on Feb 13, journal entries:
- Assuming Nike pays on Mar 1, journal entries:



# Perpetual Inventory – COGS Example

- 23) Nike sold \$7,000 clothes on credit to customers on Jan 14. The clothes cost Nike \$2,500 at the time of the transaction. Journaling the credit sale for Nike:
- Journaling the COGS for Nike:

# Perpetual Inventory – Purchase Returns Ex.

- 24) Nike bought too many clothes from supplier XYZ and opted to return \$4,000 cloths to XYZ on Jan 5. The clothes cost XYZ \$1,000 to make. The journal entries for Nike:
- The journal entries for XYZ:
- Sales returns and allowances -> contra-revenue account for the seller

# Sales Returns & Allowances – for Seller

- Sales return (customer returns product for refund)
  - Dr Sales returns and allowances\*
  - Cr Accounts receivable
- Sales allowance (customer granted price reduction as compromise for incorrect order/broken product)
  - Dr Sales returns and allowances\*
  - Cr Accounts receivable
- \*Contra-revenue accounts
  - Deducted from gross sales revenue to determine net sales
  - Debit balance, increases lower revenues

# Periodic Inventory – Journal Entries

- For purchasing inventory:
  - Dr Purchases (expense account)
  - Cr Cash/AP
- For selling goods
  - Dr Cash/AR
  - Cr Sales revenue
- For COGS
  - No entry required
  - Recall: COGS determined end of year in periodic system
  - Beginning Inv + Net purchases = COGAS , COGAS – Ending Inv = COGS

# Periodic Inventory – Purchase Discounts, Returns & Allowances

- For purchase discount:
  - Dr AP
  - Cr Purchase discounts\*
  - Cr Cash
- For purchase allowance:
  - Dr AP
  - Cr Purchase allowances\*
- For purchase return:
  - Dr AP
  - Cr Purchase returns\*
- \*Contra-expense accounts
  - Deducted from gross expenses
  - Credit balance

# Net sales reporting

- Sales revenue
- Less: Sales Discounts
- Sales returns & allowances
- Net Sales
- Less: COGS
- =Gross profit (gross margin)

# Net income reporting

- Multi-step income statement
  - = Gross profit
  - Less: Operating expenses
  - = Operating income before taxes
  - Less: Taxes
  - = Net Income
- 
- Operating expenses are rent, supplies, salaries, advertising

# Income Statement Equations

- Gross profit = Net sales – COGS
- Gross profit rate = Gross profit / Net sales
- Single-step I/S:
  - Net income = Revenues – Expenses
- Multi-step I/S:
  - Net income = Gross profit – Operating expenses
  - Net income = Net sales – COGS – Operating expenses



# Gross Profit Rate vs Markup

## Gross profit rate

- Based on net sales
- $(\text{Net sales} - \text{COGS}) / \text{Net sales}$

## Markup

- Based on price
- $(\text{Sales price} - \text{cost}) / \text{cost} * 100$

25) Ex. Nike marks up a pair of shoes to sell for retail at \$120 that cost \$60 to make. Determine the markup and gross profit rate.

# Chapter 6: Inventories

# Cost of Sales



# Perpetual vs Periodic Inventory Systems

	<b>Inventory System</b>	
<b>Item</b>	<b>Perpetual System</b>	<b>Periodic System</b>
<b>Beginning Inventory</b>	Carried over from prior period	Carried over from prior period
<b>Add: Purchases or Additions</b>	Accumulated in the Inventory account	Accumulated in the Purchases account
<b>Equals: Cost of Goods Available for Sale</b>		
<b>Less: Ending Inventory</b>	Perpetual record updated at every sale	Measured at end of period by physical inventory count
<b>Equals: Cost of Sales</b>	Measured at every sale based on perpetual record	Computed as a residual amount at end of period

# Determining Ownership of Goods

- FOB shipping point
  - Possession passes to buyer when goods are shipped
  - Buyer pays transport costs
- FOB destination
  - Possession passes to buyer when goods are delivered
  - Seller pays transport costs
- Consigned goods
  - Inventory given to a 3<sup>rd</sup> party (consignor) to sell
  - Still belongs to manufacturer/merchandiser
  - Possession not transferred, no revenue recognition

# Inventory Cost Flow Methods: Specific Identification

- Tracks specific costs to specific goods
- Common for special/unique goods
- COGS calculated specifically with goods sold in period
- Inventory calculated based on specific items remaining
- Expensive, needs detailed info
- Same results with perpetual & periodic inventory

# Inventory Cost Flow Methods: First-In, First-Out (FIFO) Assumptions

- Earliest goods bought are 1<sup>st</sup> to be sold
- 1<sup>st</sup> (oldest) goods are first to be recognized as COGS
- Oldest units not actually sold first (but their costs are recognized first)
- Oldest costs -> COGS
- Newest costs -> Ending inventory
- Used in periodic inventory (not in perpetual)

# FIFO Example

- 26) Walmart bought 600 milk cartons for sale at \$0.3 each on Jan 2. Then, they bought 300 milk cartons at \$0.4 each on Jan 5. Finally, they bought 100 milk cartons at \$0.7 on Jan 10. All milk cartons are identical. On Jan 12, Walmart sold 500 milk cartons at \$2 each. Determine COGS and ending inventory on Jan 12.



# Inventory Cost Flow Methods: Last-In, First-Out (LIFO) Assumptions

- Latest goods bought are 1<sup>st</sup> to be sold
- Latest (newest) goods are first to be recognized as COGS
- Newest units not actually sold first (but their costs are recognized first)
- Newest costs -> COGS
- Oldest costs -> Ending inventory
- Used in periodic inventory (not in perpetual)

# LIFO Example

- 27) Walmart bought 600 milk cartons for sale at \$0.3 each on Jan 2. Then, they bought 300 milk cartons at \$0.4 each on Jan 5. Finally, they bought 100 milk cartons at \$0.7 on Jan 10. All milk cartons are identical. On Jan 12, Walmart sold 500 milk cartons at \$2 each. Determine COGS and ending inventory on Jan 12.

# Inventory Cost Flow Methods: Average Cost

- Average cost =  $\text{COGAS} / \# \text{ units available for sale}$
- Average cost assigned to COGS and ending inventory
- $\text{COGS} = (\text{avg. cost per unit}) \times (\# \text{ units sold})$
- $\text{Ending inventory} = (\text{avg. cost per unit}) \times (\# \text{ units in ending inv.})$

# Average Cost Example

- 28) Walmart bought 600 milk cartons for sale at \$0.3 each on Jan 2. Then, they bought 300 milk cartons at \$0.4 each on Jan 5. Finally, they bought 100 milk cartons at \$0.7 on Jan 10. All milk cartons are identical. On Jan 12, Walmart sold 500 milk cartons at \$2 each. Determine COGS and ending inventory on Jan 12.

# Inventory Cost Flow Methods: Other Notes

- During rising prices/inflation
  - FIFO -> lowest COGS, highest ending inventory
  - LIFO -> highest COGS, lowest ending inventory
- Above reversed if falling prices
- Avg. cost yields net income between FIFO, LIFO (regardless of rising/falling prices)
- Managers are motivated to choose certain methods
- IFRS prohibits LIFO
- U.S. GAAP allows FIFO, LIFO, and weighted avg. cost methods

# Financial Statement Ratios: Inventory Turnover

- Inventory turnover = cost of sales / avg. inventory
- Avg. inventory = (beginning inventory + ending inventory) / 2
- How many times avg. inventory was produced and sold
- High ratio -> fast moving inventory

# Financial Statement Ratios: Average Days in Inventory

- Avg. days in inventory =  $365 / \text{inventory turnover ratio}$
- How long inventory is expected to be held
- Higher numbers -> concern for product obsolescence

# Chapter 8: Recognition of Accounts Receivable



# Types of Receivables

- Accounts receivable (trade receivables)
  - Credit sales
  - Current asset (collectible within <1 year)
- Notes receivable
  - Written promises from parties with specific terms on payment
- Other receivables
  - Owed to company for reasons other than regular operating transactions
  - Ex. loans to employees

# Recording Receivables

- Increased when revenue is recognized
  - Dr Accounts receivable
  - Cr Sales revenue
- Reduced on collection of payments
  - Dr Cash
  - Cr Accounts receivable
- Reduced on returns/allowances
  - Dr Sales returns/allowances
  - Cr Accounts receivable

# Receivables review from Chapter 5

- 29) Nike bought \$6,000 clothes from XYZ on account. XYZ granted Nike 2% discount. What are the journal entries for XYZ?
- Nike returns \$2,000 clothes to XYZ that were bought on account. What are the journal entries for XYZ?

# Merchandise Cards

- Preferred by management, lower transaction costs
  - Visa, MasterCard take commissions
  - Increases sales revenue, if receivables collected
- 30) Ex. A shopper bought \$200 clothing at Walmart using a Walmart credit card on Feb 1. They didn't pay the \$200 balance at the end of the month, and Walmart charges 2% per month on the balance.  
Journal entries for Walmart:

# Third-Party Credit Cards

- Non-merchandise cards
- Visa, Mastercard, American Express
- Retailers record a service charge expense
- 31) Ex. A shopper bought \$3,000 pair of Off-White sneakers and paid for it with Mastercard. Mastercard charges a 4% service fee. Journal entries for Off-White:

# Uncollectible Accounts Receivable

- Uncollectible balances in AR -> Bad debt expense
- Direct method
  - Write-off when the actual uncollectible results in a loss
  - Dr Bad debt expense
  - Cr Accounts receivable
- Direct method issues
  - Not following matching principle (write-off may happen in subsequent period to earned revenue)
  - Depends on knowing when AR is uncollectible
  - Generally not allowed in financial reporting

# Allowance Method for Bad Debts

- An estimate is made for the expected amount of bad debt for the period
  - Dr Bad debt expense
  - Cr Allowance for doubtful accounts (contra-asset account)
- If account is confirmed to be uncollectible:
  - Dr Allowance for doubtful accounts
  - Cr Accounts receivable
- If previously written-off account becomes collectible:
  - Dr Accounts receivable
  - Cr Allowance for doubtful accounts

# Bad Debt Expense vs Allowance for Doubtful Accounts

## **Bad Debt Expense**

- Temporary account
- Expense on I/S
- Estimated uncollectible AR amount for current period

## **Allowance for Doubtful Accounts**

- Permanent account
- Contra-asset, balance sheet
- Accumulates over time, reduces total value of AR



# Estimating Bad Debt Expense

- % of credit sales method
  - $(\text{Credit sales}) \times (\% \text{ estimated to be uncollectible})$
  - % usually based on prior credit history
- Aging of accounts receivables method
  - Estimate % of bad debt within different age groups of receivables
  - Computes estimate for total outstanding bad debt -> ending ADA balance
  - Record bad debt expense to adjust to the ADA balance

# Estimated Bad Debt Expense – Example

- 32) Nike uses the % of sales method. They estimate that 3% of net credit sales for 2020 will be uncollectible. If net credit sales are expected to be \$8,000 for 2020, journalize the expected bad debt.
- Nike determined that \$12,000 was uncollectible after some customers went bankrupt, so they wrote it off from AR. Journalize:

# Estimated Bad Debt Expense – Example

- 32) Later, Nike agent collected \$4,000 of AR that was previously written-off. Journalize:

# Estimated Bad Debt Expense – Example

- Nike's total AR for year ended 2020
- Not yet due = \$300K (2% estimated uncollectible)
- 1-30 days overdue = \$200K (4% estimated uncollectible)
- 31-60 days overdue = \$90K (5% estimated uncollectible)
- 61-90 days overdue = \$150K (10% estimated uncollectible)
- Over 90 days overdue = \$130K (20% estimated uncollectible)
- 33) Estimated bad debt expense if balance in ADA is \$10K?

# Selling Accounts Receivable

- Collecting payments from clients too costly
- Generate liquidity
- Cost to sell is lower than not collecting at all
- 34) Ex. If Nike decides to sell \$80K worth of receivables at a 4% service charge, the journal entries are:

# Financial Statement Ratios: Receivables Turnover

- Receivables turnover = Net credit sales / avg. net AR
- Tells # of times avg. receivables are recorded & collected during the year
- Higher ratio -> faster collection of receivables
- 35) Ex. Nike had net sales of \$20M in 2020, 80% of which were on credit. Receivables at Dec 31, 2020 were \$250K and at Dec 31, 2019 were \$180K. Receivables turnover =

# Financial Statement Ratios: Average Collection Period

- Avg. collection period =  $365 / \text{receivables turnover}$
- Tells on avg. how long it takes customers to pay
- Higher ratios -> usually better
- 36) Ex. Following last Nike example, avg. collection period is:

# Allowance for Doubtful Accounts Summary

Allowance for Doubtful Accounts	
Uncollectibles -A/R write off	B.B.
	Bad Debt Expense
	Recovery of uncollectibles
	E.B.



# Notes Receivable

- Contractual right to receive cash
- Written promise
- Principal + interest

**Term** \$1,200 **Payee** Montreal, Quebec January 5, 2015

**Principal** Sixty days after date I promise to pay to

**Interest Rate** the order of First Canadian Bank

One thousand two hundred ----- Dollars

Payable at First City Bank

**Maker** Value received with interest at 12% per annum

**Due Date** No. 10242 Due March 6, 2016 Pat Rogers

Gildan Activewear

# Notes Receivable – Calculating Interest

- Formula = (face value of note) X (annual interest rate) X (time in terms of 1 year)
- 37) Ex. Nike issued a promissory note for \$500,067 with 7% annual interest on April 3<sup>rd</sup> 2020. Calculate the interest income in Nike's books on June 9<sup>th</sup> 2020 and journal the entries:

