Financial Accounting Concepts & Assumptions

1. **Separate Entity Concept:** Activites of a business entity are spearated from those of the individual owners
2. **Time-Period Assumption:** Assumes that the long life of a company can be reported in shorter time period (anually/quarterly/monthly)
3. **Arm's-Length Transactions Assumption:** Business deaings between entities are conducted in a rational basis and all parties are acting for their own interests (i.e. no party has influence over another)
4. **Cost Principle:** Financial statement items are measured at their historical costs at the transaction date, which is assumed to represent the fair market value of the item at that date
5. **Fair Value Principle:** Assets and liabilities should be measured at fair value (price at which an an asset is bought/sold when both buyer and seller freelt agree on a price) to improve relevance of accounting information
6. **Monetary Measurement Concept:** The value of the an items included in financial statements must be measurable in dollar value
7. **Going Concern Assumption:** When preparing the financial statements, the business entity is asumed to be able to sustain itself for the foreseeable future (not under liquidation)

Financial Statements

Balance Sheet

- Reports assets, liabilities and equity a particular date
- **Assets = Liabilities + Equity = Current Assets + Non-Current Assets**
- Classified: Assets and liabilities are subdivided into current (can be converted to cash within one year) and non-current categories

Assets - Resources		
Asset	Definition	Example
Cash	Coins, currency, checks	$ in company's checking account
Accounts Receivable	Money to be received by providing g&s to a customer	$ not yet received for providing services
Inventory	Items that are purchased/manufactured and will be resold	Raw materials
Buildings	Structures used in operations	Physical store
Liabilities - Creditors' claims against resources		
Liability	Definition	Example
Accounts Payable	$ owed from buying g&s on credit	Unpaid $ used to purchase inventory that has
Income Taxes Payable	Income tax payable to govt	Unpaid corportate income tax
Mortgage Payable	$ owed to the purchase of property	Loan from buying a building
Unearned Revenue	Amount owed in services/product (not $) to a customer who paid in advance	Spotify subscription

Equity – Owners' claims against resources		
Equity	Definition	Example
Capital Stock	$ given by shareholders to obtain shares of stock	
Retained Earnings	Earnings retained in the business. Dividends distributed to owners will reduce retained earnings	Reinvestments to business from earnings

- Assets are ordered in descending order of liquidity
- Liabilities are ordered in descending order of due date

Statement of Comprehensive Income

- Reports revenue, expenses, net income and other comprehensive income over a specific period
- Measures company performance
- **Net Income = Revenue - Expenses**
- **Comprehensive Income = Net Income + Other Comprehensive Income**
- **Earning/Loss per share = Net Income / Outstanding # shares**

Statement of Changes in Equity

- Reports changes in the components of equity over a specific period, including capital stock, retained earnings and accumulated other comprehensive income (other equity)
- **Equity (ending) = Equity (beginning) + Δ Capital Stock + Δ Retained Earnings + Other Equity**
- **Δ Retained Earnings = Net Income - Dividends**

Statement of Retained Earnings

- Reports changes in the components of retained earnings over a specific period, including the beginning balance, net income, dividends and closing balance
- **RE (ending) = RE (beginning) + Net Income – Dividends**

Statement of Cash Flows

- Reports cash inflows and outflows over a specific period, classified into operating, investing and financing activities
- **Cash Balance (ending) = Cash Balance (beginning) + Δ Operating + Δ Investing + Δ Financing**

Notes to Financial Statements

- Explanatory information; consists if (i) Summary of Siginificant Accounting Policies, (ii) Additional Informatino about the Summary Totals, (iii) Disclosure of Information Not Recognized in the Financial Statements and (iv) Supplementary Information required under the Accounting Standards

Accounting Cycle

Analyse

- Recorded exchange transactions must:
  1. Involve exchange of resources
  2. Be conducted at arm's-length between 2 independent parties
  3. Be reliably measured (can be measured in dollar amount)
- Accounts:

Assets	Cash, AR, Inventories, Property, Equipment, Intangible Assets
Liability	AP, Notes Payable, Loan Payable
Equity	Capital Stock, Retained Earnings
Revenue	Sales Revenue, Service Revenue
Expense	Wages, Rental, Cost of Goods Sold, Utilities
Dividend	Dividend, Dividend Payable

Record

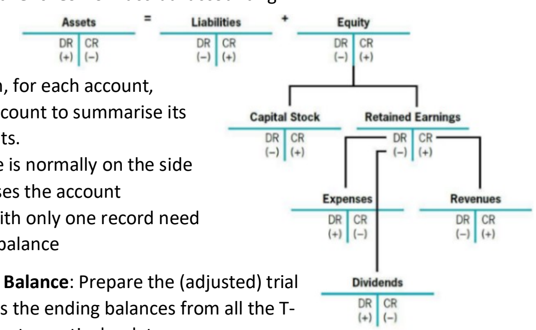
1. **Journal entry**: All exchange transactions are recorded in a journal entry in the format:

		Debit	Credit
Date	Debit Entry ……………………	XX	
	Credit Entry ……………..		XX
	Explanation		

2022			
July 1	Cash ………………………..	1,000	
	Capital Stock ………		1,000
	Issued 100 shares at $10 each		

- Sales of goods (NOT services):
  - Debits cash and/or AR, credits revenues; and
  - Debits Cost of Goods Sold expenses, credits inventory

2. **Adjusting journal entries** from accrual accounting



3. **T-account**: Then, for each account, construct a T-account to summarise its debits and credits.
   - The balance is normally on the side that increases the account
   - Accounts with only one record need not have a balance
4. **(Adjusted) Trial Balance**: Prepare the (adjusted) trial balance that lists the ending balances from all the T-accounts ending at a particular dates

Accrual Accounting

- Revenues are recognised when certain criteria are satisfied, and expenses are recorded as they are incurred to generate the revenue, regardless of when cash is paid or received
- Matching principle: An expense should be reported in the same period in which the corresponding revenue is earned
- Performed at the end of each accounting period
- Adjusting entries do not involve cash. Each entry involves revenue/expense AND a balance sheet account

Unrecorded Receivables (assets)

- Revenues earned but not yet recorded by end of accounting period
- *E.g. On 1 Nov, company enters into a year-long contract with customer to provide services each week and bill the customer every 3 mths in arrears. The contract states that the company will earn $400 per month*

Adjusting entry

Dec 31	Accounts Receivable	800	
	Service Revenue		800

Unrecorded Liabilities

- Expenses incurred but not paid during a period and not recorded at the end of that period
- *E.g. On 1 Dec, company borrowed $2,000 loan from bank, with the obligation that on the first of every month starting from 1 Jan the following year, they will make repayment of $20 interest for the past one month and principal repayment of $158 (total $178)*

2021	Adjusting entry		
Dec 31	Interest Expense	20	
	Interest Payable		20
	Interest incurred in Dec		

2022	Journal entry		
Jan 1	Interest Payable	20	
	Loan Payable	158	
	Cash Payable		178
	Repayment for Jan '22		

Prepaid Expenses

- Payments made in advance for expense items
- *E.g. On 1 Nov, company purchased a 6-month insurance policy, paying a $600 premium. This is an advance payment for 6 month of insurance at $100 per month*

2021	Adjusting entry		
Dec 31	Insurance Expense	200	
	Prepaid Insurance		200

2021	Journal entry		
Nov 1	Prepaid Insurance	600	
	Cash		600

Supplies

- *E.g. On 1 Dec, company purchased several months of supplies costing $350. At year-end, supplies costing $225 were still on hand*

2021	Adjusting entry		
Dec 31	Supplies Expense	125	
	Supplies		125

2021	Journal entry		
Dec 1	Supplies	350	
	Cash		350

Unearned Revenue

- Cash amount received from customers before its corresponding revenue can be recognised. Considers a liability
- *E.g. On 1 Dec, client pays company $225 for 3 months of services to be provided beginning 1 Dec and ending 28 Feb the following year. Assume that the services will be provided evenly over the 3 months*

2021	Adjusting entry		
Dec 31	Unearned Revenue	75	
	Service Revenue		75

2021	Journal entry		
Dec 1	Cash	225	
	Unearned Revenue		225

Unrecorded Receivables	Unrecorded Liabilities	Prepaid Expenses	Unearned Revenues
Debit asset	Debit expense	Debit expense	Debit liability
Credit revenue	Credit liability	Credit asset	Credit revenue

Closing

- **Closing entries**: Journal entries transferring all revenue, expense and dividend accounts' balances to retained earnings acount, to reset the balances of nominal account

2021	Closing entry		
Dec 31	Revenue Accounts	R	
	Expense Accounts		E
	Retained Earnings		R-E

2021	Closing entry		
Dec 31	Retained Earnings	X	
	Dividends		X

Revenues and Accounts Receivable

- Revenue recognition:
  1. Identify contract with customer
  2. Identify performance obligation(s) in the contract
  3. Determine the transaction price (TP)
  4. Allocate TP to the performance obligations
     - TP of $PO_1 = \frac{\text{SP of } PO_1}{\text{SP of all POs}} \times \text{TP of all POs}$
  5. Determine when the PO is satisfied and revenue can be recognised

Contra-revenue Accounts

- Deducted from "Sales Revenue" to report "Net Sales" in the **income statement**. They decrease revenue, so they're normal debit balance

Sales Discounts

- "x/10, n/y": x% discount if cash is paid within y days

	Journal entry		
Date	Cash	980	
	Sales Discount	**20**	
	Accounts Receivable		1,000

	Journal entry		
Date	Accounts Payable	1,000	
	Cash		980
	Inventory		**20**

Sales Returns and Allowances

- Customer returns damaged/unsatisfactory goods; receives a refund

	Journal entry		
Date	Cash	400	
	Sales Returns and Allowances	**100**	
	Accounts Receivable		500

	Journal entry		
Date	Accounts Payable	500	
	Cash		400
	Inventory		**100**

Bad Debts

Allowance method: Estimates the amount of AR that is uncollectible

- **Expected Credit Loss (ECL)**: Estimated operating expense (in **SCI**) for uncollectible amount of AR. Normal debit balance
- **Loss Allowance**: Contra to AR and deleted from AR in **BS** to report "Net AR". Normal credit balance
  - Debit write-offs; Credit estimates of uncollectible accounts
  - Credit the Loss Allowance account in the AJE by the amount to match the estimate
    - If estimated $x and there is an existing credit/debit balance of $y, credit by $(x -/+ y)
- Reported in adjusting journal entries

	Adjusting entry		
Date	Expected Credit Loss	4,500	
	Loss Allowance		4,500
	Estimated ECL for current year		

Specific customer (Write off)

	Journal entry		
Date	Loss Allowance	10,000	
	Accounts Receivable		10,000
	Write off uncollectible AR		

Loss Allowance Estimation

- **% of Total Receivables**
  - Estimate the % of total receivables balance that is uncollectible at the end of the period
- **AR Aging**
  - Categorise the ARs by age (# days past due), then find the % estimate that is uncollectible for each age range and sum the total of all the ages

Notes Receivables

- Legal contract in the form of promissory note to settle AR after the credit period
  - Face value: Ammount written on the note
  - Issuance date: Date when note is issued
  - Maturity date: Date when the note is to be paid
- **Interest Revenue** = Face Value × Annual Interest Rate × Duration (years)
- *E.g. On 1 May 2022, company accepted a 90-day, 12% note to settle an open account of AR from another company which has a balance of 5,000*

2022	Journal Entry		
May 1	Notes Receivable	5,000	
	Accounts Receivable		5,000

2022	Journal Entry		
July 30	Cash	5,150	
	Interest Revenue		150
	Notes Receivable		5,000

Dishonoured Notes Receivable

- Company did not pay before maturity date: Transfer Face Value + Interest Revenue into AR account

2022	Journal Entry		
July 30	Accounts Receivable	5,150	
	Interest Revenue		150
	Notes Receivable		5,000

Foreign Currency

- If g&s are sold in foreign currency, exchange rate fluctuations can cause exchange gain and losses
- Sale is measured at exchange rate on the date of sale (JE for that sale uses exchange rate for that day)
- Fluctuations between sale date and settlement date are recognised as **foreign exchange gain/loss**
  - Reported under sales revenue in SCI
  - Reported as credit/debit in journal entry for settlement

AR Turnover

- Measures how quickly a company collects its receivables
- Companies with poor receivables managerment are **cash poor** → cannot pay its bills timely → need to pay interest on short-term loans to cover cash shortage
- Average Net AR = $\frac{\text{Beginning AR} + \text{Ending AR}}{2}$
- AR Turnover = $\frac{\text{Net Sales}}{\text{Average Net AR}}$
- Average Collection Period = $\frac{365}{\text{AR Turnover}}$

Bank Reconciliations

- Performed monthly to reconcile differences btwn bank and book balances

Unadjusted Bank Balance	Unadjusted Book Balance
+ Deposits in transit - Oustanding checks +/- Bank errors	+ Interest paid + Direct deposits - Service charges - NSF checks - Bank transfer +/- Accounting errors
Does not require AJEs	Requires AJEs

- **Unadjusted Bank Balance**
  - Deposits in Transit: Deposits that have not been processed by bank
  - Outstanding checks: Checks written and deducted from company's cash account but not yet cleared/deducted by bank
  - Bank errors: Errors made by bank
- **Unadjusted Book Balance**
  - Interest paid: Interest paid by bank
    - DR Cash, CR Interest Revenue
  - Direct deposits: Customer directly desposit into company's bank account without informing
    - DR Cash, CR Accounts Receivable
  - Service charge: Service fees charges by bank
    - DR Service Expense, CR Cash
  - Not Sufficient Funds (NSF): Bounced check from a customer due to insufficient funds
    - DR Accounts Receivable, CR Cash
  - Bank Transfer/Bank Debit: Deductions made by the bank that have not yet been recorded on the company's books
    - DR Expense, CR Cash
  - Book errors: Errors made by the company
  - Usually these entries are grouped together to form only 2 AJEs: one AJE that debits cash and the other that credits cash

Petty Cash

- A small amount of cash kept on hand to facilitate fast and convenient transfers for small expenses
- Once the remaining balance of the petty cash hits a certain minimum, the petty cash custodian replenishes it back to the established amount by recording all the expenses that draws from the petty cash since the last replenishment
- **Cash Short and Over**: Some petty cash may be lost due to human error (e.g. wrong calculation, dropped and lost $1 coin)

2022	Journal Entry		
May 1	Petty Cash	1,000	
	Cash		1,000
	Establising petty cash fund		

2022	Journal Entry		
May 30	Misc. Expenses	200	
	Postage Expenses	500	
	Cash Short and Over	5	
	Cash		295
	Replenish petty cash fund		

Inventory & Costs of Goods Sold

- Inventory is recognised once ownership is passed to buying company:
  - FOB destination: ownership passed at destination
  - FOB shipping point: ownership passed at shipping point
  - In consignee-consignor relationship, there is no passing of ownsership (goods still belong to consigner, until they are sold to a customer by consignee)
  - DR Inventory, CR Cash/Accounts Payable
- COGS is recorded as an **expense in SCI**

Perpetual Method

- Inventory and COGS are recorded on a continual basis per transaction
- Hence, current inventory and COGS is always known throughout the year

Periodic Method

- Amounts of inventory and COGS only reported at year end, based on physical manual stock-take
- Uses temporary accounts to record the purchases, discounts etc.

	JE from Perpetual Method		
Date	Inventory	1,000	
	AP		1,000

	JE from Periodic Method		
Date	Purchases	1,000	
	AP		1,000

	JE from Perpetual Method		
Date	Inventory	500	
	Cash		500
	Transportation costs		

	JE from Periodic Method		
Date	Freight In	500	
	Cash		500
	Transportation costs		

	JE from Perpetual Method		
Date	Accounts Payable	100	
	Inventory		100
	Purchase Return		

	JE from Perpetual Method		
Date	Accounts Payable	100	
	Purchase Returns		100
	Purchase Return		

	JE from Perpetual Method		
Date	Accounts Payable	900	
	Inventory		50
	Cash		850
	Purchase Discount		

	JE from Perpetual Method		
Date	Accounts Payable	900	
	Purchase Discount		50
	Cash		850
	Purchase Discount		

- On sale, inventory and COGS is not recorded as a journal entry

	JE from Perpetual Method		
Date	Accounts Recvable	2,000	
	Cost of Good Sold	1,000	
	Sales Rev.		2,000
	Inventory		1,000

	JE from Perpetual Method		
Date	Accounts Recvable	2,000	
	Sales Rev.		2,000

- Report inventory and COGS at end of accounting period
  1. Close those temporary accounts to the **inventory** account (= Net Purchases)
  2. Conduct stock take at year end to determine the costs of ending inventory to compute **COGS**
     - COGS = **Inventory (begin)** + **Net Purchase** – **Inventory (end)**

	JE		
Date	Inventory	1,350	
	Purchase Returns	100	
	Purchase DIscounts	50	
	Freight In		500
	Purchases		1,000

	JE		
Date	Cost of Goods Sold	350	
	Inventory		350

Shrinkage

- Cost of ending inventory from year-end stock take differs from that in book balance
- Affects **only perpetual** system. Record shrinkage in **AJE** as a debit to COGS and credit to inventory
- Recorded as an **expense in SCI**, on top of COGS

Ending inventory costing under periodic system

- **Specific Identification**: Actual cost (at time of purchase) is used
- **FIFO**: Goods purchased first are assumed to be sold first
- **LIFO**: Good purchased last are assumed to be sold first; (not allowed)
- **Weighted Average Cost**: Use weighted average cost of all goods available for sale (cost of 1 unit of goods = $\frac{\text{Inventory (begin)} + \text{Net Purchase}}{\text{Total \# goods available for sale}}$)

Inventory Valuation

- Some inventories become damaged/obsolete at end of fiscal year → written down to their net realizable values (NRV) in AJEs **<u>if Cost > NRV</u>**
  - DR: COGS; CR: Allowance for Inventory Write-Down
- Allowance for Inventory Write-Down is a contra-inventor account, **reported in BS**
- Can write down item by item, or by group of similar/related items (e.g. "Running shoes" containing many brands) but cannot write down as a group of classification of inventory (e.g. finished goods)

Inventory Efficiency rations

- **Inventory Turn Over**
  - Measures how efficiently inventory is managed; higher the better
  - Inventory Turnover = $\frac{\text{Cost of Good Sold}}{\text{Average Inventory}}$; Average Inventory = $\frac{\text{Begin + End}}{2}$
- **Number of Days' Sales in Inventory**
  - Measures the average # of days from purchase to sales; shorter the better
  - Number of Days' Sales in Inventory = $\frac{365}{\text{Inventory Turnover}}$

Internal Controls

Control Activities	Cash Controls
Adequate Segregation of Duties; no one staff should perform all of the duties	Segregating duties in handling of cash and recording for cash
Proper Procedure for Authorization	Cash receipts are deposited in banks on dailt basis (prevent accumulation of large amount of cash on hand)
Physical Cotrol over Assers and Records (e.g. cameras, locks)	All payments are made with prenumbered checks (except for small-amount payments). Cash payments can conceal fraud
Adequate Documents and Records (i.e. evidence of transactions)	Prepare monthly bank reconciliation to ensure that cash is properly accounted for
Independent Checks (e.g. external audit, periodic rotations of staff)	