Lecture notes, lectures 1-8

Financial Accounting (Concordia University)

COMM 217 – Theory Notes

Chapter 1 – Financial Statements and Business Decisions

Accounting: A system that collects and processes (analyzes, measures and records) financial information about an organization and reports that information to decision makers.

Financial accounting system: periodic financial statements and related disclosures provide information for internal decision makers.

- *External users:*
  - *Creditors, Investors, Suppliers, Customers*
- *Internal decision makers: Managers*

Statement of Financial Position: Reports the financial position (assets, liabilities, shareholder's equity) of an accounting entity at a point in time.

Provides a basis of judgment to whether the company has sufficient resources available to operate the business.

**Assets = Liabilities + Shareholder's Equity*

Assets:

- *Economic resources controlled by the entity as a result of past business events, and from which future economic benefits can be obtained.*
- *Normally listed in the Statement of Financial Position in order of liquidity*

Categories:

- *Cash*
- *Land*
- *Prepayments*
- *Inventories*
- *Trade receivables (note)*
- *Goodwill*
- *Other assets*

Liabilities:

- *Sourcing of financing for the economic resources (assets) from creditors.*
- *Entity's obligations that result from past business events*

Categories:

- *Short-term borrowings (maturity is less than 1 year)*
- *Long-term borrowings (maturity is more than 1 year)*
- *Provisions*
- *Trade payables (note)*
- *Other liabilities*

Shareholder's Equity:

- *Sourcing of financing for economic resources by the owners of the business, as well as earnings over time.*
    - *Contributed capital: Investment of cash by owners*
    - *Retained earnings: The amount of earning reinvested in the business*
    - *Other components: Reflect the changes in the values of specific assets*

<u>The Statement of Financial Position</u>

Purpose: to report the financial position of an accounting entity at a particular point in time.

- *Important to creditors because assets provide a basis for judging whether the company has sufficient resources available to operate a business.*
- *Assets may be sold for cash if a company goes out of business*
- *Creditors are interested in a company's liabilities because of their concern to know whether the company can pay off its debts*
- *Shareholders Equity: the company's claims for repayment of obligations must be settled*

<u>Statement of Comprehensive Income</u>

Purpose: to report the change in shareholder's equity during a period from business activities, excluding exchanges with shareholders.

- *First part reports the account's primary measure of company's performance*
- *Second part reports other comprehensive income (***not** *recognized in statement of earnings)*
- *Elements: Revenues, Expenses, Net Earnings (net income, or profit)*
- *Important because they reflect the firms ability to sell goods and services more than the cost to produce and deliver them*
- *Investors buy the company's shares when they believe that net earnings will improve and lead to high share price.*

<u>The Statement of Changes in Equity</u>

Purpose: to report all changes in shareholder's equity during the accounting period. This statement reports the way that net earnings, distribution of net earnings, and other changes of equity affected the company's financial position.

Retained earnings: *reflect the net earnings that have been generated since the creation of the company but not distributed yet to shareholders as dividends.*

Ending Retained Earnings = *Beginning retained earnings + net earnings – dividends*

The statement of changes in equity shows how the statement of comprehensive income and the statement of financial position are linked through specific components of shareholder's equity.

- *Creditors closely monitor firms' retained earnings because the firm's policy on dividend payments to its shareholder's affected its ability to repay its debts.*

The Statement of Cash Flows

Purpose: to report cash inflows and outflows that are related to operating, investing and financing activities during the accounting period.
- *Inflows = Receipts*
- *Outflows = Payments*

Elements:
- *Operating activities: generating earnings*
- *Investing activities: cash flows related to the acquiring or sale of company's assets*
- *Financing activities: related to financing of the company itself – either through banks, creditors, or shareholders.*

Statement of cash flows is particularly useful for predicting future cash flows that may be available for payment of debt to creditors and dividends to investors.

Relationship among the 4 financial statements

1. Net earnings from Statement of Earnings results in an increase in ending retained earnings on the Statement of Changes in Equity.
2. Retained earnings from Statement of Changes in Equity is one of the three components to shareholder's equity on the Statement of Financial Position
3. The changes in the cash on the Statement of Cash Flows added to the cash balance at the beginning of the year equals the cash balance at the end of the year, which appears of the Statement of Financial Position.

Chapter 1 – Theory Answers:

a) The purpose of the statement of earnings is to present information about revenues, expenses and the net earnings of the entity for a specifies period of time, in order to help assess its financial performance during the period.

b) The purpose of the statement of financial position is to report the financial position of an entity at a given date, that is, to report about assets, obligations and shareholder's equity of the entity as a specific date.

c) The purpose of the statement of cash flows is to present information about the flow of cash in the entity (sources), the flow of cash out of the entity (uses) and the net increase or decreae in cash during the period.

d) The statement of changes in equity reports the way that net earnings, the distribution of net earnings and other changes in shareholder's equity affects the company's financial position during the accounting period.

2. Net earnings it the excess of total revenues over total expense. Net loss is the excess of total expense over total revenues.

3. The accounting equations for the statements of earnings is

Revenues – Expenses = Net earnings.

4. The accounting equation for the statement of financial position is:

Assets = liabilities + shareholder's equity.

5. The accounting equation for the statement of cash flows is:

Cash flows from operating activities +/- Cash flows from financing activities +/- Cash flows from investing activities.

6. The accounting equation for retained earnings is

Beginning retained earnings + Net earnings – Dividends = Ending retained earnings.

<u>Chapter 2 – Investing and Financing Decisions and the Statement of Financial Position</u>

The primary objective of financial reporting is to provide financial information about a business to help external parties make sound financial decisions.

Qualitative Characteristics

To fulfill primary objectives, there are 2 fundamental qualitative characteristics that are relevance and faithfulness supported by 4 enhancing qualitative characteristics:

- *Comparability*
- *Verifiability*
- *Timeliness*
- *Understandability*

Accounting Assumptions

Separate entity assumption: states that the activities of each business must be accounted for separately from the activities of its owners

Unit-of-Measure: states that accounting information should be measured and reported in the national monetary unit

Continuity: states that businesses are assumed to continue to operate into the foreseeable future.

Basic Accounting Principle

Historical cost: requires assets to be recorded at the historical cash-equivalent cost, which is paid plus the current monetary value of all non-ash considerations given the date of the exchange.

- *Example:*
  - *A company trades an old van for a new van. The value of the new van INCLUDES the value of the old van.*

Elements of the Classified Statement of Financial Position

**Investors analyze a company's statement of financial position to decide whether or not to purchase its shares or lend it money.*
**Another important factor: How easily a company can access cash to pay both debts to creditors and investors*
**Non-current vs. Current = one year*

1. Current assets (short term)
- *Cash*
- *Short-term investments*
- *Trade/other receivables*
- *Inventories*
- *Prepayments*
- *Other current assets*

**Always in order of liquidity*

2. Non-current assets (long term)
- *Property, plant, equipment*
- *Financial assets*
- *Goodwill*
- *Intangible assets*
- *Other non-current assets*

3. Current liabilities
- *Trade/other payables*
- *Short term borrowings*
- *Income taxes payable*
- *Accrued liabilities*

- *Provisions*
- *Other current liabilities*

4. Non-current liabilities

- *Long-term borrowings*
- *Deferred income tax liabilities*
- *Provisions*
- *Other liabilities*

5. Shareholder's Equity

- *Comprised of 3 components*
- *The financing provided to the company by both its owners and operations of the business.*
- ** Difference between shareholder's and creditors is that creditors are entitled to settlement of their legal claims on the corporations asset's before the shareholder's receive a penny, even if this consumer all of the corporations assets.*

a) Contributed capital: results from shareholders providing cash to the business
b) Retained Earnings: the accumulated earnings of a company that are not distributed to the shareholders, but are rather **reinvested in the company.**
c) Other components: ?

<u>Nature of Business Transactions:</u>

- *External events are exchanges of assets, goods, or services by one party for assets, services or promises to pay*
- *Internal events are not exchanges between the business and other parties, but nevertheless have a direct measurable effect of the accounting entity.* ***Discussed in Ch. 4***

Transactions and Accounts

Signing a contract involving the exchange of a promise to perform a future business transaction does not results in a transaction.
As soon as the paper is shipped to the company, the supplier gives up the inventory in exchange for a promise from the company to pay. Because a promise has been exchanged for goods, a transaction has been taken place.

- *Debit means left side of the account*
- *Credit means right side of the account*

Assets:

- *Increase with debit*
- *Decrease with credit*

Liabilities

- *Increase with credit*
- *Decrease with debit*

Shareholder's Equity

- *Increase with credit*
- *Decrease with debit*

Current Ratio =

Chapter 2 – Solutions to Exercises

1.

An asset is an economic resource controlled by an entity as a result of a past transaction or event and from which future economic benefits may be obtained.

4. (a)

The separate-entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.

Chapter 2 – Theory Questions / Solutions

2. *(b) A current asset is an asset that will be used or turned into cash within one year; inventory is always considered a current asset regardless of how long it takes to produce and sell the inventory.*

3. *(c) A liability is a probable debt or obligation of the entity as a result of a past transaction, which will be paid with assets or services.*

4. *(d) A current liability is a liability that will be paid in cash (or other current assets) or satisfied by providing service within the coming year.*

5. *(e) Contributed capital is cash (and sometimes other assets) provided to the business by owners.*

6. *(f) Retained earnings are the cumulative net earnings of a company that are not distributed to the owners and are reinvested in the business.*

2. *(b) The unit-of-measure assumption requires information to be reported in the national monetary unit. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Euros in Germany and Australian dollars in Australia.*

3. *(c) Under the continuity or going-concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.*

4. *(d) The (historical) cost principle requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all non-cash considerations.*

Chapter 3 – Operating Decisions and the Statement of Earnings

The operating cycle: is the time it takes for a company to pay cash to suppliers, sells gods and services to customers and collect cash from customers.
- *Turning cash into more cash, not from borrowing money and selling non-current assets.*

Periodicity Assumptions: means that the long life of a company can be reported into shorter periods.
1. Recognition issue: When should the effects of operating activities be recognized?
2. Measurement issue: What amounts should be recognized?

Statement of Earnings:
Multi-step:
- *Subtotals: earnings from operations, earnings before income taxes.*
- *Helps users asses the company's operating performance to predict its future profitability*
- *Has 3 major sections.*
  1. Results from continuing expenses.
  2. Results of discontinuing expenses.
  Net earnings (the sum of 1 & 2)
  3. Earnings per share.

- *Revenues: Increases in assets of settlements of liabilities from ongoing operations*
- *Expenses: Decreases in assets/ increases in liabilities to generate revenue during the period.*
- *Cost of sales: cost of products sold to customers,*
  - *The difference between sales – net sales discounts, return and allowances – and cost of sales is known as gross profit or gross margin.*
  -
- *Operating expenses: usual expenses, other than cost of sales, that are incurred in operating a business during a specific accounting period.*

Non-operating items:
- *Investment income*

- *Financing costs (*except for financial institutions*)*
- *Gains/losses*

Cash basis accounting: records revenue when cash is received and expenses when cash is paid.

- *Good for small, local merchants*

Accrual basis accounting: records revenue when earned and expenses when incurred, regardless of the timing of cash receipts or payments.

- *Revenue principle:*
    - *The entity has transferred to the buyer the significant risks/rewards of ownership of the goods. (legal titles, passing of possession)*
    - *The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor negative control over the goods sold (If the buyer has the right to rescind the purchase, it is not recognized)*
    - *The amount of revenue can be measured reliably*
    - *It is probable that economic benefits associated with the transaction will flow to the entity. (If the company is considered credit-worthy, then the company will technically be eventually guaranteed income)*
    - *The costs incurred or to be incurred with respect to the transaction can be measured reliably. (When expenses that are associated to the good cannot be measured)*

- *Matching process: Required that expenses be recorded when incurred in earning revenue*
    - *Salaries to employees who worked during the period*
    - *Utilities for the electricity used during the period*
    - *Fruits, plastic contained and other ingredients used to product fruit-based beverages that are sold during the period*
    - *Facilities that are rented during the period*
    - *Use of building and equipment for production purposes during the period.*

Transaction Analysis Rules

- *All accounts either increase/decrease with a debit/credit*
- *All transactions affect at least 2 accounts.*
- *Revenues increase net earnings, retained earnings and shareholder's equity*
    - *Revenues have a credit balance*
    - *Recording revenue results in either increasing an asset, or decreasing a liability*
- *Expenses decrease net earnings, thus decreasing retained earnings and shareholder's equity.*

    - *Expenses have debit balances*
    - *Recording an expense results in either decreasing an asset, or increasing a liability*
- *When revenues exceed expenses, the company reports net earning, increasing retained earnings and shareholder's equity.*
- *When expenses exceed revenues, a loss results that decreases retained earnings, thus shareholder's equity*

Ratios:

Total Asset Turnover Ratio:

Return on Assets:

**Average total assets: (beginning total assets + ending total assets) / 2*

Chapter 3 – Theory Questions/ Solutions

4. *Both revenues and gains are inflows of net assets. However, revenues occur in the normal course of operations, whereas gains occur from transactions peripheral to the central activities of the company. An example is selling land at a price above cost (at a gain) for companies not in the business of selling land.*

   Both expenses and losses are outflows of net assets. However, expenses occur in the normal course of operations, whereas losses occur from transactions peripheral to the central activities of the company. An example is a loss suffered from fire damage.

5. *Accrual accounting requires recording revenues when earned and recording expenses when incurred, regardless of the timing of cash receipts or payments. Cash basis accounting means recording revenues when cash is received and expenses when cash is paid.*

6. *The five criteria that must be met for revenue to be recognized under the accrual basis of accounting are: (1) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods, (2) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold, (3) the amount of revenue can be measured reliably, (4) it is probable that the economic benefits associated with the transaction will flow to the entity and (5) the costs incurred or expected to be incurred in respect of the transaction can be measured reliably.*

7. *The matching process requires that expenses be recorded in the period during which the related revenue is recognized. For example, the cost of inventory sold during a period is recorded in the same period as the sale, not when the goods are produced and held for sale.*

8. *Net earnings is added to retained earnings and is part of shareholders' equity. It is calculated as revenues minus expenses. Because revenue increases net earnings it also increases shareholders' equity. Expenses decrease net earnings and shareholders' equity.*

Chapter 4 – Adjustments, Financial Statements and the Quality of Earnings

The accounting cycle: is the process used by entities to analyze and record transactions, adjust the records at the end of the period, prepare financial statements and prepare the records for the next cycle.

Adjusting entries: are entries necessary at the end of an accounting period to identify and record all revenues and expenses of that period.

- *Revenues are recorded when earned*
- *Expenses are recorded when they are incurred to generate revenue during the same period*
- *Assets are reported at amounts that represent the probable future benefits remaining at the end of the period*
- *Liabilities are reported at amounts that represent the probable future sacrifices of assets or services owed at the end of the period.*

2 Types of Adjustments:

1. *One entry to record the cash receipt or payments during the period.*
2. *One entry to record the revenue/expense in the proper period through an adjusting entry prepared at the end of the period.*

Deferred Revenue: *Previously recorded liabilities that were created when cash was received in advance and that must be reduced to the amount of revenue actually earned during that period.*

- *Liability*
- *Represents a company's promise to perform*
- *When a customer pays for a good/service before the company delivers it.*
- *Liability decreases and revenue increases*

Accrued Revenue: *Previously unrecorded revenues that need to be recorded at the end of the cycle to reflect the amount earned and its related receivable amount.*

- *Company provides services before the customer pays*
- *Cash is owed*
- *Interest receivable, rent receivable*
- *Asset increases and revenue increases*
- *Renting out a space to someone, but the person only pays you once a year, at the end of the cycle or period*

Deferred Expense: *Previously acquired assets, such as prepaid rent, that were created when cash was paid in advance and that must be reduced to the amount of the expense actually incurred during the period through the use of the asset.*

- *Supplies, prepayments, buildings and equipment*
- *Many assets are used over time to generate revenue, such as insurance, buildings and equipment.*
- *Expense increases and asset increases*

Accrued Expense: *Expenses that have been incurred but not yet recorded because cash will be paid after the goods/services are used.*

- *Interest expense on debt, wages expense, utilities expense*
- *Accumulated over time, but not yet recognized until the end of accounting period*
- *Expenses increases and liability decreases*

*** SIDE NOTE ****

Deferred Revenue: Liability (-) Revenue (+)
Accrued Revenue: Assets (+) Revenue (+)
Deferred Expense: Expense (+) Asset (+)
Accrued Expense: Expense (+) Liability (-)

In both revenue accounts, **revenue is increasing** *at some point. The fact you may have received the payment or not dictates whether you still have a liability, (a promise to perform, or that you may still be expecting a payment to be received (such as rent receivable)*

In both expense accounts, **expense is increasing** *at some point. The expense has already occurred at some point during the year. But at the end of the year, you may have paid before the event happened. In this case, you need to adjust what portion of the payment you absorbed. An example of this is a prepayment of an insurance policy that was bought in May, but your year-end is only in December. You used up 8 months of the insurance policy; however, it was paid in full in May. If you have an accrued expense, you haven't made any payments, but the expense already happened. An example would be that you have employees who worked for you throughout the last two weeks before year-end, but you only pay them after year-end. In this case, the* *services of your employees have already been rendered… you just need to pay them. It's a liability because you owe them something. We need to adjust that during the year, whether it be a prepaid insurance, or unpaid wages, an expense occurred and you need to adjust whether you over paid, or didn't pay at all.*

Deferred Revenue is a liability: company's promise to perform because the company already received the payment.

Deferred expense is an asset: The company already made the payment, so it becomes an asset. (I.e. prepayment of insurance)

Both these represent that the payments, or receipt of payments has already been made.

<u>Contra account</u>: directly related to another account, but has a balance of the opposite side.
- *Reduction of the primary account.*
- *Normally noted as XA (for asset)*
- *Account is called "accumulated depreciation" (increases with credit, decreases with debit)*

<u>Carrying amount/net book value:</u> of an asset is the difference between its acquisition cost and accumulated depreciated, its related contra account.

<u>Unadjusted Trial Balance:</u> List of accounts with their balances that provides a check on the equality of all the debits and credits.
- *A schedule prepared for internal purposes and is not considered to be a financial statement*

Ratios:

Net profit margin ratio:

Measures how much profit is earned as a percentage of revenues generated during the period. A rising net profit margin ratio signal more efficient management of sales and expenses.

Return on equity:

**Average shareholder's equity: (beginning shareholder's equity + ending shareholder's equity) / 2*

ROE measures how much the firm earned as a percentage of shareholder's investment. In the long run, firms with higher ROE are expected to have higher share prices than *firms with lower ROE. Ratio is used to assess the effectiveness of the company's overall business strategy.*

Permanent Accounts: Statement of Financial Position accounts whose ending balances are carried into the next accounting period

Temporary Accounts: Statement of Earnings accounts that are closed to retained earnings at the end of the account period.

Income Summary: Temporary account only used during the closing process to facilitate closing temporary accounts.

Chapter 4 – Suggested Questions / Solutions

3. Adjusting entries are made at the end of the accounting period to record appropriate amounts of revenue, expenses, assets, liabilities and shareholders' equity.

The four different types are adjustments for:

1. *a) Deferred expenses – previously recorded assets that need to be adjusted at the end of the period to reflect expenses that have been incurred or used up during the period (e.g., prepaid insurance must be adjusted for the portion of insurance expense incurred in the current period).*

2. *b) Deferred revenues – previously recorded liabilities that need to be adjusted at the end of the period to reflect revenues that have been earned during the period (e.g., deferred revenue must be adjusted for the portion of revenues earned in the current period).*

3. *c) Accrued revenues – revenues that have been earned by the end of the accounting period but which will be collected in a future accounting period (e.g., recording interest receivable for interest earned but not yet collected).*

4. *d) Accrued expenses – expenses that have been incurred by the end of the accounting period but which will be paid in a future accounting period (e.g., recording an expense and a corresponding accrued liability for utilities used during the period but not yet paid).*

7. The net earnings on the statement of earnings is added to the opening balance in the statement of retained earnings. The deduction of dividends declared during the period leads to the ending balance of retained earnings which is reported on the statement of financial position. The change in the cash account on the statement of financial position is analyzed and categorized on the statement of cash flows into cash from (or used in) operating activities, investing activities, or financing activities.

12. Netearningsistheresultofsubtractingallaccruedexpensesfromallaccruedrevenue. Accrual means that an enforceable obligation exists for customers to pay for a service or product that has been provided. Therefore, the seller can recognize the dollar value of the sale even though cash has not been received. Similarly an enforceable obligation exists for the seller to pay for resources purchased even though the cash has not yet been paid out. Accruals are subject to specific time periods wherein they must be recognized. Cash flow from operations reports only the cash received and paid by a company during a specified time period in relation to its regular operations.

Chapter 7 – Reporting and Interpreting Sales Revenue, Receivables and Cash

Accounting for sales revenue – Criteria

1. *The entity has transferred to the buyer the significant risks and rewards of the goods*
2. *The entity retains neither continuing managerial involvement to the degree usually associated with the ownership nor effective control of the goods sold*
3. *The amount of revenue can be measured reliably*
4. *It is probable that the economic benefit with the transaction will flow to the entity*
5. *The costs incurred or to be incurred with respect to the transaction can be measured reliably*

For the sellers: these criteria are most often met and sales revenue is recorded when the title and risks of ownership are passed to the buyer

Revenues from goods sold FOB shipping point are normally recognized at shipment
Revenues from goods sold FOB destination point are normally recognized at delivery

Sales Discounts to Business

Sales Revenue – Discounts = Net Sales

2 types of discounts, both entice consumer to pay earlier

Credit card discount: fee charged by credit card company
Cash (sales) discounts: used to prompt a payment from a trade receivables account

Example: 2/10, n/30
2 → percentage (2%)
10 → number of days

n → Net
30 → Maximum credit period

Sales return and allowances: a reduction of gross sales revenue for return of or allowances for unsatisfactory goods

Ratios:

Gross profit percentage *(GPP) =*

The gross profit percentage measures how much gross profit is generated from every sales dollar. It reflects the ability to charge premium prices and produce goods and service at a low cost.

- *Low cost strategy: rely on more efficient management of production to reduce costs and increase GPP*
- *Used to assess the effectiveness of a company's product development*

Trade Receivable: Pending income from a good sold
Note Receivable: Pending income from an investment

Write offs and Recording Bad Debt Expense

The allowance method: bases bad debt expense on an estimate of uncollectable amounts
1. Estimating or recording bad debts expense
2. Writing off specific amounts to be uncollectable during the period

<u>DURING THE ACCOUNTING PERIOD:</u>

*We "write-off" certain amounts that we assume we cannot collect. If a company went bankrupt, and can't pay off their debt, we take the amount out of the T/R account, and put it in account called Allowance for Doubtful Accounts**

If company ABC is going to write off $10, then they would record this during the year:

Allowance for doubtful accounts……………………………...10
Trade Receivables……………………………...10

If a company suddenly can pay half its debt, we must reverse the transaction above, and then record the payment received by the client. This is a two-step process because *during the year, we already established that the company probably can't pay. When they suddenly give us the money owed, we must put it back where it came from, (back into the T/R account) and then recognized the payment as if nothing ever happened.*

Trade receivables…………………..5
Allowance for doubtful accounts……………5

Cash……………………………………5
Trade Receivables………………………………5

END OF THE ACCOUNTING PERIOD:

Bad Debt Expense: *The account associated to the estimated uncollectable amounts.*

If company ABC assumed that $5 is deemed uncollected at the end of the account period,

Bad debt expense (E +, SE -)…………………………5
Allowance for doubtful accounts (XA +, A -_…………………………5
**Allowance for doubtful accounts (AFDA) is a contra-asset account. We are removing the amount from the trade receivables accounts because we assume that we won't be able to collect this amount. We are then adding it to AFDA; in return, the asset account decreases because they work against each other. Also, the fact that we cannot redeem this money increases our expense account.*

Company ABC already has an AFDA account with a balance of $31,000. Ending balance is 40,000. They wrote off $2,000 during the year 2014.
Journal Entries to record:
a) The company wrote off 32,000 as uncollectable
b) The company collected 8,000 from the previously written off amount

Ex: T-Account for:
Allowance for Doubtful Accounts

	$31,000
32,000	

	8,000
	The difference between the ending balance, transactions, and beginning balance is the **Bad debt expense**

Ending balance: $40,000

1) DO NOT record the write off of $2,000!! If the question is giving you the ending balance, then the write-off is included in that.

2) Record the Journal Entries:

a) AFDA……………………….32,000
Trade Receivables……32,000

b) Trade Receivables..……8,000
AFDA………………………8,000

Cash………………..………..8,000
Trade Receivables.……8,000

31,000 + 32,000 – 8,000 + Bad debt expense = 40,0000

Bad debt expense = $33,000 because….

Bad debt expense (E+, SE -)…………33,000
AFDA (XA +, A -)……………………………..33,000

Ratios:

Receivable turnover ratio:

**Net credit sales is anything purchase on account*

This ratio tells us how many times a company turned over their receivables. The higher this number, the more times they've received payments

This ratio is needed to calculate the:

Average Collection Period:

This ratio reflects how many days, on average, it takes for the company to receive payments. If the company has a term n/30, and their average collection period is 43, then the company must alter its techniques in order to receive payments quicker. They may offer incentives, like sales discounts etc. …

<u>Reconciliation and Bank Statements</u>

Bank statement: month report from a bank that shows deposits, cheques and other debits and credits.

Bank reconciliation: the process of verifying the accuracy of both the bank statement and the cash accounts of a business

The most common causes of difference are bank service charges, NSF cheques, and interest earned or incurred, deposits in transit, outstanding cheques and erros.

<u>Chapter 8 – Reporting and Interpreting Cost of Sales and Inventory</u>

Cost of sales – directly related to sales revenue
- *The amount of units sold x their unit cost*

Equation:
Beginning Inventory + Purchases – Ending Inventory = Cost of Sales
**Sales – COS = gross profit*

<u>Perpetual:</u>
- *Detailed inventory*
- *Maintained throughout the year, recording each transaction*
- *Merchandise purchased from supplier:*

Inventory xxx
Trades payable xxx

- *Merchandise returned is just the opposite*

<u>Periodic</u>
- *Ending inventory, C.O.S. are determined at the end <u>only</u>*

Merchandise purchase from supplier:

Purchases *xxx*
Trades payable *xxx*

Merchandise returned*:*

Trades payable *xxx*
Purchases returns/allowance *xxx*

First in, first out (FIFO): *Assumes the oldest units (first ones in) are the firs the be sold (first ones out)* ******think of milk**

In a Perpetual system…you must continuously update the inventory system calculating the cost of sales for each sales transaction.

In a Periodic system…the only difference is the cost of sales is computed at the end. When using FIFO, the order of costs in and out of inventory is identical to both.
**Note that the cost of goods sold does not change when using either of these systems.*
Weighted-Average Cost Method: *uses the weighted-average unit cost of the goods available for sale for both cost of sales and ending inventory*

In a Perpetual system…the inventory is kept up to date after every transaction. Creating a table is most useful for this

In a Periodic system…the cost of sales is computed at the end. The cost of sales is always slightly higher because in this system, the weighted-average cost includes the average cost per unit of all units available during the accounting period.

**Note than in a perpetual inventory system, the COGS is always closer to the FIFO cost because the moving average cost is increased with each new purchased good.*

If a company wants highest pre-tax earnings, then they should opt for high profit and low costs. FIFO would be used for lowest cost of sales.

If a company wants a more favourable tax flow, then they would opt for lower pre-tax earnings. In this case, they would need high cost, and low profit. They would use the weighed-average cost method in a periodic system because the cost of goods sold is *considered for every transaction. The cost of producing the good is incurred in the selling price.*

<u>Net realizable value:</u> The expected sales price less estimated selling costs

Ratios:

Inventory turnover ratio:

**Average inventory: beginning + end / 2*

The ratio tells use how many times the average inventory was produced and sold during the period. A high ratio indicated that the inventory moves quickly. Low ratio indicates that the inventory has been sitting there for a while – and may be an indication of obsolescence.

Average days to sell inventory:
Indicates the average time it takes the company to produce and delivery inventory