Asset Valuation

Accounting Cycle Part 1

- Accounting is the language of business.
- Accounting seeks to communicate business information.
- Parties interested in business information:
  - — Investors
  - — Creditors
- General purpose financial statements provide information to investors and creditors.
- Two required general purpose financial statements are the
  - — Balance Sheet
  - — Income Statement
- Balance Sheet:

A = L + OE

Asset Valuation

(Dollar Amount of the Assets on the Balance Sheet)

Objective vs. Subjective Approaches
GAAP requires an objective approach.

Historical Cost Principle: Assets will be valued at the price paid upon acquisition.

A real estate developer purchases land for **$500,000** cash in the year **20X1**, and unsuccessfully tries to rezone it for commercial development. A year later the city council agrees to the rezoning and an appraisal at **12/31/X2** values the land at **$900,000**.

At what amount should this land be valued on the developer's **12/31/X2** balance sheet?

Balance Sheet Assets = Historical Cost = $500,000

Historical cost of an asset in an arms-length purchase = **Fair Market Value (FMV) at the time of purchase**

Historical Cost Principle: Assets will be valued at the price paid upon acquisition or the fair market value of the asset at the time of its acquisition or receipt.

Exception to Historical Cost Principle: In the event that an asset purchase was not an arm's-length transaction, then the asset will be valued at its Fair Market Value (FMV), conservatively determined at the date of purchase.

Asset Valuation

Attitude of Conservatism.

Another exception to Historical Cost Principle: If there is credible evidence that an asset's fair market value is below its historical cost, that cost will usually be reduced to reflect the lower fair market value.

Additional principles/concepts to consider:

1. **Monetary Measurement Principle**
2. **Entity Concept**

An Accounting System

A company's accounting system is the means whereby all of a company's transactions and their effect on the company's financial position (**A = L + OE**) are identified, recorded and summarized so as to periodically produce the general purpose financial statements required under GAAP.

The First Three Steps in an Accounting System designed to produce financial statements

1. Identify each business transaction.
2. Analyze each transaction to determine its effect on the financial position of the business (**A = L + OE**).
3. Record the transactions and their effect on the financial position in a journal (computerized or hard copy record).

For every transaction

A = L + OE

and

DR = CR

A	=	L	+	OE
Cash	=	Notes Payable	+	Capital Stock
DR / CR		DR / CR		DR / CR
100 /		/		/ 100
200 /		/ 200		/
+ / –		– / +		– / +

In understanding the process of recording transactions, we need to introduce some new language and terminology.

CASH

Left Side	**Right Side**
Increases	Decreases
300	200
Balance 100	
Debit (DR)	Credit (CR)

True or False? FALSE

Debit means increase.

True or False? TRUE

Debit means increase in assets.

How do you remember the effect of Debits and Credits on the various kinds of accounts?

1. Memorize:

	DR	CR
Assets	+	-
Liabilities	-	+
Owners' Equity	-	+
Capital Stock	-	+
Retained Earnings	-	+
Revenues	-	+
Expenses	+	-
Dividends	+	-

2. Equation Approach:

A = L + OE

OE: Capital Stock + Retained Earnings

Retained Earnings: Net Income - Dividends

+ Dividends ~~Dividends~~

Net Income: Revenues - Expenses

+ Expenses ~~Expenses~~

Assets Expenses Dividends	=	Liabilities Capital Stock	Retained Earnings Revenues

DR	CR
+	-

DR	CR
-	+

Journal Entries

The Standard Form of Manually Prepared Journal Entries

	DR	CR
Account Name	XXX	
Account Name		XXX

Examples:

A. 1. Identified transaction - $100 of cash contributed by owners to the company for stock.

2. Analyze effect on:

A = L + OE

↑ Cash ↑ Capital Stock

3. Record through journal entry:

Cash	100	
Capital Stock		100

B. 1. Identified transaction: $200 of cash borrowed from Dad.

2. Analyze effect on:

A = L + OE

↑ Cash ↑ Note Payable

3. Record through journal entry:

	DR	CR
Cash	200	
Note Payable		200

C. 1. Identified transaction: $225 of inventory purchased for cash.

2. Analyze effect on:

A = L + OE

↑ Inventory (candy)
↓ Cash

3. Record through journal entry:

	DR	CR
Inventory	225	
Cash		225

D. 1. Identified transaction: Inventory which cost $225 is sold to a customer for $275 of cash.

2. Analyze effect on:

A = L + OE

↑ Cash (275) ↑ Revenues (275)
↓ Inventory (225) ↓ Expenses (225)

3. Record through journal entry:

Cash	275	
Sales Revenues		275
Cost of Goods Sold (expense)	225	
Inventory		225

Common mistake for this transaction:

Cash	275	
Profit or Net Income or		50
Ret. Earn or Revenue		
Inventory		225

E. 1. Identified transaction- $10 of cash dividend paid to owner.

2. Analyze effect on:

A = L + OE

↓ Cash ↓ Dividends

3. Record through journal entry:

Dividends	10	
Cash		10

Cash

+ Debit	- Credit

Why does my bank statement show debits as decreases and credits as increases in my cash account? This is opposite from what I am learning and doing here.

If a student opens a checking account at the local bank by depositing $1,000 at the bank, the bank will account for this transaction as follows:

Bank's perspective

A = L + OE

Cash		Payable to Depositor	
1,000			1,000

Journal Entries

If the student writes a **$200** check on their account to Wal-mart, when the check is honored by the bank sending **$200** to Wal-mart, then the bank's accounting will be:

A = L + OE

Cash		Payable to Depositor	
1,000			1,000
	200	200	
800			800

If the student then wished to close their account, the bank would be obligated to pay them **$800**.

The bank statement sent to depositors is in fact a representation of the bank's *liability account* to the depositor.

Some additional transactions:

F. 1. Identified transaction: Inventory costing $250 is purchased on account.

2. Analyze effect on:

A = L + OE

↑ Inventory ↑ Accounts Payable

3. Record through journal entry:

Inventory	250	
Accounts Payable		250

G. 1. Identified transaction: Inventory costing $75 is sold on account to a customer for $100.

2. Analyze effect on:

A = L + OE

↑ Accounts Receivable (100) ↑ Revenues (100)

↓ Inventory (75) ↓ Expenses (75)

3. Record through journal entry:

Accounts Receivable	100	
Sales Revenues		100
Cost of Goods Sold (expense)	75	
Inventory		75

H. 1. Identified transaction: $100 cash collection of customer account receivable.

2. Analyze effect on:

A = L + OE

↑ Cash

↓ Accounts Receivable

3. Record through journal entry:

Cash	100	
Accounts Receivable		100

I. 1. Identified transaction: $250 cash payment of accounts payable.

2. Analyze effect on:

A = L + OE

↓ Cash ↓ Accounts Payable

3. Record through journal entry:

Accounts Payable	250	
Cash		250

J. 1. Identified transaction: $20 dollars of cash is paid for last month's rent.

2. Analyze effect on:

A = L + OE

↓ Cash ↓ Rent Payable ↓ Rent Expense

Is the payment of a bill or an obligation for rent, utilities, salaries or other costs of doing business accounted for as payment of a liability or payment of an expense?

It Depends!

Journal Entries

Example: Stephen receives a bill from Dad for $20 of rent for the month of June on June 30th. The bill is not payable until July 10th.

Conventional Approach:

Entry on June 30th:

A	=	L	+	OE
No Cash Involved		↑Rent Payable		↓Rent Expense
0		20		(20)

Entry on July 10th:

A	=	L	+	OE
↓ Cash		↓ Rent Payable		
(20)		(20)		

	A	=	L	+	OE
Net effect:	↓ Cash				↓ Rent Expense
	(20)		0		(20)

Lazy Man's Approach:

Entry on June 30th: **None**

Entry on July 10th:

A	=	L	+	OE
↓ Cash				↓ Rent Expense
(20)				(20)

Cash	Rent Expense
- 20	-20

J. 1. Identified transaction: $20 dollars of cash is paid on June 30th for June's rent that had not been previously recorded.

2. Analyze effect on:

A	=	L	+	OE
↓ Cash				↓ Rent Expense

3. Record through journal entry

Rent Expense	20	
Cash		20

Problem: Preparing Journal Entries

Prepare general journal entries to record the following transactions for the month of January, 20X1 for XYZ Corporation:

a. Owners contributed $10,000 cash to the company in exchange for 1,000 shares of stock in the company.
b. Inventory costing $25,000 was purchased on account from suppliers/vendors.
c. A cash payment of $1,250 was paid to Provo Power as payment of a utility bill for the month of December, 20X0. Assume this utility bill was previously recorded as a liability for last December.
d. Equipment was purchased for $70,000, paying $15,000 in cash and executing a note requiring the payment of $55,000 principal in two years plus interest.
e. Sold inventory costing $30,000 to customers on account for a price of $55,000.
f. Paid salaries and wages not previously recorded to employees for the month of January amounting to $7,000.
g. Collected $37,000 of cash from customer accounts receivable.

Problem: Preparing Journal Entries

Prepare general journal entries to record the following transactions for the month of January, 20X1 for XYZ Corporation:

h. Paid accounts payable of $22,000.
i. Sold inventory costing $7,000 to cash paying customers for $12,000.
j. Purchased $1,000 of office supplies with cash.
k. Paid previously unrecorded telephone bill of $1,000 for January.
l. Received January's rent of $2,000 from a tenant leasing office space in the company's building.
m. Received $1,000 of interest for the month of January on a note receivable.
n. Paid the previous year's income taxes amounting to $5,000. Assume these taxes had been previously recorded as a liability in the prior year.
o. Paid previously unrecorded January advertising costs amounting to $3,000.
p. Paid cash dividends to stockholders amounting to $4,000.

Answer: Preparing Journal Entries

a.	Cash	10,000	
	Capital Stock		10,000
b.	Inventory	25,000	
	Accounts Payable		25,000
c.	Utilities Payable	1,250	
	Cash		1,250
d.	Equipment	70,000	
	Cash		15,000
	Note Payable		55,000
e.	Accounts Receivable	55,000	
	Sales Revenue		55,000
	Cost of Goods Sold	30,000	
	Inventory		30,000

Answer: Preparing Journal Entries

f.	Salary & Wage Expense	7,000	
	Cash		7,000
g.	Cash	37,000	
	Accounts Receivable		37,000
h.	Accounts Payable	22,000	
	Cash		22,000
i.	Cash	12,000	
	Sales Revenue		12,000
	Cost of Goods Sold	7,000	
	Inventory		7,000
j.	Office Supplies	1,000	
	Cash		1,000

Answer: Preparing Journal Entries

k.	Telephone Expense	1,000	
	Cash		1,000
l.	Cash	2,000	
	Rent Revenue		2,000
m.	Cash	1,000	
	Interest Revenue		1,000
n.	Income Tax Payable	5,000	
	Cash		5,000
o.	Advertising Expense	3,000	
	Cash		3,000
p.	Dividends	4,000	
	Cash		4,000

Posting to General Ledger

The First Four Steps in an Accounting System Designed to Produce Financial Statements

1. Identify each business transaction.
2. Analyze each transaction to determine its effect on the financial position of the business.
3. Record the transactions and their effect on the financial position in the journal (computerized or hard copy record).
4. Summarize the effect of all transactions on each account by ***posting*** the journal entries to the ***general ledger***.

What is a general ledger?

A company's general ledger is a file in the memory of a computerized accounting system or a book of accounts in a manual system that has a separate record for each kind of asset, liability or owners' equity including each kind of revenue, expense and dividend. Each of these records is commonly referred to as an ***account***. Each account in the general ledger is intended to accumulate the increases and decreases recorded in the journal producing a periodic summarizing balance for the account.

General Journal

Date	Account	Debit	Credit
6/1	Cash	100✓	
	Capital Stock		100
6/1	Cash	200✓	
	Note Payable		200
6/1	Inventory	225✓	
	Cash		225✓
6/1	Cash	275✓	
	Sales Revenues		275
	Cost of Goods Sold	225	
	Inventory		225✓
6/1	Dividends	10	
	Cash		10✓
6/2	Inventory	250✓	
	Accounts Payable		250
6/2	Accounts Receivable	100	
	Sales Revenues		100
	Cost of Goods Sold	75	
	Inventory		75✓
6/2	Cash	100✓	
	Accounts Receivable		100
6/2	Accounts Payable	250	
	Cash		250✓
6/2	Rent Expense	20	
	Cash		20✓

General Ledger:

Cash

Beg. Balance	0	
	100	225
	200	10
	275	250
	100	20
End. Balance	170	

Inventory

Beg. Balance	0	
	225	225
	250	75
End. Balance	175	

Problem: Posting to a General Ledger

Given the following account balances for XYZ Corporation at the start of the year, January 1, 20X1:

Prepare a general ledger T-account for each account noting the beginning balance and post all transactions from the preceding problem to the proper accounts to determine the 1/31/X1 balance for each account.

Balances at 1/1/X1:	DR	CR
Cash	30,200	
Accounts Receivable	27,550	
Inventory	41,500	
Office Supplies	1,000	
Equipment	350,000	
Notes Receivable	120,000	
Accounts Payable		22,000
Utilities Payable		1,250
Income Taxes Payable		5,000
Notes Payable		332,000
Capital Stock (9,000 shares)		90,000
Retained Earnings		120,000
Dividends	0	
Sales Revenue		0
Rent Revenue		0
Interest Revenue		0
Cost of Goods Sold	0	
Utilities Expense	0	
Telephone Expense	0	
Salary and Wage Expense	0	
Advertising Expense	0	
Income Tax Expense	0	
Totals:	570,250	570,250

Answer: Posting to a General Ledger

Cash

1/1/X1	30,200		
a.	10,000	1,250	c.
g.	37,000	15,000	d.
i.	12,000	7,000	f.
l.	2,000	22,000	h.
m.	1,000	1,000	j.
		1,000	k.
		5,000	n.
		3,000	o.
		4,000	p.
1/31/X1	32,950		

Accounts Receivable

1/1/X1	27,550		
e.	55,000	37,000	g.
1/31/X1	45,550		

Inventory

1/1/X1	41,500		
b.	25,000	30,000	e.
		7,000	i.
1/31/X1	29,500		

Answer: Posting to a General Ledger

Office Supplies

1/1/X1	1,000	
j.	1,000	
1/31/X1	2,000	

Equipment

1/1/X1	350,000	
d.	70,000	
1/31/X1	420,000	

Notes Receivable

1/1/X1	120,000	
1/31/X1	120,000	

Accounts Payable

		22,000	1/1/X1
h.	22,000	25,000	b.
		25,000	1/31/X1

Posting to General Ledger

Answer: Posting to a General Ledger

Utilities Payable

Debit	Credit
	1,250 1/1/X1
c. 1,250	
	0 1/31/X1

Income Taxes Payable

Debit	Credit
	5,000 1/1/X1
n. 5,000	
	0 1/31/X1

Notes Payable

Debit	Credit
	332,000 1/1/X1
	55,000 d.
	387,000 1/31/X1

Capital Stock

Debit	Credit
	90,000 1/1/X1
	10,000 a.
	100,000 1/31/X1

Answer: Posting to a General Ledger

Retained Earnings

Debit	Credit
	120,000 1/1/X1
	120,000 1/31/X1

Dividends

Debit	Credit
1/1/X1 0	
p. 4,000	
1/31/X1 4,000	

Sales Revenue

Debit	Credit
	0 1/1/X1
	55,000 e.
	12,000 i.
	67,000 1/31/X1

Rent Revenue

Debit	Credit
	0 1/1/X1
	2,000 l.
	2,000 1/31/X1

Answer: Posting to a General Ledger

Interest Revenue

Debit	Credit
	0 1/1/X1
	1,000 m.
	1,000 1/31/X1

Cost fo Goods Sold

Debit	Credit
1/1/X1 0	
e. 30,000	
i. 7,000	
1/31/X1 37,000	

Utilities Expense

Debit	Credit
1/1/X1 0	
1/31/X1 0	

Telephone Expense

Debit	Credit
1/1/X1 0	
k. 1,000	
1/31/X1 1,000	

Answer: Posting to a General Ledger

Salary & Wage Expense

Debit	Credit
1/1/X1 0	
f. 7,000	
1/31/X1 7,000	

Advertising Expense

Debit	Credit
1/1/X1 0	
o. 3,000	
1/31/X1 3,000	

Income Tax Expense

Debit	Credit
1/1/X1 0	
1/31/X1 0	

The Steps of the Accounting System
Designed to Produce Financial Statements

1. Identify each business transaction.
2. Analyze each transaction to determine its effect on the financial position of the business (A=L+OE).
3. Record the transactions and their effect on financial position in a journal (computerized or hard copy record).
4. Summarize the effect of all transactions on each account by *posting* the journal entries to the *general ledger*.
5. Prepare a trial balance.

What is a trial balvance?

A listing of all assets, liabilities, owners' equity (capital stock, retained earnings, revenues, expenses and dividends) noting their ending general ledger balances.

Stephen's Sweet Shop - Trial Balance

	Debit	Credit
Cash	170	
Inventory	175	
Accounts Receivable	0	
Accounts Payable		0
Capital Stock		100
Note Payable		200
Retained Earnings		0
Dividends	10	
Sales Revenues		375
Cost of Goods Sold	300	
Rent Expense	20	
	675	675

Posting to General Ledger

For every transaction:

DR = CR

This is a self-checking device.

Inventory	200	
Accounts Payable		200

The Steps of the Accounting System

Designed to Produce Financial Statements

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Stephen's Sweet Shop - Trial Balance

	Debit	Credit
Cash	170	
Inventory	175	
Accounts Receivable	0	
Accounts Payable		0
Capital Stock		100
Note Payable		200
Retained Earnings		0
Dividends	10	
Sales Revenues		375
Cost of Goods Sold	300	
Rent Expense	20	
	675	675

For every transaction:

DR = CR

This is a self-checking device.

Inventory	200	
Accounts Payable		200

Computerized accounting systems are programmed to reject any transactions that do not have equal debit and credit amounts.

Problem: Preparing a Trial Balance

Prepare an income statement and statement of retained earnings for the month of ending 1/31/X1 along with a balance sheet of 1/31/X1 for XYZ Corporation. Use the data from the trial balance produced in the preceding problem, "Preparing a Trial Balance."

(Hint: the retained earnings amount for the balance sheet at 1/31/X1 will be the ending balance reflected on the statement of retained earnings.)

(See trial balance on the next slide)

Answer: Preparing a Trial Balance

Trial Balance at 1/31/X1	DR	CR
Cash	32,950	
Accounts Receivable	45,550	
Inventory	29,500	
Office Supplies	2,000	
Equipment	420,000	
Notes Receivable	120,000	
Accounts Payable		25,000
Utilities Payable		0
Income Taxes Payable		0
Notes Payable		387,000
Capital Stock		100,000
Retained Earnings		120,000
Dividends	4,000	
Sales Revenue		67,000
Rent Revenue		2,000
Interest Revenue		1,000
Cost of Goods Sold	37,000	
Utilities Expense	0	
Telephone Expense	1,000	
Salary & Wage Expense	7,000	
Advertising Expense	3,000	
Income Tax Expense	0	
Totals	702,000	702,000

Preparing Financial Statements from the Trial Balance

The Financial Statements can be prepared from the Trial Balance.

	Debit	Credit
Cash	170	
Inventory	175	
Accounts Receivable	0	
Accounts Payable		0
Capital Stock		100
Note Payable		200
Retained Earnings		0
Dividends	10	
Sales Revenues		375
Cost of Goods Sold	300	
Rent Expense	20	
	675	675

Stephen's Sweet Shop
Income Statement
for the month of June, 20X1

Revenues:	
Sales Revenues	$ 375
Less: Expenses	
Cost of Goods Sold	300
Rent Expense	20
Net Income	$ 55

Stephen's Sweet Shop
Statement of Retained Earnings
for the month of June, 20X1

Retained Earnings, Beginning Balance	$ 0
Add: Net Income	55
Less: Dividends	(10)
Retained Earnings, Ending Balance	$ 45

Stephen's Sweet Shop
Balance Sheet
As of June 30, 20X1

Assets:	
Cash	$ 170
Inventory	175
Total Assets	$ 345
Liabilities and Owner's Equity:	
Liabilities:	
Note Payable	$ 200
Owner's Equity:	
Capital Stock	100
Retained Earnings	45
Total Liabilities and Owners Equity	$ 345

Problem: Preparing Financial Statements

Prepare an income statement and statement of retained earnings for the month ending **1/31/X1** along with a balance sheet as of **1/31/X1** for XYZ Corporation. Use the data from the trial balance produced in the preceding problem #11. (Hint: The retained earnings amount for the balance sheet at **1/31/X1** will be the ending balance reflected on the statement of retained earnings.)

(See trial balance on the next page.)

Problem: Preparing Financial Statements

Trial Balance at 1/31/X1

	DR	CR
Cash	32,950	
Accounts Receivable	45,550	
Inventory	29,500	
Office Supplies	2,000	
Equipment	420,000	
Notes Receivable	120,000	
Accounts Payable		25,000
Utilities Payable		0
Income Taxes Payable		0
Notes Payable		387,000
Capital Stock		100,000
Retained Earnings		120,000
Dividends	4,000	
Sales Revenue		67,000
Rent Revenue		2,000
Interest Revenue		1,000
Cost of Goods Sold	37,000	
Utilities Expense	0	
Telephone Expense	1,000	
Salary & Wage Expense	7,000	
Advertising Expense	3,000	
Income Tax Expense	0	
Totals	702,000	702,000

Preparing Financial Statements from the Trial Balance

Answer: Preparing Financial Statements

XYZ Corporation
Income Statement
for the month ending 1/31/X1

Revenues:		
Sales Revenue	$67,000	
Rent Revenue	2,000	
Interest Revenue	1,000	
Total Revenues	70,000	
Less Expenses:		
Cost of Goods Sold	37,000	
Telephone Expense	1,000	
Salary & Wage Expense	7,000	
Advertising Expense	3,000	
Total Expenses	48,000	
Net Income	$22,000	
Earnings per share	$2.20	
($22,000 ÷ 10,000 shares)		

Answer: Preparing Financial Statements

XYZ Corporation
Statement of Retained Earnings
for the month ending 1/31/X1

Retained Earnings, 1/1/X1	$120,000
Add: Net Income	22,000
Less: Dividends	(4,000)
Retained Earnings, 1/31/X1	$138,000

Answer: Preparing Financial Statements

XYZ Corporation
Balance Sheet
as of 1/31/X1

Assets:		Liabilities and Stockholders' Equity:	
Current Assets:		Current Liabilities:	
Cash	$32,950	Accounts Payable	$25,000
Accounts Receivable	45,550	Long Term Liabilities:	
Inventory	29,500	Notes Payable	387,000
Office Supplies	2,000		412,000
	110,000	Stockholders' Equity:	
Long Term Assets:		Capital Stock	100,000
Equipment	420,000	Retained Earnings	138,000
Notes Receivable	120,000		238,000
	540,000	Total Liabilities and Stockholders' Equity	$650,000
Total Assets	$650,000		