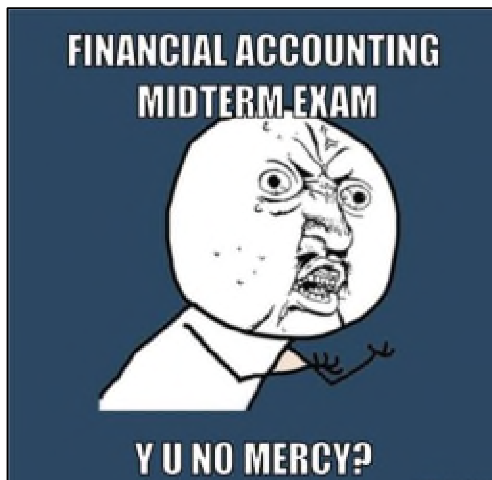
COMM 293 Review Session Answer Key

By Richard Wong, BCom '14

Wednesday, October 14, 2015
6:30 pm – 8:30 pm



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========== BREAK ==========

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I. INTRODUCTION

Richard Wong, Sauder BCom '14
Accounting and Human Resources

- Past Teaching Assistant – COMM 293

- Past President, UBC Accounting Club / UBC TACS

- Currently pursuing my CPA designation as a Senior Associate with PwC Tax!

- Just wrote the CFE!

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II. FINANCIAL STATEMENTS

The two most fundamental equations of financial accounting:

Assets = Liabilities + Shareholders' Equity

Debits = Credits

Assets

- Resource controlled by an entity.
- Result of past events.
- Has future benefits / value.

Examples: Cash, Accounts Receivable, Equipment

Liabilities

- Present obligation of the company.
- Result of past events.
- Settlement involves an outflow of resources.

Examples: Accounts Payable, Bond Payable, Notes Payable

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Shareholders' Equity

- Difference between total assets and total liabilities.

Examples: Pref. Shares, Common Shares, Retained Earnings

Summary

When You..	Total Assets	When You..	Total Liab.
DR an Asset	↑	DR a Liab.	↓
CR an Asset	↓	CR a Liab.	↑

Question #1. Is it an asset, liability, or shareholders' equity account?

Cash	(Asset)	Liability	Shareholders' Equity
Common Shares	Asset	Liability	(Shareholders' Equity)
Retained Earnings	Asset	Liability	(Shareholders' Equity)
Prepaid Expenses	(Asset)	Liability	Shareholders' Equity
Income Tax Payable	Asset	(Liability)	Shareholders' Equity
Goodwill	(Asset)	Liability	Shareholders' Equity
Advertising Expenses	Asset	Liability	Shareholders' Equity

None. It is an expense. It affects retained earnings, but is not a direct shareholders' equity account.

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Types of Financial Statements

1. Balance Sheet (Statement of Financial Position)

- Assets = Liabilities + Shareholders' Equity

Bread Pitt
Balance Sheet
as at December 31, 2015

Assets	**Liabilities**
Cash	Accounts Payable
Building	Bonds Payable
Equipment	**Shareholders' Equity**
Inventory	Common Shares
	Retained Earnings
Total Assets	**Total Liabilities and Shareholders' Equity**

2. Income Statement (Statement of Comprehensive Income)

- Revenues - Expenses = Net Income

Bread Pitt
Income Statement
For the year ended December 31, 2015

Revenues
Sales Revenue
Total Revenue

Expenses
Cost of Goods Sold
Rent Expense
Supplies Expense
Total Expenses

Net income

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3. Statement of Retained Earnings

- Beginning R/E + Net Income - Dividends = Ending R/E

Bread Pitt
Statement of Retained Earnings
as at December 31, 2015

Beginning Retained Earnings, January 1
Net Income
Dividends
Ending Retained Earnings, December 31

4. Cash Flow Statement (Statement of Cash Flows)

- Cash flows from operating, investing, and financing activities.
  - Operating: Day to day business activities (ex. Collection of accounts receivables).
  - Investing: Purchasing / selling of assets (ex. Equipment).
  - Financing: Using / reducing debt / equity (ex. Stock issuance).

Question #2. How are the balance sheet, income statement, and statement of retained earnings connected?

The balance sheet, income statement, and statement of retained earnings are connected through the following accounts:

- Balance Sheet: Retained earnings
- Income Statement: Net income

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As a company earns revenues and incurs expenses, its net income goes up and down on the income statement.

As net income goes up and down, retained earnings goes up and down on the statement of retained earnings.

The ending retained earnings balance gets reported on the balance sheet as shareholders' equity.

Key Takeaway:

- When revenues go up, net income goes up, retained earnings goes up, shareholders' equity goes up.
- When expenses increase, net income goes down, retained earnings goes down, shareholders' equity goes down.

Question #3. The Sock Market sells socks to Finance students at Sauder. On December 31, The Sock Market reports $20,000 in equipment, $10,000 in bonds payables, $15,000 in patents, and $1,000 in salary expenses. How much will the Stock Market have in Shareholders' Equity on their balance sheet?

Assets = Liabilities + Shareholders' Equity

Assets: Equipment (20,000) + Patents (15,000) = 35,000

Liabilities: Bonds Payable (10,000) = 10,000
35,000 (Assets) = 10,000 (Liabilities) + Shareholders' Equity

Shareholders' Equity = 25,000

(1,000 expense is included in retained earnings of shareholders' equity.)

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III. ACCRUAL ACCOUNTING CONCEPTS

The Three Golden Rules of J/E

1. Debits = Credits

2. Always DEBIT expenses.

3. Always CREDIT revenues.

…UNLESS YOU ARE MAKING AN ADJUSTING / CORRECTING ENTRY.

What do I debit and what do I credit?

Think of debits as what I'm RECEIVING.
Think of credits as what I'm GIVING UP.

Question #4. Florist Gump is a floral boutique in Richmond, BC. Florist Gump engaged in the following transactions in 2015:

a. Collected $300,000 in accounts receivable on January 5th.

	Debit	Credit
DR. Cash	300,000	
CR. Accounts Receivable		300,000

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b. Issued 100 common shares for $15 per share on February 8th.

	Debit	Credit
DR. Cash (100 x $15)	1,500	
CR. Common Shares		1,500

c. Flora, the CEO, used company funds to pay $2,000 of personal property taxes in April.

Personal expenses cannot be included!	Debit	Credit
DR. Loan Receivable	2,000	
CR. Cash		2,000

d. Florist Gump purchased $30,000 of inventory, on account, on May 13th.

	Debit	Credit
DR. Inventory	30,000	
CR. Accounts Payable		30,000

e. Florist Gump paid $4,000 to suppliers on account on June 15th.

	Debit	Credit
DR. Accounts Payable	4,000	
CR. Cash		4,000

f. Florist Gump sold $1,000 of inventory on July 18th. This inventory cost Florist Gump $250. The customer is willing to pay $400 on cash and the remaining on account.

	Debit	Credit
DR. Cash	400	
DR. Accounts Receivable (1,000 – 400)	600	
CR. Sales Revenue		1,000
DR. Cost of Goods Sold	250	
CR. Inventory		250

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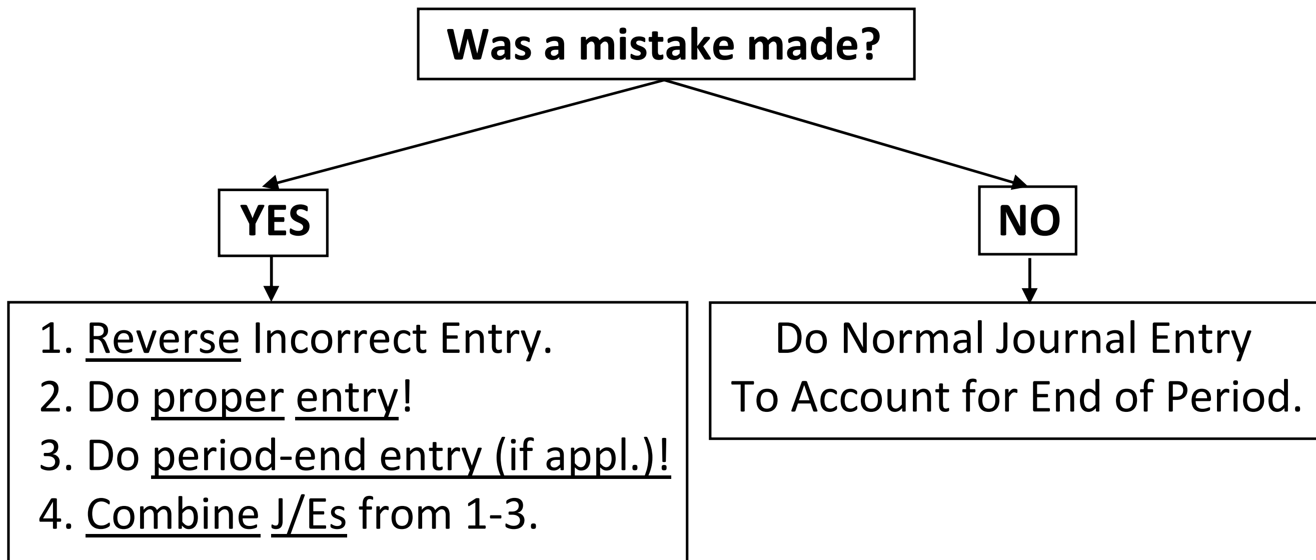
Required: Prepare a journal entry to reflect each of these events so Flora, the CEO, will "leaf" you alone.

Adjusting and Correcting Entries



Question #5. The Merchant of Tennis is a sports shop in Shakespearean times. After discussions with their auditors, they discovered that several adjusting and correcting entries are still required.

Required: Please make the year-end adjusting entries required for December 31, 2015. The Merchant of Tennis is counting on you to be "audit" you can be.

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a. The Merchant of Tennis purchased a 2-year insurance policy on July 1st, 2014. On this date, it debited insurance expense by $40,000 and credited cash. No other entries pertaining to insurance have been made until today.

What was the error?: Should have DR. Prepaid Insurance and CR. Cash!

	Debit	Credit
DR. Cash	40,000	
CR. Insurance Expense		40,000
DR. Prepaid Insurance	40,000	
CR. Cash		40,000
DR. Insurance Expense ($40,000 x (1.5 years / 2 years))	30,000	
CR. Prepaid Insurance		30,000
DR. Prepaid Insurance	**10,000**	
CR. Insurance Expense		**10,000**

b. At the end of the year, staff reported $2,000 of supplies inventory on their balance sheet. However, a detailed count by their auditors produced only $1,100 of supplies.

What was the error?: No error. Just an adjusting entry required.

	Debit	Credit
DR. Supplies Expense (2,000 – 1,100)	900	
CR. Supplies Inventory		900

c. The company recorded a collection of $20,000 from its supplier by debiting cash and crediting accounts payable.

What was the error?: Should've DR. Cash and CR. Accounts Receivable

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	Debit	Credit
DR. Accounts Payable	20,000	
CR. Cash		20,000
DR. Cash	20,000	
CR. Accounts Receivable		20,000
No year-end adjusting entry.		
DR. Accounts Payable	**20,000**	
CR. Accounts Receivable		**20,000**

IV. MERCHANDISING OPERATIONS

Revenue Recognition Criteria

Revenue and costs must be recognized when:

1. Risks and rewards of ownership have been transferred to the buyer.
2. The seller does not manage the asset or have any control over it.
3. The amount of revenue can be measured reasonably.
4. Collectability is reasonably assured.
5. Costs can be measured reliably.

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Long-Term Contracts

2 methods of recognizing revenue:

1. % of Completion Method = Recognize same % of costs and revenues.
   - Why?: Matching Principle.
   - Outcome of contract and stage of completion must be reliably measurable.

2. Completed Contract Method: Recognize revenues and expenses at completion.
   - Used if outcome of contract or stage of completion cannot be reliably measurable.
   - Not permitted under IFRS.

Question #6. Spruce Springsteen Inc. produces industrial lawnmowers for arenas and stadiums in the Lower Mainland. On July 1, 2015, they struck a deal with Stadium X to manufacture 4 industrial lawnmowers for a total price that will be within the range of $1,000,000 and $1,400,000 (depending on market rates at the time of delivery).

Stadium X paid a deposit of $200,000 on July 1st and will pay the remainder upon completion of the contract. Total costs to manufacture all 4 machines are $500,000. On December 31st, 2 lawnmowers were finished and delivered to Stadium X.

Required: Prepare the 2 journal entries that Spruce Springsteen Inc. would record on December 31, 2015.

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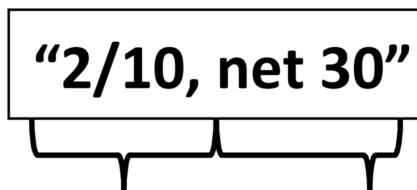
When we accepted the deposit, we would have

DR. Cash 200,000
CR. Deferred revenue 200,000

At December 31, we have finished and delivered 2 lawnmowers out of 4. Therefore, we are 50% complete and can recognize the revenues and costs for 50% of the lawnmowers.

	Debit	Credit
DR. Deferred Revenue (This is the deposit!)	200,000	
DR. Accounts Receivable	300,000	
CR. Sales Revenue (1,000,000 / 4 machines x 2 machines)		500,000
DR. Cost of Goods Sold	250,000	
CR. Inventory		250,000

Sales Discounts



If you pay within 10 days, 2% discount.

Balance due in 30 days.

Journal Entry When Item is Sold

DR. Accounts receivable XX
CR. Sales revenue XX

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DR. Cost of goods sold XX
CR. Inventory XX

Journal Entry If Item is Paid For Within 10 Days (Discount Applicable)

DR. Cash XX
DR. Sales Discount XX
CR. Accounts Receivable XX

Journal Entry If Item is Paid For After 10 Days (No Discount)

DR. Cash XX
CR. Accounts Receivable XX

5-10 MINUTE BREAK!
Please complete the CMP Survey!

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V. INVENTORY

Tangible items that are…

- Held for sale by a business   OR
- Used to produce goods for sale by a business.

Inventory is a current asset as it is generally used within 1 year.

Inventory is displayed on financial statements through:

- Inventory on the Balance Sheet.
- Cost of Goods Sold on the Income Statement.

Cost of Goods Sold ("COGS")

Cost of inventory sold by your business

- Is an expense and is therefore ALWAYS debited.

Two Ways to Calculate:

Number of Goods Sold x Per Unit Cost = COGS

Beginning Inventory + Purchases - Ending Inventory = COGS

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Inventory Costing Methods

1. Specific Identification (Specific ID)
   - Each item is individually identified and recorded.
   - Used primarily for expensive items.

2. First In, First Out (FIFO)
   - Earliest goods purchased are the earliest goods sold.

3. Weighted Average
   - COGS is based on the average cost per unit.

High-Level Summary

If unit costs are rising…

- FIFO provides the lowest cost of goods sold, the highest net income / gross profit, and the highest ending inventory.

If unit costs are declining…

- FIFO provides the highest cost of goods sold, the lowest net income / gross profit, and the lowest ending inventory.

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Question #7. The Codfather is a fish market based out of Seattle, Washington.

On January 1, they purchased 10 pink salmon for $5 each. (Fish #1-10)
On January 5, they purchased an additional 10 pink salmon for $8 each. (Fish #11-20).
On January 10, they purchased an additional 10 pink salmon for $10 each. (Fish #21-30).
On January 12, a customer purchased 15 pink salmon from the Codfather for $20 each (They chose fish #1-10, 11-14, and 21 - The customer felt that there was something fishy about #15-20).

Required: What is the gross profit (revenues – costs) of the Codfather under each of the inventory costing methods?

Specific ID

Revenue: 20 x 15 = $ 300
Cost: 1-10 5 x 10 = $ 50
11-14 4 x 8 = $ 32
21 1 x 10 = $ 10

Total Cost: $ 92

Gross Profit = 300 - 92
Gross Profit = 208

FIFO

Revenue: 20 x 15 = $ 300
Cost: 1-10 5 x 10 = $ 50
11-15 5 x 8 = $ 40

Total Cost: $ 90

Gross Profit = 300 - 90
Gross Profit = 210

Weighted Average

Revenue: 20 x 15 = $ 300
Cost: 1-10 5 x 10 = $ 50
11-20 8 x 10 = $ 80
21-30 10 x 10 = $ 100

Total COGAS = $ 230
$ 230 / 30 = $ 7.67 per fish

7.67 / fish x 15 fish = 115
Total Cost = 115
Gross Profit = 185

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Inventory Systems

1. Periodic

- Company physically counts inventory remaining @ end of period.
- Not as up to date, but easier and cheaper.

Recognition:

- Purchases: Involve a debit to a temporary account - "Purchases".
- Revenues: Recorded at time of sale.
- COGS: Recorded after inventory count is completed.

Journal Entries:

Purchases:	DR. Purchases
	CR. Accounts Payable
Sale to Customer:	DR. Accounts Receivable
	CR. Sales Revenue
After Inv. Count:	DR. Cost of Goods Sold
	DR. Inventory
	CR. Purchases

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2. Perpetual

- Inventory record adjusted after each transaction (purchase / sale).
- Up to date. Used by big companies.

Recognition:

- Purchases: Involve a debit to a balance sheet account - "Inventory".
- Revenues: Recorded at time of sale.
- COGS: Recorded at time of sale.

Journal Entries:

Purchases:

DR. Inventory
    CR. Accounts Payable

Sale to Customer:

DR. Accounts Receivable
    CR. Sales Revenue

DR. Cost of Goods Sold
    CR. Inventory

Inventory Turnover

$$365 \div \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \text{Inventory Turnover (in Days)}$$

* Average inventory = (This Year + Last Year) / 2

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<u>Question #8</u>. Hairanoia sells industrial-strength hairdryers to professional hairdressers. They began the 2015 fiscal year with $4,500 in inventory.
On March 5, 2015, Hairanoia purchased $5,000 of inventory on credit.
On May 9, 2015, Hairanoia sold 10 hairdryers to Shear Madness for $4,500. The client paid in cash. The inventory cost the company $300 per unit.

a. Assuming that Hairanoia uses a **perpetual** inventory system, record the journal entry for March 5.

	Debit	Credit
DR. Inventory	5,000	
CR. Accounts Payable		5,000

b. Assuming that Hairanoia uses a **perpetual** inventory system, record the journal entry for May 9.

	Debit	Credit
DR. Cash	4,500	
CR. Sales Revenue		4,500
DR. Cost of Goods Sold ($300 x 10)	3,000	
CR. Inventory		3,000

c. Assuming that Hairanoia uses a **periodic** inventory system, record journal entry for March 5.

	Debit	Credit
DR. Purchases	5,000	
CR. Accounts Payable		5,000

d. Assuming that Hairanoia uses a **periodic** inventory system, record the J/E for May 9.

	Debit	Credit
DR. Cash	4,500	
CR. Sales Revenue		4,500

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VI. INTERNAL CONTROLS AND CASH

Bank reconciliations tie the cash amount in the company's books to the cash amount in the bank.

Why Perform a Bank Reconciliation?

1. Identify bookkeeping errors.

2. Seek and resolve discrepancies.

3. Contribute to the company's internal controls.

How Do I Perform a Bank Reconciliation?

Perform both a "Bank to Books" AND "Books to Bank" Reconciliation. Both must end up with the same "Adjusted Cash Balance".

Bank to Books

1. Start with the bank's cash balance!

2. Adjust for transactions that the bank has not yet recorded to find the "Adjusted Cash Balance".

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+ (Adding)	- (Subtracting)
Deposits in Transit (Deposits made on a weekend when the bank was closed.)	Outstanding Cheques (Cheques already written, but have not yet been cashed.)
Bank Errors (Arithmetic Errors, Clerical Errors)	

Books to Bank

1. Start with the company's cash balance!

2. Adjust for transactions that affect cash that have not yet been recorded in the company's books to find the "Adjusted Cash Balance".

+ (Adding)	- (Subtracting)
Interest Earned in Bank Account	Bank Charges Not Yet Recorded in Books
	NSF Cheques* (Bounced Cheques)
Company Errors (Arithmetic Errors, Clerical Errors)	

* NSF is short for "not sufficient funds" and refers to "bounced cheques". When the company receives a cheque, it assumes that the customer has paid and increases its cash balance (DR. Cash / CR. A/R). When it discovers that the customer's cheque has bounced, the company must reduce its cash balance and

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re-increase its A/R balance (DR. A/R / CR. Cash). Therefore, to reconcile the cash on the company's books with that of the bank's statement, we must reduce the company's books for the amount of the NSF cheque.

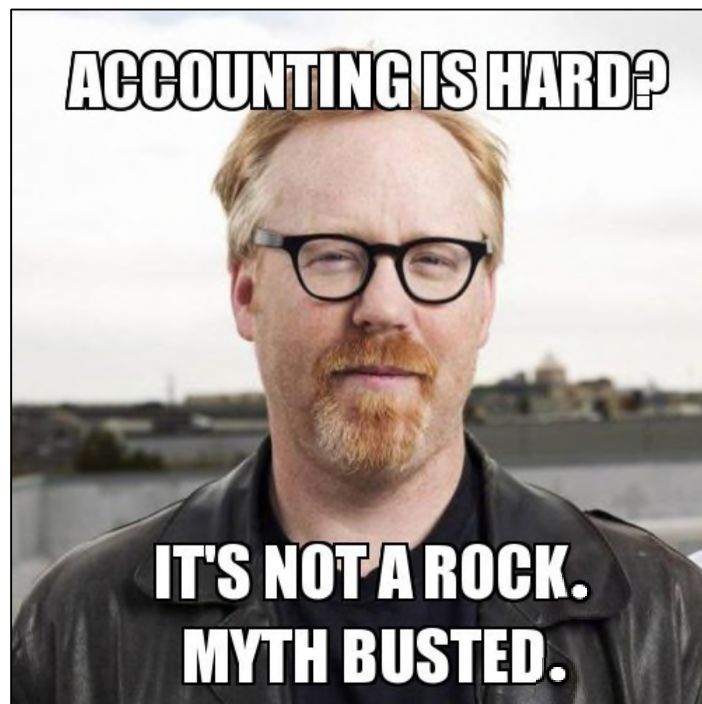
Example: Bread Pitt sells an industrial oven to the Pie Piper for $2,000.

DR. Accounts Receivable	2,000	
CR. Sales Revenue		2,000

Pie Piper pays Bread Pitt by cheque.

DR. Cash	2,000	
CR. Accounts Receivable		2,000

If the cheque bounces, Bread Pitt's cash balance is overstated by $2,000 (they did not receive the payment they thought). To reconcile this, it must decrease its cash balance by $2,000 to match that of the bank's statements.



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VII. ACCOUNTS RECEIVABLE

1. % of Sales Method
   - Use historical data to determine % that goes uncollected.

2. % of A/R Method (Aging Method)
   - Use historical data to determine % that goes uncollected 0-30 days, 30-60 days, 60-90 days, and over 90 days out.

Estimate of Uncollectible Amount

DR. Bad Debt Expense
    CR. Allowance for Doubtful Accounts

When A/R Becomes "Bad"

DR. Allowance for Doubtful Accounts
    CR. Accounts Receivable

If Client Repays Bad Debt

DR. Accounts Receivable
    CR. Allowance for Doubtful Accounts

DR. Cash
    CR. Accounts Receivable

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Calculating Ending ADA	**Calculate Ending A/R**
Beginning ADA	Beginning A/R
+ BDE for the Year	+ Credit Sales
- Write-Offs	- Cash Collections
+ Recoveries	- Write-Offs
= Ending ADA	+ Recoveries
	= Ending A/R

Question #9: Wok on Water is the largest wholesaler of pots and pans in Western Canada. Approximately 60% of the company's sales are made on credit and customers have twenty days from the date of sale to remit payment.

The following information is available for the year ended December 31, 2015:

Accounts receivable, gross (1/1/2015)	$ 500,000
Allowance for doubtful accounts (1/1/2015)	65,000
Total sales in 2015	1,000,000
Payments on account received from customers	52,000
Write-offs of accounts receivable	80,000
Recoveries of bad debts during 2015	15,000

Wok on Water provides for doubtful accounts using either of the following calculations:

1) 5% of credit sales for the year, or
2) 10% of current receivables and 25% of receivables which are overdue as at year-end.

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As at December 31, 2015, 50% of gross accounts receivable are current.

Question 9a. Determine the December 31, 2015 balances in "Bad Debts Expense" and "Allowance for Doubtful Accounts" if the company uses the percentage of credit sales method.

Step 1. Find out amount of credit sales.

Credit Sales: 1,000,000 x 60% = 600,000

Step 2. Find bad debt expense for the year.

Bad debt expense for the year = 600,000 x 0.05 = 30,000

Step 3. Find ending allowance for doubtful accounts.

Opening ADA + BDE for year – Write offs + Recoveries = Ending ADA
65,000 + 30,000 – 80,000 + 15,000 = 30,000

Bad debt expense balance = 30,000
ADA Balance = 30,000

Question 9b. Determine the December 31, 2015 balance of "Allowance for Doubtful Accounts" if the company uses the aging method.

Step 1. Find out amount of credit sales.

Credit Sales: 1,000,000 x 60% = 600,000

Step 2. Find ending accounts receivable.

Opening A/R + Credit Sales – Cash collections – Write offs + Recoveries = Ending A/R
500,000 + 600,000 – 52,000 – 80,000 + 15,000 = 983,000

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Step 3. Find bad debt expense.

Current Bad Debt Expense= 983,000 x 50% x 10% = 49,150
Non-current Bad Debt Expense = 983,000 x 50% x 25% = 122,875

Step 4. Find ending allowance for doubtful accounts.

Opening ADA + BDE for year – Write offs + Recoveries = Ending ADA
65,000 + 122,875 + 49,150 – 80,000 + 15,000 = 172,025

ADA Balance = 172,025

VIII. GENERAL ADVICE

- Practice, practice, practice. Don't just memorize!
- Redo any in-class practice problems.
- Do relevant textbook questions.
- Read relevant textbook sections.
- Form a study group?

If all else fails, stick to the basics…

- **Debits = Credits**
- **Assets = Liabilities + Shareholders' Equity**
- **The various types of financial statements are connected through retained earnings.**

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