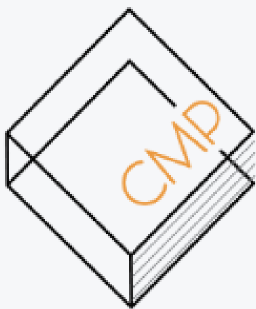

COMM 293 **WITH SOLUTIONS**

MIDTERM REVIEW SESSION

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Section 1: Accounting Basics

Accounting Equation:

- Assets = Liabilities + Shareholder's Equity
- Must always be balanced

Balance sheet components

Assets:

- Under control of entity
- Result from past business events/transitions
- *Inflow* of future economic benefits must be probable
- Historical cost principle: recorded at historical cost when asset is purchased
- Examples: cash, accounts receivable, inventory, prepaid expenses, PP&E, intangibles

Liability:

- Debts or firm obligations
- Result from past business events/transactions
- *outflow* of future economic benefits must be probable
- Examples: accounts payable, wages payable, interests payable, unearned revenue

Shareholders' Equity

- What's left over after subtracting total liabilities from total assets
  1) Contributed capital: permanent investments by shareholders determined by number of shares outstanding
  2) Retained earnings: amount earned but not yet distributed to shareholders
     Beginning RE + net income – dividends = ending RE
  3) Others

Financial statements

Balance sheet:

- Reports amount of assets, liabilities, and shareholders' equity of an entity
- Financial position at a *point* at time
- Organization: current and non-current / in order of liquidity

Statement of comprehensive income / income statement:

- Reports revenue less expenses
- Financial performance over a *period* of time

Statement of changes in equity / retained earnings statement:

- Provides information on *changes in financial position* over a *period* of time

Statement of cash flows:

- Accrual accounting reflects economic events when they happen rather cash exchanges (revenue ≠ cash collected)
- Reports inflows and outflows of cash over a *period* of time
- Three components:
  1) Operating activities
  2) Investing activities
  3) Financing activities
- Two formats:
  1) Direct method
  2) Indirect method

Income statement components

Revenue:

- The earnings that a business has from sales of goods or services
- Results in *increases* in equity

Expenses:

- Outflows or depletions of assets or incurrence of liabilities
- Results in *decreases* in equity

ʕ •ᴥ• ʔpractice - classify accounts

Accounts receivable asset – B/S

Allowance for doubtful accounts contra-asset – B/S

Building asset - B/S

Accumulated depreciation contra-asset – B/S

Notes payable liability – B/S

Unearned revenue liability - B/S

Prepaid expenses asset – B/S

Common shares SE – B/S

Sales revenue revenue – I/S

Retained earnings SE – B/S

Tax expenses expense – I/S

Goodwill asset – B/S

Cost of goods sold expense – I/S

Accounting standard used in Canada:

- public entities: must use *IFRS* (International Financial Reporting Standards) set by IASB (International Accounting Standards Board)
- private entities: use *IFRS or APSE* (Accounting Standards for private Enterprises)

Disclosure Process:

- annual reports: financial statements + MD&A
- press releases
- quarterly reports
- others

Section 2: Accounting Cycles

The Accounting Cycle:

1. journalize transactions (**journal entries**)
2. post transactions to the general ledger (**T-account**)
3. trial balances (**debits = credits**)

4. adjusting journal entries
5. adjusted trial balance
6. prepare financial statements
7. closing journal entries
8. post-closing trial balance

Journal Entries – Debits & Credits:

- increase in asset: debit
- increase in liability: credit
- increase in common stocks: credit
- increase in revenue: credit
- increase in expense: debit
- increase in gain: credit
- increase in loss: debit
- increase in dividends: debit

DEAD rule: debit expenses, assets, dividends

T-account:

- After journal entries are prepared, post dollar amounts to each account affected by the transaction

Account name	
Dr.	Cr.

- normal balance: debit accounts have debit balances & credits accounts have credit balances

Asset	
Dr.	Cr.
Normal balance	

Double-entry accounting systems:

- at all times, the debit movements must equal to credit movements in the accounts
- each transaction affects at least two accounts

Recognizing revenue and expenses

- use accrual accounting according to GAAP – recorded as incurred

- **revenue recognition principle**: revenues must be recorded when earned, regardless of when cash is received
- **expense recognition / matching principle**: costs incurred to generate revenue should be recognized as expenses in the period that revenue is recognized, regardless of when cash is paid

Adjusting Entries:

Deferrals:

- prepaid expenses: expenses paid in cash *before* they are used or consumed; asset account
- unearned revenues: cash received *before* services are performed; liability account

Accruals:

- accrued revenues: revenues for services performed but *not yet* received in cash
- accrued expenses: expenses incurred but *not yet* paid in cash

ʕ •ᴥ• ʔ**Practice – prepaid expenses**

Journalize the transactions:

January 1: company pre-pays the full year of rent for $120,000

Dr. Prepaid rent $120,000

Cr. Cash $120,000

Every month end, company records rent expense

Dr. rent expense $10,000

Cr. Prepaid rent $10,000

ʕ •ᴥ• ʔ**Practice – unearned revenue**

Journalize the transactions:

A property management company receives full-year rental payments of $120,000 in advance from a tenant.

Dr. cash $120,000

Cr. Unearned revenue $120,000

Every month end, company records revenue

Dr. unearned revenue $10,000

Cr. Rental revenue $10,000

Depreciation:

- allocating the cost of a tangible assets over its useful life
- accumulated depreciation: contra asset account; credit account
- book value = historical cost of asset – accumulated depreciation

Closing entries:

- balance sheet accounts are permanent accounts
- income statement accounts are temporary account
- must close out all temporary accounts to have zero balance at the period end
- four-step process:
  1) close all revenues and gains to income summary
  2) close all expense and losses to income summary
  3) close the income summary account to retained earnings
  4) close dividends to retained earnings

ʕ •ᴥ•ʔ**Practice - Accounting Cycle**

ABC Company prepares financial statements on a monthly basis. At the beginning the June 2019, the company had the following account balances. Prepare T-accounts for June.

Cash $ 2,800
A/R $4,600
Equipment $3,600
Accumulated depreciation $1,300
Taxes payable $1,500
Common shares $100
Retained earnings $8,100

Cash

Debit	Credit
2,800	

A/R

Debit	Credit
4,600	

Taxes Payable

Debit	Credit
	1,500

Common Shares

Debit	Credit
	100

Equipment

Debit	Credit
3,600	

Accum. Depreciation

Debit	Credit
	1,300

Retained Earnings

Debit	Credit
	8,100

Some additional information about ABC for the month of June:

1. **On June 15, the company paid the $1,500 taxes owing**
2. **On June 22, the company collected $3,500 on A/R**
3. **On June 25, the company billed a client for $5,000 plus $600 tax for services provided in the month of June; $600 is collected on behalf of government**

Journalize transactions and update the T-accounts.

6/15: Dr. Taxes payables $1,500
Cr. Cash $1,500
6/22: Dr. cash $3,500
Cr. A/R $3,500
6/25: Dr. A/R $5,600
Cr. sales revenue $5,000
Cr. Taxes payable $600

Cash

Debit	Credit
2,800	1500
3500	
4800	

A/R

Debit	Credit
4,600	3500
5600	
6700	

Taxes Payable

Debit	Credit
1500	1,500
	600
	600

Common Shares

Debit	Credit
	100
	100

Equipment

Debit	Credit
3,600	
3600	

Accum. Depreciation

Debit	Credit
	1,300
	1300

Retained Earnings

Debit	Credit
	8,100
	8100

Sales Revenue

Debit	Credit
	5000
	5000

The computer equipment was purchased for $3,600 and is being depreciated over 36 months on straight-line basis. Record depreciation expense at end of the period. Prepare Journal entry and update the T-accounts.

6/30: Dr. depreciation expense $100

Cr. Accumulated depreciation $100

Cash

Debit	Credit
2,800	1500
3500	
4800	

A/R

Debit	Credit
4,600	3500
5600	
6700	

Taxes Payable

Debit	Credit
1500	1,500
	600
	600

Common Shares

Debit	Credit
	100
	100

Equipment

Debit	Credit
3,600	
3600	

Accum. Depreciation

Debit	Credit
	1,300
	100
	1400

Retained Earnings

Debit	Credit
	8,100
	8100

Sales Revenue

Debit	Credit
	5000
	5000

Depreciation Expense

Debit	Credit
100	
100	

(TO CORRECT A FORMAT MISTAKE: SHOULD ONLY HIGHLIGHTNG 100 HERE)

Prepare trail balance

account	debit	credit
cash	4800	
A/R	6700	
equipment	3600	
Accumulated depreciation		1400
Taxes payable		600
Common shares		100
Retained earnings		8100
Sales revenue		5000
Depreciation expense	100	
Total	15200	15200

Close out the temporary accounts to RE and update T-accounts.

6/30 Dr. sales revenue $5,000

Cr. Depreciation expense $100

Cr. Net income $4,900

Dr. net income $4,900

Cr. Retained earnings $4,900

Taxes Payable

Debit	Credit
1500	1,500
	600
	600

Common Shares

Debit	Credit
	100
	100

Retained Earnings

Debit	Credit
	8,100
	4900
	13,000

Sales Revenue

Debit	Credit
5000	5000
	0

Depreciation Expense

Debit	Credit
100	100
0	

balance sheet classification:

- assets:
  current assets (expect to convert to cash within one year or its operating cycle): cash, A/R, supplies
  long-term investments: investments in stocks and bonds of other companies
  Property, plant, and equipment (PP&E): land, building, equipment's
  Intangible assets: goodwill, copyrights, patents
- liabilities & SE:
  current liabilities (paid within one year): accounts payable, salaries payable, interests payable
  long-term liabilities (paid after one year): bonds payable, long-term notes payable, pension liabilities
  shareholders' equity
- operating cycle: the average time to turn inventory to cash

Multi-step income statement:

- Net sales

  - COGS

  = gross profit

  - operating expenses

  = operating income

  - interests

  - taxes

  = net income

Section 3: Inventory

Two inventory systems:

- perpetual: continuous tracking

  pros:

  1) better control
  2) lower change of misappropriation of inventory
  3) real-time reporting of gross margins and profits
  4) can better detect when stock is low

  cons:

  1) more expensive to maintain
  2) may not be necessary for small businesses

- periodic: calculated at period end

  pros:

  1) less costly to maintain

  cons:

  1) does not maintain up-to-date records
  2) inventory level only determined at period end

Journal Entries – Inventory:

purchase inventory	Dr. Inventory Cr. A/P or cash	
sales of goods	Dr. A/R Cr. Sales revenue Dr. COGS Cr. Inventory	For period inventory system, COGS is recorded at period end instead of time of sale
transportation costs buyer incurs	Dr. inventory Cr. A/P or cash	consider as part of costs of purchasing inventory
transportation costs seller incurs	**For buyer:** no entry **For seller:** Dr. delivery expenses Cr. A/P or cash	
purchase discount	**Perpetual:** Dr. A/P Cr. Inventory Cr. Cash **Periodic:** Dr. A/P Cr. Purchase discount Cr. Cash	Due to early payments; reduces cost of inventory

Purchase allowance	**Perpetual:** Dr. A/P Cr. Inventory **Periodic:** Dr. A/P Cr. Purchases allowances	Due to incorrect or defected item; reduces cost of inventory Not physically returned
Purchase returns	**Perpetual:** Dr. A/P Cr. Inventory **Periodic:** Dr. A/P Cr. returns	reduces cost of inventory physically returned
Returns and allowance from the perspective of seller	Dr. sales returns and allowance Cr. A/R Dr. inventory Cr. COGS	contra-rev account

ʕ •ᴥ• ʔ**Practice – account for inventory transactions**

Journalize the following transactions

Cash purchases of inventory, $3,900

Dr. Inventory $3,900

Cr. Cash $3,900

Sale on account (including credit cards), $19,400

Dr. A/R $19,400

Cr. Sales revenue $19,400

Cost of goods sold (perpetual inventory system), $4,200

Dr. COGS $4,200

Cr. Inventory $4,200

Collections on account, $18,900

Dr. cash $18,900

Cr. A/R $18,900

Purchase discount:

- 2/10, n/30
  Meaning: the buyer can get a 2% cash discount if it pays cash in 10 days. Otherwise, the buyer must pay the net amount in 30 days
- Cash discount = invoice value * discount percent

COGS:

- Beginning inventory
  + new purchases (net of allowance, discount, returns)
  =cost of goods available sale (COGAS)
  - ending inventory
  = cost of goods sold (COGS)

Ownership of goods

- FOB shipping point: title and responsibility of goods transfer from seller to buyer when the goods are placed in a delivery vehicle
  FOB destination: transfer from seller to buyer once the goods are delivered to buyer's specific location

Inventory cost components:

- Inventory: goods that a business holds for sales purpose
- Cost of inventory: whatever costs directly related to inventory
- Cost of purchased inventory: invoice prices + delivery costs – returns and allowances – discounts

Inventory cost flow assumptions:

- Specific identification:
  - Tracks specific costs with specific goods
  - Usually for expensive or unique goods

- Requires very detailed information, thus very expensive

- First-in, first-out (FIFO)
  - Assume the earliest goods purchased are the first to be sold
  - The oldest goods are first recognized as COGS
- Last-in, first-out (LIFO)
  - Assumes the latest goods purchased are the first to be sold
  - The newest goods are first recognized as COGS
- Weighted average cost method

  Three-step process:
  1) Average cost per unit = $COGAS / #units AS
  2) $COGS = #units sold * average cost per unit
  3) $ending inventory = #units in ending inventory * average cost per unit

ʕ •ᴥ•ʔPractice – cost flow assumptions

The following shows ABC company's inventory records on Oct 31, 2018

10/1 beginning inventory 100 units @ $9.2 = $920

10/15 purchase 700 units @ $10 = $7,000

10/26 sale 600 units @ $20 = $12,000

The company operating expenses throughout the year of a total is $3,000, and the company is not subject to income taxes. Prepare income statement at year end under weighted-average and FIFO assuming periodic system is used.

Weighted average:

Avg cost per unit = (920+7000) / (100+700) = $9.9

COGS = 9.9*600 = $5,940

FIFO:

COGS = 100*9.2 + 500*10 = $5,920

	For the year ended December 31, 2017	
	Weighted avg	FIFO
sales revenue	$12,000	$12,000
COGS	$5,940	$5,920

Gross profit	**$6,060**	**$6,080**
Operating expense	**$3,000**	**$3,000**
Net income	**$3,060**	**$3,080**

Effects of cost flow choice & implications:

- In periods of rising prices, LIFO results in higher COGS and lower ending inventory, and thus results in lower net income and lower income taxes
- Incentives for choosing one method over another:
  - Net income effects: prefer to report higher earnings
  - Income tax effects: prefer to pay less taxes
- IFRS prohibits the use of LIFO
- Average-cost method always have results between FIFO and LIFO

Financial statement analysis – inventory turnover:

- Inventory turnover = COGS / average inventory
  - Average inventory = (beginning inventory + ending inventory) / 2
  - how many times average inventory sold and replaced during a period
  - in general, the higher the better

- average days in inventory = 365 / inventory turnover
  - indicated how long inventory is expected to be held by company
  - in general, the lower the better

inventory valuation – lower of cost or market (LCM):

- if the market value is lower than original cost, conservatism dictates write down
- a previous written down can be reversed under IFRS
- write up is not allowed

Section 4: Internal Control

The Fraud Triangle:

- opportunity & financial pressure & rationalization

Internal Control:

- processes by which the company provide reasonable assurance regarding reliability of the company's financial reporting, the effectiveness and efficiency of its operations, and its compliance with applicable laws and regulations
- related regulation: SOX (US) & CSOX (Canada)
- 6 principles:
  1) Establish of responsibility
  2) Segregation of duties
  3) Documentation procedures
  4) Physical controls
  5) Independent internal verification
  6) Human resource controls

- Accounts that are more susceptible to fraud: A/R, cash and cash equivalents

Section 5: Accounts Receivables

Recognizing & Recording Receivables:

Sales made	Dr. A/R Cr. Sales revenue
Collections on bills	Dr. cash Cr. A/R
Returns and allowances	Dr. sales returns and allowances Cr. A/R
Sell A/R	Dr. cash Dr. Service charge expense Cr. A/R

Bad debt expenses:

In the same period of sales made	Dr. bad debt expense Cr. Allowance for doubtful accounts*	An estimate *contra-A/R account
When an account determined as uncollectible	Dr. allowance for doubtful accounts Cr. A/R	
When a previously written-off account becomes collectible	Dr. A/R Cr. allowance for doubtful accounts	

- A/R – ADA = net realizable value of A/R
- Two methods of estimating the amount of bad debt expense:
  - Percentage of credit sales method: net credit sales * % estimate of bad debt
  - Aging of A/R method: expected value according to % estimate of bad debt within each age group

ʕ •ᴥ• ʔPractice – ADA

Journalize the following transactions:

1. **Credit sales $100,000**

   Dr. A/R $100,000

   Cr. Sales revenue $100,000

2. **The company estimates that 3% of the credits sales are uncollectible**

   Dr. bad debt expense $3,000

   Cr. ADA $3,000

3. **Cash collections $93,700**

   Dr. cash $93,700

   Cr. A/R $93,700

4. **Write-offs of uncollectables, $1,800**

   Dr. ADA $1,800

Cr. A/R $1,800

Financial statement analysis – receivables turnover:

- Receivables turnover = net credit sales / average net A/R
  - How many times average receivables are recorded & collected during the year
  - In general, the higher the better
- Average collection period = 365/receivables turnover
  - The average time it takes a customer to pay its accounts
  - In general, the shorter the better