Notes

Accounting
350

FALL 2024

Financial Accounting

System

designed to provide

Financial Information — about → Economic Entities

Intended to be

Useful — MAKING → **Decisions**

2

INPUT

- **Economic Events (Transactions)**

PROCESSING

- **Record** • **Classify** • **Summarize**

OUTPUT

- **Financial Statements**

3

Accounting Equation

A = L + SE

4

A = L + SE

Assets

Something of value that is owned or controlled.

5

A = L + SE

Liabilities

A promise to pay cash, provide goods, or perform services in the future.

6

$A = L + SE$

Stockholders' Equity

7

$A = L + SE$

Assets = Equities

Claims against the assets.

8

$A = L + SE$

Creditors

Owners

Stockholders

9

A = L + SE

Debt

Issue of Stock

+

Earnings

10

Stockholders' Equity

Capital Stock

Shares of stock sold to investors who become owners (stockholders).

11

Stockholders' Equity

Retained Earnings

Total earnings from all prior years that have been retained (not distributed to stockholders as dividends).

12

Stockholders' Equity

Capital Stock

Retained Earnings

+ Revenues
- Expenses
- Dividends

13

Stockholders' Equity

Capital Stock

Retained Earnings

+ Net Income
- Dividends

14

Corporation ⟷ **Sole Proprietorship**

Retained Earnings → **Capital**

Capital Stock → **Capital**

Dividends → **Drawings or Withdrawals**

15

Revenue

measures what is

Earned

Most often the result of providing goods or services to customers.

5-Step Revenue Recognition Model (ACCT 351)

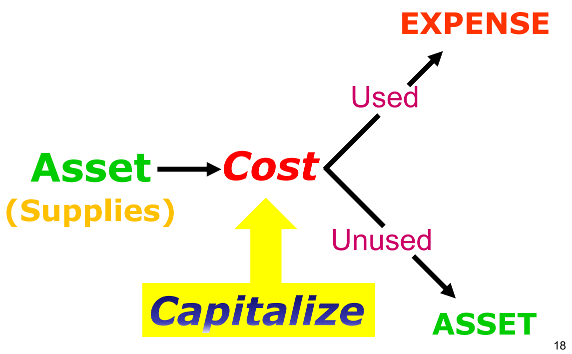
16

Expense

A **cost** that helps to produce **revenue**.

17

Cost versus Expense



18

Revenue

(Measures what is earned.)

~ **Creates** an **asset** ~

Examples: **Accounts Receivable** and **Cash**

Expense

(A cost that helps to produce revenue.)

~ **Creates** a **liability** or **uses** up an **asset** ~

Examples: **Accounts Payable** and **Cash**

19

Revenue $\xrightarrow{\text{not}}$ **Asset**

Revenue $\xrightarrow{\text{creates}}$ **Asset**

Expense $\xrightarrow{\text{not}}$ **Liability**

Expense $\xrightarrow{\text{creates}}$ **Liability**

or

Expense $\xrightarrow{\text{uses}}$ **Asset**

20

Revenue

Beta performed services for $500.

A	=	L	+	SE
+500				+500 (revenue)

$\downarrow$

Cash

or **Accounts Receivable**

21

Expense

Beta received a $200 telephone bill and paid it **upon receipt**.

A	=	L	+	SE
-200				-200 (expense)
Cash				

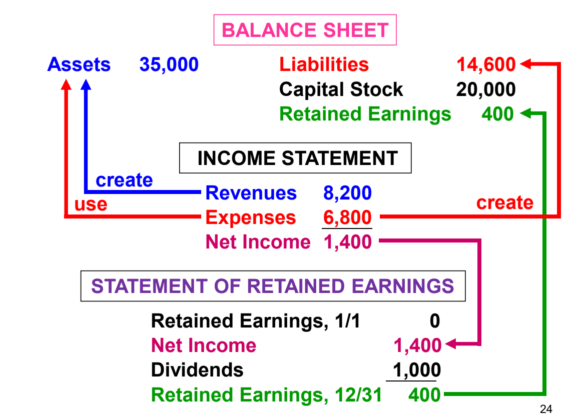
22

Expense

Beta received a $200 telephone bill and paid it at the **end** of the month.

A	=	L	+	SE
		+200		-200 (expense)
		Utilities Payable		

23



24

STATEMENT OF RETAINED EARNINGS	
Retained Earnings, 1/1	0
Net Income	1,400
Dividends	1,000
Retained Earnings, 12/31	400

STATEMENT OF OWNER'S EQUITY	
Capital, 1/1	0
Net Income	1,400
Drawings	1,000
Capital, 12/31	400

25

	A	= L	+ SE
Issued $5,000 of capital stock.	+5,000		+5,000
Purchased a $2,000 computer on credit.	+2,000	+2,000	
Received a $500 telephone bill but did not pay it.		+500	-500
Performed services on account for $3,000.	+3,000		+3,000
Obtained a $4,000 loan from the bank.	+4,000	+4,000	
Paid telephone bill.	-500	-500	

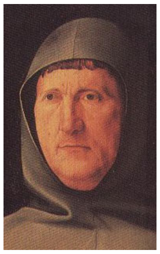
26

Debit	Credit
Left Side	Right Side

Debitum (debere) **Owes us**

Creditum (credere) **Trusts us**

27



Luca Pacioli

15^{th} century Italian monk

Father of Accounting

- Double-Entry Bookkeeping
- Assets/Liabilities
- Revenues/Expenses
- Trial Balance
- Accounting Equation
- Accounting Cycle
- Closing Entries

"A person should not go to sleep at night until the debits equal the credits."

28

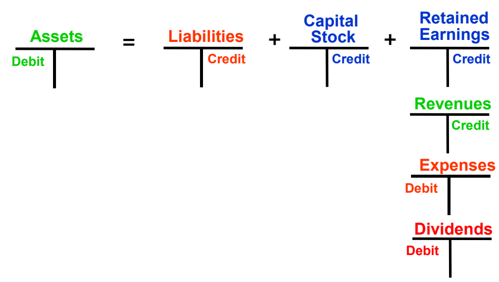
Left Side = Right Side

Assets	=	Liabilities	+	Stockholders' Equity
Debit (Increase)		Credit (Increase)		Credit (Increase)

29

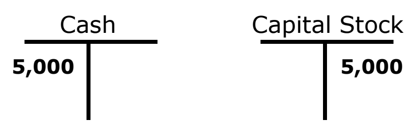
Assets	=	Liabilities	+	Stockholders' Equity
Credit (Decrease)		Debit (Decrease)		Debit (Decrease)

30



31

Issued $5,000 of capital stock.

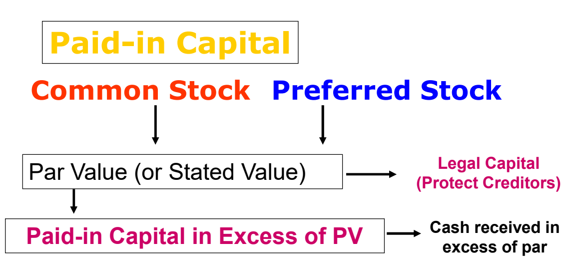


Cash 5,000

Capital Stock 5,000

32

Capital Stock



33

Issued 1,000 shares of $1 par value common stock for $5 per share.

Cash		Common Stock		PIC in Excess of Par Value	
5,000			1,000		4,000

Cash	**5,000**	
Common Stock		**1,000**
Paid-in Capital in Excess of PV		**4,000**

34

Purchased a $2,000 computer on credit.

Equipment		Accounts Payable	
2,000			2,000

Equipment	**2,000**	
Accounts Payable		**2,000**

35

Received a $500 telephone bill but did not pay it.

Utilities Expense		Utilities Payable	
500			500

Utilities Expense	**500**	
Utilities Payable		**500**

36

Performed services on account for $3,000.

Accounts Receivable		Service Revenue	
3,000			3,000

Accounts Receivable 3,000

Service Revenue 3,000

⇩

Professional Service Fees
Fees Earned
Service Fees

37

Obtained a $4,000 loan from the bank.

Cash		Notes Payable	
4,000			4,000

Cash 4,000

Notes Payable 4,000

38

Paid telephone bill.

Utilities Payable		Cash	
500			500

Utilities Payable 500

Cash 500

39

Accrual Accounting

Revenues are recorded in the period **earned**.

Expenses are **matched** to the revenues they help produce.

40

Performed $1,000 of services in year 1. Collected $600 in year 1 and $400 in year 2.

~

Paid $300 for supplies in year 1; used $200 in year 1.

~

Purchased a $500 piece of equipment for cash at the beginning of year 1 (useful life = 5 years).

41

Performed $1,000 of services in year 1. Collected $600 in year 1 and $400 in year 2.

	Year 1	Year 2
Received	$ 600	$ 400
Earned	$1,000	0

	Year 1	Year 2
Cash	$ 600	$ 400
Accrual	$1,000	None

42

Year 1	Cash	Accrual
Revenues:		
Service Revenue	**600**	**1,000**

43

Paid $300 for supplies in year 1; used $200 in year 1.

Year 1		Year 2	
Paid	$300	Paid	0
Used	$200	Used	$100

	Year 1	Year 2
Cash	$300	None
Accrual	$200	$100

44

Year 1	Cash	Accrual
Revenues:		
Service Revenue	600	1,000
Expenses:		
Supplies	**300**	**200**

45

Purchased a $500 piece of equipment for cash at the beginning of year 1 (useful life = 5 years)

$$\frac{\$500}{5 \text{ years}} = \$100$$

46

Purchased a $500 piece of equipment for cash at the beginning of year 1 (useful life = 5 years)

Year 1		Year 2	
Paid	$500	Paid	0
Used	$100	Used	$100

	Year 1	Year 2
Cash	$500	None
Accrual	$100	$100

47

Year 1	Cash	Accrual
Revenues:		
Service Revenue	600	1,000
Expenses:		
Supplies	300	200
Depreciation	500	100
Net Income	**(200)**	**700**

48

Depreciation Expense 100
Accumulated Depreciation 100

Balance Sheet	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Equipment	500	500	500	500	500	500
Less: **Accumulated Depreciation**	100	200	300	400	500	500
Book Value	400	300	200	100	0	0

Loss = $75 - $100 = $25
Gain = $150 - $100 = $50

Allocate

49

Depreciation

Expenses the cost of tangible assets.

Amortization

Expenses the cost of intangible assets.
Examples: Copyrights, trademarks, patents.

Depletion

Expenses the cost of natural resources.
Examples: Oil, gas, mining, timber.

50

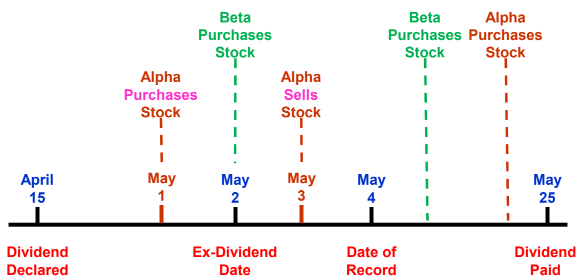
Declaration Date
Dividends 1,000
Dividends Payable 1,000

Ex-Dividend Date (2 to 4 weeks later)
No entry

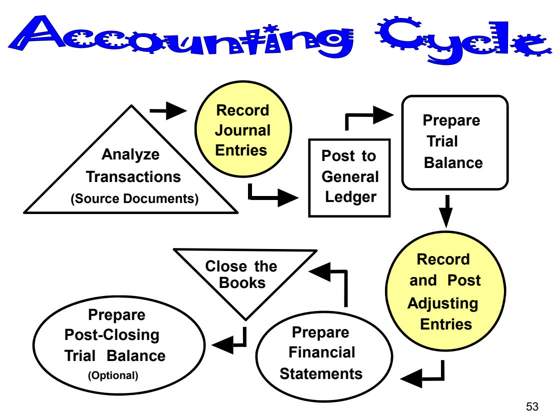
Date of Record (2 days later)
No entry

Payment Date (2 to 4 weeks later)
Dividends Payable 1,000
Cash 1,000

51



52



53

The Adjusting Process

Adjusting Journal Entries (AJE)

Accrual accounting requires that economic events be recorded in the proper accounting period.

Year 1 Year 2

Some economic events affect more than one accounting period.

Some economic events that were not recorded as transactions are required to be recorded as AJEs.

54

Accrued Revenues

Earned but not yet collected or recorded.

Deferred Revenues

Collected in advance but not yet earned.

Accrued Expenses

Incurred but not yet paid or recorded.

Deferred Expenses

Paid (prepaid) but not yet incurred.

55

Accrued Revenues

Earned but not yet collected or recorded.

Facts: On December 1, Alpha made a 60-day loan of $5,000 to another company. Alpha will receive interest of $100 at the end of 60 days.

Dec 31	Interest Receivable	50	
	Interest Revenue		50

56

Dec 31	Salaries Expense	3,000	
	Salaries Payable		3,000

Accrued Expenses

Incurred but not yet paid or recorded.

Facts: Alpha pays employee wages of $5,000 per week. Paychecks are issued on the 2nd and 4th Friday of each month. The last payday is Friday the 26th.

57

December - January

M	T	W	TH	F
22	23	24	25	26
29	30	31	1	2
5	6	7	8	9

58

Dec 31 AJE	Salaries Expense	3,000	
	Salaries Payable		3,000
Jan 9	Salaries Expense	7,000	
	Salaries Payable	3,000	
	Cash		10,000

Use of reversing entries –

Jan 1 **Reversing**	Salaries Payable	3,000	
	Salaries Expense		3,000
Jan 9	Salaries Expense	10,000	
	Cash		10,000

59

Jan 9	**Salaries Expense**	**7,000**	
	Salaries Payable	3,000	
	Cash		10,000

Jan 1 **Reversing**	Salaries Payable	3,000	
	Salaries Expense		**3,000**
Jan 9	**Salaries Expense**	**10,000**	
	Cash		10,000

60

Facts: On December 1, Alpha rented one of its vacant warehouses to another company for 6 months at $1,000 per month. The total rent of $6,000 was received in advance.

Deferred Revenues

Collected in advance but not yet earned.

Dec 1	Cash	6,000	
	Unearned Rent Revenue		6,000
Dec 31	Unearned Rent Revenue	1,000	
	Rent Revenue		1,000

61

$$\frac{\$3{,}000}{3 \text{ years}} = \$1{,}000$$

Dec 31	Insurance Expense	1,000	
	Prepaid Insurance		1,000

Facts: On January 1, Alpha purchased a 3-year insurance policy for $3,000.

Deferred Expenses

Paid (prepaid) but not yet incurred.

62

Unusual AJEs (Called "Alternative Approach" in the textbook.)

Prepaids initially recorded as **expenses**

Recorded prepaid rent paid for one year on March 1.

Normal

Mar 1	Prepaid Rent	12,000	
	Cash		12,000

AJE required to record **10 months** of rent expense is:

Dec 31 AJE	Rent Expense	10,000	
	Prepaid Rent		10,000

Unusual

Mar 1	Rent Expense	12,000	
	Cash		12,000
Dec 31 AJE	Prepaid Rent	2,000	
	Rent Expense		2,000

63

Advances initially recorded as revenues

Recorded rent received in advance for one year on March 1.

Normal

Mar 1	Cash	12,000	
	Unearned Rent Revenue		12,000

AJE required to record **10 months** of rent revenue is:

Dec 31 AJE	Unearned Rent Revenue	10,000	
	Rent Revenue		10,000

Unusual

Mar 1	Cash	12,000	
	Rent Revenue		12,000
Dec 31 AJE	Rent Revenue	2,000	
	Unearned Rent Revenue		2,000

64

Closing Process

Permanent (Real)

Temporary (Nominal)

Creates zero balances in all **temporary** accounts to begin the new accounting period.

Transfers **revenues expenses**, and **dividends** (and all other temporary accounts) into **retained earnings**

65

BALANCE SHEET

Assets	35,000	Liabilities	14,600
		Capital Stock	20,000
		Retained Earnings	400

INCOME STATEMENT

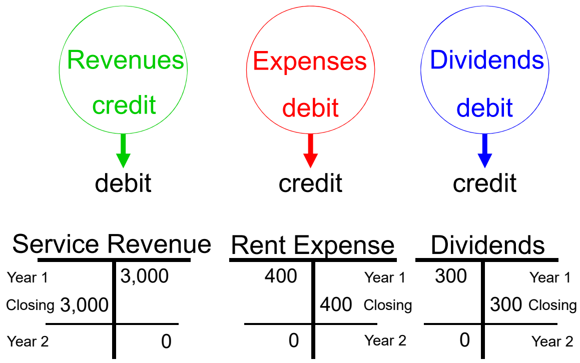
Revenues	8,200
Expenses	6,800
Net Income	1,400

STATEMENT OF RETAINED EARNINGS

Retained Earnings 1/1	0
Net Income	1,400
Dividends	1,000
Retained Earnings 12/31	400

66

To zero out the old balances . . .



67

Cash	$ 700	
Accounts Receivable	1,500	
Supplies	400	
Accounts Payable		$ 300
Capital Stock		1,800
Retained Earnings		0
Dividends	300	
Service Revenue		3,000
Rent Expense	400	
Salaries Expense	1,000	
Utilities Expense	500	
Income Tax Expense	300	
Total	$ 5,100	$ 5,100

68

Service Revenue	**3,000**	
Retained Earnings*		**3,000**
Retained Earnings*	**2,200**	
Rent Expense		**400**
Salaries Expense		**1,000**
Utilities Expense		**500**
Income Tax Expense		**300**
Retained Earnings	**300**	
Dividends		**300**

***Or Income Summary**

69

Retained Earnings (or Income Summary)

Expenses	2,200	3,000	Revenues
		800	Credit Balance **Net Income**
Dividends	300		
		500	Increase

70

Revenues → Retained Earnings
(and all other temporary accounts with a normal credit balance)

Expenses → Retained Earnings
(and all other temporary accounts with a normal debit balance)

Dividends → Retained Earnings

71

Beginning Inventory + **Net Purchases** = Cost of Goods Available for Sale

→ Sold and becomes **Cost of Goods Sold**

→ Not sold and is still in **Ending Inventory**

72

Beginning inventory	**$ 5,000**
Net purchases	**20,000**
Goods available for sale	**25,000**
Less: Ending inventory	**3,000**
Cost of Goods Sold	**$22,000**

73

Sales

Sales returns & allowances

Sales discounts

Net Sales

Purchases

Purchase returns & allowances

Purchase discounts

Net Purchases

74

Inventory Systems

Perpetual			**Periodic**		

Buyer

Purchase

Inventory	**300**		**Purchases**	**300**	
Accounts Payable		**300**	**Accounts Payable**		**300**

Return

Accounts Payable	**50**		**Accounts Payable**	**50**	
Inventory		**50**	**Purchase R & A**		**50**

Discount

Accounts Payable	**250**		**Accounts Payable**	**250**	
Cash		**245**	**Cash**		**245**
Inventory		**5**	**Purchase Discounts**		**5**

75

Perpetual		Periodic	

Seller

Sale

Accounts Receivable	300		Accounts Receivable	300	
Sales		300	Sales		300
Cost of Goods Sold	180				
Inventory		180			

Return

Sales R & A	50		Sales R & A	50	
Accounts Receivable		50	Accounts Receivable		50
Inventory	30				
Cost of Goods Sold		30			

Discount

Cash	245		Cash	245	
Sales Discounts	5		Sales Discounts	5	
Accounts Receivable		250	Accounts Receivable		250

76

Beginning Inventory	20	+1	21
Net Purchases	70		70
Cost of Goods Available	90	+1	91
Ending Inventory	30		30
Cost of Goods Sold	60	+1	61

77

Beginning Inventory	20		20
Net Purchases	70	+1	71
Cost of Goods Available	90	+1	91
Ending Inventory	30		30
Cost of Goods Sold	60	+1	61

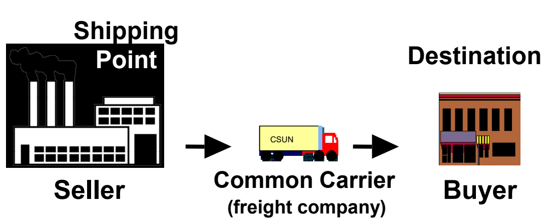
78

Beginning Inventory	20		20
Net Purchases	70		70
Cost of Goods Available	90		90
Ending Inventory	30	+1	31
Cost of Goods Sold	60	-1	59

79

Beginning Inventory	20		20
Net Purchases	70	+1	71
Cost of Goods Available	90		91
Ending Inventory	30	+1	31
Cost of Goods Sold	60		60

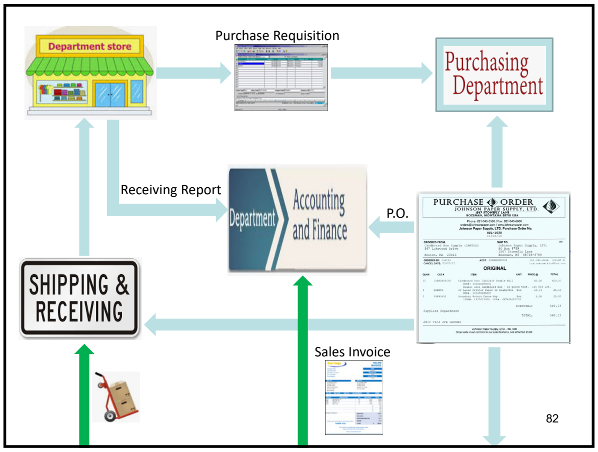
80

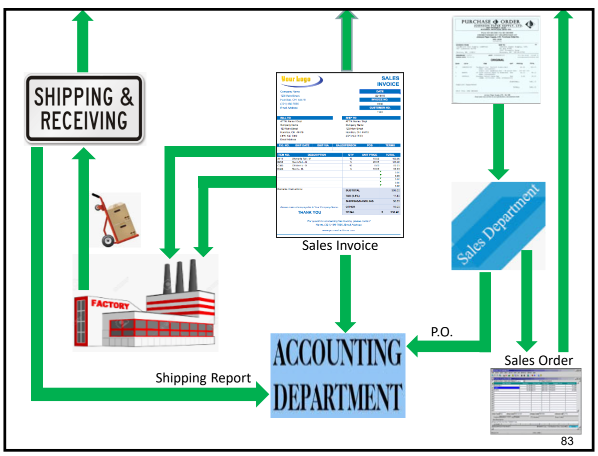


FOB Shipping Point
- Buyer's Expense
- Buyer's Inventory
- Buyer's Risk

FOB Destination
- Seller's Expense
- Seller's Inventory
- Seller's Risk

81



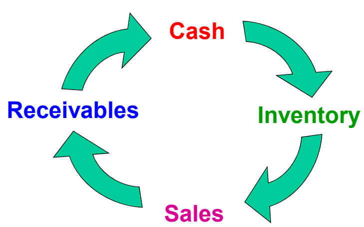


Sales			**910**
Less: Sales returns and allowances		**6**	
Sales discounts		**4**	**10**
Net sales			**900**
Beginning inventory		**200**	
Purchases	**365**		
Less: Purchase returns and allowances	**4**		
Purchase discounts	**3**		
Net purchases		**358**	
Add: Freight-in		**2**	
Cost of goods available for sale		**560**	
Less: Ending inventory		**60**	
Cost of goods sold			**500**
Gross profit			**400**

84

Operating expenses			
Selling expenses			
Freight-out	10		
Advertising expense	70	80	
General & administrative expenses			
Depreciation expense	100		
Salaries expense	200	300	
Total operating expenses			380
Income from operations			20
Other revenues and gains			
Gain on sale of . . .	20		
Interest revenue	30	50	
Other expenses and losses			
Loss on sale of . . .	5		
Interest expense	15	20	30
Income before income taxes			50
Income tax expense			10
Net income			40

Operating Cycle



86

Current

Within one year or the normal operating cycle, whichever is longer.

Current Asset

Cash or other assets expected to be converted into cash, sold, or consumed within one year or the normal operating cycle, whichever is longer.

Current Liability

Obligations expected to be paid (liquidated) with current assets or the creation of other current liabilities within one year or the normal operating cycle, whichever is longer.

87

Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Quick Ratio

$$\frac{\text{Current Assets (minus prepaids and inventory)}}{\text{Current Liabilities}}$$

Remember: Supplies are a prepaid.

88

Assets

Current assets
- Cash → Stated value
- Investment securities → Fair value
- Accounts receivable → Net realizable value
- Inventories → Lower of cost or NRV
- Prepaids (Prepaid expenses) → Cost
- Other current assets

Noncurrent assets
- Long-term investments
- Property, Plant, and Equipment
- Intangible assets
- Goodwill
- Other noncurrent assets

89

Liabilities

Current liabilities
- Notes payable
- Accounts payable
- Salaries payable
- Interest payable
- Income taxes payable
- Utilities payable
- Unearned revenue
- Current portion of long-term debt

Long-term liabilities
- Notes payable
- Bonds payable
- Loans payable
- Deferred income taxes

90

Stockholders' Equity

Preferred stock
Common stock
Paid in capital in excess of par
Retained earnings
Accumulated other comprehensive income

Less: Treasury stock

91

Disclosure

Full Disclosure Principle

Accounting information that could influence the judgment and decisions of an informed user must be disclosed subject to the cost-benefit constraint.

92

Disclosure

Parenthetical notations
Supporting schedules
Audit report
Notes
- Summary of Significant Accounting Policies (Revenue recognition, asset allocation, inventory pricing).
- Marketable securities (ACCT 351)
- Contingency gains and losses (ACCT 351)
- Subsequent events (ACCT 351 and ACCT 460)
- Pension plans (ACCT 352)
- Changes in stockholders' equity (ACCT 352)
- Related-party transactions (ACCT 350 – Chapter 3)
- Changes in accounting principles (ACCT 352)
- Purchase commitments (ACCT 351)
- Segment reporting (ACCT 350 – Chapter 3)

93

Related-Party Transactions

Disclosure of transactions with individuals or entities in which preferential treatment might exist (influence).

- Involving top management or their family.
- A business controlled by someone in top management.
- A subsidiary or parent company.
- Purchase or sale of assets below or above market value.
- Loans having below or above normal interest rates.

Segment Reporting

Disclosure of the different segments of the business.

- 10% or more of revenues, assets, or net income.
- Or 75% of total revenue is from segments.
- Disclosures should also include geographic areas and major customers (10% of revenue).

94

Sales
Cost of goods sold
Gross profit
Operating expenses
Income from operations
} Operating

Other revenues and gains
Other expenses and losses
} Nonoperating

Income before income taxes
Income tax expense

- Income from continuing operations
- **Discontinued operations** (net of taxes)

Net income

95

Discontinued Operations

Disposing of a <u>component</u> of a business in which the operations and cash flows can be clearly distinguished (operationally and reporting).

Represents a strategic shift that has a major impact on the operations and financial results. [Judgment]

- **Major product or service line**
- **Major geographical area**
- **Subsidiary**
- **Division**

(1) Operations and cash flows of component have been (or will be within one year) eliminated.

(2) No significant continuing involvement.

96

Restaurant sells its fast food chain.

Sporting Goods Inc. sells its bicycle division.

Sells one of several manufacturing plants.

Sells manufacturing plant and outsources

Shoe manufacturer and distributor

Sells retail stores.

Sells west coast manufacturing division.

Office supplies and furniture manufacturer

Sells furniture business.

Product groups (must get out of the business)

Bausch & Lomb (sold its sunglass business)

97

If disposal is completed by end of year -

Report (net of taxes)

(a) Income (loss) from DO

(b) Gain (loss) on disposal of DO

If disposal is not completed by end of year -

Report as held-for-sale (net of taxes)

(a) Income (loss) from DO

(b) Impairment loss (if any)

Separate the assets/liabilities as held-for-sale

- Do not depreciate or amortize assets.

98

Net of Income Taxes

IBIT	**$200,000**
Income tax expense **(20%)**	-40,000
Net income (net of taxes)	**$160,000**

Assume "income from operations" of $300,000 and a "loss" of $100,000.

Sales	$xxx,xxx		
Cost of goods sold	xxx,xxx		
Gross profit	xxx,xxx		
Operating expenses	xxx,xxx		
Income from operations	**$300,000**	X 20% = $60,000	
Other expenses and losses	**100,000**		
IBIT	**$200,000**		
Income tax expense (20%)	40,000	→	40,000
Net income	**$160,000**	Tax Benefit	**$20,000**

99

Loss	$100,000
20% tax **benefit**	-20,000
Loss (net of taxes)	$ 80,000

IBIT	$300,000	
Income tax expense	60,000	Discontinued Operations
Income from CO	$240,000	
Loss from DO (net)	80,000	
Net income	**$160,000**	

IBIT	$200,000	Not Discontinued Operations
Income tax expense	40,000	
Net income	**$160,000**	

100

Change in Accounting Principle

- **Change from one GAAP method to another.**
- **New method must be preferable or required**
- **Disclosure note**
- **Retrospectively adjust financial statements**
- **Report the cumulative effect of net income on retained earnings prior to earliest year reported.**

Example: Alpha changes from LIFO to FIFO in year 6. Alpha has been in existence for 6 years.

Year 1 Year 2 Year 3 Year 4 Year 5 Year 6

101

Change in Accounting Estimate

- **Do not restate or report cumulative effect (report prospectively)**
- **Disclosure note if material**

Change in Reporting Entity

- **Restate prior period financial statements**
- **Disclosure note**

Correction of Accounting Errors

- **If material, make prior period adjustment to RE.**
- **Correct account balances**
- **Restate prior period financial statements.**
- **Disclosure note**

102

Comprehensive Income

All changes in stockholders' equity (net assets) except those resulting from investments by and distributions to owners.

Net income
+Other Comprehensive Income (OCI)
Comprehensive Income

Other Comprehensive Income is controlled by external market conditions, not a result of operations.

Net Income
OCI:
- Foreign Currency Translation Adjustment
- Unrealized Gains/Losses on Available-for-Sale Securities
- Impairment of Investment in Debt Securities
- Deferred Gains/Losses on Derivative Financial Instruments
- Minimum Pension Liability

Comprehensive Income

103

Extension of the Income Statement

Sales
Cost of goods sold
Gross profit
Operating expenses
Net income
Foreign currency translation adjustment
Unrealized gains/losses on available-for-sale securities
Impairment of investment in debt securities
Deferred gains/losses on derivative financial instruments
Minimum pension liability
Comprehensive income

Income Statement

Sales
Cost of goods sold
Gross profit
Operating expenses
Net income

Statement of Comprehensive Income

Net income
Other comprehensive income
- Foreign currency translation adjustment
- Unrealized gains/losses on available-for-sale securities
- Impairment of investment in debt securities
- Deferred gains/losses on derivative financial instruments
- Minimum pension liability

Comprehensive income

104

Cash Basis versus Accrual Basis

Cash Basis

- Revenues are recognized when cash is received.
- Expenses are recognized when cash is paid.

Accrual Basis

- Revenues are recognized when earned.
- Expenses are recognized when they help to produce a revenue.

105

Cash Basis versus Accrual Basis

Year 1

Cash	100	
Sales		100
Accounts Receivable	50	
Sales		50

(Cash Basis) $100 + $50 A/R Incr = $150 (Accrual Basis)

Year 2

Cash	120	
Sales		120
Cash	50	
Accounts Receivable		50

(Cash Basis) $170 - $50 A/R Decr = $120 (Accrual Basis)

106

Cash Basis versus Accrual Basis

Cash	2,000	
A/R	1,000	
Sales		3,000

Cash Basis Revenue =
Accrual Basis Revenue =

Cash Basis NI =

Accrual Basis NI =

Miscellaneous Expense	1,000	
Cash		700
A/P		300

Cash Basis Expense =
Accrual Basis Expense =

Cash to Accrual NI =

______ + $1,000 A/R Incr - $300 A/P Incr = ______

107

Cash Basis $\xrightarrow{\text{Net Income}}$ Accrual Basis

Cash Basis = Accrual Basis

Cash Sales (Also fees and other revenues)
Cash Expenses

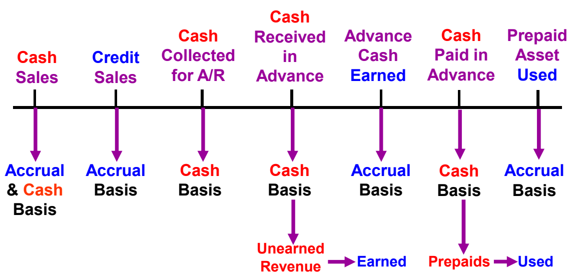
Cash Basis > Accrual Basis

Unearned Revenue (Cash received in advance)
Credit Expenses
Satisfying a Receivable

Cash Basis < Accrual Basis

Credit Sales (Also fees and other revenues)
Prepaids (Cash paid in advance)
Satisfying a Liability (Payable)

108



109

Assets are created by **Revenues**
- **Cash, A/R, and other receivables**

Liabilities are created by **Expenses**
- **A/P and other payables**

Assets are used up by **Expenses**
- **Cash, Supplies, and Inventory**

Liabilities are created by receipt of **Cash**
- **Unearned revenue and notes payable**

Assets are created by payment of **Cash**
- **Supplies and inventory**

110

Cash Basis Net Income

Changes in *Current* Assets & Liabilities

Increases

Decreases

Accrual Basis Net Income

Un-expense? Removing an expense from net income.

Example:

Net income = $100,000 containing an expense of $1,000.
If the $1,000 is un-expensed, net income = ?

111

Questions to ask . . .

1. Does the CA/CL increase or decrease?
2. What kind of journal entry creates that increase or decrease?
3. Does that journal entry affect cash basis or accrual basis?

If cash basis, remove it. If accrual basis, include it.

112

Cash Basis Net Income → **A/R** → Accrual Basis Net Income

A/R Increase $1,000

A/R		Sales	
1,000			1,000

$50,000 Cash Basis Sales → +1,000 → $51,000 Accrual Basis Sales

$3,000 Cash Basis NI → +1,000 → $4,000 Accrual Basis NI

A/R Decrease $1,000

Cash		A/R	
1,000			1,000

$50,000 Cash Basis Sales → -1,000 → $49,000 Accrual Basis Sales

$3,000 Cash Basis NI → -1,000 → $2,000 Accrual Basis NI

113

Cash Basis Net Income → **Prepaids** → Accrual Basis Net Income

Prepaid Increase $1,000

Prepaid		Cash	
1,000			1,000

$50,000 Cash Basis Expense → -1,000 → $49,000 Accrual Basis Expense

$3,000 Cash Basis NI → +1,000 → $4,000 Accrual Basis NI

Prepaid Decrease $1,000

Expense		Prepaid	
1,000			1,000

$50,000 Cash Basis Expense → +1,000 → $51,000 Accrual Basis Expense

$3,000 Cash Basis NI → -1,000 → $2,000 Accrual Basis NI

114

Cash Basis Net Income → **A/P** → Accrual Basis Net Income

A/P Increase $1,000

Expense	
1,000	

A/P	
	1,000

$50,000 Cash Basis Expense → +1,000 → $51,000 Accrual Basis Expense

$3,000 Cash Basis NI → -1,000 → $2,000 Accrual Basis NI

A/P Decrease $1,000

A/P	
1,000	

Cash	
	1,000

$50,000 Cash Basis Expense → -1,000 → $49,000 Accrual Basis Expense

$3,000 Cash Basis NI → +1,000 → $4,000 Accrual Basis NI

115

Cash Basis Net Income → **Unearned Revenue** → Accrual Basis Net Income

Unearned Revenue Increase $1,000

Cash	
1,000	

U/Revenue	
	1,000

$50,000 Cash Basis Revenue → -1,000 → $49,000 Accrual Basis Revenue

$3,000 Cash Basis NI → -1,000 → $2,000 Accrual Basis NI

Unearned Revenue Decrease $1,000

U/Revenue	
1,000	

Sales	
	1,000

$50,000 Cash Basis Revenue → +1,000 → $51,000 Accrual Basis Revenue

$3,000 Cash Basis NI → +1,000 → $4,000 Accrual Basis NI

116

Cash Basis Net Income → **Inventory** → Accrual Basis Net Income

Inventory Increase $1,000

Inventory (Pur)	
1,000	

Cash	
	1,000

$50,000 Cash Basis CGS → -1,000 → $49,000 Accrual Basis CGS

$3,000 Cash Basis NI → +1,000 → $4,000 Accrual Basis NI

Inventory Decrease $1,000

CGS (RE/Inc Sum)	
1,000	

Inventory	
	1,000

$50,000 Cash Basis CGS → +1,000 → $51,000 Accrual Basis CGS

$3,000 Cash Basis NI → -1,000 → $2,000 Accrual Basis NI

117

	12/31/year 1	12/31/year 2	Change	Cash to Accrual CGS	Cash to Accrual NI
Assets					
Inventory	$5,000	$6,000	+$1,000	-$1,000	+$1,000
Liabilities					
A/P (for inventory)	$2,000	$3,000	+$1,000	+$1,000	-$1,000

Cash paid for inventory (CGS) = $120,000

Accrual Basis CGS =

$120,000 - $1,000 (Inv) + $1,000 (A/P) = $120,000

Cash Basis NI = $50,000

Accrual Basis NI =

$50,000 + $1,000 (Inv) - $1,000 (A/P) = $50,000

118

FASB Accounting Standards Codification

The official source of authoritative, nongovernmental U.S. GAAP.

http://asc.fasb.org

119

Areas (9 Categories) Revenue

- Topics (XXX) 605 (Revenue Recognition)
  - Subtopics (YY) 10 (Overall)
    - Sections (ZZ) 25 (Recognition)
      - Subsections 1
        - Paragraphs (>>)

120

In-text Citation

(FASB, (current year), ASC para. 605-10-25-1)
or
(FASB, (current year), ASC ¶ 605-10-25-1)

Reference (on reference page)

Financial Accounting Standards Board (FASB) (current year). *Accounting Standards Codification (ASC) paragraph 605-10-25-1, Revenue Recognition – Overall – Recognition – Revenue and Gains*. Retrieved (current date), from http://asc.fasb.org.

121

During the current year, Alpha Software Company began and completed the creation of the new Houdini computer **software** program to be **sold** to customers. Alpha incurred a total project cost of $10 million prior to marketing the software. Of this amount, $7 million was spent creating the product design and working model of Houdini that provided certainty that the software could be produced as designed. The remaining $3 million was spent performing final testing, debugging, minor coding adjustments, fine-tuning, and creating master copies. You are asked for your advice about how to account for the $10 million of **research** and **development costs** – expense it, capitalize it, or some combination of both.

122

The computer software cost of $7 million that is incurred prior to reaching technological feasibility should be expensed as research and development. (FASB, 20XX, ASC para. 985-20-25-1)

Technological feasibility is reached when "all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications" have been completed such as creating a detailed program design or a working model and product design. (FASB, 20XX, ASC para. 985-20-25-2)

The remaining costs of $3 million incurred after reaching technological feasibility should be capitalized. (FASB, 20XX, ASC para. 985-20-25-3)

123

Purpose Paragraph

You have requested that our firm provide Alpha Software Company advice about whether the costs to produce the Houdini software should be expensed or capitalized. Our recommendation is that your company should expense $7 million in the current year as research and development, and capitalize the remaining $3 million.

124

Supporting Paragraph

The costs Alpha incurred prior to reaching technological feasibility should be expensed and the remaining costs should be capitalized. Alpha incurred a total of $10 million of research and development costs to produce the software. Of this amount, the $7 million incurred to create the product design and working model of the Houdini software prior to reaching technological feasibility should be expensed in the current period. (FASB, 20XX, ASC para. 985-20-25-1)

125

Technological feasibility is reached when "all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications" have been completed. (FASB, 20XX, ASC para. 985-20-25-2) The remaining costs of $3 million incurred to perform final testing, debugging, minor coding adjustments, fine-tuning, and creating master copies should be capitalized. (FASB, 20XX, ASC para. 985-20-25-3)

126

Goodwill Closing Paragraph

We appreciate the opportunity to have advised you and look forward to doing so again in the future. If you have any additional questions or would like further clarification, please contact me at your convenience.

Attachments and Schedules

Include the important numbers and data in the text of the document so that the reader doesn't have to look for it in the schedule or attachment.

127

Letter

- Date
- Name, title and address of recipient
- Salutation
- Purpose paragraph
  a. Briefly describe why this letter is being sent (connect to the recipient).
  b. Identify the issue.
  c. Provide recommendation/conclusion/advice.
- Supporting paragraph(s): The body should have one paragraph for each major issue or alternative.
  a. 1st sentence (topic sentence) – Summarize the content of the paragraph.
  b. Explain "why" by weaving the relevant facts into your analysis.
  c. Cite sources to support your analysis.
- Goodwill closing paragraph
- Closing greeting
- Signature, name, and title

128

Letterhead	FRAF First Rate Accounting Firm 12345 Audit Lane • Northridge, California 91330 • 818-677-5555
Date	**March 20, 20XX**
Name, Title, Address	Mr. Jonathan Smith Controller Alpha Software Company 3123 Client Road Northridge, CA 91330
Salutation	Dear Mr. Smith:
Purpose	You have requested that our firm provide Alpha Software Company advice about whether the costs to produce the Houdini software should be expensed or capitalized. Our recommendation is that your company should expense $7 million in the current year as research and development, and capitalize the remaining $3 million.
Supporting	The costs Alpha incurred prior to reaching technological feasibility should be expensed and the remaining costs should be capitalized. Alpha incurred a total of $10 million of research and development costs to produce the software. Of this amount, the $7 million incurred to create the product design and working model of the Houdini software prior to reaching technological feasibility should be expensed in the current period. (FASB, 20XX, ASC para. 985-20-25-1)
Supporting	Technological feasibility is reached when "all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications" have been completed. (FASB, 20XX, ASC para. 985-20-25-2) The remaining costs of $3 million incurred to perform final testing, debugging, minor coding adjustments, fine-tuning, and creating master copies should be capitalized. (FASB, 20XX, ASC para. 985-20-25-3)
Goodwill Closing	We appreciate the opportunity to have advised you and look forward to doing so again in the future. If you have any additional questions or would like further clarification, please contact me at your convenience.
Closing Greeting	Sincerely,
Signature, Name, Title	Maria Cruz Maria Cruz Partner

129

Memo

- To, From, Date, Subject
- No name, title and address of recipient
- No Salutation
- Purpose paragraph
  - a. Briefly describe why this memo is being sent.
  - b. Identify the issue.
  - c. Provide recommendation/conclusion/advice.
- Supporting paragraph(s): The body should have one paragraph for each major issue or alternative.
  - a. 1st sentence (topic sentence) – Summarize the content of the paragraph.
  - b. Explain "why" by weaving the relevant facts into your analysis.
  - c. Cite sources to support your analysis.
- Goodwill closing paragraph
- No closing greeting
- No signature, name, and title

130

To, From, Date, Subject →

To: Maria Cruz, Partner
From: Albert Ray, Staff Accountant
Date: March 20, 20XX
Subject: Houdini Software Research for Alpha Software Company

Purpose →

You requested that I research whether the costs for the Alpha Software Company to produce the Houdini software should be expensed or capitalized. My recommendation is that Alpha should expense $7 million in the current year as research and development, and capitalize the remaining $3 million.

Supporting →

The costs Alpha incurred prior to reaching technological feasibility should be expensed and the remaining costs should be capitalized. Alpha incurred a total of $10 million of research and development costs to produce the software. Of this amount, the $7 million incurred to create the product design and working model of the Houdini software prior to reaching technological feasibility should be expensed in the current period. (FASB, 20XX,ASC para. 985-20-25-1)

Supporting →

Technological feasibility is reached when "all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications" have been completed. (FASB,20XX,ASC para. 985-20-25-2) The remaining costs of $3 million incurred to perform final testing, debugging, minor coding adjustments, fine-tuning, and creating master copies should be capitalized. (FASB, 20XX,ASC para. 985-20-25-3)

Goodwill Closing →

Let me know if you have any questions or would like further clarification.

131

Email

- Subject line: Brief description that describes the content of the email.
- No name, title and address of recipient
- Salutation
- Introductory paragraph: Only if the recipient doesn't know you or why you are writing.
- Purpose paragraph
  - a. Briefly describe why this email is being sent.
  - b. Identify the issue.
  - c. Provide recommendation/conclusion/advice.
- Supporting paragraph
  - a. 1st sentence (topic sentence) – Summarize the content of the paragraph.
  - b. "Briefly" explain your analysis (much less than for a letter or memo).
  - c. Cite sources to support your analysis.
- Goodwill closing paragraph
- Closing greeting
- Use signature box for contact information.

132

To, From, Subject	From: Cruz, Maria <maria.cruz@fraf.com> · Reply · Forward · Archive · Junk · Delete · More Subject: How to Account for Houdini Software · 3/20/20XX, 10:43 AM To: Smith, Jonathan
Salutation	Dear Mr. Smith:
Purpose	You have requested that our firm provide Alpha Software Company advice about whether the costs to produce the Houdini software should be expensed or capitalized. Our recommendation is that your company should expense $7 million in the current year as research and development, and capitalize the remaining $3 million.
Supporting	The costs Alpha incurs prior to it being determined that the software can be successfully marketed (technological feasibility) should be expensed and the remaining costs should be capitalized. Alpha incurred a total of $10 million of research and development costs to produce the software. Of this amount, the $7 million incurred to create the product design and working model of the Houdini software prior to reaching technological feasibility should be expensed in the current period. (FASB, **20XX,** ASC para. 985-20-25-1)
Goodwill Closing	We appreciate the opportunity to have advised you and look forward to doing so again in the future. If you have any additional questions or would like further clarification, please contact me at your convenience.
Closing Greeting	Sincerely, *Maria Cruz*
Signature box and maybe signature	Maria Cruz Partner First Rate Accounting Firm 12345 Audit Lane Northridge, California 91330 818-677-5555

133

	Letter	Memo	Email
Subject Line	None	✓	✓
Recipient's Name, Title, Address	✓	None	None
Salutation	✓	None	Maybe
Purpose Paragraph	✓	✓	✓
Supporting Paragraph	✓	✓	✓
Goodwill Closing Paragraph	✓	✓	✓
Closing Greeting	✓	None	✓
Signature, Name, Title	✓	None	Maybe

134

How to Improve Your Writing Skills

1. Read one good novel every three to six months.

2. Utilize the services at the Learning Resource Center at https://www.csun.edu/undergraduate-studies/learning-resource-center.

3. Obtain online help for Handout 7 writing assignment. See https://youtu.be/3ACppa0U0wc to view a tutorial about how to make an appointment for online help.

135

Paraphrasing

- The goal is to make it simpler and easier for the reader to understand.
- Converting someone else's words into your own.
- Even though you use your own words, you must cite the original source because it is someone else's idea, concept, or work product.

136

Spiceland, chapter 6, p. 275

According to the FASB's conceptual framework, "Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

In simpler terms, revenue is the inflow of cash or accounts receivable that a business receives when it provides goods or services to its customers.

137

According to the FASB's conceptual framework, "Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

In simpler terms, revenue is the inflow of cash or accounts receivable that a business receives when it provides goods or services to its customers.

138

According to the FASB's conceptual framework, "Revenues are inflows . . . [of cash or accounts receivable] of an entity or settlements of its liabilities [such as unearned revenue] . . . from delivering or producing goods, rendering services . . ."

According to the FASB's conceptual framework, "[r]evenues are inflows . . . [of cash or accounts receivable] of an entity or settlements of its liabilities [such as unearned revenue] . . . from delivering or producing goods, rendering services . . ."

139

Proofreading

- Don't rely only on a spell checker.
- Check for grammar, tone, and typos.
- Have someone else read what you wrote and tell you what it means.
- Examples of how the typo of a single letter or misplaced word can change the meaning:
  - Correct: "As a result of our meeting, we are now able to prepare your financial statements by the deadline."
    Error: "As a result of our meeting, we are not able to prepare your financial statements by the deadline."
  - Placement of the word "only" can give multiple meanings.
    - Maria received an offer for an internship from XYZ.
    - Only Maria received an offer for an internship from XYZ.
    - Maria only received an offer for an internship from XYZ.
    - Maria received an offer for an internship only from XYZ.

140

Farther (distance) & Further (additional)

- I can go much farther.
- I provided further information.

Than (more than) & Then (if . . . then)

- We studied more than they did.
- If they study, then we will also study.

Imply & Infer (the speaker implies, the listener infers)

- Did the professor imply that the exam would be difficult?
- Did the students infer that the exam would be difficult?

Spell Receivable, Depreciation, & Dividend correctly.
Wrong: Recievable, Depriciation, & Divident

141

Advise (verb) & **Advice** (noun)

- Please advise that person about the rules.
- I gave the person good advice.

Insure (insurance) & **Ensure** (guarantee) & **Assure** (to convince)

- Did that insurance company insure your car?
- I will ensure that the door is locked.
- I assure you that everything is good.

May (permission) & **Can** (physical act)

- May I leave the room? (Not can I leave the room?)
- Can I finish the marathon? (Physically able to finish?)

Principle (rule) & **Principal** (money or person)

142

Affect (verb) & **Effect** (noun)

- Cold winters affect the quality of grapes.
- The effect of cold winters on the quality of grapes is bad.

i.e. (saying it differently to clarify) & **e.g.** (for example)

- The weather has been unusual (i.e., really hot).
- The weather has been warm (e.g., 100 degrees in March).

Who (verb follows) & **Whom** (follows a preposition)

- I know who is going to the concert.
- I know to whom I will give the concert tickets.

Who is saying what to Whom?

It's correct if you can substitute the following pronouns for who and whom.

(I, he, she) is (am) saying what to (me, him, her)?

143

Don't End a Sentence With a Preposition

I don't know who I'm going to give this gift to.

I don't know to whom I'm going to give this gift.

144

Avoid saying . . .

Basically . . .

Like . . .

Ya know . . .

Uh . . . Um . . .

Whatever . . .

To be honest . . . *or* To tell you the truth . . .

To be candid . . . Believe me when I tell you . . .

The response to "thank you" should be "you're welcome", not "no problem."

145

AICPA *Code of Professional Conduct*

In the performance of any professional service, a member shall maintain **objectivity** and **integrity**, shall be free of **conflicts of interest**, and shall **not knowingly misrepresent facts** or **subordinate** his or her **judgment to others**.

Subordinate - someone has a duty or responsibility to make a decision but lets others make it.

Objectivity - a state of mind; imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Integrity - a character trait that relates to honesty. Looks beyond the letter of the law to its underlying spirit.

146

Handout 5	Cash Basis	Change	Accrual Basis
Sales	$67,300	+1,700 A/R Increase	$69,000
Cost of goods sold	30,600	+ 900 A/P Increase - 700 Inv Increase	30,800
Gross profit	$36,700		$38,200
Salaries expense	$15,500	+ 400 S/P Increase	$15,900
Supplies expense	2,500	+1,100 Supplies Decrease	3,600
Depreciation expense	0	+1,200	1,200
Dividends	6,000	-6,000	
Other OE	5,500		5,500
Total expenses	$29,500		$26,200
IBIT	$ 7,200		$12,000
Income tax expense	2,000		3,000
Net income	$ 5,200		$9,000

147

Beginning Inventory	$ 5,600
Purchases	31,500
Cost of Goods Available	$37,100
Ending Inventory	6,300
Cost of Goods Sold	$30,800

+700

Cash purchases	$30,600
Plus: A/P increase	900
	$31,500

148

Sales		**$69,000**
Beginning inventory	**$ 5,600**	
Purchases	**31,500**	
Cost of goods available for sale	**$37,100**	
Less: Ending Inventory	**6,300**	
Cost of goods sold		**30,800**
Gross profit		**$38,200**
Operating expenses:		
Salaries expense	**$15,900**	
Supplies expense	**3,600**	
Depreciation expense	**1,200**	
Other operating expenses	**5,500**	
Total operating expenses		**26,200**
Income before income taxes		**$12,000**
Income tax expense		**3,000**
Net income		**$ 9,000**

149

Cash		**$ 7,900**
Accounts receivable		**5,900**
Supplies		**1,000**
Inventory		**6,300**
Equipment	**$12,000**	
Less: Accumulated depreciation	**6,000**	**6,000**
Total assets		**$27,100**
Accounts payable		**$ 7,000**
Salaries payable		**900**
Income tax payable		**3,000**
Total liabilities		**$10,900**
Common stock		**7,000**
Retained earnings		**9,200**
Total stockholders' equity		**$16,200**
Total liabilities and stockholders' equity		**$27,100**

150

Cash Basis Net Income	$5,200
Accounts Receivable (Inc)	+1,700
Inventory (Inc)	+ 700
Dividends	+6,000
Depreciation	- 1,200
Supplies (Dec)	- 1,100
Accounts Payable (Inc)	- 900
Salaries Payable (Inc)	- 400
Income Tax Payable (Inc)	- 1,000
Accrual Basis Net Income	$9,000

151

Statement of Cash Flows

- Ability to generate positive future net cash flows.
- Ability to meet obligations and pay dividends.
- Need for external funding.
- Reasons for differences between net income and associated cash receipts and payments.
- Assess the cash and noncash aspects of financing and investing activities.

152

Cash	2,000	
A/R	1,000	
Sales		3,000

Cash Basis Revenue =
Accrual Basis Revenue =

Accrual Basis NI =

Cash Basis NI =

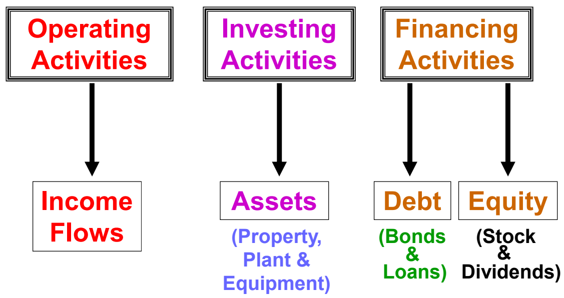
Miscellaneous Expense	1,000	
Cash		700
A/P		300

Cash Basis Expense =
Accrual Basis Expense =

Accrual to Cash NI =

_______ - $1,000 A/R Incr + $300 A/P Incr = _______

153



Operating Activities

Operating activities involve the cash effects of transactions that enter into the determination of net income, such as **cash receipts** from sales of goods and services and **cash payments** to suppliers and employees for acquisitions of inventory and expenses.

155

Investing Activities

Examples of investing activities include transactions involving:

- ✓ Making and collecting loans.
- ✓ Acquiring and selling investments
- ✓ Acquiring and selling property, plant, and equipment.

156

Financing Activities

Typical financing activities include transactions involving:

- Obtaining capital from owners.
- Providing owners with a return on, and a return of, their investment.
- Obtaining cash from creditors.
- Repaying creditors for amounts borrowed.

157

Accrual Net Income
(revenues - expenses)
±
Adjustments
=
Operating Cash Flows (net cash)

Net Income → Net Cash

158

Adjustments

Net Income
\+ Depreciation and Amortization Expense
\+ Losses
\- Gains
\- Increases in Current Assets (other than cash)
\+ Decreases in Current Assets (other than cash)
\+ Increases in Current Liabilities
\- Decreases in Current Liabilities

= Cash Flow from Operating Activities

159

Questions to ask . . .

1. Does the CA/CL increase or decrease?
2. What kind of journal entry creates that increase or decrease?
3. Does that journal entry affect cash basis or accrual basis?

If accrual basis, remove it. If cash basis, include it.

160

Accrual Basis Net Income → **A/R** → Cash Basis Net Income

A/R Increase $1,000

A/R		Sales	
1,000			1,000

$3,000 Accrual Basis NI → -1,000 → $2,000 Cash Basis NI

A/R Decrease $1,000

Cash		A/R	
1,000			1,000

$3,000 Accrual Basis NI → +1,000 → $4,000 Cash Basis NI

161

Accrual Basis Net Income → **Prepaids** → Cash Basis Net Income

Prepaid Increase $1,000

Prepaid		Cash	
1,000			1,000

$3,000 Accrual Basis NI → -1,000 → $2,000 Cash Basis NI

Prepaid Decrease $1,000

Expense		Prepaid	
1,000			1,000

$3,000 Accrual Basis NI → +1,000 → $4,000 Cash Basis NI

162

Accrual Basis Net Income → **A/P** → Cash Basis Net Income

A/P Increase $1,000

Expense	
1,000	

A/P	
	1,000

$3,000 Accrual Basis NI → +1,000 → $4,000 Cash Basis NI

A/P Decrease $1,000

A/P	
1,000	

Cash	
	1,000

$3,000 Accrual Basis NI → -1,000 → $2,000 Cash Basis NI

163

Accrual Basis Net Income → **Unearned Revenue** → Cash Basis Net Income

Unearned Revenue Increase $1,000

Cash	
1,000	

U/Revenue	
	1,000

$3,000 Accrual Basis NI → +1,000 → $4,000 Cash Basis NI

Unearned Revenue Decrease $1,000

U/Revenue	
1,000	

Sales	
	1,000

$3,000 Accrual Basis NI → -1,000 → $2,000 Cash Basis NI

164

Accrual Basis Net Income → **Inventory** → Cash Basis Net Income

Inventory Increase $1,000

Inventory (Pur)	
1,000	

Cash	
	1,000

$3,000 Accrual Basis NI → -1,000 → $2,000 Cash Basis NI

Inventory Decrease $1,000

CGS (R/E)	
1,000	

Inventory	
	1,000

$3,000 Accrual Basis NI → +1,000 → $4,000 Cash Basis NI

165

	Year 1	Increase (Decrease)	Year 2
Cash	$15,000	4,000	$19,000
Accounts receivable	17,000	(7,000)	10,000
Inventory	40,000	12,000	52,000
Prepaid rent	2,000	2,000	4,000
Equipment	$12,000	8,000	20,000
Accumulated depreciation	(3,000)		(6,000)
Total assets	$83,000		$99,000
Accounts payable	$10,000	3,000	$13,000
Salaries payable	5,000	3,000	8,000
Common stock	34,000	1,000	35,000
Retained earnings	34,000		43,000
Total liabilities & stockholders' equity	$83,000		$99,000

Sales		$110,000
Cost of goods sold		45,000
Gross profit		65,000
Rent expense	$12,000	
Salaries expense	30,000	
Utilities expense	2,000	
Depreciation expense	3,000	
Tax expense	3,000	50,000
Net income		$15,000

166

Indirect Method

Net Cash Flow from Operating Activities		
Net income	$15,000	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	3,000	
Decrease in accounts receivable	7,000	
Increase in accounts payable	3,000	
Increase in salaries payable	3,000	
Less: Increase in inventory	(12,000)	
Increase in prepaid rent	(2,000)	
Net cash provided by operating activities		17,000
Cash Flows from Investing Activities		
Payment for purchase of equipment	(8,000)	
Net cash used for investing activities		(8,000)
Cash Flows from Financing Activities		
Issuance of common stock	1,000	
Payment of dividends	(6,000)	
Net cash provided by financing activities		(5,000)
Net increase in cash		$ 4,000

167

Indirect Method

Net income	$15,000	
Add: Depreciation expense	3,000	
Decrease in accounts receivable	7,000	
Increase in accounts payable	3,000	
Increase in salaries payable	3,000	
Less: Increase in inventory	(12,000)	
Increase in prepaid rent	(2,000)	
Net cash provided by operating activities		$17,000

Direct Method

Cash received from customers	$117,000	
Cash paid for inventory	(54,000)	
Cash paid for rent	(14,000)	
Cash paid for utilities	(2,000)	
Cash paid to employees	(27,000)	
Cash paid for income taxes	(3,000)	
Net cash provided by operating activities		$17,000

168

Nonmonetary Exchange

Alpha obtained a $10,000 loan from Beta Bank.

Cash	$10,000	
Notes Payable		$10,000

Alpha used the $10,000 to purchase equipment.

Equipment	$10,000	
Cash		$10,000

Alpha purchased equipment in return for a note.

Equipment	$10,000	
Notes Payable		$10,000

169

Equipment	**$20,000**
Accumulated Depreciation	**16,000**
Book Value	**$ 4,000**

Sold (Cash received)

> Book Value → **Gain**

< Book Value → **Loss**

170

	Gain	Loss
Cash Received	$ 5,000	$ 1,000
Book Value	4,000	4,000
Gain	$ 1,000	
Loss		$ (3,000)

171

Gain

Cash	5,000	
Accumulated Depr	16,000	
Equipment		20,000
Gain on Sale		1,000

Loss

Cash	1,000	
Accumulated Depr	16,000	
Loss on Sale	3,000	
Equipment		20,000

172

Gain

Cash	5,000	
Accumulated Depr	16,000	
Equipment		20,000
Gain on Sale		1,000

Statement of Cash Flows

Net Cash Flow from **Operating Activities**

Net income	**$15,000**
Less: **Gain on sale of equipment**	**(1,000)**

Cash Flows from **Investing Activities**

Proceeds from sale of equipment	**5,000**

173

Loss

Cash	1,000	
Accumulated Depr	16,000	
Loss on Sale	3,000	
Equipment		20,000

Statement of Cash Flows

Net Cash Flow from **Operating Activities**

Net income	**$15,000**
Add: **Loss on sale of equipment**	**3,000**

Cash Flows from **Investing Activities**

Proceeds from sale of equipment	**1,000**

174

Time Value of Money

Present Value

Simple Interest

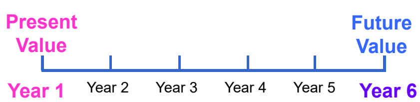
Interest on original principal only.

Principal X Rate X Time

175

Compound Interest

Interest on both principal and unpaid accrued interest.



176

Compounded Semiannually

2 interest periods per year

4 years = 8 periods

8% = 4%

Table 2

177

Compounded Quarterly

4 interest periods per year

4 years = 16 periods

8% = 2%

178

n	2.0%	4.0%	5.0%	6.0%	8.0%
1	0.98039	0.96154	0.95238	0.94340	0.92593
2	0.96117	0.92456	0.90703	0.89000	0.85734
3	0.94232	0.88900	0.86384	0.83962	0.79383
4	0.92385	0.85480	0.82270	0.79209	0.73503
5	0.90573	0.82193	0.78353	0.74726	0.68058
6	0.88797	0.79031	0.74622	0.70496	0.63017
7	0.87056	0.75992	0.71068	0.66506	0.58349
8	0.85349	0.73069	0.67684	0.62741	0.54027

179

Present Value of a Single Sum

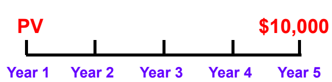


Table 2, compounded annually

(n=4,i=8%) $10,000 (0.73503) = $7,350

180

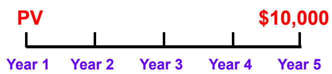


Table 2, compounded semiannually

(n=8,i=4%) **$10,000 (0.73069) = $7,307**

181

Annuity

Series of equal periodic payments or receipts.

Present Value of an Ordinary Annuity

PV one period before the first payment or receipt.

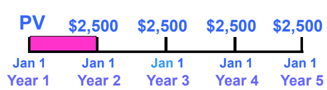


Table 4, compounded annually

(n=4,i=8%) **$2,500 (3.31213) = $8,280**

182

Present Value of an Annuity Due

PV on the day of the first payment or receipt.

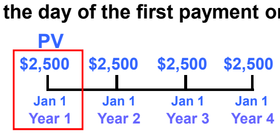
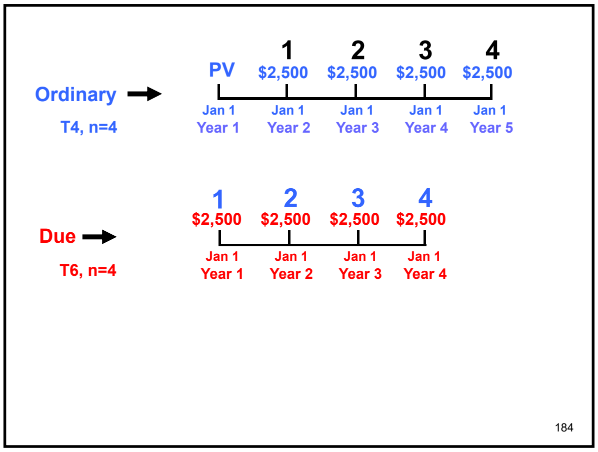
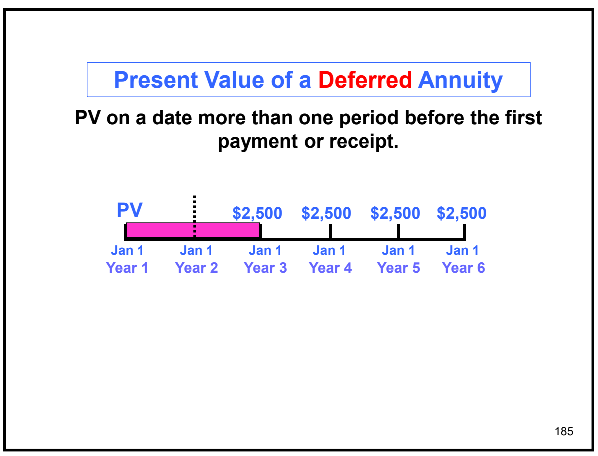


Table 6, compounded annually

(n=4,i=8%) **$2,500 (3.57710) = $8,943**

183


Ordinary
T4, n=4
PV
1 2 3 4
$2,500 $2,500 $2,500 $2,500
Jan 1 Year 1
Jan 1 Year 2
Jan 1 Year 3
Jan 1 Year 4
Jan 1 Year 5
Due
T6, n=4
1 2 3 4
$2,500 $2,500 $2,500 $2,500
Jan 1 Year 1
Jan 1 Year 2
Jan 1 Year 3
Jan 1 Year 4
184


Present Value of a Deferred Annuity
PV on a date more than one period before the first payment or receipt.
PV
$2,500 $2,500 $2,500 $2,500
Jan 1 Year 1
Jan 1 Year 2
Jan 1 Year 3
Jan 1 Year 4
Jan 1 Year 5
Jan 1 Year 6
185

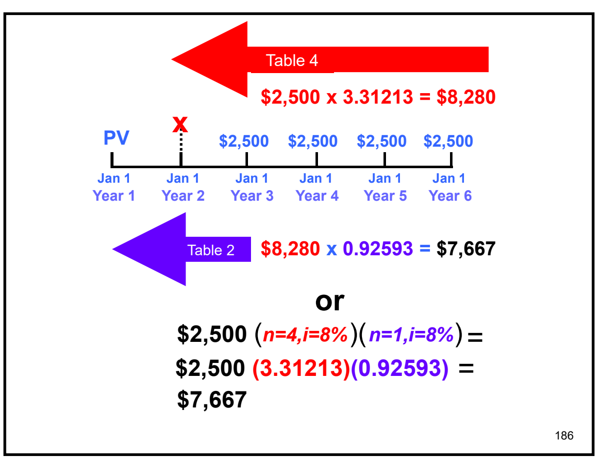


Table 4
$2,500 x 3.31213 = $8,280
PV
x
$2,500 $2,500 $2,500 $2,500
Jan 1 Year 1
Jan 1 Year 2
Jan 1 Year 3
Jan 1 Year 4
Jan 1 Year 5
Jan 1 Year 6
Table 2
$8,280 x 0.92593 = $7,667
or
$2,500 (n=4,i=8%)(n=1,i=8%) =
$2,500 (3.31213)(0.92593) =
$7,667
186

How much should I deposit today if I want to receive four annual payments of $2,500 beginning year 3 (two years from today) using interest of 8% compounded annually?

Ordinary

PV | | $2,500 | $2,500 | $2,500 | $2,500

Jan 1 Year 1 | Jan 1 Year 2 | Jan 1 Year 3 | Jan 1 Year 4 | Jan 1 Year 5 | Jan 1 Year 6

$\$2,500\ \underset{T4,\ n=4}{(3.31213)}\underset{T2,\ n=1}{(0.92593)} = \$7,667$

Due

PV | | $2,500 | $2,500 | $2,500 | $2,500

Jan 1 Year 1 | Jan 1 Year 2 | Jan 1 Year 3 | Jan 1 Year 4 | Jan 1 Year 5 | Jan 1 Year 6

$\$2,500\ \underset{T6,\ n=4}{(3.57710)}\underset{T2,\ n=2}{(0.85734)} = \$7,667$

187

Generally Accepted Accounting Principles (GAAP)

GAAP are the guidelines, procedures, and practices that a company is required to use in recording and reporting the accounting information in its audited financial statements.

"Generally accepted" means that either an authoritative accounting rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted because of universal application.

188

GAAP ← **General Purpose Framework**

vs.

Income Tax Basis

vs.

Cash Basis

vs.

Modified Cash Basis

vs.

Regulatory Basis

vs.

Contract Basis

← **Special Purpose Frameworks**

OCBOA

Other Comprehensive Basis of Accounting

"Financial Reporting Framework" (FRF) is replacing the terms "basis of accounting"

Financial Reporting Framework for Small and Medium-Sized Entities

(FRF for SME)

↓

Manager Owner

- ❑ Assesses performance
- ❑ What is owned
- ❑ What is owed
- ❑ Cash flow

189

Audit Review Compilation

Level of assurance: Whether material modification of financial statements is needed and/or whether the financial statements are free from material misstatement.

Compilation: "No" assurance that material modification isn't needed to the financial statements. Merely prepares financial statements using what the client provides.

Review: "Limited" assurance that material modification isn't needed to the financial statements.

Audit: "High level" of assurance that the financial statements are free from material misstatement.

Statements on Standards for Accounting & Review Services **(SSARS) contain the standards for compilations and reviews.** ***Statements on Auditing Standards*** **(SAS) contain the standards for audits. (Both are issued by committees of the AICPA)**

190

1933-1934

- **Securities Act**
- **Securities Exchange Act**
- **Created the Securities and Exchange Commission**

SEC has the legal authority to prescribe accounting principles and reporting practices for all companies issuing publicly traded securities.

- **5 commissioners appointed by the President of the United States for 5-year terms.**
- **One of the commissioners serves as chair (also appointed by the President).**
- **No more than 3 may be from the same political party.**

191

History of GAAP in the Private Sector

1938	1959	1973	2009 – Present
Committee on Accounting Procedure formed	Accounting Principles Board formed	Financial Accounting Standards Board formed	**FASB** Accounting Standards Codification
CAP issued 51 *ARBs*	APB issued 31 *Opinions*	FASB issued 168 *Statements*	FASB has issued ___ *Updates*

192

FASB

- 7 members
- Paid, full-time, 5-year terms
- Autonomous
- Severed all ties
- CPA not required

193

Financial Accounting Foundation

- American Accounting Association
- American Institute of Certified Public Accountants
- Chartered Financial Analyst Institute
- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry and Financial Markets Association

Private Company Council

Emerging Issues Task Force

194

Public Company Accounting Oversight Board (PCAOB)

- **Created as a result of the Sarbanes-Oxley Act.**
- **Establishes auditing, quality control, ethics, and independence standards and rules.**
- **Appointed by the SEC.**
- **Five members, limited to two CPAs.**
- **If chair is a CPA, cannot have practiced in the last 5 years.**

195

Sarbanes-Oxley Act

- The lead audit partner and review partner must rotate every 5 years.
- Auditors are prohibited from offering a variety of non-audit services to audit clients.
- CEOs and CFOs must personally certify the financial statements and disclosures.
- The audit committee hires the auditor, determines compensation, oversees the auditor's work, and resolves disagreements between the auditor and management (auditors report directly to the audit committee).
- Code of ethics is required for senior financial officers.
- Companies must document and assess the effectiveness of their internal controls.

196

Charges Given to the FASB

To develop a conceptual framework of accounting theory.

197

Charges Given to the FASB

To establish standards (GAAP) for financial accounting practices.

198

FASB Conceptual Framework

- To guide the FASB in establishing accounting standards.
- To provide a frame of reference for resolving accounting questions in situations where a standard does not exist.
- To determine the bounds for judgment in the preparation of financial statements.
- To increase users' understanding of and confidence in financial reporting.
- To enhance comparability.

Slides 200-203 will not be covered in the class lecture. For the exam, study these slides and pp. 17-24 in Spiceland.

199

Objective of Financial Reporting

To provide financial information that is **useful** to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Fundamental Qualitative Characteristics

- **Relevance**
  - Predictive Value
  - Confirmatory Value
  - Materiality
- **Faithful Representation**
  - Completeness
  - Neutrality
  - Free from Error

Enhancing Qualitative Characteristics

- Verifiability
- Timeliness
- Understandability
- Comparability

200

Fundamental Qualitative Characteristics

- **Relevance**: Capable of making a difference in decisions
  - **Predictive Value**: Predicts future outcomes
  - **Confirmatory Value**: Provides feedback about previous predictions (confirms or changes).
  - **Materiality**: Evaluates the effect on decisions based on the nature and magnitude of reported items.
- **Faithful Representation**: Faithfully represents what it purports to represent
  - **Completeness**: Provides all necessary information.
  - **Neutrality**: Free from bias (not intended to achieve a predetermined result).
  - **Free from Error**: No errors or omissions in description of process used.

201

Enhancing Qualitative Characteristics

- Verifiability
- Timeliness
- Understandability
- Comparability

Pervasive Constraint

Cost/Benefit

202

Verifiability: Independent measurers, using the same measurement methods, obtain similar results.

The primary concern of auditing is termed the attest function, which is the review of a sample of a company's transactions to provide assurance that the recording and reporting of the financial information can be duplicated substantially by an independent measurer (CPA).

Timeliness: Available to users before information loses its capacity to influence their decisions.

Understandability: Classifying, characterizing, and presenting information clearly and concisely.

Comparability: Accounting information enables users to identify and explain similarities and differences between two or more enterprises.

203

Materiality: Examines both the nature of an item and the relative size of an item (rather than the absolute size).

- The 5% rule (5% of net income or assets).

Example of a bright-line (a quantitative measure).

In addition to the 5% rule, the SEC considers an item material if any of the following exist (uses judgment, not bright-lines):

SEC
- Results in meeting Wall Street or analysts targets.
- Preserves a positive earnings pattern.
- Converts a loss into a profit or vice versa
- Increases management's compensation (bonuses)
- Hides an illegal transaction

204

Principles

Historical Cost Principle

Assets and liabilities are reported at the **exchange** or **acquisition price**.

Exceptions:

- **Lower of cost and net realizable value (inventory)**
- **Fair value (debt and equity security investments)**
- **Net realizable value (account receivables)**

205

Matching Principle

The **matching** principle states that expenses are recognized in the same period as the revenue they help to produce (generate).

206

Full Disclosure Principle

Accounting information that could **influence** the judgment and decisions of an informed user must be disclosed subject to the cost-benefit constraint.

- **Financial Statements**
- **Notes to Financial Statements**
- **Supplementary Information**

207

International Accounting Standards Board (IASB)

14 members

Requires 9 to approve

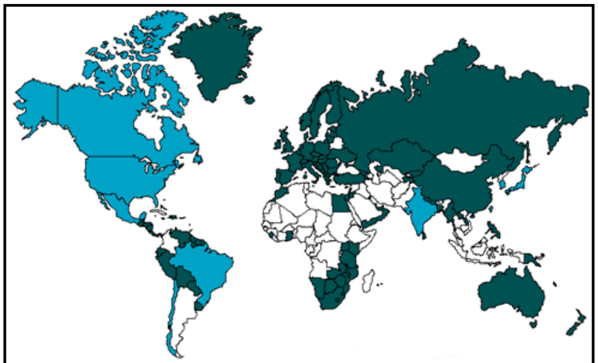
International Financial Reporting Standards (IFRS)

IASC (1973-2001) issued 41 IAS

IASB (2001-present) has implemented 17 IFRS

U.S. GAAP → **Convergence** ← International GAAP

208



Countries that require or permit IFRSs

Countries seeking convergence with the IASB or pursuing adoption of IFRSs

Taken from http://www.iasb.org/About+Us/About+IASB/IFRSs+around+the+world.htm.

209

GAAP	IFRS
Rules Based	**Principles Based** (Objectives Oriented)
Rules, exceptions, & bright-line tests.	Professional judgment & achieving the objective.
Avoid litigation, but there is risk of gaming the rules.	Loss of comparability

210

FASB ⇨ Convergence ⇦ IASB

- Based on conceptual framework.
- State objective of the standard.
- Provide enough detail, but not too much.
- Minimize exceptions.
- Avoid bright-line or percentage tests that achieve technical compliance but evade the intent of the standard.

211

Declining Balance

Facts: Cost = $10,000
Life = 5 years
Salvage Value = $1,000

Straight-Line % = 1/5 or 20%
Double-Declining Balance (200%) = 40%

212

Double-Declining Balance

Facts: Cost = $10,000
Life = 5 years
Salvage Value = $1,000

Year 1	40%	x	$ 10,000	=	$4,000
Year 2	40%	x	6,000	=	2,400
Year 3	40%	x	3,600	=	1,440
Year 4	40%	x	2,160	=	864
Year 5	$1,296	-	1,000	=	296

Remaining book value = $1,000

213