

1. What are the three different forms of business organizations? What are the advantages and the disadvantages to each of these forms?

- Two different forms only: Business entities and Non-business entities
- Business entities consist of: sole proprietorship, corporation and partnership
- Business entities are organized to earn income

1. Sole Proprietorship

a. Advantages:

- (1). No organizational formalities.
- (2). Decision making is informal and centered in the owner.
- (3). No qualification requirements for doing business in other states.
- (4). Minimal reporting to governmental entities.
- (5). Business profits are subject to only one tax, at the individual level, and are not subject to double tax as would be the case if the profits were realized by a C corporation.
- (6). Losses are available on the owner's personal income tax return and can offset other income (subject to the passive loss rules).

b. Disadvantages:

- (1). Owner has unlimited liability for obligations and liabilities of the business.
- (2). Death or disability of owner terminates business.
- (3). Sale or other transfer of business requires transfer of individual assets.
- (4). No opportunity to utilize equity capital contributed by persons other than the owner.
- (5). Business profits are taxed as income to the owner and, as a result, will be subject to self-employment tax as well as income tax.

2. Partnership

a. Advantages:

- (1). Multiple owners can provide a combination of individual resources and talents.
- (2). Minimal formalities are required for organization.
- (3). Decision making may be informal.
- (4). No qualification requirements for doing business in other states.
- (5). Minimal reporting to governmental entities.
- (6). Business profits are subject to only one tax, at the individual partner level, and are not subject to double tax as would be the case if the profits were earned by a C corporation.
- (7). Losses are available on the partners' personal income tax returns and can offset other income (subject to the passive loss rules).
- (8). Special allocations may be made for income tax purposes.
- (9). Disproportionate distributions may be made to partners.

b. Disadvantages:

- (1). Partners have unlimited liability for obligations and liabilities of the business.
- (2). Death, disability, or withdrawal of a partner may terminate partnership.
- (3). All partners have the right to participate in management.
- (4). All partners have broad authority to act on behalf of, and incur debts and liabilities for, the partnership.
- (5). Business profits are taxed as income to the individual partners and, as a result, may be subject to self-employment tax as well as income tax.

5. Corporation

a. Advantages:

- (1). All shareholders enjoy limited liability.
- (2). Ownership interests are freely transferable.
- (3). Perpetual existence unaffected by the death of shareholders or transfer of shares.
- (4). Centralized management.
- (5). No limitation on the number or types of shareholders.
- (6). Flexibility of financing is available through the sale of various types of securities to many investors.
- (7). Tax-favored fringe benefits are available to employee-shareholders.
- (8). Income is taxable at corporate rates, which are for the most part lower than individual rates.
- (9). Noncorporate shareholders may qualify for an exclusion from federal income tax of one-half of the capital gains realized on stock of a small business corporation organized as a C corporation.

b. Disadvantages:

- (1). Formalities are required for organization and operation.
- (2). Qualification is required for doing business in other states.
- (3). Regular reporting to governmental entities is required.
- (4). Stock transfers are subject to securities law regulation.
- (5). Income is subject to double taxation.
- (6). Losses of business may not be deducted by individual shareholders.
- (7). The distribution of property by a C corporation to its shareholders is generally a taxable event for income tax purposes as to both the corporation and the shareholders. Thus, withdrawing property from a corporation can be extremely expensive from a tax standpoint.

- Non-business entities: organizations operated for some purpose other than to earn a profit; hospitals, governments etc
- Not sure about the advantages and disadvantages

2. Define the three business activities of a company and provide examples of each of these activities.

- (1) Financing Activities: allocates the money needed to start a business ex. Issuance of long-term debt, reduction of long-term debt, issuance of common shares, repurchase of common shares and dividends paid
- (2) Investing Activities: investing in productive assets ex. Property additions, acquisitions, sale of central station complex, sale of investment
- (3) Operating Activities: operations which satisfy the purpose of the business ex. Net income, depreciation and amortization, deferred income taxes, gain on sale, accounts receivable, material and supplies, accounts payable and accrued charges and other net current assets and liabilities

3. What is the purpose of financial accounting?

- To communicate with outsiders through financial statements

4. Who are the primary users of accounting information?

- Shareholders and potential shareholders
- Bondholders, bankers, and other creditors

- Government agencies
- Other external users

5. What is the purpose of each of the financial statements? How are the financial statements interrelated?

- (1) Income Statement: summarizes revenues and expenses
- (2) Statements of Retained Earnings: summarizes the incomes earned and dividends paid over the life of a business
- (3) Balance sheet: summarizes the assets, liabilities, and shareholders' equity at a specific point

- They are interrelated because the net income allocated from the income statement is used on the statement of retained earnings to calculate ending balance [total retained earnings] and then the retained earnings is used on the balance sheet to calculate the total liabilities and shareholders' equity

6. What is the accounting equation and how is it connected to the financial statements?

- The accounting equation is the foundation of the entire accounting system
- $\text{Assets} = \text{liabilities} + \text{shareholders' equity}$
- It is connected to the financial statements because it builds up the balance sheet?

7. You are deciding whether to invest in a company shares. Which financial statement would you want to see, and which areas would you be most interested in?

- I would see the balance sheet and be most interested in the shareholders' equity and the amount of common shares

8. What is the conceptual framework and why is it important?

- Conceptual framework aids accountants in their role as interpreters and communicators of relevant information
- Its purpose is to act as a foundation for specific principles and standards needed by the profession
- Important part of conceptual framework is the assumptions accountants make in preparing financial statements
- Assumptions include: cost principle, going concern, monetary unit etc? [or they are only principles]

9. Define the cost principle. Give an example of when the cost principle has been violated. Define the going concern assumption. What other principle is interrelated with the going concern assumption?

- (1) Cost Principle: Assets are recorded at the cost to acquire them. The cost principle has been violated by companies who do not carry assets at their market value, but at their original cost → referred to as historical cost
- (2) Going Concern: the assumption that the entity is not in the process of liquidation and that it will continue indefinitely – the monetary unit is interrelated with the going concern assumption

10. Define the monetary unit assumption. Give an example of when it has been violated.

- (1) Monetary Unit: the yardstick used to measure amounts in financial statements; the dollar. It has been violated because it is subject to instability and will lose value within 10 years

11. Define the time period assumption. How is this assumption connected to accrual accounting?

- (1) Time Period: artificial segment on the calendar, used as the basis for preparing financial

statements. This assumption connects to accrual accounting because accrual accounting is recorded when revenue is earned which would fall under the artificial segment on the calendar.

12. What are generally accepted accounting principles?

- The various methods, rules, practices, and other procedures that have evolved over time in response to the need to regulate the preparation of financial statements

13. What are the five categories in the financial statements? What are the characteristics or attributes of each of these five categories? Why is an understanding of each of these categories and their characteristics important when creating the financial statements?

- (1) Assets: a future economic benefit to an organization
- (2) Revenue: inflows of assets resulting from the sale of products and services
- (3) Expense: outflows of assets resulting from the sale of goods or services
- (4) Liability: obligation of a business
- (5) Retained earnings: the part of the owners equity that represents the income earned less dividends paid over the life of an entity

They are important because they provide the information needed to create the financial statements

Chapter 2

Formulas

Working Capital = Current Assets – Current Liabilities

- Current assets – anything other than supplies used, land, buildings, investments, franchising agreements.
- Current Liabilities – anything other than bonds, and notes payable (over a year)

Current Ratio = Current Assets / Current Liabilities

- Ratio used to allow us to compare the liquidity of companies of different sizes and of a single company over time. i.e. almost a 2 to 1 ratio for Dixon Sporting Goods

Profit Margin = Net Income / Sales

- i.e Dixon Sporting goods $41000 / 357500 = 11\%$. So for every dollar of Sales, Dixon has \$0.11 in net income.

Balance Sheets/Statements

Balance Sheet – Shows all assets, liabilities, and equity.

Income Statement (Single-Step Format) – shows all expenses subtracted from all revenues to display net income

Statement of Retained Earnings – shows retained earnings at the beginning of the year, adds the net income of the year and then subtracts the dividends declared and paid to give you the final retained earnings at the end of the year.

1. What is the objective of financial reporting?

- (1) The primary objective: provide information for decision making
- (2) Supporting objective: assist with the prediction of cash receipts to investors and creditors
- (3) Supporting objective: reflect the management’s stewardship of resources and claims to resources

2. What makes accounting information useful? List the qualitative characteristics that underlie all financial statements. Define each of the qualitative characteristics.

- The qualitative characteristics make it useful
- (1) Understandability: the quality of accounting information that makes it comprehensible to those willing to spend the necessary time
 - (2) Relevance: the capacity of information to make a difference in a decision
 - (3) Reliability: the quality that makes accounting information dependable in representing the events that it purports to represent
 - a. Verifiability: info that is free from error
 - b. Representational faithfulness: corresponds to actual event
 - c. Neutrality: neutral info – not slanted to bad or good
 - d. Conservatism: information that is uncertain
 - (4) Comparability: the quality that allows a user to analyze two or more companies and look for similarities and differences
 - (5) Consistency: the quality that allows a user to compare two or more accounting periods of a single company
 - (6) Materiality: the magnitude of accounting information omission or misstatement that will affect the judgement of someone replying on the information
 - (7) Benefits versus cost constraint: benefits should exceed costs of providing information

3. What is depreciation?

- The process of allocating the cost of a long-term tangible asset over its useful life. Also termed amortization

4. What is materiality and why is it important for the financial statements?

- Materiality: the magnitude of accounting information omission or misstatement that will affect the judgement of someone replying on the information
- Ex: Pens not important to count for in cost, but computer is important

5. What is the benefit versus cost constraint. How may this affect how a company records transactions?

- It is: benefits of accounting information should exceed the cost of providing it
- Do not know how it affects company

6. What is a classified balance sheet and why is it important? Why do companies produce classified balance sheets?

- A classified balance sheet is a balance sheet which includes current and non-current assets and current liabilities and long-term liabilities
- Companies produce them because they provide details on current and non current assets and liabilities

- 7. Define current assets. Define noncurrent assets. Define current liabilities and long-term liabilities. What is shareholders equity?**
- Current assets: an asset that is expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year
 - Noncurrent assets: any assets that do not meet the definition of a current asset
 - Current liabilities: an obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year
 - Long-term liabilities: any obligation that will not be paid or otherwise satisfied within the next year of the operating cycle
 - Shareholders' equity: the owners' claims on the assets of the business. Claims arise from 2 sources: *contributed capital and retained earnings*
- 8. What is the purpose of the income statement? Is the income statement for a point in time or a period of time? What is the single step income statement?**
- The purpose is to summarize the results of operating of an entity for a period of time
 - It is for period time
 - Single step income statement: an income statement in which all expenses are added together and subtracted from all revenues
- 9. What is the purpose of the statement of retained earnings? What is included on the statement of retained earnings?**
- Purpose is to explain the changes in the components of owners' equity during the period
 - Retained earnings and capital stock are included on the statement
- 10. What is the purpose of the cash flow? What are the three activities that we will see on the cash flow statement?**
- purpose is to summarize the cash flow effects of a company's operating, investing, and financing activities of the period.
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Chapter 3

Two types of events affect an entity: internal and external.

- An **external event** involves interaction between the entity and its environment. For example, the *payment* of wages to an employee is an external event, as is the hiring of a new sales manager.
- An **internal event** occurs entirely within the entity. The use of a piece of equipment is an internal event.

We will use the term **transaction** to refer to any event, external or internal, that is recognized in a set of financial statements.

Transactions typically include the following two types of events:

1. An external event that involves exchange of assets and liabilities between the entity and external parties. Examples of such external events include paying a monthly

utility bill, selling merchandise to a customer, or issuing shares to new shareholders.

2. An internal event, where the effects on the entity can be reliably measured. Examples of such events include using materials and equipment to manufacture a product, incurring losses due to natural disaster, or accruing interest on a bank loan.

Source document - provides the evidence needed in an accounting system to record a transaction. Source documents take many different forms. An invoice received from a supplier is the source document for a purchase of inventory on credit. A cash register tape is the source document used by a retailer to recognize a cash sale. The payroll department sends the accountant the time cards for the week as the necessary documentation to record wages.

1. What is the difference between an event and a transaction? Which one is recorded on the financial statements and which is not?

- (1) Event: a happening of consequence to an entity
 - a. Internal: occurring within the entity
 - b. External: involving interaction between an entity and its environment
- (2) Transaction: any event that is recognized in a set of financial statements

- Transaction is recorded on financial statements

2. What is the cost principle? Give an example of when the cost principle would be violated.

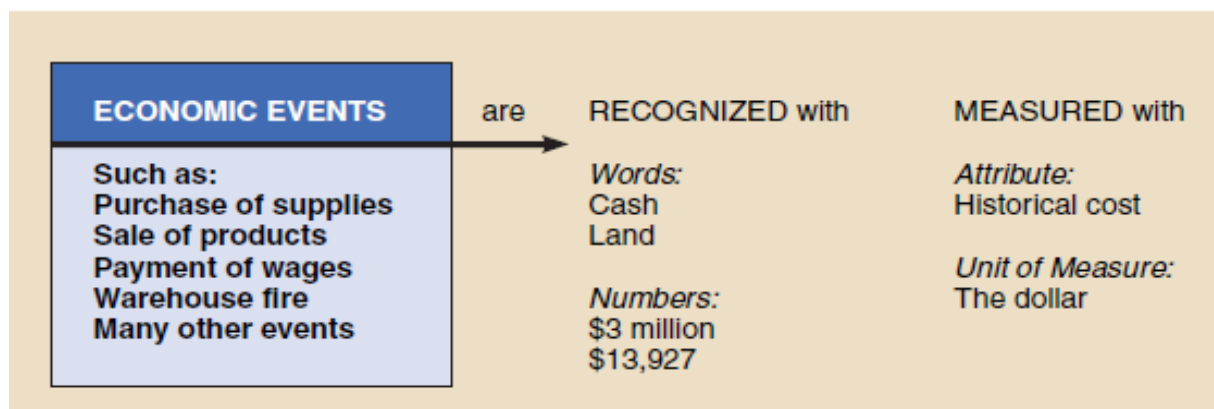
- Requires that we record an asset at the cost to acquire it and continue to show this amount on all balance sheets until we dispose of the asset
 - Would be violated when the asset is not carried at market value, but at its original cost
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Chapter 4

Realizable value - The amount of cash, or its equivalent, that could be received by selling an asset currently.

Historical cost – The amount paid for an asset and used as a basis for recognizing it on the balance sheet and carrying it on later balance sheets.

Recognition – The process of including an item in the financial statements of an entity.



Cash basis A system of accounting in which revenues are recognized when cash is received and expenses when cash is paid.

Accrual basis A system of accounting in which revenues are recognized when earned and expenses when incurred.

	Cash Basis	Accrual Basis
Revenue is recognized	When Received	When Earned
Expense is recognized	When Paid	When Incurred

TYPE	SITUATION	EXAMPLES	ENTRY DURING PERIOD	ENTRY AT END OF PERIOD
Prepaid expense	Cash paid before expense is incurred	Insurance policy Supplies Rent Buildings Equipment	Asset Cash	Expense Asset
Unearned revenue	Cash received before revenue is earned	Deposits Rent Subscriptions Gift certificates	Cash Liability	Liability Revenue
Accrued liability	Expense incurred before cash is paid	Salaries and wages Interest Taxes Rent	No Entry	Expense Liability
Accrued asset	Revenue earned before cash is received	Interest Rent	No Entry	Asset Revenue

Formulas

The basic formula for computing interest follows:

$$I = P \times R \times T$$

where

- I - the dollar amount of interest
- P - the principal amount of the loan
- R - the annual rate of interest as a percentage
- T - time in years (often stated as a fraction of a year).

The total interest on Granger's loan is as follows:

$$\$20,000 = 0.09 \times 3/12 \times \$450$$

Alternatively, the formula for finding the total interest on the loan can be modified to compute the interest for one month:

$$\$20,000 = 0.09 \times 1/12 \times \$150$$

At the beginning of January, Glengarry acquired exercise equipment and issued a \$100,000 note as part of the payment. **The note has an 18-month term and a 9% interest rate.** Although interest will not be repaid until the loan's maturity date, Glengarry must accrue interest for the first month. The calculation of interest for one month is

$$\$100,000 \times 0.09 \times 1/12 = \$750.$$

The adjusting entry is as follows:

(a) Interest Expense 750

Interest Payable 750

To record interest for one month on 9%, \$100,000 note

Assets = Liabilities + Shareholders' Equity
 +750 -750

At the beginning of January, Glengarry acquired exercise equipment at a cost of \$150,000. The exercise equipment has an estimated **useful life of 9 years and an estimated residual value of \$15,000 at the end of its life.** The monthly depreciation is computed by dividing the depreciable cost of \$135,000 by the useful life of 120 months:

$$\begin{array}{rcl} \$150,000 - \$15,000 & = & \$135,000 \\ \hline & & \hline & = & \$1,250 \text{ per month} \end{array}$$

$$\begin{array}{rcl} 9 \text{ years} \times 12 \text{ months} & & 108 \text{ months} \end{array}$$

(b) Depreciation Expense 1,250

Accumulated Depreciation 1,250

To record depreciation for the month

Assets = Liabilities + Shareholders' Equity
 -1,250 - 1,250

1. **What economic events should be recognized in the financial statements? What is the definition of the word recognition in regards to accounting? What is the definition of historical cost? Are financial statements based on historical cost or market value? Be sure to explain why.**
 - Matching principle should be used when recording events – match events to revenues and expenses
 - Recognition: the process of including an item in the financial statements of an entity
 - Historical cost: the amount paid for an asset and used as a basis for recognizing it on the balance sheet and carrying it on later balance sheets
 - Financial statements record market value – I don't know why
2. **What unit of measure is used in the financial statements?**

- Units of money.
- Money: something accepted as a medium of exchange or as a means of payment
- 3. Describe the cash basis of accounting. Describe the accrual basis of accounting. What is the drawback of the cash basis accounting? Why do financial statements use the accrual basis of accounting?**
 - Cash basis: a system of accounting in which revenues are recognized when cash is received and expenses when cash is paid
 - Accrual basis: a system of accounting in which revenues are recognized when earned and expenses when incurred
 - Drawback of the cash basis is that is not always accurate?
 - I do not know why they use accrual
- 4. What does the income statement and the statement of cash flows reveal to a business? Compare the income statement and the statement of cash flow – in what way are they similar? In what way are they different?**
 -
- 5. What is the connection between the time period assumption and accrual accounting?**
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- 6. How is the accrual basis of accounting connected to adjusting entries?**
 - The accrual basis of accounting necessitates a number of adjusting entries at the end of the period, and adjusting entries are made at the end of a period for a company on the accrual basis of accounting
- 7. Define adjusting entries. What are the four types of adjusting entries and what are their characteristics/attributes?**
 - Adjusting entries: journal entries made at the end of a period by a company using the accrual basis of accounting
 - Prepaid expense – cash paid before expense is incurred
 - Unearned revenue – cash received before revenue is earned
 - Accrued liability – expense incurred before cash is paid
 - Accrued asset – revenue earned before cash is received
- 8. How would a deposit received from a customer be recorded in the financial statements? What type of adjusting entry would be needed at the end of the year for this deposit?**
 - ?
- 9. What is straight-line depreciation? How is it calculated? What is accumulated depreciation and what financial statement does it show up on?**
 - Straight-line depreciation: the assignment of an equal amount of depreciation to each period
 - Calculated by dividing depreciable cost by useful life
 - Don't know what accumulated depreciation is?
 - Shows up on the balance sheet
- 10. A company takes out a loan at the beginning of the year. Interest and principal are due at maturity. The loan is for 18 months. What type of adjusting entry would be needed at the end of the fiscal year? What would be the impact on the accounting equation of this type of adjusting entry?**

- - 11. What is a prepaid expense and what financial statement is it recorded on?
 - Prepaid expense is cash paid before the expense is incurred
 - 12. What is an unearned revenue and is it included under Revenues on the income statement? Why or why not?
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Chapter 5

- Credit terms are normally written 2/10, n/30 which means a 2 percent **purchase discount** may be taken if the invoice is paid within 10 days of the invoice date. Net amount of the invoice is due within 30 days.
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Chapter 6

Methods

Specification - Is the most realistic ending inventory

Last In First Out -Results in cost of goods sold being closest to current product costs

First In First Out- Results in highest income during periods of inflation

First In First Out - Results in highest ending inventory during periods of inflation

Weighted Average Cost - Smooths out costs during periods of inflation

Specification - Is not practical for most businesses

Weighted Average Cost - Puts more weight on the cost of the larger number of units purchased

First In First Out - Is an assumption that most closely reflects the physical flow of goods for most businesses

Last In First Out - Is not an acceptable method under IFRS

Weighted Average Cost Method

The **weighted average cost method** is a relatively easy approach to costing inventory. It assigns the same unit cost to all units available for sale during the period. The weighted average cost is calculated as follows for our example:

$$\frac{\text{Cost of Goods Available for Sale}}{\text{Units Available for Sale}} = \text{Weighted Average Cost}$$

$$\frac{\$17,100}{1,500} = \underline{\underline{\$11.40}}$$

Ending inventory is found by multiplying the weighted average unit cost by the number of units on hand:

$$\text{Weighted Average Cost} \times \text{Number of Units in Ending Inventory} = \text{Ending Inventory}$$

$$\$11.40 \times 600 = \underline{\underline{\$6,840}}$$

Cost of goods sold can be calculated in one of two ways:

Cost of goods available for sale	\$17,100
Less: Ending inventory	<u>6,840</u>
Equals: Cost of goods sold	<u><u>\$10,260</u></u>

or

$$\text{Weighted Average Cost} \times \text{Number of Units Sold} = \text{Cost of Goods Sold}$$

$$\$11.40 \times 900 = \underline{\underline{\$10,260}}$$

Why is valuing inventory a major problem in accounting?

- ???

Name the three types of inventory costing methods.

- FIFO
- Specific Identification
- Weighted average

Define the specific identification method of valuing inventory. What are its benefits and drawbacks? What type of companies would use specific identification?

- It is an inventory costing method that relies on matching unit costs with the actual units sold
- Benefits:
 - Able to specifically identify which units are sold and which units are on hand
 - relates the ending inventory goods directly to the specific price they were bought for
- Drawbacks:
 - Difficulty of keeping track of individual items of inventory sold
 - Allows managers to manipulate income (ex. Increase net income and lowering COGS by selling units with the lowest possible unit cost)
- For example, a serial number can be found on a car that allows dealers to identify a car on hand and thus its unit cost
- Examples of companies that use this identification include
 - Car Dealership
 - Appliance dealer

Define the weighted average cost method. How is it calculated? What type of companies would use the weighted average method?

- An inventory costing method that assigns the same unit cost to all units available for sale during the period

- Calculation: $\text{Cost of goods available for sale} / \text{units available for sale} = \text{weighted average cost}$
- Example: Companies that maintain a large supply of undifferentiated inventory items such as fuels and grains.

Define the first in first out method. How's it calculated? What type of companies would use this method?

- An inventory costing method that assigns the most recent costs to ending inventory
- Calculation: ending inventory start with the most recent inventory and work backward...COGS start with beginning inventory and work forward
- Example: Convenience store, grocery store

How does the company decide on the best method to use when valuing its inventory?

If the company is in a period of rising prices which method, weighted average or first in first out, would result in the highest cost of goods sold? Highest gross profit? Highest value of inventory on the balance sheet? How would this change if it was a period of declining prices?

- They determine on the best method depending on whether prices are rising or declining during the period
- Weighted average would result in higher COGS
- FIFO would have the highest gross profit
- FIFO would have highest value of inventory on the balance sheet
- If declining all the effects would just be reversed

What is the main purpose of using an inventory costing method?

- The main purpose is to match costs with revenues

Can a company change between the weighted average method and the first in first out method at any time? If the company changed their method of valuing inventory would they have to notify external users? How would they do this?

- They can change their method
- Yes you would need to be able to justify your decision to external users
- They would do this by disclosing their decision to stakeholders

What is the lower of cost or market rule? Does it need to be applied and if so, when? Why is it used? How does the lower of cost or market rule violate the cost principle? Why is this permitted?

- The LCM is a conservative inventory valuation approach that is an attempt to anticipate declines in the value of inventory before its actual sale
- It needs to be applied when the market value of the inventory may be less than the cost to the company
- It is used to immediately accounting for loss due to market value decline
- It violates the cost principle by recording assets at the price it was acquired at and then changing the amount on the balance sheet before it is disposed
- This is allowed because the LCM rule is a prudent reaction to uncertainty involved and, thus, an application of conservatism in accounting

Chapter 7

Define Accounts Receivable.

- a creditor's accounts of money owed to him; normally arise from the sale of products or services

Define the subsidiary ledger. What is it and why is it used?

- The detail for a number of individual items that collectively make up a single general ledger account
- It is used to keep track of balance owed by each customer

Why is the value of Accounts Receivable problematic?

- You can't assume that all of your customers will pay you back
- How are they recorded?
- How are they valued at year end for inclusion on the published Financial Statements?

What is the direct write-off method? Is it allowed? Why or why not?

- The recognition of bad debt expense at the point an account is written off as uncollectable
- No
- It violates the matching principle which states that all costs associated with making sales in a period should be matched with the sale of that period and not when they are determined to be uncollectable

What is the allowance method? Why is it used instead of the direct write off method? What are the two different types of allowance methods?

- A method of estimating bad debts on the basis of either the net credit sales of the period or the accounts receivable at the end of the period.
- It is used instead of direct write off because it is an estimation of the amount of bad debt before the debt actually occurs
- Two types include Percentage of Net Credit Sales Approach and Percentage of Accounts Receivable Approach

Under the allowance method percentages are used to estimate the uncollectible accounts. Who decides on these percentages? How are these decisions made? What information is used?

- The percentage is the average percentage of bad debts to net credits
- Management estimates how much of the year end A/R balance will go back in the next 12 months and creates a percentage
- Management records the amount they estimated in the CURRENT year, against the CURRENT income (matching principle)

What is an aging schedule? Which method uses an aging schedule?

What type of adjusting entry is made at the end of the month under the allowance method? Is it a prepaid expense? Unearned revenue? Accrued asset? Or an accrued liability?

- A form used to categorize the various individual accounts receivable according to the length of time each had been outstanding
- The aging schedule is using a variation of the percentage of account receivable approach
- I THINK that it is a prepaid expense because both assets and expenses are affected in the adjusting entry

Chapter 8

Straight-Line Method The **straight-line method** of depreciation allocates the cost of the asset evenly over time. This method calculates the annual depreciation as follows:

$$\text{Depreciation} = (\text{Acquisition Cost} - \text{Residual Value})/\text{Life}$$

For example, assume that on January 1, 2008, Kemp Company purchased a machine for \$20,000. The company estimated that the machine's life would be five years and that its residual value at the end of 2012 would be \$2,000. The annual depreciation should be calculated as follows:

$$\begin{aligned} \text{Depreciation} &= (\text{Acquisition Cost} - \text{Residual Value})/\text{Life} \\ \text{Depreciation} &= (\$20,000 - \$2,000)/5 \\ &= \$3,600 \end{aligned}$$

An asset's **book value** is defined as its acquisition cost minus its total amount of accumulated depreciation. Thus, the book value of the machine in this example is \$16,400 at the end of 2008:

$$\begin{aligned} \text{Book Value} &= \text{Acquisition Cost} - \text{Accumulated Depreciation} \\ \text{Book Value} &= \$20,000 - \$3,600 \\ &= \$16,400 \end{aligned}$$

Units-of-Production Method In some cases, the decline in an asset's usefulness is directly related to wear and tear as a result of the number of units it produces. In those cases, depreciation should be calculated by the **units-of-production method**. With this method, the asset's life is expressed in terms of the number of units that the asset can produce. The depreciation *per unit* can be calculated as follows:

$$\text{Depreciation per Unit} = (\text{Acquisition Cost} - \text{Residual Value}) / \text{Total Number of Units in Asset's Life}$$

The annual depreciation for a given year can be calculated based on the number of units produced during that year, as follows:

$$\text{Annual Depreciation} = \text{Depreciation per Unit} \times \text{Units Produced in Current Year}$$

For example, assume that Kemp Company in the previous example wanted to use the units-of-production method for 2008. Also assume that Kemp has been able to estimate that the total number of units that will be produced during the asset's five-year life is 18,000. During 2008 Kemp produced 4,000 units. The depreciation per unit for Kemp's machine can be calculated as follows:

$$\begin{aligned} \text{Depreciation per Unit} &= (\text{Acquisition Cost} - \text{Residual Value})/\text{Life in Units} \\ \text{Depreciation per Unit} &= (\$20,000 - \$2,000)/18,000 \\ &= \$1 \text{ per Unit} \end{aligned}$$

The amount of depreciation that should be recorded as an expense for 2008 is \$4,000:

$$\begin{aligned} \text{Annual Depreciation} &= \text{Depreciation per Unit} \times \text{Units Produced in 2008} \\ \text{Annual Depreciation} &= \$1 \text{ per Unit} \times 4,000 \text{ Units} \\ &= \$4,000 \end{aligned}$$

Depreciation will be recorded until the asset produces 18,000 units. The machine cannot be depreciated below its residual value of \$2,000.

One form of accelerated depreciation is the **double-declining-balance method**. Under this method, depreciation is calculated at double the straight-line rate but on a declining amount. The first step is to calculate the straight-line rate as a percentage. The straight-line rate for the Kemp asset with a five-year life is

$$100\%/5 \text{ Years} = 20\%$$

The second step is to double the straight-line rate:

$$2 \times 20\% = 40\%$$

This rate will be applied in all years to the asset's book value at the beginning of each year. As depreciation is recorded, the book value declines. Thus, a constant rate is applied to a declining amount. This constant rate is applied to the full cost or initial book value, not to cost minus residual value as in the other methods. However, the machine cannot be depreciated below its residual value.

The amount of depreciation for 2008 would be calculated as follows:

$$\begin{aligned} \text{Depreciation} &= \text{Beginning Book Value} \times \text{Rate} \\ \text{Depreciation} &= \$20,000 \times 40\% \\ &= \$8,000 \end{aligned}$$

The amount of depreciation for 2009 would be calculated as follows:

$$\begin{aligned} \text{Depreciation} &= \text{Beginning Book Value} \times \text{Rate} \\ \text{Depreciation} &= (\$20,000 - \$8,000) \times 40\% \\ &= \$4,800 \end{aligned}$$

The complete depreciation schedule for Kemp Company for all five years of the machine's life would be as follows:

YEAR	RATE	BOOK VALUE AT BEGINNING OF YEAR	DEPRECIATION	BOOK VALUE AT END OF YEAR
2008	40%	\$20,000	\$ 8,000	\$12,000
2009	40	12,000	4,800	7,200
2010	40	7,200	2,880	4,320
2011	40	4,320	1,728	2,592
2012	40	2,592	592	2,000
Total			<u>\$18,000</u>	

In the Kemp Company example, the depreciation for 2012 cannot be calculated as $\$2,592 \times 40\%$ because this would result in an accumulated depreciation amount of more than \$18,000. The total amount of depreciation recorded in Years 1 through 4 is

Capital assets are always recorded at historical cost. What costs must be included in capital assets? What is the definition of the acquisition cost?

- ???
- The amount that includes all of the costs normally necessary to acquire an asset and prepare it for its intended use (original cost)

What is depreciation? Why do we record it?

- The allocation of the original cost less residual value of a capital asset to the periods benefited by its use
- Why? Because the accrual accounting process requires a proper matching of expenses and revenue to accurately measure income. Therefore, the accountant must estimate the decline in usefulness of capital assets and allocate the acquisition cost in a manner consistent with the decline in usefulness

What is the straight line method of depreciation? How is it calculated?

- A method by which the same dollar amount of depreciation is recorded in each year of asset use
- Calculation: $(\text{acquisition costs} - \text{residual value}) / \text{Life}$

What is book value? How is it calculated?

- The original cost of an asset minus the amount of accumulated depreciation
- Calculation: $\text{Acquisition cost} - \text{Accumulated depreciation}$

What is the accelerated depreciation method? Define double declining balance.

- A higher amount of depreciation is recorded in the early years and a lower amount in later years.
- Double declining balance is when depreciation is recorded twice the straight-line rate, but the balance is reduced each period

What is the difference between the two depreciation methods; straight-line and doubled declining?

- Both methods result in the same depreciation total over the entire time period but the amount of depreciation per year depends on the method of depreciation. Straight line gives the same amount every year and Double-declining gives different amounts.

If the company purchased the capital asset and was deciding between straight-line and double declining balance, without doing any calculations, which method would result in the highest depreciation expense in the first few years? Which method would result in the highest book value in the first few years?

- Highest depreciation expense: Double-declining
- Highest book value: Straight Line

Over the life of an asset which method, straight-line or double declining balance, would result in the highest total depreciation expense? Sure to explain your answer.

- The total depreciation expense is the same for both methods at the end of the life years. Although the annual depreciation may differ, the end result is still the same because the ending residual value is the same no matter what method you use.

Over the life of an asset which method, straight-line or double declining balance, would result in the highest cash flow? Be sure to explain your answer.

- None of the above because depreciation is “non-cash” charge that reduces net income. Depreciation affects earnings and not cash-flow.

How does the company decide between different depreciation methods?

- The depreciation method chosen should be based on the decline in the assets usefulness. A company can choose a different depreciation method for each individual fixed asset or for each class or category of fixed asset.

If the company owns a piece of machinery whose technology is expected to change within a short period of time which method of depreciation would you use and why?

- The double declining balance because it results in an accelerated depreciation pattern which

is most appropriate for assets subject to a rapid decline in usefulness as a result of technical factors.

If the company owns a building that is expected to last 100 years which method of depreciation would you use and why?

- The straight line method because the book value of the building will seem to be higher giving the company a more profitable look. Also, a constant depreciation is both easier and more simple

How do companies decide between depreciation methods? (p. 358)

- A company should choose the depreciation method that best allocates the original cost of the asset to the periods benefited by the use of the asset
- They decide on the method by determine which of the following factors that they want:
 - **Simplicity** → Straight Line is easiest to compute and record
 - **Reporting to shareholders** → Straight Line maximizes net income
 - **Comparability** → Use the same method as other firms in the same industry or line of business
 - **Management bonus plans** →if management is paid a bonus based on net income they are most likely to use Straight Line
 - **Technological competitiveness** → If technology is changing rapidly then they should use a accelerated method
 - **Reporting to Canada revenue agency** →Firms will usually claim maximum capital cost allowance to minimize taxable income in reporting to the CRA

When a capital asset is disposed of what is the impact on the accounting equation? What accounts are affected and how when a capital asset is disposed of?

Assets = Liability + ShareholderEquity
Accumulated depreciation of asset + Gain (or loss) on sale of asset (either + or -)
Cash +
Asset -

When an asset is acquired part way through the year what adjustment do you have to make to the depreciation expense?

- $[(\text{Acquired cost} - \text{salvage value}) / \text{Life}] \times (\text{however many months left in the year}/12) = \# \times (\text{however many months left in the year}/12) = \text{the depreciation for that year}$
- On page 366

When an asset is sold part way through the year what adjustment do you have to make to the depreciation expense before recording the disposal?

- “Methods similar to the acquisition approaches also can be used for the year of disposal of capital asset to calculate the depreciation up to that date of disposal to reflect the use of the asset” page 366

- Asset cost – accumulated depreciation = book value
 - Sale price – book value = gain/ loss on asset
12. When an asset is acquired part way through the year what adjustment do you have to make to the depreciation expense?
 - You depreciate monthly (x/12)
 13. When an asset is sold part way through the year what adjustment do you have to make to the depreciation expense before recording the disposal?
 - 1st record depreciation expense for the part year
 - 2nd update accumulated depreciation account to the date of sale
 - 3rd determine gain/loss

Chapter 11

1. What are the advantages and disadvantages of issuing shares compared to taking on debt?
 - Advantages
 - Flexibility: dividends on shares can be increased in profitable years and reduced in less profitable. Debt interest is fixed
 - Exchanges facilitate trading: large companies have ready markets for shares through the stock exchanges. Sometimes debt is not as widely traded
 - Return on investment: shares generally provide a higher return in dividends and in growth than interest on debt
 - Disadvantages
 - Control: issuing shares involves giving voting rights to new investors, less control of the company for existing shareholders
 - Tax consequences: interest on debt is tax deductible for the issuing company, dividends on shares are not
 - Impact on ratios: issuing shares decreases several important financial ratios, including earnings per share
2. What are preferred shares? What are their advantages and disadvantages? When we say that a preferred share is key motive what does that mean? What does it mean when it is convertible or callable?
 - Many companies have a class of shares called preferred shares
 - Advantage:
 - Flexibility they provide because their terms and provisions can be tailored to meet firms needs
 - If dividends are declared, the preferred shareholders must receive dividends first, before the holders of common shares
 - Some preferred share issues have a *cumulative feature*, which means that if a dividend is not declared to the preferred shareholders in one year, dividends are considered to be in *arrears*
 - Preferred shares may also be convertible or callable
 - **Convertible feature:** allows preferred shares to be exchanged for common shares
 - Offer shareholders the advantage of the low risk generally associated with

preferred shares and the possibility of the higher return that is associated with common shares

- **Callable feature:** allows the firm to eliminate a class of shares by paying the shareholders a specified amount
 - Firms may exercise the call option to eliminate a certain class of preferred shares is too high and other, more cost-effective financing alternatives are available
 - Preferred shares are attractive to many investors because they offer a return in the form of a dividend at a level of risk that is lower than that of most common shares
3. What is the impact on the accounting equation when shares are issued for non-cash consideration?
- Shares increases and the asset increases (such as land or building)
4. What is this difference between a cash dividend and a stock dividend? When may a company pay a cash dividend? When does a company uses stock dividend instead?
- Cash dividends become a liability on the date they are declared
 - Declaration:
 - Retained earnings goes down(Shareholders equity goes down)
 - Cash dividend payable increases
 - When paid:
 - Cash goes down
 - Cash dividend payable goes down
5. What is a stock split? Why would a company split their stocks?
- Stock split: the creation of additional shares with a reduction of the book value of the shares
 - Firms use it to increase the number of shares, reduce the market price per share, and make shares more accessible to a wider range of investors
 - Stock splits reduce the book value per share
 - No accounting transaction is recorded when stock splits are declared and executed

Chapter 12

1. Why do companies produce the cash flow statement? What is different between the cash flow statement an income statement? What is the basis of the income statement? The cash flow statement?
- Statement of cash flows: the financial statement that summarizes an entity's cash receipts and cash payments during the period from operating, investing, and financing activities
 - Why have a cash flow statement?
 - Shows how a company manages their cash
 - Indicates a entity's sources and uses of cash
 - Need cash to run company
 - Income statement:
 - Based on accrual accounting

- Includes revenues that have not been received in cash (A/R)
- Includes expenses that have not been paid in cash (A/P)
- Does not show how cash is managed
- Cash flow statement:
 - Cash flow based on cash basis accounting
 - Shows external users a different view of the company's performance (cash based)
 - Only cash paid or received
 - Shows movement of cash during the year

2. Define the three sections of the cash flow statement. Give examples of the types of activities within each section.

- Operating: activities concerned with the acquisition and sale of products and services
 - Inflow and outflow of cash
 - Current assets and current liabilities
 - Ex: collection of A/R, paying A/P, payment of wages, payment of taxes
- Investing: activities concerned with the acquisition and disposal of long term assets
 - Purchase and selling of property, land, equipment
 - Purchase and sale of another company (investment)
- Financing: activities concerned with the raising and repayment of funds in the form of debt and equity
 - Long term liabilities and shareholders equity
 - Issuance of capital stock, bonds, bank note
 - Paying dividends
 - Repurchase of shares

3. How does the cash flow statement tie-in to the balance sheet?

- Shows the inflow and outflow of assets

4. Which section of the cash flow is considered the most important when determining if a company will survive long-term?

- Operating, you need to have cash in order to run a business