

## CHAPTER 1

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Key words	Definitions
<b>Business</b>	All activities necessary to provide the members of an economic system with goods and service
<b>Business entity</b>	Organization operated to earn a profit
<b>Economic entity concept</b>	The assumption that a single, identifiable unit must be accounted for in all situations
<b>Sole proprietorship:</b>	Form of a organization with a single owner
<b>Partnership:</b>	A business owned by two or more individuals; organization form often used by accounting firms and law firms
<b>Corporation:</b>	A form of entity organized under the laws of a particular jurisdiction; ownership evidenced by shares
<b>A share:</b>	A certificate that acts as ownership in a corporation
<b>Bond:</b>	A certificate that represents a corporation's promise to repay a certain amount of money and interest in the future
<b>Non-business entity:</b>	Organization operated for some purpose other than to earn a profit
<b>Liability</b>	an obligation of a business
<b>Capital stock</b>	Indicates the owners contributions to a corporation
<b>Shareholder</b>	one of the owners of a corporation
<b>Asset</b>	Future economic benefit
<b>Revenue</b>	An inflow of assets resulting to the sales of goods and services
<b>Expense</b>	An outflow of assets resulting to the sales of goods and services
<b>Accounting</b>	Process of identifying, measuring, and communicating economic information to various users
<b>Management accounting</b>	The branch of accounting concerned with providing management
<b>Financial Accounting</b>	The branch of accounting concerned with communication with outsiders through financial statements
<b>Owners' equity</b>	the owners claims to the assets of an entity
<b>Shareholders' equity</b>	the owners' equity of a corporation
<b>Retained earnings</b>	the part of owners' equity that represents the income earned less dividends paid over the life of an entity
<b>Balance sheet</b>	the financial statement that summarizes the assets, liabilities, and owners' equity at a specific point in time
<b>Income statement</b>	A statement that summarizes revenues and expenses for a period of time
<b>Dividends</b>	a distribution of the net income of a business to its shareholders
<b>Statement of retained earnings</b>	the statement that summarizes the income earned and dividends paid over the life of a business

<b>Cost principle</b>	assets are recorded and reported at the cost paid to acquire them
<b>Going concern</b>	the assumption that an entity is not in the process of liquidation and that it will continue indefinitely
<b>GAAP</b>	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

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## CHAPTER 2

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Balance sheet: tells what obligations will be due in the near future and what assets will be available to satisfy them

Income statement: revenues and expenses for a period of time

Statement of cash flow: where cash came from and how it was used.

- OBJECTIVES OF FINANCIAL REPORTING:

Primary

- Provide information that is useful to investors, members, contributors, creditors, and other users in making their resource allocation decisions and or assessing management stewardship

Supporting

- Provide information to help present and potential investors and creditors in predicting the ability of the entity to earn income and generate cash flows in the future to meet its obligations and to generate a return on investments
- Show how the management of an entity has discharged its stewardship and responsibility to those that have provided resources to the entity

Exhibit 2-1 (page 53)

### Characteristics that make accounting information useful

Characteristics	Details
<b>Understandability</b>	The quality of accounting information that makes it comprehensible to those willing to spend the necessary time to study the information with reasonable diligence
<b>Relevance</b>	Capacity of information to make a difference in a decision <ul style="list-style-type: none"> <li>• Predictive value: helps users predict future results</li> <li>• Feedback value: reflects use of financial statements in confirming or correcting previous decisions.</li> </ul>
<b>Reliability</b>	Quality that makes accounting information dependable in representing the events that it purports to represent <ul style="list-style-type: none"> <li>• Verifiability: making sure it is free from error</li> <li>• Representational faithfulness: corresponds to an actual event (i.e: having bought land)</li> <li>• Neutrality: Not slanted to portray a company's position in better/worse light than it actually is</li> <li>• Conservatism: uncertain information should be presented so that assets and revenues are not overstated while liabilities and expenses are not understated.</li> </ul>
<b>Comparability &amp; consistency</b>	<ul style="list-style-type: none"> <li>• Quality that allows a user to analyze <u>two or more companies and look for similarities and differences</u></li> <li>• Depreciation: Process of allocating the cost of a long-term tangible asset over its useful life.</li> <li>• Consistency: quality that allows a user to compare two or more accounting periods <u>for a single company</u></li> </ul>

## Materiality

Magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information.

Exhibit 2-2 (page 57)

## BALANCE SHEET

### Operating cycle

- Current assets: 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. (short term)

- Cash, Accounts receivable, inventory temporary investments, prepaid expenses.
- Typically called either *temporary investments* or *marketable securities*

- Non-current assets: Assets that do not meet definition of a *current asset* (long term).

Divided in three common categories:

- Investments: Securities that are not expected to be sold within the next year are classified as *investments*. (usually in stocks of other companies)
- Property, plant and equipment: assets held for use in the operation of a business rather than for resale. **(land is always put first)**
- Intangibles: they provide benefits to the firm over the long term, although they lack physical substance. (Trademarks, copyrights, franchise rights, patents, goodwill...)

- Current liability: Obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than a year.
- Long term liabilities: Obligations that will not be satisfied within the next year or the operating cycle. (note payables and payable bonds → promise to pay money in the future)
- Shareholders' equity: owners claim on the assets of the business.
  - Contributed capital (*capital stock*): indicates the owners investment in the business
  - Earned capital (*retained earnings*) : represents the accumulated earnings or income since its inception minus all dividends paid.

### Balance sheet

- Liquidity: ability of a company to pay its debts as they come due.

### **Working capital = Current Assets – Current Liabilities**

- Working capital determines the liquidity of a company
- Strive for a balance in working capital
  - little/negative working capital = inability to pay creditors on timely basis
  - Overabundance working capital = not investing enough of its funds.
- Current Ratio: Related measure of liquidity that allows us to compare the liquidity of companies of different sizes and of a single company over time.

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

- Determines the liquidity of a company
- Receivables and Inventory: Receivables are more liquid than inventory because receivables are only one step away from being cash, whereas inventory must be sold and then the receivable collected. \*\*

## INCOME STATEMENT

\*Used to summarize the results of operations of an entity for a period of time.  
(Revenues and expenses)

\* **Gains** and **losses** also show on the income statement\*

- Profit margin: the ratio of its net income to its sales

$$\text{Profit Margin} = \frac{\text{Net income}}{\text{Sales}}$$

## STATEMENT OF RETAINED EARNINGS

\*explain the changes in the components of owners' equity during the period.

- Retained earnings and capital stock are the two primary components of shareholders' equity

## STATEMENT OF CASH FLOW

\*summarize the cash flow effects of a company's operating, investing, and financing activities for the period.

Activity	Explanation	Example
<b>Financing</b>	Acquisition and sale of long-term or non-current assets (long term investments, property, plants, and equipment, and intangible assets). - to start or expand a business, the owner or owners quite often need cash from outside sources	<ul style="list-style-type: none"><li>▪ Borrowing money from creditors which creates a liability - source of cash<ul style="list-style-type: none"><li>• bank loan</li><li>• debt securities (bonds)</li><li>• goods on credit from suppliers</li></ul></li><li>▪ Repayment of money borrowed - use of cash</li><li>▪ Selling ownership interests in the corporation to shareholders - source of cash</li><li>▪ Payment of dividends - use of cash</li></ul>
<b>Investing</b>	result from the insurance and repayment, or retirement, of long-term liabilities and capital stock - obtaining resources or assets needed to operate the business and investing idle cash	<ul style="list-style-type: none"><li>▪ Purchasing assets (property, plant and equipment) - use of cash</li><li>▪ Selling old assets (property, plant and equipment) - source of cash</li><li>▪ Purchasing short or long term investments (bonds or shares of other corporations) - use of cash</li><li>▪ Selling short or long term investments - source of cash.</li></ul>
<b>Operating</b>	Purchase and sale of a product - comprise the primary activities for which the organization is in business - the day to day running of the business.	<ul style="list-style-type: none"><li>▪ Revenue is received from sales or services - source of cash.</li><li>▪ Expenses are paid to earn revenue - use of cash</li></ul>

## CHAPTER 3

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*Transaction: any event, external or internal, that is recognized in a set of financial statement*

Event	Explanation
External	involves interaction between the entity and its environment
Internal	occurs entirely within the entity

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An event must be *measured* to be recognized:

- External event that involves **exchange of assets and liabilities between the entity and external parties.**
- Internal event, where the effects on the entity can be reliably measured

Source Documents: a piece of paper that is used as evidence to record a transaction

Double entry system

- Account: record used to accumulate amounts for each individual asset, liability, revenue, expense, and component of shareholders' equity
- Chart of accounts: a numerical list of all the accounts used by a company
- Ledger: A book, file, hard drive, or other device containing all the accounts
- Posting: The process of transferring amounts from a journal to the ledger account

## CHAPTER 4

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In accounting, accountants and managers must answer two questions

1. What economic events should be communicated, or **recognized**, in the statements?
2. How should the effects of these events be **measured** in the statement?

- Recognition: Process of including an item in the financial statements of an entity. Recognition consists of the addition of the amount involved into statement totals together with a narrative description of the item in a statement
  - Form of communication between entity and external users.
  - Accountants have a moral and ethical responsibility to provide users with financial information that will be useful in making their decisions (the process = recognition)
  - Depicts the real thing (i.e: assets such as cash), through sets of financial statements
- Measurement: Quantifying the effects of economic events on the entity
  - Depicting a financial statement in both words and *numbers*, must measure the financial effects of the event on the company. Divided in two choices:
    - The accountant must decide on the attribute to be measured
      - 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. (simple and verifiable) **Reliable value**
      - Realizable value: The amount of cash, or its equivalent, that could be received by selling an asset currently. (estimate) **Relevant value**
    - A scale measurement, or unit of measure, must be chosen
      - Money: unit of measure, accepted as a medium of exchange or as a means of payment.
        - Stability, however (keep in mind inflation)
- **Page 146 for summary**

Accrual basis of accounting

The foundation for the measurement of income in our modern system of accounting.

### Cash Basis vs. Accrual Basis

A system of accounting in which revenues are recognized when cash is received and expenses when cash is paid	A system of accounting in which revenues are recognized when earned and expenses when incurred
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What the Statement of cash flows and income statement reveal

- Income statement: Revenues are recognized when they are earned and expenses when they are incurred. **Reflects the revenues actually earned by the business**, regardless of whether cash has been collected.

- Statement of Cash flow: information, through the interest of shareholders and creditors, concerning the cash flow of an entity. Tells **the reader about the actual cash inflows** during a period of time
- See page 148 for examples

#### Accrual accounting and adjusting entries

- Adjusting entries: Journal entries made at the end of a period by a company using the accrual basis of accounting. Although they are not needed if a cash basis is used. It is the nature of the accrual basis that results in the need for adjusting entries.
- Relation between cash flow and accrual basis
- Four different types of adjusting entries:

1. Cash paid before expense is incurred (credit cash, debit prepaid expense account) expense (example: assets)
  - a. Depreciation : process of allocating the cost of a long-term tangible asset over its useful life
    - i. Straight line method: the assignment of an equal amount of depreciation to each period
    - ii. Contra account: an account with a balance that is opposite of a related account (in this case the accumulated depreciation is the contra account of depreciation)
2. Cash received before revenue is earned. (debit cash, credit liabilities)
  - **Unearned revenue**: a liability resulting from the receipt of cash before the recognition of revenue
3. Expense incurred before cash is paid( credit assets, debit shareholders)
  - **Accrued liability** : a liability resulting from the recognition of an expense before the payment of cash

$$I = P * R * T$$

- 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

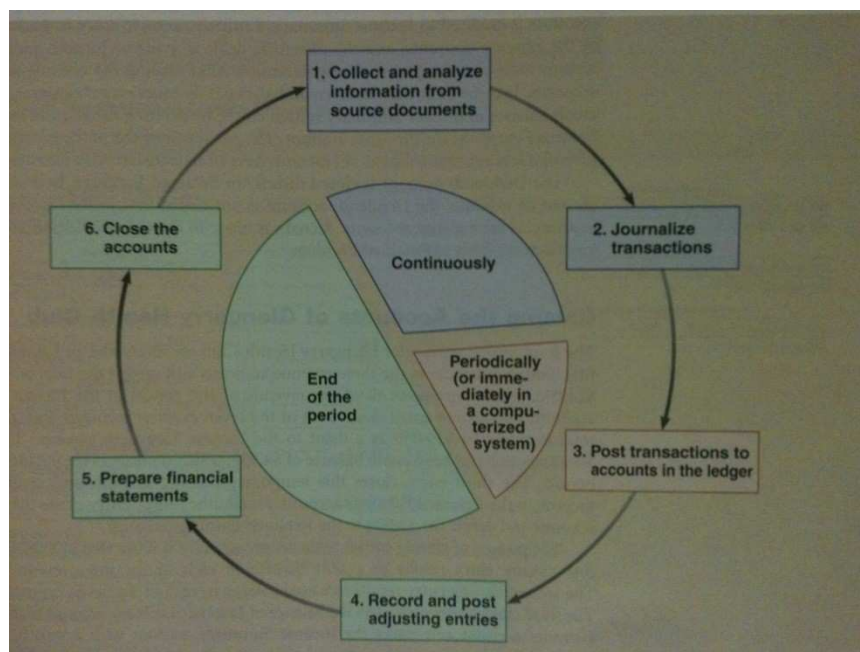
Computing interest

4. Revenue earned before cash is received ( debit assets, credit shareholders)
  - **Accrued Asset**: an asset resulting from the recognition of revenue before the receipt of cash

Type of A/E	Accrued Asset A/E	Accrued Liability A/E	Prepaid A/E	Unearned A/E
Initial Entry/ Acct. on T/B	NO	NO	YES – Look at the asset section of the T/B	YES – look at unearned revenue on the T/B
Always involves	Incr. A/R Incr. Rev.	Incr. Exp Incr. Liab.	Incr. Exp Decr. Asset	Decr. Unearned Rev. Incr. Revenue
Made due to:	Rev. Recog. Principle	Matching Principle	Matching Principle	Rev. Recog. Principle

- See page 157 for terminology and summary

### Accounting Cycle





## Chapter 5

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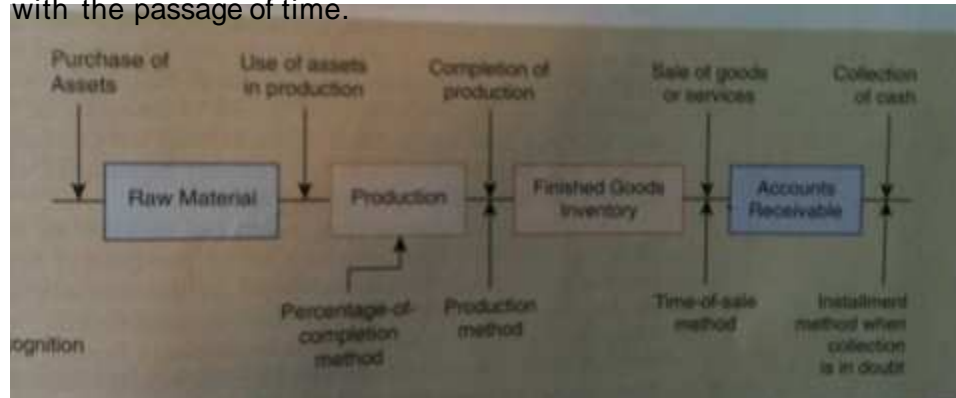
**Revenues** → Increases in economic resources resulting from ordinary activities such as the sale of goods, the rendering of services, or the use by others of the entity's resources.

### Revenue recognition principle

Revenues are recognized in the income statement when they are earned

- **The performance is achieved (earned)**
  - **The amount is reasonably measurable**
  - **The collection of cash is reasonably assured (payment/promise of payment)**
- Guidelines for revenue recognition
- Manufactured Goods and Merchandise
    - Time of sale method: Used by merchandising and manufacturing industries to recognize revenue when goods are sold; once the seller has made sufficient effort to make the product, find the buyer, serve the buyer... and receive either the payment or the promise of payment from the buyer.
  - Long term contracts
    - Percentage-of-completion method: used by contractors to recognize revenue before the completion of a long term contract; where the sales price is fixed by a contract and where the realization of revenue depends on the production (construction of a bridge)
  - Franchises
    - Franchisor grants exclusive rights to sell a product or service in a geographic area to a franchise. Generation of franchise is done from one of two sources:
      - From the sale of the franchise and related services, such as help in selecting a site and hiring employees. Fees and equipment sales are generally recognized as income when each restaurant commences operations and payment is received from the franchisee.(tim hortons)
      - From continuing fees based on performance; example: a fixed percentage of sales by the franchisee. Royalties, based on a percentage of monthly sale, are recognized as income on the accrual basis(tim hortons)
  - Commodities
    - Production method: in which revenue is recognized when a commodity is produced rather than when it is sold; used for precious metals, as well as for certain agricultural products and marketable securities. Recognized *before* the sale. (ex: gold mining)
  - Installment sales
    - Installment method (cash basis): is acceptable only when the seller has no reasonable basis for estimating the degree of collectability. Recognized *after* the sale
  - Rent and interest

- When revenue is earned continuously over time. A product or service is not delivered at a specific point in time, instead the earnings process takes place with the passage of time.



## Accounts we need to know

Acct Name	Category	Statement
Accounts Rec.	Current assets	Balance sheet
Inventory	Current assets	Balance sheet
Accounts Payable	Current liabilities	Balance sheet
Sales	Revenues	Income statement
Sales returns and allowances	Contra-revenue	Income statement
Sales discounts	Contra-revenue	Income statement
Cost of goods sold	Expenses	Income statement
Freight Out	Expenses	Income statement

## Matching principle and expense recognition

- Matching principle: the revenues for the period are associated with the costs of generating those revenues.
- Costs and expenses
  - Companies incur a variety of costs, regardless of when it pays cash.
  - The incurrence of some costs gives rise to assets; while the incurrence of other costs do not give rise to assets because no future benefit from these costs are discernible
  - An asset cease being an asset when its economic benefits expire and it becomes an expense. Therefore assets are unexpired costs; expenses are expired costs
- Direct and indirect matching
  - Certain costs **directly generate revenues**. Thus these expenses can be matched directly with revenues (costs of goods sold)
  - Indirect form of matching is used to recognize the benefits associated with certain types of costs (long term assets). **Indirectly help generate revenue**
  - **Expired costs:**
    - Costs of goods sold expense
    - Depreciation expense
    - Utilities expense
- Multiple-step income statement: subdivide the income statement into specific sections and provide the reader with important subtotals.
  1. Gross profit
  2. Income from operations
    - a. Reflects operating expenses and income from operations; expenses incurred pursuant to the operating activities of a company,.
  3. Income before income taxes (non operating revenues and expenses → interest)

4. Income after income taxes → deduct income tax expense from income before income taxes to arrive at the → NET INCOME

#### DIFFERENCE BETWEEN SERVICE AND MERCHANDISING COMPANIES

- ◆ Unlike expenses for a service company, expenses for a merchandising company are divided into two categories:
  - Cost of goods sold - the total cost of merchandise sold during the period.

$$\text{Gross profit} = \text{Sales revenue} - \text{cost of goods sold}$$

- Operating expenses - expenses that are incurred in the process of earning sales revenues..

$$\text{Net earnings/loss} = \text{Gross profit} - \text{Operating expense}$$

#### PREPARE ANALYSIS FOR PURCHASES UNDER A PERPETUAL INVENTORY SYSTEM USING THE ACCOUNTING EQUATION

- Business documents
  - Every cash purchase should be supported by a cash register receipt, indicating the items purchased and the amounts paid.
  - Each credit purchase should be supported by a **purchase invoice**, which indicates the total purchase price and other relevant information.

\*note: INVENTORY IS A PREPAID EXPENSE. We own it, it has a future economic benefit.  
SUMMARY FOR PURCHASE TRANSACTION

Transaction	Assets	Liabilities	Shareholders Equity
Purchase inventory for resale using cash.	+Inventory y -Cash		
Purchase inventory for resale on account.	+ Inventory	+ Accounts payable	
Paying freight costs on inventory purchased, FOB shipping point	+inventor y -Cash		
Returning inventory to supplier for cash	+ Cash - Inventory		
Returning inventory to supplier for credit.	- Inventory	-Accounts payable	
Paying suppliers on account within the discount period	- Inventory -Cash	- Accounts payable	

Paying suppliers on account after the discount period

-Cash

-Accounts payable

### Prepare Entries for Sales under a Perpetual Inventory System using the Accounting Equation

- **Sales revenues** are recorded when goods are transferred from the seller to the buyer.
- Each sales transaction should be supported by a **business document**, which provides written evidence of the sale.
  - **Cash register tapes** provide evidence of cash sales.
  - A **sales invoice** provides written evidence of a credit sale
- **What if Wal-Mart decides to ship the product to the customer FOB Destination?**
  - Freight costs incurred by the seller (FOB destination) are an operating expense, and are debited to an account called **Freight Out** or **Delivery Expense**.
- **Sales Returns and Allowances.**

Assets	Liabilities	Shareholders equity
-Cash(cdt)		-sales return and allowances (sales contra account) (dbt)
+Inventory (dbt)		+Costs of goods sold(cdt)

- **Sales discount**
  - **First record sale**

Assets	Liabilities	Shareholders equity
+accounts receivable (dbt)		+sales (cdt)
-Inventory (cdt)		-Costs of goods sold(dbt)

- **Record payment during discount period**

Assets	Liabilities	Shareholders equity
-accounts receivable (cdt)		+ Sales discount (cdt)
+Cash (dbt)		

**\*\*accounts receivable – cash = sales discount\*\***

### SUMMARY FOR SALES TRANSACTION

\Transaction	Asset	Liabilities	Shareholders Equity
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<b>Selling inventory to customers – sales entry at the selling price</b>	+A/R or Cash		+Sales (revenue)
<b>Selling inventory to customers – cost entry at the cost of inventory</b>	-Inventory		-Cost of goods sold (exp.)
<b>Paying freight costs on inventory sold, FOB destination</b>	-Cash		-Freight Out Expense
<b>Customer returns inventory – reversal of the sales entry</b>	-A/R OR Cash		-Sales Returns and allowances
<b>Customer returns inventory – reversal of the cost entry</b>	+Inventory		+Cost of goods sold (exp.)
<b>Customer pays their account within the discount period.</b>	+Cash -A/R		-Sales discount
<b>Customer pays their account after the discount period</b>	+Cash -A/R		

## Chapter 6

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### INVENTORY COSTING METHODS WITH A PERIODIC SYSTEM

- Fundamental concepts in accounting are the relationship between asset valuation and the measurement of income.
  - Reminder: assets are *unexpired costs*, expenses are *expired costs*.
    - Value to an asset on the balance sheet = future expense recognized on the income statement over the life of the asset
    - The amount recorded as the cost of inventory = the amount recognized as cost of goods sold on the income statement!
- **Inventory costing methods**

The inventory costing methods are based on assumptions of cost flows, not on physical flows.

- Specific Identification Method: a method that relies on matching unit costs with the actual units sold
  - Practical difficulty in keeping track of individual items of inventory sold.
  - Allows management to manipulate their income.
- Weighted Average Cost Method: a method that assigns the same unit cost to all units available for sale during the period.
  - Based on the cost of *all* units available for sale during the period, not just the beginning inventory or purchases
- First-in, first-out method (FIFO): a method that assigns the most recent costs to ending inventory.
  - This cost flow assumption is fairly accurate reflection of the physical flow of products.
- Last-in, first out method (LIFO): a method that assigns the most recent cost to cost of goods sold
  - Stockpiling operations, operate under this basis
  - Widely used in the United States because its tax saving advantage.
  - Seldom used in Canada because it is not permitted for tax purposes in Canada.

### EFFECTS OF INVENTORY COSTING METHODS

- How does a company decide on the best method to use?

The primary determinant in selecting an inventory costing method should be the ability of the method to accurately reflect the net income of the period.

- Costing methods, gross profit, Income tax expense, net income
  - The weighted average cost is assigned to the cost of goods sold; while with FIFO, the older costs are assigned to expense.

- Depending of the period, each method could have a different effect on the gross margin, affecting the income and therefore leads to an effect on the taxes (see page 256)
- Changing inventory methods
  - Purpose of each method is to *match costs with revenues*.
  - Each company must be able to justify a change in method (can't just switch from one to another). Taking advantage of the result from a method is not valid.
- Valuing inventory at lower of cost or market
  - Lower-of-cost-or-market (LCM rule): a conservative valuation approach that is an attempt to anticipate declines in the value of inventory before its actual sale.
    - Used in instances where it is likely that the retailer will have to sell the merchandise for less than the normal selling price.
    - At the end of each accounting period, the original cost, as determined using one of the costing methods, is compared with the market price of the inventory. If the market is less than cost, the inventory is written down to the lower amount.
    - Accounts affected: Inventory (credited) and *Loss on decline in value of Inventory* (shareholders' equity; debited as a result of reporting the loss on decline in value of inventory on the income statement)
  - Why Lower of Cost or Market is used
    -