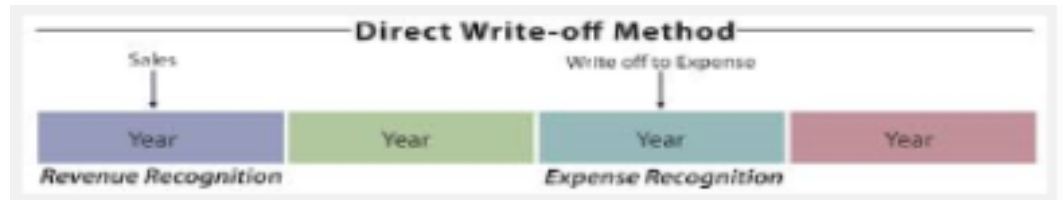


## Accounting Final Review

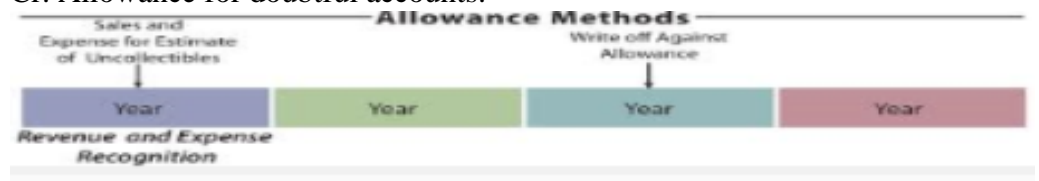
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### Chapter 8 – Reporting and Analyzing Receivables

- Types of Receivables.
  - The term receivables refers to amounts that are due to a business from customer or other entities.
    - We can expect to receive money from them.
  - Receivables are frequently classified as:
    - 1. Accounts receivable.
    - 2. Notes receivable.
    - 3. Other receivables.
      - Ex. Interest receivable, loans to company officers, advances to employees, and recoverable sales taxes and income taxes.
      - Ex. Tax receivable.
- Recognizing Accounts Receivables.
  - Accounts receivable are:
    - Amounts owed by customers on account, to the firm.
    - Result from the sale of a good or service.
    - Generally expected to be collected within 30 days or less.
    - Usually the most significant type of claim held by a company.
  - A receivable is recorded when service is provided on account or a point of sale of merchandise on account.
  - Receivables are reduced when:
    - Cash is collected.
    - The customer takes advantage of a sales discount.
    - The customer returns the product.
  - Receivables are increased:
    - If a customer does not pay in full within a specified period of time (usually 30 days), an interest (financing) charge may be added to the balance due (this increase is also recognized as interest revenue).
      - Seller recognizes interest revenue and increases the account receivable balance owed by the customer.
  - Some accounts receivable become uncollectible.
  - Losses from these uncollectible accounts are debited to an account called “bad debts expense”.
- The method of recording.
  - 1. Direct write off method.
    - Dr. Bad Debts Expense.
    - Cr. Accounts receivable.



- 2. Allowance method
  - Dr. Bad Debts Expense.
  - Cr. Allowance for doubtful accounts.



- Estimating Uncollectible accounts
  - 1. Percentage of total receivables:
    - Management estimates the percentage of outstanding receivables that will result in losses from uncollectible accounts.
    - Ex. Uncollectible accounts are expected to be 4% of the accounts receivables.
  - 2. Aging the accounts receivable method.
    - Classifies the outstanding accounts by age and applies percentages to these categories based on past experience.

	Total	Number of Days Outstanding				
		0-30	31-60	61-90	91-120	Over 120
Accounts receivable	\$377,000	\$222,000	\$90,000	\$38,000	\$15,000	\$12,000
% uncollectible		1%	4%	5%	8%	10%
Estimated bad debts						

- Accounts Receivable uncollectible goes down as time passes.
  - This is because more people will pay them off sooner.
- Higher percentage of default goes up as time passes.
  - If they didn't pay sooner, they aren't going to pay later.
- Recognizing Accounts Receivables.
  - Once the appropriate estimate for uncollectible accounts is determined, an adjusting entry can be recorded.
  - The amount of the adjusting entry is the difference between the required balance, and the existing balance in the allowance.

Dec. 31	Bad Debts Expense Allowance for Doubtful Accounts (To record estimate of uncollectible accounts)	10,000	10,000
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- Statement of Financial Position Presentation.

Accounts receivable	\$200,000
Less: Allowance for doubtful accounts	<u>11,000</u>
Net realizable value	<u>\$189,000</u>

- - Allowance for doubtful accounts is considered a contra-asset account.
  - Net realizable value:
    - The collectible portion of the accounts receivable at the statement date.
- Recording the write off of an uncollectible.
- Actual uncollectibles are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time the specific account is written off as uncollectible.
    - Dr. Allowance for doubtful accounts.
    - Cr. Accounts receivable.

Mar. 1	Allowance for Doubtful Accounts Accounts Receivable (Write off of T. Ebbet account)	2,500	
			2,500

- A write off reduces A/R and the ADA equally.
- NRV on the SFP remains the same.

Accounts Receivable				Allowance for Doubtful Accounts					
Feb. 28	Bal.	227,500	Mar. 1	2,500	Mar. 1	2,500	Dec. 31	Bal.	11,000
Mar. 1	Bal.	225,000					Mar. 1	Bal.	8,500

	Before Write Off	After Write Off
Accounts receivable	\$227,500	\$225,000
Less: Allowance for doubtful accounts	<u>11,000</u>	<u>8,500</u>
<b>Net realizable value</b>	<b><u>\$216,500</u></b>	<b><u>\$216,500</u></b>

- 
- Recovery of an Uncollectible account.
  - When a Bad Debt is recovered, two entries are required to fix it:
    - 1. The entry made in writing off the account is reversed. If a partial payment is received, only that amount is reinstated.
      - Dr. Accounts Receivable.
      - Cr. Allowance for doubtful accounts.
    - 2. The collection is recorded in the usual manner.
      - Dr. Cash.
      - Cr. Accounts Receivable.
- Summary of the Allowance method.
  - 1. Recording estimated uncollectible accounts.

- Any increase to the allowance is recorded as increases in the bad debts expense.
    - 2. Recording the write off of an uncollectible account.
      - Actual accounts are written off when they are determined to be uncollectible.
      - This write off reduces the allowance.
    - 3. Recording the recovery of an uncollectible amount.
      - If a written off account is later collected, the write off is reversed, and the collection is recorded.
- Notes Receivable.
  - A Note receivable is a formal instrument of credit issued as evidence of debt.
  - Normally require payment of interest and extends for 30 days or even longer.
  - May be current or non-current assets depending on their due dates or maturities.
  - Notes and accounts receivable resulting from sales are called TRADE RECEIVABLES.
  - A promissory note is a written promise to pay a specified amount of money on demand or at a definite time.
  - The party making the promise to pay is THE MAKER: Note payable.
  - The party to whom payment is to be made is called THE PAYEE: Notes Receivable.
  - At the time a note is received, it is recorded at the principal value or face value with no interest added.
    - Interest gets added later.
- Acquisition of Interest on Notes Receivable.
  - As time passes, interest revenue accrues on the note.
    - Interest rates are always stated as an annual rate and must be adjusted for partial periods.
    - $\text{Interest} = (\text{face value of note}) * (\text{annual Interest Rate}) * (\text{Time in terms of One Year})$ .
  - Adjusting journal entry:
    - Interest receivable
      - Interest Revenue.
    - This is to accrue interest on notes receivable.
- Honoured Note Receivable.
  - Dr. Cash.
    - Cr. Notes Receivable.
    - Cr. Interest Receivable.
    - Cr. Interest Revenue (for the last month).
  - To record collection of a note and its interest.
- Dishonoured Note Receivable.
  - If eventual collection is expected.
    - Dr. Accounts Receivable.

- Cr. Notes Receivable
    - Cr. Interest Receivable.
    - Cr. Interest Revenue.
  - If these is no hope for collection then...
    - Dr. Allowance for doubtful accounts.
      - Cr. Notes Receivable.
      - Cr. Interest Receivable.
- Net Realizable Value.
  - Notes receivable are reported at their net realizable value.
  - Each note must be analysed to determine its probability of collection.
  - If eventual collection is in doubt, record BDE and ADA.
- Statement Presentation of Receivables.
  - Each of the major types of receivables should be identified in the statement of financial position or in the notes to the financial statements.
  - Short-term receivables are reported in the current assets section of the statement of financial position following cash and short term investments.
  - Only the NET REALIZABLE VALUE of receivables must be disclosed.
  - It is helpful to report both the GROSS AMOUNT of receivables and the Allowance for doubtful accounts either in the statement or in the notes to the financial statements.
    - Accounts receivable – allowance for doubtful accounts = NRV.
  - Bad Debts Expense.
    - Is recorded in the operating expense section of the income statement.
  - Interest Revenue:
    - Is recorded in the non-operating section.
- Managing Receivables.
  - 5 Steps to managing receivables.
    - 1. Determine to whom to extend credit.
    - 2. Establish a payment period.
    - 3. Monitor collections.
    - 4. Evaluate the Liquidity of Receivables.
    - 5. Accelerate cash receipts from receivables when necessary.
      - Loans secured by receivables.
      - Sales of receivables:
        - Securitization.
        - Factoring.
- Ratios
  - To evaluate the liquidity of receivables:
    - 1. Receivables turnover:
      - $\text{Receivables turnover} = (\text{net Credit Sales}) / \text{AVG Gross Receivables}$ .
      - Higher is better.
      - Net credit sales = revenue.

- AVG Gross Receivables=
      - (this year net A/r + Last Year Net A/R) / 2.
  - 2. Average Collection Period.
    - AVG Collection period = (365 days) / Receivables turnover.
    - Lower is better.
      - WE want to get paid faster.
- Other Receivables.
  - Accelerate cash receipts from receivables:
    - Loans secured by receivables.
      - Borrow money from a bank by using receivables as collateral.
    - Sale of receivables:
      - Securitization: Transfer receivables to investors in return for cash.
      - Factoring: Sell the receivables to a factor.

## Chapter 9 – Reporting and Analyzing Long-Lived Assets.

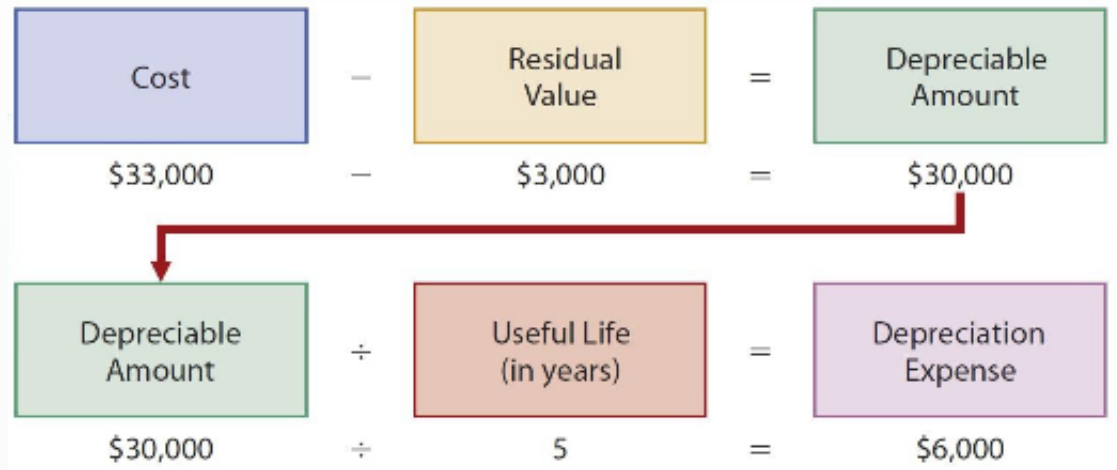
- Property, Plant, and Equipment (PPE).
  - Are long-lived resources.
  - Have a physical substance.
  - Are used in the operations of a business.
  - Are not intended for sale to customers.
  - Also known as Fixed Assets, tangible assets, or capital assets.
- PPE are originally recorded at cost:
  - 1. Purchase price, including taxes and duties, less discounts or rebates.
  - 2. Expenditures necessary to bring asset to its intended location and make it ready for its intended use.
  - 3. Estimated cost of future obligations to dismantle, remove or restore the asset at the end of its useful life.
    - Also called asset retirement cost.
- Operating Expenditures.
  - Expenses found in the income statement.
  - Not part of the value of the cost.
  - Benefit only a current period.
  - Are required to maintain an asset in its normal condition and often recur, although not always annually.
  - Are expensed.
  - If its to repair an equipment, consider it an inconvenience cost.
- Capital Expenditures.
  - Benefits future periods.
  - Include costs that increase the life of an asset or its productivity or efficiency.
  - Are normally larger than operating expenditures and occur less frequently.
  - Are capitalized (included in the asset account).
  - Example: Air condition repair in a company truck.

- If it improves the equipment, consider it as an upgrade.
- PPE often subdivided into four classes:
  - 1. Land.
  - 2. Land improvement.
  - 3. Building.
  - 4. Equipment.
- 1. Land
  - The cost of land can include:
    - The cash purchase price.
    - Closing costs such as title, legal fees, and survey costs.
    - Costs incurred to prepare the land for its intended use such as clearing, grading, and filling.
  - The cost of land is not depreciated because it has an unlimited useful life.
- 2. Land Improvements.
  - Are costs of structural additions to land.
  - Decline in service potential, and require maintenance and replacement to keep their value.
  - Examples:
    - Driveways, fences, sidewalks, and parking lots.
  - Land Improvements are recorded separately from land and are Depreciated.
- 3. Buildings
  - All necessary expenditures relating to the purchase or construction of a building are charged to the building account.
  - When a building is purchased, costs include:
    - The purchase price.
    - Closing costs.
    - All costs to make the building ready for its intended use.
      - Expenditures for remodelling rooms and offices.
      - Expenditures for replacing or repairing the road, floors, electrical wiring, and plumbing.
  - When a new building is constructed, its cost consists of:
    - The contract price.
    - Architect fees.
    - Building permits.
    - Excavation costs.
    - Interest Costs.
  - Annual costs such as licenses and insurance are operating expenditures.
- Accounting for PPE
  - 1. The cost model.
    - Records PPE at cost of acquisition.
    - Depreciation is recorded each period.
    - The assets are carried at carrying amount (cost – the accumulated depreciation).

- 2. The revaluation model.
  - Carrying amount of PPE is adjusted to reflect its fair value.
  - Can be applied only to assets whose fair value can be reliably measured.
  - Revaluation gains are recorded in OCI and can be reversed later.
- IFRS allows firms to choose between the two, but the most commonly used is the cost model.
- Depreciation.
  - The process of allocating the cost of a long-lived asset over its useful (service) life in a rational and systematic manner.
  - It is not a process of asset valuation.
  - Journal Entry:
    - Dr. Depreciation expense.
      - Cr. Accumulated depreciation.
- Components of depreciation
  - 1. Cost
    - How much it costs to acquire.
    - Purchase price plus all costs necessary to get the asset ready for use.
  - 2. Useful life.
    - The period of time over which an asset is expected to be available for use or the number of units of production or units of output that are expected to be obtained from an asset.
    - Is an estimate.
  - 3. Residual value.
    - An estimate of the amount that a company would obtain from the disposal of the asset if the asset were sold as it will be and in the condition it is expected to be in at the end of its useful life.
- Depreciation Methods:
  - 1. Straight Line.
  - 2. Diminishing Balance.
  - 3. Units of production.
  - Each method results in the same amount of total depreciation over the asset's useful life.
    - The only difference is how much we allocate each year.
- 1. Straight-Line Depreciation.
  - Is the most widely used method of depreciation.
  - An equal amount of depreciation is expensed each year of the asset's useful life as long as the cost of the asset, the useful life, and the residual value did not change.
  - Annual depreciation =  $(\text{cost} - \text{residual value}) / (\text{estimated useful life measured in years})$ .
  - Example:
    - A delivery van was bought on Jan 1, 2015.
    - Cost \$33,000.

- Estimated residual value \$3,000.
- Estimated useful life (in years) 5.
- Estimate useful life (in KM) 100,000.

Depreciation is constant for each year of the asset's useful life



PERFECT PIZZAS LTD.  
Straight-Line Depreciation Schedule

Year	Depreciable Amount	×	Depreciation Rate	=	Depreciation Expense	End of Year	
						Accumulated Depreciation	Carrying Amount
							\$33,000
2015	\$30,000		20%		\$ 6,000	\$ 6,000	27,000
2016	30,000		20%		6,000	12,000	21,000
2017	30,000		20%		6,000	18,000	15,000
2018	30,000		20%		6,000	24,000	9,000
2019	30,000		20%		6,000	30,000	3,000
					<u>\$30,000</u>		

residual value

- Carrying amount can never go below the residual value.
- 2. The Diminishing-Balance method.
  - Produces a decreasing annual depreciation expense over an asset's useful life.
    - Depreciation is calculated based on the asset's carrying amount, which diminishes each year as accumulated depreciation increases.
  - Annual depreciation = carrying amount \* the depreciation rate.
    - Residual value is not included in the calculation.
    - Depreciation rate = straight-line rate x multiplier.

$$\begin{array}{rcccl}
 \text{Carrying Amount at} & & & & \\
 \text{Beginning of Year} & \times & \text{Depreciation Rate} & = & \text{Depreciation} \\
 & & \text{(Straight-Line Rate} \times \text{Multiplier)} & & \text{Expense} \\
 \$33,000 & \times & 20\% \times 2 & = & \$13,200
 \end{array}$$

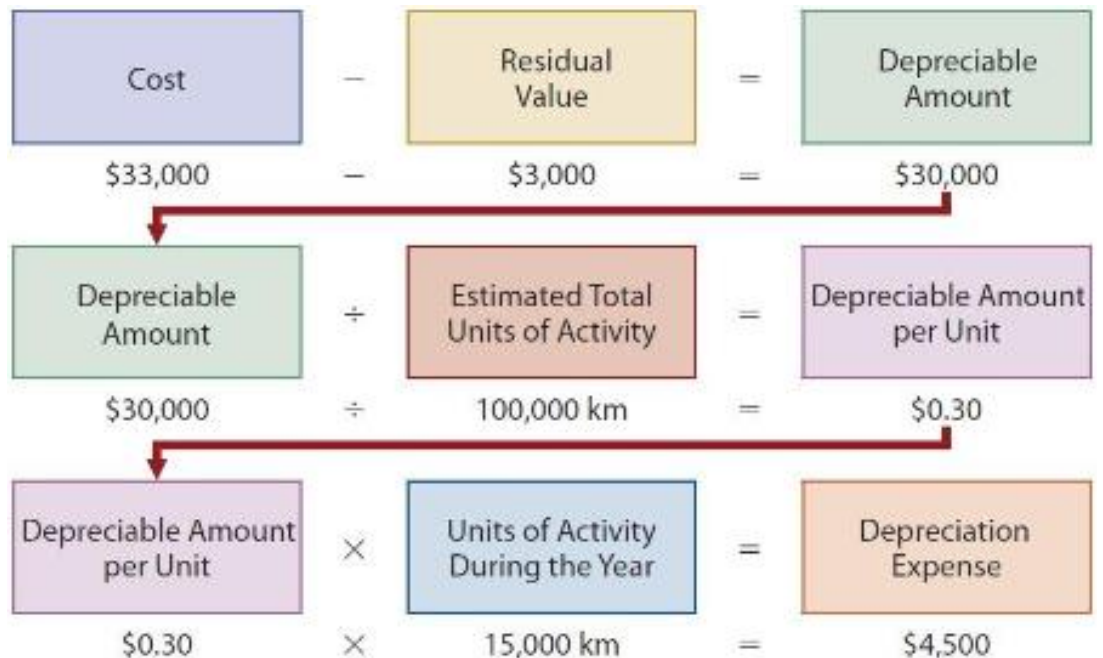
**PERFECT PIZZAS LTD.**  
Double-Diminishing-Balance Depreciation Schedule

Year	Carrying Amount Beginning of Year	×	Depreciation Rate	=	Depreciation Expense	End of Year	
						Accumulated Depreciation	Carrying Amount
							\$33,000
2015	\$33,000		40%		\$13,200	\$13,200	19,800
2016	19,800		40%		7,920	21,120	11,880
2017	11,880		40%		4,752	25,872	7,128
2018	7,128		40%		2,851	28,723	4,277
2019	4,277		40%		1,277*	30,000	3,000
					<u>\$30,000</u>		

\*The calculation of \$1,711 ( $\$4,277 \times 40\%$ ) is adjusted to \$1,277 so that the carrying amount will equal the residual value of \$3,000.

residual  
value

- For the last year, we don't depreciate by full value.
  - We depreciate by whatever brings us to the ending residual value.
- 3. The Units of Production Method
  - The life of an asset is expressed in terms of the total units of production or the total use expected from the asset.
  - Production levels used to measure depreciation include units of output, machine hours, kilometres driven, or hours used.
  - Two steps to calculate depreciation:
    - 1. Determine the depreciation amount per unit:  $(\text{Cost} - \text{residual value}) / (\text{total estimated units of production})$ .
    - 2. Multiply the depreciation amount per unit by the units produces or used during the year to arrive at annual depreciation.



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PERFECT PIZZAS LTD. Units-of-Production Depreciation Schedule					
Year	Units of Production	Depreciable Amount/Unit	Depreciation Expense	End of Year	
				Accumulated Depreciation	Carrying Amount
					\$33,000
2015	15,000	\$0.30	\$ 4,500	\$ 4,500	28,500
2016	30,000	0.30	9,000	13,500	19,500
2017	20,000	0.30	6,000	19,500	13,500
2018	25,000	0.30	7,500	27,000	6,000
2019	10,000	0.30	3,000	30,000	3,000
	<u>100,000</u>		<u>\$30,000</u>		

residual value

- 
- Impairments
  - Carrying amount = cost – accumulated depreciation to date.
  - Recoverable amount = asset's fair value, selling costs of similar assets in an active market.
  - If carrying amount > recoverable amount, the asset is impaired.
  - Impairment loss = the carrying amount – recoverable amount.
- Journal Entry
  - To record an impairment loss:
    - Dr. impairment loss.
    - Cr. Accumulated depreciation.

- Companies must review their assets regularly for possible impairment, and do so whenever a change in circumstance affects fair value.
- The impairment loss is reported on the income statement as part of profit from continuing operations.
- Impairments.
  - IFRS allows the reversal of a previously recorded impairment loss.
- Impairment journal entries are reversible, not a high amount though.
  - The maximum for reversal is if impairment did not occur.
  - Initial value will hold.
  - Cannot be valued greater.
- Disposal of PPE
  - Sale of PPE.
    - 4 Steps to record the sale of PPE:
      - 1. Update Depreciation.
      - 2. Calculate the carrying amount.
      - 3. Calculate the gain or loss. The gain or loss is the different between proceeds and the carrying amount.
      - 4. Record the disposal.

Gain	Loss
Dr. cash, Dr. Accumulated Depreciation Cr. asset account <b>Cr. Gain</b>	Dr. cash, Dr. Accumulated Depreciation <b>Dr. Loss</b> Cr. asset account

- Retirement of an asset.
  - Recorded as a special case of a sale, one where no cash is received.
  - If the asset is retired before it is fully depreciated, there is a loss on disposal (=carrying amount at the date of retirement).
  - Even if the carrying amount is zero, a journal entry is still required to remove the accounts related to the retired asset.
  - If the company is still using a fully depreciated asset, the asset and its accumulated depreciation will continue to be reported on the statement of financial position, without further depreciation, until the asset is retired.
- Financial Statements Presentation.
  - Statement of Financial Position.
    - Reported as:
      - Property, plant, and equipment.
      - Intangible assets.
      - Goodwill.
    - Disclose cost and accumulated depreciation (amortization) of each major class of assets.
      - Either in statement or in notes.

- Disclose depreciation / amortization methods and useful lives or rates.
    - IFRS also requires additional disclosures.
  - Income Statement
    - Depreciation expense.
      - (gains and losses on disposal and impairment losses are included in the operating section).
  - Statement of Cash Flows
    - Cash flows from the purchase and sale of long-lived assets are reported in the investing section.
- Methods for evaluating the Use of Assets.
  - 1. Return on assets:
    - Is an overall measure of profitability.
    - Indicates the amount of profit generated by each dollar invested in assets.
    - Return on assets =
      - Profit / Average Total Assets.
  - 2. Asset Turnover:
    - Indicates how efficiently a company is able to generate sales with a given amount of assets.
    - Indicates how many dollars of sale are generated by each dollar invested in assets.
    - Asset Turnover =
      - Net sales / Average Total assets.
  - Together, Profit margin and asset turnover explain the return on assets ratio:
    - Profit Margin \* Asset Turnover = return on assets.
    - Or =
      - Profit / Average Asset turnover = return on assets.

## comparing

## IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Models for valuing property, plant, and equipment	Choice of cost model or revaluation model	Only cost model allowed
Models for valuing investment properties	Choice of cost model or valuation model for investment properties	No separate recognition of investment properties—considered to be property, plant, and equipment—so only cost model allowed

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# Comparing IFRS and ASPE

Impairment requirements for property, plant, and equipment and intangible assets with finite lives	Must determine each year if indicators of impairment are present and if so perform an impairment test. Reversals of impairment losses are allowed.	No annual requirement to determine if indicators of impairment exist, but when it is apparent they exist, an impairment test must be done. An impairment test occurs in two steps: (1) determine that the cash flows from the asset do not exceed its carrying value, and (2) calculate the impairment loss. Impairment losses cannot be reversed.
Goodwill and intangible assets with indefinite lives	Must perform impairment test annually. Impairment losses can be reversed on intangible assets but not on goodwill.	Same approach used as above.
Terminology	<i>Depreciation</i> is used to describe cost allocation for property, plant, and equipment. Long-term leases that are essentially the purchase of an asset are called <i>finance leases</i> .	<i>Amortization</i> may be used instead of <i>depreciation</i> for property, plant, and equipment. Long-term leases that are essentially the purchase of an asset are known as <i>capital leases</i> .

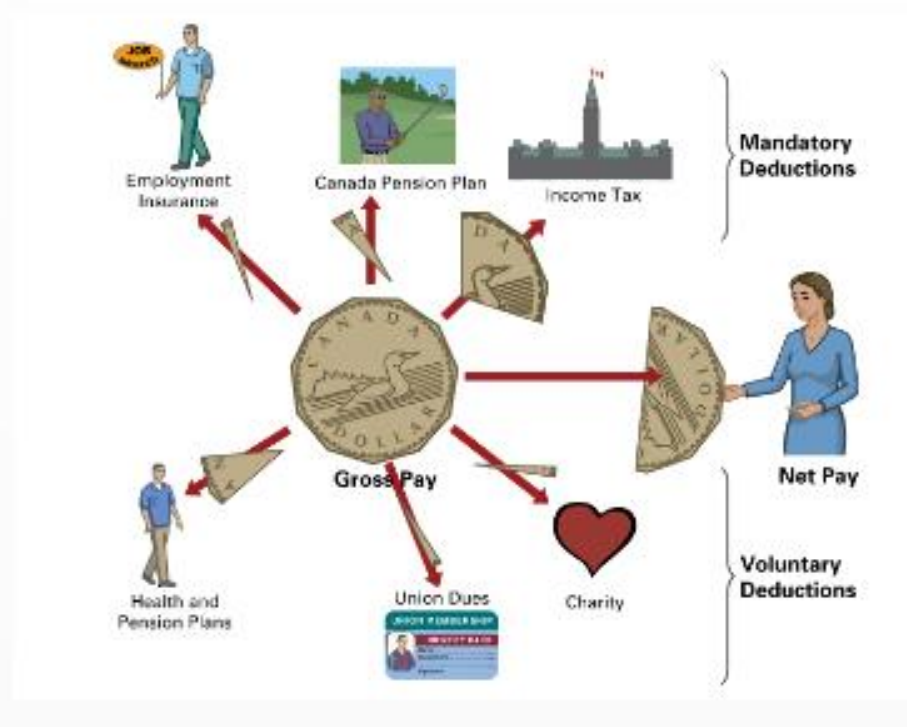
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## Chapter 10 – Reporting and Analyzing Liabilities

- Liabilities.
  - Liabilities are present obligations that result from past transactions. We distinguish between:
    - 1. Current liabilities.
      - Existing current assets (cash).
      - Through the creation of other current liabilities (note payable).
    - 2. Non-current liabilities.
      - Debts that do not meet both of the aforementioned criteria.
- Current Liabilities.
  - Types of current liabilities:
    - Bank indebtedness.
    - Accounts payable.
    - Accrued liabilities (taxes, salaries, interest).
    - Unearned revenue.
    - Notes or loans payable.
    - Current portion of non-current debt.
  - Operating Line of Credit:
    - Pre-authorized by the bank that allows companies to borrow money up to a pre-set limit, when it is needed.
    - Interest is usually charged at a floating (variable) interest rate on any amounts used from the line of credit.

- Security, called collateral, is usually required by the bank as protection in the event of default on the loan.
      - A bank indebtedness is a negative or credit bank balance (debt to the bank) which is reported as a current liability on the statement of financial position.
        - No special journal entry is required to record an overdrawn amount.
    - Sales Taxes
      - 1. Federal Goods and Services Tax (GST)
      - 2. Provincial Sales Tax (PST or QST).
      - 3. Combined into one harmonized sales tax (HST) in some provinces.
      - The retailer collects the sales tax from customers when the sale occurs and remits the tax to the federal and provincial collecting authorities (usually monthly).
      - In the case of GST and HST, collection may be offset against payments (ex. Sales tax payments made by the company on its own eligible purchases). Only the net amount owing or recoverable will be paid or refunded.
    - Recorded as Sales Tax Payable and is a liability.
    - Property Taxes.
      - Taxes are charged by the municipal and provincial governments and are calculated at a specified rate for every \$100 of the assessed value of the property (ex. Land and building).
      - Paid annually.
      - Are generally for the calendar year, through bills, are not usually issued until the spring.
    - Property Taxes Journal Entries.
      - 1. At reception of the bill, record the expense for the period that has already passed.
        - Dr. Property tax expense.
          - Cr. Property tax payable.
      - 2. At payment of the bill, record the payment of the expense and the prepayment.
        - Dr. Property tax payable (for the first quarter considered).
        - Dr. Property tax expense (for the first quarter considered).
        - Dr. Prepaid property tax (For the next 3 quarters).
          - Cr. Cash.
      - 3. At year end, adjust the prepaid tax.
        - Dr. Property tax expense.
          - Cr. Prepaid property Tax.
- Payroll
  - Three types of liabilities related to employees' salaries or wages:
    - 1. The net pay owed to employees.

- 2. Employee payroll deductions.
- 3. Employer payroll obligations.
- 1. Net Pay.
  - Management personnel are normally paid salaries, which are expressed as a specific amount per week, per month, or per year.
  - Part-time employees or employees paid on an hourly basis or by the work produced are normally paid wages.
  - Salaries + Wages = gross pay or gross earnings.
  - Gross pay – payroll deductions = net pay.



- 
- 2. Employee Payroll Deductions.
  - Mandatory payroll deductions include amounts withheld for federal and provincial income taxes, Canadian pension plan (CPP) contributions, and employment insurance (EI) premiums.
  - Voluntary deductions are for charities, unions, pension, and insurance contributions.
  - Dr. Salaries expense.
    - Cr. Income tax payable.
    - Cr. CPP.
    - Cr. EI Payable.
    - Cr. Cash.
- 3. Employer Payroll obligations.
  - Employers pay payroll costs such as the employer’s share of CPP and EI.

- Also, they fund the worker's compensation plan. These costs are recorded as an employee benefits expense.
    - Dr. Employee Benefits Expense.
      - Cr. CPP Payable.
      - Cr. EI Payable.
    - Until these payroll deductions and costs are remitted to the third parties that they are collected for, they are reported as current liabilities.
- Short-term Notes Payables.
  - Obligations in the form of written notes.
  - Often used instead of accounts payable because they give the lender written documentation of the obligation, which helps if legal remedies are needed to collect the debt.
  - Notes and loans are sometimes used interchangeably.
  - Notes payable are frequently issued to meet short-term financing needs and usually require the borrow to pay interest.
  - Notes that are due for payment within one year or less are classified as current liabilities.
  - Short term notes can have a floating interest rate; however, it is more common for them to have a fixed interest rate.
  - Journal Entries:
    - 1. Record issue of note:
      - Dr. Cash.
        - Cr. Notes Payable.
    - 2. Record accrued interest.
      - Dr. Interest expense.
        - Cr. Interest payable.
    - 3. Record payments of note plus interest.
      - Dr. Notes payable.
      - Dr. Interest Payable.
      - Dr. interest Expense (for the last month).
        - Cr. Cash.
- Current Liabilities
  - Current maturities of non-current debt.
    - Current portion of a non-current debt should be included in current liabilities.
    - A journal entry is not required to recognize this classification.
- Financial Statement Presentation and Analysis of Liabilities.
  - Current liabilities are the first category under liabilities on the statement of financial position.
  - Each of them mean types of current liabilities is listed separately within this category.

- Current liabilities are generally listed in their order of liquidity (by their due dates) but this is not always possible because of the varying maturity dates that may exist for specific obligations such as notes payable.
  - Other orders are also possible.
    - Ex. Reverse- Liquidity.
  - Non-current liabilities are reported in a separate section of the statement of financial position immediately following current liabilities.
  - Summary data regarding debts may be presented on the SFP, while detailed data (such as interest rates, maturity dates, conversion privileges, and assets pledged as collateral) are usually shown in the notes to the financial statements.
- Analysis:
- Liquidity Ratios measure the short-term ability of a company to pay its current obligations and to meet unexpected needs for cash.
    - The Current Ratio
      - = Current Assets / Current Liabilities.
      - Is a commonly used measure of liquidity.
    - The current ratio should be supplemented by other ratios such as receivables turnover and inventory turnover.
  - Solvency Ratios
    - Measures the ability of a company to repay its long-term debt and survive over a long period of time.
      - Debt to Total Assets
        - = Total Liabilities / Total Assets.
        - Indicates the extent to which a company's assets are financed by debt.
      - Times Interest Earned.
        - Gives an indication of a company's ability to meet interest payments as they come due.
        - Times Interest Earned =
          - $(\text{Profit} + \text{Interest expense} + \text{Income tax expense}) / \text{Interest Expense}$ .

## Chapter 11 – Reporting and Analyzing Shareholders' Equity.

- Corporate form of an organization.
  - Corporation.
    - Legal entity that is separate and distinct from its owners (shareholders).
    - Commonly classified by purpose and by ownership.
    - Purpose.
      - Profit (McDonald's, Sears Canada, Research in motion).

- Not for Profit (United Way, Canadian Cancer Society, University of Ottawa).
  - Ownership.
    - Publicly held corporation.
      - Shares traded on organized stock exchange and may have thousands of shareholders.
    - Privately held corporation.
      - Shares not traded on organized stock exchange and may have only a few shareholders.
- Characteristics of Corporations.
  - Separate Legal Existence.
    - An entity separate and distinct from owners.
      - Acts under its own name rather than in the name of shareholders.
      - May buy, own, and sell property, borrow money, may sue or be sued, and pays its own income tax.
  - Limited liability of shareholders.
    - Creditors have recourse only to corporate assets to satisfy claims.
      - Liability of shareholders limited to investment in corporation.
  - Transferable ownership rights.
    - Ownership is evidenced by shares, which are transferable units.
    - Transfer of ownership rights among shareholders has no effect on operating activities of the corporation or on a corporation's assets, liabilities or shareholders' equity.
  - Ability to acquire capital.
    - Easy for corporations to raise capital.
      - Only small amounts of money need to be invested making shares attractive to many individuals.
  - Continuous life.
    - Corporations have an unlimited life.
      - The continuance of a corporation is not affected by withdrawal, death, or incapacity of a shareholder, employee or officer.
  - Corporation Management.
    - Shareholders manage a corporation indirectly through a board of directors, which they elect.
    - Board of directors formulate operating policies and select officers to execute policy and to perform daily management functions.
    - The corporation hires professional managers to run the business, so the owners are not required to have managerial expertise.
    - This separation of ownership and management can be viewed as an advantage or as a weakness.
  - Government regulations.

- Federal and provincial laws usually prescribe the requirements for issuing share and the distributions of profits permitted to shareholders.
    - Provincial securities regulations govern the sale of share capital to the general public, and corporations listed in foreign security markets must also respect their requirements.
    - Complying with securities regulations increases the cost and complexity of the corporate form of organization.
  - Income Tax.
    - Corporations, as separate legal entities, must pay federal and provincial income tax.
    - Shareholders must pay taxes on cash dividends.
- Share Issue Considerations.
  - The shares of a company are divided into different classes such as Class A and Class B.
    - The rights and privileges for each class of shares are stated in the articles of incorporation.
    - The classes are usually identified by the generic terms common shares, and preferred shares.
  - Rights of common shareholders:
    - 1. Voting rights.
    - 2. Dividends.
    - 3. Residual Claim.
- Preferred shares:
  - 1. Dividend preference:
    - Priority claim over common shares on any distribution of dividends.
      - 1. Cumulative dividends:
        - When dividends are declared to be payable, preferred shareholders must be paid both current year dividends and any unpaid prior year dividends (dividends in arrears) before common shareholders receive dividends.
      - 2. Non-Cumulative Dividends:
        - Dividend that is not paid in any year is lost forever.
  - 2. Liquidation Preference:
    - Priority claim over common shareholders on corporate assets if the corporation fails.
  - 3. Other preferences:
    - Example, convertible preferred shares, redeemable preferred shares, retractable preferred shares.
- Authorized Share Capital
  - The number of authorized shares a corporation is authorized to sell is indicated in its articles of incorporation.
  - It may be specified as an unlimited amount or a certain number.



- Retained earnings are the cumulative profits since incorporation that have not been distributed to the shareholders in the form of dividends.
    - Dividends are generally reported as an annual dollar amount per share, even though it is usual to pay dividends quarterly.
    - Cash Dividends are the most common in practice, but stock dividends are also declared fairly often.
- Cash Dividends
  - Cash dividends are the distribution of cash to shareholders.
  - For a corporation to pay a cash dividend, it must meet a two part solvency test and be declared by the board of directors:
    - Solvency test:
      - 1. It must have sufficient cash or other resources to be able to pay its liabilities as they come due after the dividend is declared and paid.
      - 2. The net realizable value of its assets must exceed the total of its liabilities and share capital.
    - Declaration of Dividends.
      - The board of directors have full authority to determine the amount of retained earnings to be distributed in the form of dividends and the amount to be retained in the business.
      - Dividends are not a liability until declared.
- Entries for Cash Dividends:
  - 3 dates are important in connection with dividends.
    - 1. The Declaration Date.
    - 2. The Record Date.
    - 3. The Payment Date.
- 1. The Declaration Date.
  - The date the board of directors formally authorizes the dividend and announces it to shareholders.
    - Dr. Cash Dividends.
      - Cr. Dividends payable.
    - To record the declaration of cash dividend.
- 2. The Record Date:
  - The purpose of the record date is to identify the persons or entities that will receive the dividend.
  - No entry is required on the record date.
- 3. The Payment Date:
  - Dividend cheques are mailed to the shareholders and the payment of the dividend is recorded.
  - The entry on the payment date is:
    - Dr. Dividends payable.
      - Cr. Cash.

- To record payment of cash dividend.

**Example:**

On December 1, 2012, the directors of IBR Inc. declare a \$0.50 per share cash dividend on 100,000 common shares. On January 20, IBR Inc. pays the dividends. Prepare the journal entries.

1. Declaration date

The dividend is \$50,000 (100,000 x \$0.50), and the entry to record the declaration is:

```

Cash Dividends    50,000
Dividends Payable  50,000
                    (To record declaration of cash dividend)
  
```

2. Record date

No journal entry

3. Payment date

```

Dr. Dividends Payable 50,000
Cr. Cash               50,000
  
```

- Stock Dividend

- Distribution of the corporation's own shares to shareholders.
- Results in a decrease in Retained earnings, and an increase in share capital.
- Does not decrease total shareholders' equity or total assets.
- Valued using the fair value per share at the declaration date.
- On the declaration date:
  - Dr. Stock dividends.
    - Cr. Common stock dividend distributable.
- When the dividend shares are issued.
  - Dr. Common stock dividend distributable.
    - Cr. Common shares.

	Cash dividend	Stock dividend
Declaration date	Dr. Cash dividends Cr. Dividends payable	Dr. Stock dividends Cr. Common stock dividends distributable
Payment date	Dr. Dividends payable Cr. Cash	Dr. Common stock dividends distributable Cr. Common shares

- Total Shareholders' equity before stock dividend and after are the same.

- Stock Splits.

- Like a stock dividend, it involves the issue of additional shares to shareholders according to their percentage ownership.
- A stock split results in a reduction in the legal capital per share and is usually much larger than a stock dividend.
- The purpose of a stock split is to increase the marketability of the shares by lowering the share price, making it easier for the corporation to issue additional shares and also to increase investor interest.

- In a stock split, the number of shares is increased in the same proportion that the legal capital per share is decreased.
- A stock split does not have any effect on total share capital, retained earnings, and total shareholders' equity. However, the number of shares increases.
- Because a stock split does not affect the balances in shareholders' equity accounts, it is not necessary to journalize a stock split.

**Example:**

Assume that instead of issuing a 10% share dividend, IBR splits its 50,000 common shares on a 2-for-1 basis.

What is the effect of IBR's stock split on shareholders' equity?

	Before	After
	<u>Share Split</u>	<u>Share Split</u>
Shareholders' equity		
Common shares	\$500,000	\$500,000
Retained earnings	<u>300,000</u>	<u>300,000</u>
Total shareholders' equity	<u>\$800,000</u>	<u>\$800,000</u>

Number of shares 50,000 100,000

- - Everything stays the same except quantity of shares.
  - No journal entries required.
- Comparison between dividends and stock splits.

	<u>Assets</u>	=	<u>Liabilities</u>	<u>Shareholders' Equity</u>		<u>Number of Shares</u>
				+ <u>Share Capital</u>	+ <u>Retained Earnings</u>	
Cash dividend	-		NE	NE	-	NE
Stock dividend	NE		NE	+	-	+
Stock split	NE		NE	NE	NE	+

- Financial Statement Presentation.
  - Statement of Financial Position Presentation.
    - In the shareholders' equity section of the statement of financial position, we report.
      - Contributed capital.
      - Retained Earnings.
      - Accumulated other comprehensive income.
  - Statement of changes in equity.

- This statement discloses changes in total shareholders' equity for the period, as well as changes in each shareholders' equity account, including:
      - Contributed capital.
      - Retained Earnings.
      - Accumulated other comprehensive income.
- 1. Contributed Capital.
  - Share Capital – Consists of preferred and common shares.
  - Preferred shares are shown before common shares because of their additional rights.
  - Information about the legal capital, number of shares authorized, number of shares issued, and any particular share preferences are reported for each class of shares.
  - Additional Contributed Capital includes amounts contributed from reacquiring and retiring shares, or from other shareholders transactions.
- 2. Retained Earnings
  - Are the cumulative profits (or losses) that have been retained in the company (not distributed to shareholders) since its incorporation.
  - The normal balance is a credit balance, but if a deficit (debt balance) exists, it is reported as a deduction from shareholders' equity.
- 3. Accumulated Other Comprehensive Income (AOCI).
  - Includes the gains and losses that bypass profits but affect shareholders' equity.
  - Comprehensive income includes all changes in shareholders' equity during a period except changes that result from the sale or repurchase of shares or the payment of dividends.
  - Examples of comprehensive income include:
    - Certain translation gains and losses on foreign currency.
    - Unrealized gains and losses from cash flow hedges,
    - Unrealized pension cost from a minimum pension liability adjustment.
  - Not all companies will have examples of other comprehensive income. However, if they do, they must report:
    - Comprehensive income separately in a statement of comprehensive income.
    - Accumulated other comprehensive income as a separate component of shareholders' equity.

## Example: SFP

OZABAL INC.  
Statement of Financial Position (Partial)  
December 31, 2012

Shareholders' equity	
Contributed capital	
Share capital	
\$1.25 Preferred shares, no par value, noncumulative, 100,000 shares authorized, 10,000 issued.....	\$250,000
Common shares, no par value, unlimited number of common shares authorized, 250,000 issued.....	500,000
Common stock dividends distributable .....	50,000
Contributed capital – reacquisition of common shares .	<u>25,000</u>
Total contributed capital.....	\$ 825,000
Retained earnings (Note R) .....	900,000
Accumulated other comprehensive loss .....	<u>(50,000)</u>
Total shareholders' equity .....	<u>\$1,675,000</u>

## Example: statement of changes in equity

STENDEL CORPORATION  
Statement of Changes in Equity  
Year Ended December 31, 2012

	Common Shares		Retained Earnings	Accumulated Other Comprehensive Loss	Total
	Number of Shares	Legal Capital			
Balance, Jan. 1	75,000	\$1,700,000	\$ 900,000	\$(125,000)	\$2,475,000
Cash dividends			(75,000)		(75,000)
Stock split, April 1	150,000				
Stock dividends	11,250	157,500	(157,500)		
Profit			400,000		400,000
Balance, Dec. 31	<u>236,250</u>	<u>\$1,857,500</u>	<u>\$1,067,500</u>	<u>\$(125,000)</u>	<u>\$2,800,000</u>

- Evaluate Dividends and Earnings Performance.
  - o Dividend Record
    - The payout ratio
      - Measures the percentage of profits distributed in the form of cash dividends to common shareholders.
      - Payout ratio =
        - o = (Cash Dividends) / (profit).

- Higher is better if investor looking for income from dividends.
  - The Dividend Yield.
    - Measures the profit generated by each share, based on the market price of the shares.
    - Dividend Yield=
      - = (Divided per share) / (Market price per share).
      - Higher is better if investor is looking for income.
- Earnings Performance
  - 1. Earnings Per Shares (EPS)
    - = (profit available to common shareholders) / (weighted average number of common shares).
    - The weighted average number of common shares is calculated by multiplying the number of shares issued by the fraction of the year that they have been issued.
      - When a corporation has securities that may be converted into common shares, it must report basic earnings per share and diluted earnings per share.
      - The diluted earnings per share is a hypothetical figure that assumes all securities that can be converted into, or exchanged for, common shares have actually been converted or exchanged.
    - Cannot compare EPS between companies.
      - Different earnings, different quantity of shares.
  - 2. Return on common shareholders' equity.
    - Widely used ratio that measures profitability from the common shareholders' viewpoint.
    - Profits available to the common shareholders is profits less any preferred dividends.
    - Return on common shareholders' equity =
      - = (profit available to common shareholders) / (AVG common shareholders' equity).
    - Higher is better.

## comparing IFRS and ASPE

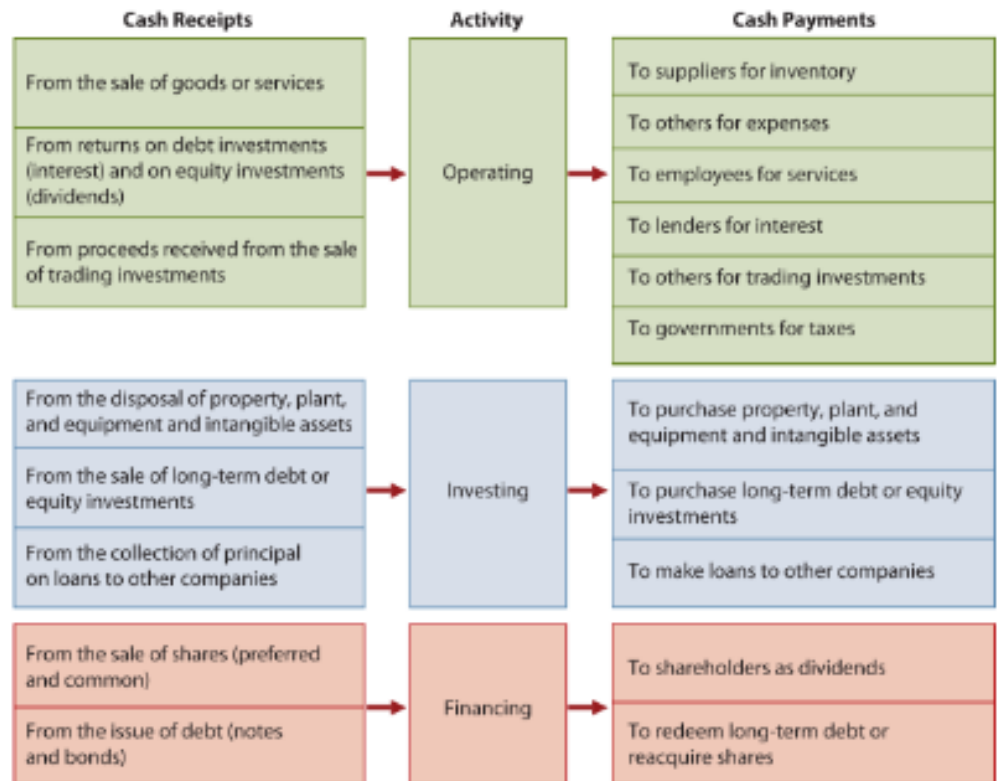
Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Issue of shares for noncash considerations	When shares are issued for a noncash consideration, they should be recorded at the fair value of the consideration (e.g., goods or services) received. If the fair value of the consideration received cannot be reliably determined, then the fair value of the consideration given up would be used instead.	When shares are issued for a noncash consideration, they should be recorded at the most reliable of the two values—the fair value of the consideration (e.g., goods or services) received or the fair value of the consideration given up.
Comprehensive income	Must present accumulated other comprehensive income in statement of financial position and detail changes in other comprehensive income in the statement of changes in equity.	Disclosure of comprehensive income is not required.
Statement of changes in equity/retained earnings	Changes in all shareholders' equity accounts are presented in a statement of changes in equity.	Changes in retained earnings are presented in a statement of retained earnings. Changes in share capital and other accounts are presented in the notes to the financial statements.
Earnings per share	Required to present in the income statement (or statement of comprehensive income).	Not required to present in the income statement.

○

### Chapter 13 – Statement of Cash Flows

- Purpose and Content of the Statement of Cash Flows.
  - Purpose:
    - Is to help investors, creditors, and others assess:
      1. The reasons for the difference between profits and cash provided or used by operating activities.
      2. The investing and financing transactions during the period, or why assets and liabilities have increased or decreased.
      3. The company's ability to generate future cash flows.
  - Content:
    - The information reported in the statement of cash flows includes:
      - 1. Cash receipts.
      - 2. Cash payments.
      - 3. Net Change in Cash.
    - The statement of cash flows classifies each receipts and cash payments into three types of activities:
      - 1. Operating activities.
      - 2. Investing Activities.
      - 3. Financing activities.

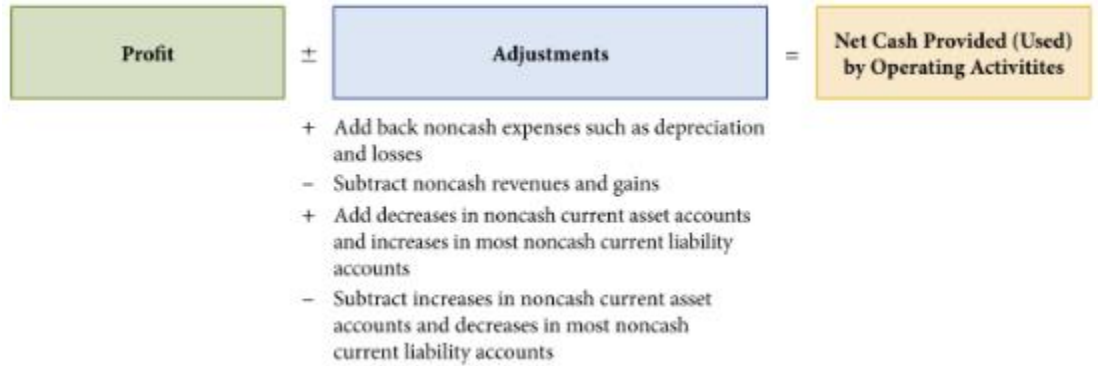
- Under IFRS
  - The Interest Received and Dividends Received.
    - Categorized by investing or operating.



- - Cash Payments and Cash Receipts are considered investing activities.
  - Under IFRS:
    - Companies have a choice between the classification of interest and dividends.
    - Interests and dividends received may be classified as operating or investing.
    - Interests and dividends paid may be classified as operating or financing.
- Noncash Activities include:
  - Issue of debt to purchase assets.
  - Issue of shares to purchase assets.
  - Conversions of debt into equity.
  - Exchanges of property, plant, and equipment.
- Significant investing and financing activities that do not affect cash are not reported in the body of the statement of cash flows.
  - However, these activities are reported in a note to the financial statements.
  - Only considered things on a cash basis.

COMPANY NAME Statement of Cash Flows Period Covered		
<b>Operating activities</b>		
(Prepared using indirect or direct method)	<u>XX</u>	
Net cash provided (used) by operating activities		XXX
<b>Investing activities</b>		
(List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by investing activities		XXX
<b>Financing activities</b>		
(List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by financing activities		<u>XXX</u>
Net increase (decrease) in cash		<u>XXX</u>
Cash, beginning of period		<u>XXX</u>
Cash, end of period		<u>XXX</u>

- - o Two methods for the operating activities section.
    - Direct method.
    - Indirect Method.
  - o Investing and financing only have one method.
- The Operating Activities Section
  - o Profit must be converted from an accrual basis to a cash basis:
    - Earned revenues may include credit sales that have not yet been collected in cash.
      - These we don't count.
    - Expenses incurred may not have been paid in cash.
      - Perhaps, prepaid expenses, or traded equity.
  - o Conversion may be done by either of two methods:
    - 1. The Indirect method.
      - Converts total profit from an accrual basis to a cash basis.
    - 2. The Direct Method.
      - Converts each individual revenue and expense account from an accrual basis to a cash basis, identifying specific cash receipts and payments.
- 1. Indirect Method.



- - Depreciation expense is an expense that is noncash.
- a) Noncash Expenses and Revenue.
  - a. The Income statement includes expenses that do not use cash.
    - i. Ex.
      1. Depreciation expense, amortization expense.
      - ii. Noncash expenses reduces profits but does not reduce cash, non cash expenses are added to profit.
    - b. The Income statement includes noncash revenues:
      - i. Ex.
        1. Amortization of a bond discount.
        - ii. Noncash revenues are deducted from profit.
  - b) Losses and Gains
    - a. All gains and losses from investing activities and financing activities must be eliminated from profits to arrive at cash from operating activities.
    - b. If we do not eliminate these gains and losses, they would be counted twice, once in profits and again in the investing or financing activities section.
    - c. +Losses and / or -Gains on the income statement.
  - c) Changes in Current Asset and Current Liability Accounts
    - a. Accounts receivable.
      - i. Decrease in A/R.
        1. Revenues on an accrual basis would be lower than revenues on a cash basis.
        2. The amount of the decrease in accounts receivable is added to profit.
      - ii. Increase in A/R:
        1. Revenues on an accrual basis are higher than cash receipts.
        2. The amount of the increase in accounts receivable is deducted from profits.
      - iii. When looking at revenue: the standard method is to value it at 50,000.
        1. When looking at the cash basis revenue, the method only values how much of the A/R actually got paid, so if we only received 20,000 in cash, then our revenue at this point would be valued at 30,000 dollars less than the standard revenue.
        2. COGS

- a. Looking at COG purchased.
- b. T account of merchandise inventory.
- b. Merchandise Inventory.
  - i. When merchandise inventory increases during the year, the cost of goods purchased is greater than the cost of goods sold recorded in the income statement.
  - ii. Any increase (decrease) in the merchandise inventory account must be deducted from (added to) profit to arrive at net cash provided (used) by operating activities.
  - iii. The analysis will be completed by converting the cost of goods purchased from an accrual basis to a cash basis (need to analyse accounts payable).
- c. Prepaid Expenses
  - i. An increase in prepaid expenses means that cash paid for expenses is higher than expenses reported on an accrual basis. Cash payments were made in the current period, but expenses have been deferred to future periods.
  - ii. The increase (decrease) in prepaid expenses is deducted from (added to) profit to arrive at net cash provided (used) by operating activities.
- d. Changes in Accounts Payable.
  - i. Accounts Payable is increased by the purchase of merchandise and decreased by payments to suppliers.
  - ii. An increase (decrease) in accounts payable means that less (more) cash paid for purchases than was deducted in the accrual based expenses.
  - iii. An increase in accounts payable must be added to profit.
- e. Changes in Income Tax Payable.
  - i. The change in the Income tax payable account reflects the different between income tax incurred and income tax actually paid.
  - ii. A decrease (increase) in income tax payable would result in a decrease (increase) to cash provided (used) by operating activities since the amount paid was greater than (less than) the tax incurred.
  - iii. A decrease to Income Tax Payable will result in the amount being deducted from profit.

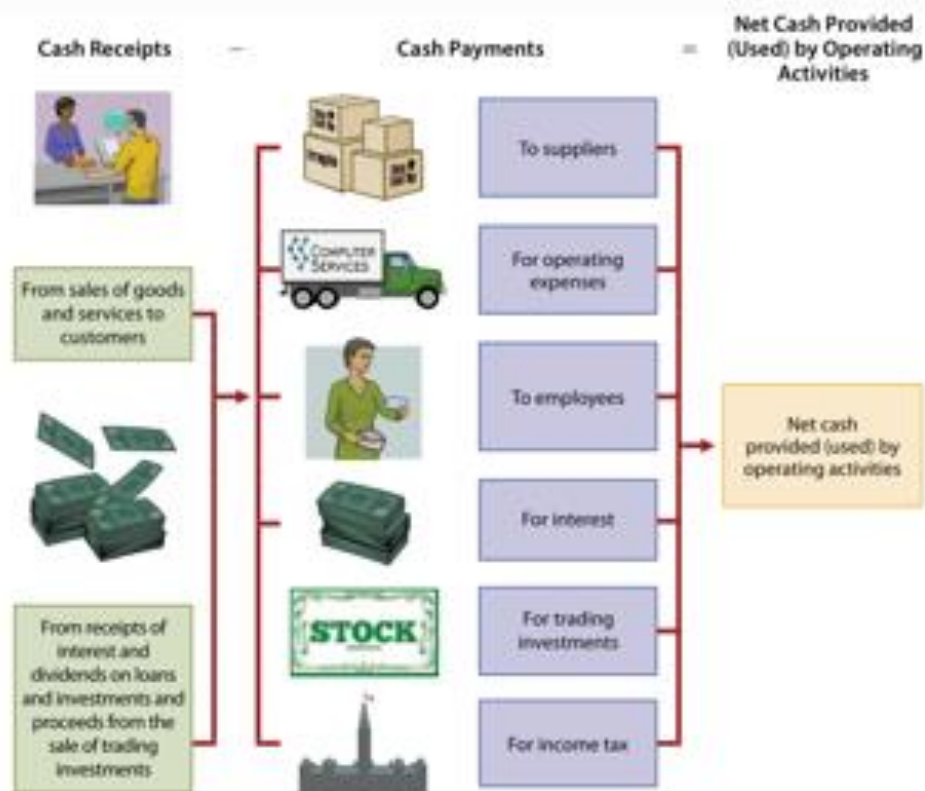
Noncash expenses	Depreciation expense (property and equipment) Amortization expense (intangible assets)	Add Add
Losses and gains	Losses including impairment losses Gains and reversal of impairment losses	Add Deduct
Changes in certain noncash current asset and current liability accounts	Increase in current asset account Decrease in current asset account Increase in current liability account Decrease in current liability account	Deduct Add Add Deduct

- o Start with profit and make several adjustments.

- Noncash Expenses.
- Losses and gains.
- Changes in certain noncash current asset and current liability accounts.
- This is the indirect method.

COMPUTER SERVICES CORPORATION		
Statement of Cash Flows—Indirect Method (partial)		
Year Ended December 31, 2012		
Operating activities		
Profit		\$145,000
Adjustments to reconcile profit to net cash provided (used) by operating activities		
Depreciation expense	\$ 9,000	
Loss on sale of equipment	3,000	
Decrease in accounts receivable	10,000	
Increase in merchandise inventory	(5,000)	
Increase in prepaid expenses	(4,000)	
Increase in accounts payable	16,000	
Decrease in income tax payable	(2,000)	
	<u>27,000</u>	
Net cash provided by operating activities		<u>172,000</u>

- The DIRECT METHOD



- Under the Direct Method, net cash provided (or used) by operating activities is calculated by adjusting each item in the income statement from the accrual basis to the cash basis.

- Analyze the items reported in the income statement in the order in which they are listed.
- The cash receipts and cash payments related to these revenues and expenses are determined by adjusting for changes (increases or decreases) in the related current asset and current liability accounts.
- Cash Receipts
  - 1. Cash Receipts from Customers.

Accounts Receivable	
Jan 1 Balance	
Sales on account	<span style="color: red;">Receipts from customers</span>
Dec 31 Balance	

Cash receipts from customers	=	Revenue	<table style="border: none;"> <tr> <td style="font-size: 2em; vertical-align: middle;">{</td> <td style="padding: 0 10px;">+ Decrease in accounts receivable or - Increase in accounts receivable</td> </tr> </table>	{	+ Decrease in accounts receivable or - Increase in accounts receivable
{	+ Decrease in accounts receivable or - Increase in accounts receivable				

- Revenue +decreases in accounts receivable.
- Revenue -Increases in accounts receivable.
- 2. Other Cash Receipts
  - For example: Interest and Dividends.
  - Must be adjusted for any receivable amounts as was done above.

- Cash Payments.

- 1. Cash payments to suppliers.
  - Find purchases during the year.
    - Adjust cost of goods sold for the change in inventory.
    - The increase in inventory is added to the costs of goods sold.
    - The decrease would be deducted from the cost of goods sold.
  - Determine cash payment to suppliers.
    - Adjust purchases for the change in accounts payable.
    - An increase in accounts payable is deducted from the cost of goods purchased to arrive at cash payments to suppliers.
    - A decrease in accounts payable is added to the cost of goods purchased.

Cash payments to suppliers	=	Cost of goods sold	<table style="border: none;"> <tr> <td style="font-size: 2em; vertical-align: middle;">{</td> <td style="padding: 0 10px;">+ Increase in inventory or - Decrease in inventory</td> <td style="font-size: 2em; vertical-align: middle;">{</td> <td style="padding: 0 10px;">+ Decrease in accounts payable or - Increase in accounts payable</td> </tr> </table>	{	+ Increase in inventory or - Decrease in inventory	{	+ Decrease in accounts payable or - Increase in accounts payable
{	+ Increase in inventory or - Decrease in inventory	{	+ Decrease in accounts payable or - Increase in accounts payable				

- An increase in A/P means that purchases are greater than cash payments to suppliers; therefore, an increase in accounts payable is deducted from the cost of goods purchased to arrive at cash payment to suppliers.
- 2. Operating expenses.
  - Must be adjusted for:
    - 1. Prepaid expenses.

- Any increase in prepaid expenses must be added to operating expenses.
- Any decrease must be deducted from operating expenses.
- 2. Accrued expenses payable.
  - An increase in the accrued liability account is deducted from operating expenses.
  - A decrease is added to the operating expenses.

Cash payments for operating expenses	=	Operating expenses	{	+ Increase in prepaid expenses or - Decrease in prepaid expenses	}	+ Decrease in accrued expenses payable or - Increase in accrued expenses payable
--------------------------------------	---	--------------------	---	--	---	--

Cash payments to employees	=	Salaries expense	{	+ Decrease in salaries payable or - Increase in salaries payable	}
----------------------------	---	------------------	---	--	---

Cash payments for income tax	=	Income tax expense	{	+ Decrease in income tax payable or - Increase in income tax payable	}
------------------------------	---	--------------------	---	--	---

Cash payments for interest	=	Interest expense	{	+ Decrease in interest payable or - Increase in interest payable	}
----------------------------	---	------------------	---	--	---

COMPUTER SERVICES CORPORATION			
Statement of Cash Flows (partial)			
Year Ended December 31, 2012			
Operating activities			
Cash receipts from customers			\$517,000
Cash payments			
To suppliers	\$(139,000)		
For operating expenses	(145,000)		
For interest	(12,000)		
For income tax	(49,000)		
Net cash provided by operating activities		<u>(345,000)</u>	<u>172,000</u>

- The Investing Activities Section
  - Regardless of whether the indirect or direct method is used to calculate operating activities, investing activities are measured and reported in the same way.

- The individual inflows and outflows from investing activities are reported separately.
- Determine the net cash provided (used) by investing activities by analyzing changes in non-current asset accounts.
  - PPE.
  - Goodwill..
  - Intangible assets.
  - Asset acquisitions are uses of cash.
  - Disposals are sources of cash (for the proceeds of disposition).

Investing activities		
Purchase of building	\$(120,000)	
Purchase of equipment	(25,000)	
Sale of equipment	<u>4,000</u>	
Net cash used by investing activities		(141,000)

○  
- The Financing Activities Section

- Regardless of whether the indirect or direct method is used to calculate operating activities, financing activities are measured and reported in the same way.
- The individual inflows and outflows from financing activities are reported separately.
- Determine the net cash provided (used) by financing activities by analyzing changes in non-current liability and shareholders' equity accounts.

Financing activities		
Issue of common shares	\$ 20,000	
Payment of cash dividend	<u>(29,000)</u>	
Net cash used by financing activities		<u>(9,000)</u>

○

COMPUTER SERVICES CORPORATION  
Statement of Cash Flows  
Year Ended December 31, 2012

Operating activities		
Cash receipts from customers		\$517,000
Cash payments		
To suppliers	\$(139,000)	
For operating expenses	(145,000)	
For interest	(12,000)	
For income tax	<u>(49,000)</u>	<u>(345,000)</u>
Net cash provided by operating activities		172,000
Investing activities		
Purchase of building	\$(120,000)	
Purchase of equipment	(25,000)	
Sale of equipment	<u>4,000</u>	
Net cash used by investing activities		(141,000)
Financing activities		
Issue of common shares	\$ 20,000	
Payment of cash dividend	<u>(29,000)</u>	
Net cash used by financing activities		<u>(9,000)</u>
Net increase in cash		22,000
Cash, January 1		<u>33,000</u>
Cash, December 31		<u>\$ 55,000</u>
Note x: Significant noncash investing and financing activities		
Issue of bonds to purchase land		\$110,000

- Using Cash Flows to Evaluate a Company.

o Liquidity

▪ Cash current debt coverage ratio.

- = (cash provided (used) by operating activities) / (Average current liabilities).
- Higher is better.
- The higher the cash current debt coverage ratio is, the better the company's liquidity.
- Additional ratios such as the receivables turnover and inventory turnover must also be calculated in order to properly assess a company's liquidity.

o Solvency

▪ 1. Cash total debt coverage ratio.

- Measures the long term debt paying ability (cash basis).
- = (cash provided (used) by operating activities) / (Average total liabilities).
- Higher is better.

▪ 2. Free Cash Flow

- Measures discretionary cash flow remaining from operating activities available to use to expand operations, reduce debt, go

after new opportunities, or pay additional dividends, among other alternatives.

- = (net cash provided (used) by operating activities) – (net capital expenditures) – (dividends paid).
- Net capital expenditures =
  - = (amounts paid for the acquisition of PPE) – (any recoveries from the sale of these assets (investing activities section)).
  - Higher is better.

## comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Classification of activities	Interest and dividends received may be classified as operating or investing activities.  Interest and dividends paid may be classified as operating or financing activities.  Once the choice is made, it must be applied consistently.	Interest and dividends received are classified as operating activities.  Interest paid is classified as an operating activity. Dividends paid are classified as a financing activity.

### Chapter 14 – Performance Measurement.

- Comparative analysis.
  - Horizontal analysis (trend analysis)
    - A technique to determine the change over time.
      - Percentage of base period amount.
      - Percentage change for the period.
  - Vertical analysis (common size analysis).
- Horizontal Analysis.

$$\text{Horizontal Percentage of Base-Period Amount} = \frac{\text{Analysis-Period Amount}}{\text{Base-Period Amount}}$$

$$\text{Horizontal Percentage Change for Period} = \frac{\text{Analysis-Period Amount} - \text{Prior-Period Amount}}{\text{Prior-Period Amount}}$$

	2012	2011	2010	2009
Net sales	\$4,077.0	\$3,849.6	\$3,718.2	\$3,619.7
% of base-year (2009) amount	112.6%	106.4%	102.7%	100.0%
% change for the year	5.9%	3.5%	2.7%	—

- 
- To find percentage, divided new amount of ne sales by the previous amount.

- Vertical Analysis

- Expresses each item in a financial statement as a percent of a base amount (total assets or net sales).

$$\text{Vertical Percentage of Base Amount} = \frac{\text{Analysis Amount}}{\text{Base Amount}}$$

- 
- Looking at the percentage composition of assets.
  - Seeing how much of total assets is comprised of cash.

- Comparative Analysis

- There are 3 types of comparisons:
  - Intracompany basis:
    - Comparisons within a company.
  - Intercompany basis:
    - Comparisons between 2 or more competitor companies.
  - Industry averages
- Usually compare to prior years.

- Ratio Analysis

- 1. Liquidity Ratios.
  - Measure short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash.
- 2. Solvency Ratios
  - Measure the ability of the company to survive over a long period of time.
- 3. Profitability Ratios.
  - Measure the earnings or operating success of a company for a given period of time.

- Liquidity Ratios

- Short term lenders and other creditors such as bankers and suppliers are particularly interested in assessing liquidity:
  - Main liquidity Measures:
    1. Working Capital.

2. Current Ratio
3. Cash Current Debt Coverage
4. Receivables Turnover
5. Average Collection Period
6. Inventory Turnover
7. Days in Inventory.

1. Working Capital.

- a. Measure of the short term ability to pay obligations.
  - i. **Working Capital = Current assets – Current Liabilities.**
- b. Positive working capital indicates the likelihood for paying current liabilities is favourable.
- c. Higher is better.

2. Current Ratio

- a. Measure of short term ability to pay obligations.
  - i. **Current Ratio = (Current Assets) / (Current liabilities).**
- b. More dependable indicator of liquidity than working capital.
- c. Higher is better.
- d. If current ratio is low, it means that we need to borrow more money to function.

3. Cash Current Debt Coverage.

- a. Better indicator of liquidity because it uses cash provided (used) by operating activities that cover a period of time, rather than current assets that represent a balance at a point in time.

$$\text{Cash Current Debt Coverage} = \frac{\text{Cash Provided (Used) by Operating Activities}}{\text{Average Current Liabilities}}$$

- b.
- c. Higher is better.

4. Receivables Turnover.

- a. The ratio measures the number of times, on average, that receivables are collected during the year.

$$\text{Receivables Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Gross Receivables}}$$

- b.

5. Average Collection Period

- a. How long it usually take for A/R collections to come through.

$$\text{Average Collection Period} = \frac{365 \text{ Days}}{\text{Receivables Turnover}}$$

- b.

- c. Lower is better for Average Collection Period.
- 6. Inventory Turnover.
  - a. The ratio measures the number of times, on average, that inventory is sold during the period:

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

- b.
- 7. Days in Inventory
  - a. Indicates the average age of the inventory.

$$\text{Days in Inventory} = \frac{365 \text{ Days}}{\text{Inventory Turnover}}$$

- b.
- Solvency Ratios
  - o Long term creditors and shareholders are interested in a company's long run solvency, particularly its ability to pay interest as it comes due and to repay the face value of debt at maturity.
  - o Main measures:
    - 1. Debt to total assets.
    - 2. Times Interest Earned.
    - 3. Cash total debt coverage.
    - 4. Free cash flow.

- 1. Debt to Total Assets Ratio.
  - a. Measures the percentage of assets financed by lenders and other creditors.
  - b. The higher the percentage of debt financing, the riskier the business and the lower a company's solvency.

$$\text{Debt to Total Assets} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

- c.
- d. Lower is better.
- 2. Times Interest Earned.
  - a. An indication of a company's ability to meet interest payments as they come due.

$$\text{Times Interest Earned} = \frac{\text{Profit + Interest Expense + Income Tax Expense (EBIT)}}{\text{Interest Expense}}$$

- b.
- c. Higher is better.
- 3. Cash Total Debt Coverage.

- a. Indicates the company's ability to repay its liabilities from cash generated from operating activities (without having to liquidate productive assets).
- b. The higher the cash total debt coverage ratio is, the more solvent a company is.

$$\text{Cash Total Debt Coverage} = \frac{\text{Cash Provided (Used) by Operating Activities}}{\text{Average Total Liabilities}}$$

c.  
4. Free Cash Flow

- a. Describes the cash remaining from operating activities after adjusting for capital expenditures and dividends.

$$\text{Net Cash Provided (Used) by Operating Activities} - \text{Net Capital Expenditures} - \text{Dividends Paid} = \text{Free Cash Flow}$$

b.  
- Profitability Ratios

- o Profitability ratios are important because a company's profits or lack of it affects its ability to obtain debt and equity financing.
- o Its liquidity position and its growth.
- o Creditors and investors are interested in evaluating profitability.
- o Profitability is frequently used as the ultimate test of management's operating effectiveness.
- o Common Measures:
  1. Return on Common Shareholders' Equity.
  2. Profit Margin.
  3. Return on Assets.
  4. Asset Turnover.
  5. Gross Profit Margin.
  6. Earnings per Share (EPS).
  7. Price Earnings Ratios (PE).
  8. Payout ratio.
  9. Dividend Yield.

1. Return on Common Shareholders' Equity.

- a. Widely used ratio that measures profitability from the common shareholders' viewpoint.
- b. Profits available to the common shareholders re profits less any preferred dividends.

$$\text{Return on Common Shareholders' Equity} = \frac{\text{Profit} - \text{Preferred Dividends}}{\text{Average Common Shareholders' Equity}^*}$$

- c.
2. Return on Assets
    - a. An overall measure of profitability.
    - b. The return on assets ratio indicates the amount of profit generated by each dollar invested in assets.

$$\text{Return on Assets} = \frac{\text{Profit}}{\text{Average Total Assets}}$$

- c.
3. Profit Margin.
    - a. A measure of how much the selling price covers all expenses (including COGS).
    - b. Measures the percentage of each dollar of sales that results in profit.

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

- c.
4. Asset Turnover.
    - a. Indicates how efficiently a company is able to generate sales with a given amount of assets, in other words, how many dollars of sales are generated by each dollar invested in assets.

$$\text{Asset Turnover} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

- b.
5. Gross Profit Margin.
    - a. Expressed as a percentage.
    - b. Indicates a company's ability to maintain an adequate selling price above its costs of goods sold.

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

- c.
6. Earnings Per Share
    - a. Measures the profit earned on each common share.
    - b. Provides a useful perspective for determining investment return.

$$\text{Earnings Per Share} = \frac{\text{Profit} - \text{Preferred Dividends}}{\text{Weighted Average Number of Common Shares}}$$

- c.
- d. Cannot be used to compare between companies due to difference in number of shares and number in earnings.

7. Price-Earnings Ratio (PE)

- a. Measures the ratio of the market price of each common share to its earnings per share.
- b. Commonly known as a market measure because it uses a company's share price, which reflects the stock market's investors' expectations for the company.

$$\text{Price-Earnings Ratio} = \frac{\text{Share Price}}{\text{Earnings Per Share}}$$

- c.
- d. Can be used to compare between companies.

8. Payout Ratio

- a. Measures the percentage of profits distributed in the form of cash dividends to common shareholders.

$$\text{Payout Ratio} = \frac{\text{Cash Dividends}}{\text{Profit}}$$

b.  
9. Dividend Yield

- a. Reports a rate of return a shareholder earned from dividends during the year.
- b. Also known as a market measure, because of the use of the stock market price in its calculation.

$$\text{Dividend Yield} = \frac{\text{Dividend per Share}}{\text{Market Price per Share}}$$

c.

- Limitations of Financial Analysis.

- o Can be impacted by:
  - Alternative accounting principles.
    - Different depreciation methods can be used.
    - Not always the same.
  - Professional judgment.

- Appraisals are never homogenized.
  - Estimates are never homogenized.
  - Many estimates have to be made.
  - Ex. Allowance for doubtful accounts, useful life.
- Comprehensive Income.
- Diversification.
- Inflation.
- Economic Factors.
- Alternative Accounting Policies.
  - Variations among companies in the application of GAAP may lessen the comparability of their statements.
    - Companies may choose from a large number of acceptable accounting policies. Different choices result in differing financial positions, which again affect how easily their results can be compared.
    - Although different accounting policies may be detectable from reading the notes to the financial statements, adjusting the data to compensate for differences is difficult, if not impossible.
- Professional Judgment.
  - Management must use professional judgment in choosing the most appropriate accounting principle for the circumstance.
    - Management's choices may be biased in favour of a presentation that furthers certain company objectives.
    - Estimates are used in determining the allowance for uncollectible receivables, estimated useful lives, and residual values for depreciation, and the fair values of certain investment securities and properties.
    - To the extent that these estimates are inaccurate or biased, ratios and percentage that are based on such information will also be inaccurate or biased.
- Comprehensive Income
  - Most financial ratios excludes total comprehensive income, or other comprehensive income, from the analysis.
  - There are no standard ratio formulas incorporating comprehensive income.
- Inflation.
  - Our accounting information system does not adjust data for price-level changes.
  - Comparisons are still relevant because data that have not been adjusted for inflation are being used consistently for both revenues and expenses, and for each period.
  - In Canada, Inflation is not very significant.
- Diversification.
  - Diversification can limit the usefulness of financial analysis. Many companies are so diversified that they cannot be classified by industry.

- Deciding what industry a company is in, can actually be one of the main challenges to an effective evaluation of its results.
- Companies may appear to be comparable but are not.
- When companies have significant operations in different lines of business, they are requested to report additional disclosures in a segmented information note to their financial statements. There are specific revenue, profit, and asset tests to determine if a company is required to report segmented information or not.
- Economic Factors.
  - Economic measures such as the rate of interest, unemployment, and changes in demand and supply can have a significant impact on a company's performance.
  - One must use this information along with nonfinancial information to try to assess what changes related to the economic situation and what changes related to factors that management can, or should be able to, control.
  - If there were economic crises, or any other economic factor, this would flaw our ratio analysis.

## comparing

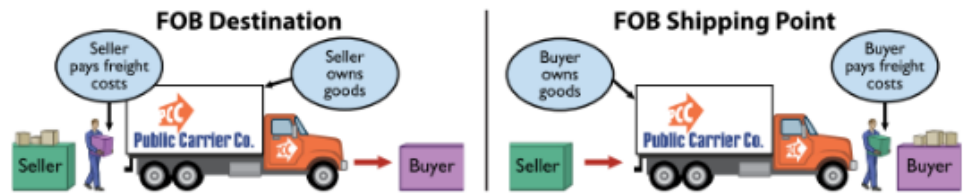
# IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Earnings per share	Must be reported on the face of the income statement or statement of comprehensive income.	Earnings per share is not required to be reported.
Comprehensive income	If other comprehensive income is significant, selected profitability ratios should be recalculated using total comprehensive income rather than profit.	Comprehensive income is not reported.
Segmented reporting	There are specific revenue, profit, and asset tests to determine if information must be reported in the notes to the financial statements for segments.	There are no disclosure requirements for reporting segment information.

### Chapter 6 – Reporting and Analyzing Inventory.

- Determining Inventory Quantities.
  - Two steps to determine inventory quantities:
    - 1. Take a physical inventory of goods on hand.
    - 2. Determine ownership of goods.
      - Goods in Transit.
      - Consigned Goods.

- 1. Taking a physical inventory of goods on hand.
  - All companies need to determine quantity of inventory at the end of each accounting period.
    - For companies using the perpetual or periodic inventory system.
  - Involves actually counting, weighing, or measuring each kind of inventory on hand.
  - A good system of internal control minimises errors in counting inventory.
- 2. Determining ownership of goods.
  - Goods in Transit.
    - Should be included in the inventory of the company that has legal title to the good on the date of count.



- 
- Whoever pays the transit costs essentially owns the inventory.
- FOB Shipping Point:
  - Buyer pays transit costs.
  - Buyer owns the merchandise.
- FOB Destination:
  - Shipper pays transit costs.
  - Shipper owns the merchandise until it is signed off.
- Consigned Goods:
  - The consignee sells the goods on behalf of the consignor in exchange for a fee, without ever transferring legal title or ownership.
  - Consigned goods are counted in the inventory of the cognisor, but not the consignee.
  - CONSIGNOR owns the consigned goods.
  - CONSIGNEE only holds, but doesn't own the consigned goods.
- Methods of cost determination continued.



- 
- Methods
  - 1. Specific identification method.
  - 2. Cost formula methods:

- FIFO (first in first out).
  - Average cost.
- 1. Specific identification method:
    - Used when goods are not ordinarily interchangeable.
    - Tracks the actual physical flow of goods.
    - It reports ending inventory as its actual cost.
    - Normally only used in perpetual inventory system.
    - Used primarily for goods that are not homogenized.
    - Ex.
      - Selling Artwork, Sofas, Cars.
  - 2. Cost Formula Methods:
    - Assumes a flow of costs that may be the same as the actual flow of goods.
    - Flow of costs can be different from the flow of goods.
    - Two methods under IFRS:
      - First in First out (FIFO)



- 
- Average Cost



- FIFO
  - Assumes that the earliest goods purchases are the first to be sold and recognizes as cost of goods sold.
  - Can be used in perpetual and periodic systems.
  - The results under FIFO in a perpetual system are the same as in a periodic system.



-

Date	Purchases			Cost of Goods Sold			Balance		
	Units	Cost	Total	Units	Cost	Total	Units	Cost	Total
Jan. 1							100	\$10	\$1,000
Apr. 15	200	\$11	\$ 2,200				100	10	} 3,200
							200	11	
May 1				100	\$10	} \$1,550	150	11	1,650
				50	11				
Aug. 24	300	12	3,600				150	11	} 5,250
							300	12	
Sept. 10				150	11	} 4,650	50	12	600
				250	12				
Nov. 27	400	13	5,200				50	12	} 5,800
							400	13	
	<u>900</u>		<u>\$11,000</u>	<u>550</u>		<u>\$6,200</u>			

○  
- The Average Cost

- Assumes that it is not possible to measure a specific physical flow of inventory.



- 
- Used under both perpetual and periodic inventory systems.
  - The results will differ depending on which one you use.
- The allocation of the cost of goods available for sale between COGS and ending inventory is made based on the weighted average unit cost.



- 
- A new average, also known as a moving average, is calculated after each purchase in the perpetual inventory system.
- Only one average is calculated under the periodic inventory system and the allocation is made at the end of the period.



Date	Purchases			Cost of Goods Sold			Balance		
	Units	Cost	Total	Units	Cost	Total	Units	Cost	Total
Jan. 1							100	\$10.00	\$1,000.00
Apr. 15	200	\$11.00	\$ 2,200.00				300	10.67	3,200.00
May 1				150	\$10.67	\$1,600.00	150	10.67	1,600.00
Aug. 24	300	12.00	3,600.00				450	11.56	5,200.00
Sept. 10				400	11.56	4,622.22	50	11.56	577.78
Nov. 27	400	13.00	5,200.00				450	12.84	5,777.78
	<u>900</u>		<u>\$11,000.00</u>	<u>550</u>		<u>\$6,222.22</u>			

- - Average Cost Calculation.
    - (beginning inventory value + New Inventory value) / (total quantity of inventory)
- FIFO or the Average Cost Formula.
  - The company should consider:
    - Whether the method corresponds to the physical flow of goods.
    - Whether the inventory cost on the statement of financial position is close to the recent costs.
  - Whatever cost formula a company chooses, it should be used consistently from one accounting period to another.
- Advantages of Cost Determination Methods

Specific Identification	FIFO	Average
<ul style="list-style-type: none"> <li>Exactly matches costs and revenues on the income statement.</li> <li>Tracks the actual physical flow.</li> </ul>	<ul style="list-style-type: none"> <li>Ending inventory on the statement of financial position includes the most current costs (closest to replacement cost).</li> <li>Approximates the physical flow of most retailers.</li> </ul>	<ul style="list-style-type: none"> <li>Cost of goods sold on the income statement includes more current costs than FIFO.</li> <li>Smooths the effects of price changes by assigning all units the same average cost.</li> </ul>

- Financial Statement Effects of Cost Determination Methods (during a period rising prices).

	<u>Specific Identification</u>	<u>FIFO</u>	<u>Average</u>
<u>Income statement</u>			
Cost of goods sold	Variable	Lowest	Highest
Gross profit	Variable	Highest	Lowest
Profit	Variable	Highest	Lowest
<u>Statement of financial position</u>			
Cash (pre-tax)	Same	Same	Same
Ending inventory	Variable	Highest	Lowest
Retained earnings	Variable	Highest	Lowest

- Presentation and Analysis of Inventory.
  - Value the inventory at the lower of cost and net realizable value.
    - Net realizable value = selling price – any costs required to make the goods ready for sale.
    - The lower of cost and net realizable value basis should be applied to individual inventory items as opposed to total inventory.
    - In certain cases, the lower of cost and net realizable value can be applied to groups of similar items.
    - LCNRV.

	Cost	NRV	LCNRV
Vehicle A	\$16,000	\$15,500	\$15,500
Vehicle B	14,500	15,300	14,500
Vehicle C	14,800	14,500	14,500
Vehicle D	13,200	14,800	13,200
Vehicle E	11,500	11,400	11,400
Total inventory	<u>\$70,000</u>	<u>\$71,500</u>	<u>\$69,100</u>

- 
- If the value of inventory is less than cost, inventory is written down.
- Journal entry for write down:
  - Dr. COGS
    - Cr. Merchandise inventory.
- When conditions that caused the write down to no longer exist:
  - Reverse inventory write down.
    - The reversal can only be written back up to the original cost.
- Reporting Inventory.
  - In the statement of financial position:
    - At the lower of cost and NRV (LCNRV).
  - In the notes to the statements.
    - Total amount of inventory.
    - Cost of goods sold.
    - Cost determination method.
    - Amount of write downs or reversals.

## Chapter 5 – Merchandising Operations.

- Inventory System
  - Companies that produce goods for sale are called manufacturers.
  - A manufacturer has inventory classified into:
    - Raw materials.
    - Work in progress.
    - Finished goods.
  - Two systems to account for inventory:
    - Perpetual.
    - Periodic.
  - Perpetual
    - Detailed records of the cost of each inventory purchase and sales are maintained.
    - Always updated.
    - Costs of good sold is determined each time a sale occurs.
    - Inventory records are up to date and provide timely information to management.
  - Periodic

- Detailed records are not kept throughout the period.
  - Updated only at the end of the accounting period.
  - Cost of goods sold determined only at the end of the accounting period.
  - The physical inventory count at the end of the accounting period determines ending inventory.
- Recording Purchases of merchandise.
- 1. Purchases.

Perpetual	Periodic
<b>Dr. Merchandise Inventory</b> Cr. Cash or A/P	<b>Dr. Purchases</b> Cr. Cash or A/P

- 2. Sales Taxes.
  - GST, PST, HST.
  - Do not form part of the cost of the merchandise.
- 3. Freight costs.
  - Costs of transporting the goods to the buyers' place of business.
  - Freight terms state who pays the freight charges.
  - **FOB SHIPPING POINT.**
    - Buyer owns, buyer pays.
  - **FOB DESINATION.**
    - Seller owns, seller pays.



- This helps identify who pays for shipping and who is responsible if the merchandise is damaged in transit.
- **FOB Shipping Point.**
- Goods are delivered by the seller to the point of shipping.
  - The buyer pays the freight costs to get the goods from the point of shipping to the destination.
  - The buyer is responsible for any damage that may occur along the way.
  - Freight cost is part of the cost of purchasing this inventory.
  - Journal entry for the buyer.

Perpetual	Periodic
Dr. Merchandise inventory Cr. Cash or A/P	Dr. Freight in Cr. Cash or A/P

- 
- No journal entry for the seller.
- FOB Destination
  - Goods are delivered by the seller to their destination.
  - The seller pays the freight costs to get the goods from the point of shipping to the destination.
  - The seller is responsible for any damage that may occur along the way.
  - Freight cost is an operating expense for the seller.
- Purchase returns and allowances.
  - Purchase return:
    - The buyer returns the goods to the seller and receives a cash refund or credit.
  - Purchase allowance:
    - The seller gives an allowance (deduction) from the purchase price.

Perpetual	Periodic
Dr. Cash or A/P Cr. Merchandise inventory	Dr. Cash or A/P Cr. Purchase returns and allowances

- 
- Purchase returns and allowances are contra asset accounts.
- Discounts
  - Quantity discount:
    - Gives a price reduction according to the volume of the purchase.
    - Not recorded separately, discounted price is recorded as cost of purchase.
  - Purchase discount:
    - Offered to encourage early payment of a balance due.
    - Example:
      - 2/10, n/30.
      - 2% off if paid within 10days, otherwise, the total cost due in 30 days.
    - Recorded separately when payment is made.

Perpetual	Periodic
Dr. A/P Cr. Cash Cr. Merchandise inventory	Dr. A/P Cr. Cash Cr. Purchase discounts

▪

Transaction	perpetual	periodic
Purchase of merchandise	Dr. Merchandise inventory Cr. Cash or A/P	Dr. Purchases Cr. Cash or A/P
Freight on merchandise purchased (FOB shipping)	Dr. Merchandise inventory Cr. Cash or A/P	Dr. Freight in Cr. Cash or A/P
Return of purchased merchandise	Dr. Cash or A/P Cr. Merchandise inventory	Dr. Cash or A/P Cr. Purchase returns and allowances
Paying creditors on account within discount period	Dr. A/P Cr. Merchandise inventory Cr. Cash	Dr. A/P Cr. Purchase discounts Cr. Cash

- Recording sales or merchandise.

o 1. Sales

Perpetual	Periodic
Dr. Cash or A/R Cr. Sales (to record the sale)	Dr. Cash or A/R Cr. Sales (to record the sale)
Dr. Cost of goods sold Cr. Merchandise inventory (to record the cost of merchandise sold)	No entry

o

o COGS: Total cost of the merchandise that was sold during the period.

o 2. Sales Taxes

- Are collected on behalf of the federal and the provincial governments and must be periodically remitted to these authorities.
- Are not recorded as a revenue, but recorded as a liability (ex. Sales taxes payable) until they are paid to the government.
- At the end of the period, calculate how much tax money they received, how much they need to pay, and then they remit their funds to where it needs to go.

o 3. Freight Costs

- If FOB Destination:
  - Freight charges are paid by the seller.
  - The seller prepares the following entry:

Perpetual	Periodic
Dr. Freight out Cr. Cash or A/P	Dr. Freight out Cr. Cash or A/P

○ 4. Return of Sold Merchandise.

▪ The seller:

- Returns cash to the buyer.
- Reduces the buyer's accounts receivable.
- Use of a contra revenue account: sales return and allowances.

Perpetual	Periodic
Dr. Sales returns and allowances Cr. Cash or A/R (to record return of goods)	Dr. Sales returns and allowances Cr. Cash or A/R (to record return of goods)
Dr. Merchandise inventory Cr. Cost of goods sold (to record cost of goods returned)	No entry

○ 5. Discounts

▪ Quantity Discount:

- No separate entry is made.

▪ Sales Discount:

- Use sales discount account.
  - Contra revenue account to sales.
  - Normal balance: debit.

Perpetual	Periodic
Dr. Cash Dr. Sales discounts Cr. Accounts receivable	Dr. Cash Dr. Sales discounts Cr. Accounts receivable

Transaction	Perpetual	Periodic
Sale of merchandise	Dr. Cash or A/R Cr. Sales  Dr. Cost of goods sold Cr. Merchandise inventory	Dr. Cash or A/R Cr. Sales  No entry
Freight (FOB destination)	Dr. Freight out Cr. Cash or A/P	Dr. Freight out Cr. Cash or A/P
Return of sold merchandise	Dr. Sales returns and allowances Cr. Cash or A/R  Dr. Merchandise inventory Cr. Cost of goods sold	Dr. Sales returns and allowances Cr. Cash or A/R  No entry
Collection of account within discount period	Dr. Cash Dr. Sales discounts Cr. A/R	Dr. Cash Dr. Sales discounts Cr. A/R

Transaction	perpetual	periodic
Purchase of merchandise	Dr. Merchandise inventory Cr. Cash or A/P	Dr. Purchases Cr. Cash or A/P
Freight on merchandise purchased (FOB shipping)	Dr. Merchandise inventory Cr. Cash or A/P	Dr. Freight in Cr. Cash or A/P
Return of purchased merchandise	Dr. Cash or A/P Cr. Merchandise inventory	Dr. Cash or A/P Cr. Purchase returns and allowances
Paying creditors on account within discount period	Dr. A/P Cr. Merchandise inventory Cr. Cash	Dr. A/P Cr. Purchase discounts Cr. Cash

- Income Statement Presentation

- Two different forms of the income statement:
  - 1. Single step income statement:
    - Revenues.
    - Expenses.
  - 2. Multiple-step income statement.
    - Shows several steps in determining profit or loss:
      - 1. Net Sales.
      - 2. Gross Profit.
      - 3. Profit from operations.

- 4. Profit before income tax (non operating activities).
- 5. Profit.
- Under IFRS, expenses should be classified either by nature or by function.
  - By nature: Salaries, transportation, depreciation, advertisement cost.
  - By function: Expenses are reported according to the activity for which they were incurred (COGS, Administrative, selling).

## Single-step income statement

<b>Revenues</b>	
Net sales	\$460,000
Interest revenue	<u>3,400</u>
Total revenues	<u>463,400</u>
<b>Expenses</b>	
Cost of goods sold	316,000
Operating expenses	114,000
Interest expense	1,800
Loss on sale of equipment	<u>200</u>
Total expenses	<u>432,000</u>
Profit before income tax	31,600
Income tax expense	<u>6,300</u>
<b>Profit</b>	<u>\$ 25,300</u>

# Single-step income statement



- 
- Multi-Step Income statement.
  - Sales revenue
  - Cost of goods sold
  - =Gross profit
  - Operating expenses
  - =Profit from operations
  - +(-) other revenues (expenses)
  - =Profit before income tax
  - income tax expense
  - =Profit
- o

# Multiple-step income statement

<b>Sales revenues</b>		
Sales		\$480,000
Less: Sales returns and allowances	\$12,000	
Sales discounts	<u>8,000</u>	<u>20,000</u>
<b>Net sales</b>		<b>460,000</b>
<b>Cost of goods sold</b>		<b><u>316,000</u></b>
<b>Gross profit</b>		<b>144,000</b>
<b>Operating expenses</b>		
Salaries expense	\$45,000	
Rent expense	19,000	
Utilities expense	17,000	
Advertising expense	16,000	
Depreciation expense	8,000	
Freight out	9,000	
Loss on sale of equipment	<u>200</u>	
Total operating expenses		<u>114,200</u>
<b>Profit from operations</b>		<b>29,800</b>

<b>Profit from operations (continued)</b>		<b>\$ 29,800</b>
<b>Other revenues and gains</b>		
Interest revenue	\$3,400	
<b>Other expenses and losses</b>		
Interest expense	<u>1,600</u>	<u>1,800</u>
Profit before income tax		31,600
Income tax expense		<u>6,300</u>
<b>Profit</b>		<b><u>\$ 25,300</u></b>

## comparing

## IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Income statement	Expenses must be classified by nature or by function.	Expenses can be classified in any manner the company finds useful.

## Chapter 4 – Accrual Accounting Concepts

- Cash versus accrual basis accounting.
  - Cash basis accounting:
    - Events are recognized in the period that cash is paid or received.
      - Revenue is recorded only when cash is received.
      - Expenses are recorded only when cash is paid.
      - Does not matter if assets are used half way through the year, we look at how much you paid, or how much you got paid.
  - Accrual basis accounting:
    - Transactions are recorded in the periods in which the events occur.
      - Revenue is recorded when earned, rather than when cash is received.
      - Expenses are recorded when incurred, rather than when cash is paid.
- Cash basis accounting can lead to misleading information for decision making.
  - Revenues and expenses can be manipulated by timing the receipt and payment of cash.
- Accrual basis of accounting is central to all accounting standards.
  - Revenue is recorded when earned.
  - Expense is recorded when incurred.
- Timing Issues
  - Revenue recognition
    - Revenue is recognized (recorded) when there is an increase in future economic benefits arising from an increase in an asset or a decrease in a liability, due to ordinary activities.
  - Criteria for recognition:
    - 1. The sales or performance effort is substantially complete.
    - 2. The amount is determinable (measurable).
    - 3. Collection is reasonably assured.
- Timing Issues for Expenses.
  - Expense recognition.
    - Expenses are recognized when there is a decrease in future economic benefits due to an ordinary activity:
      - A decrease in an asset.
      - An increase in a liability.
    - This change can be measured reliably.
  - Often coincide with revenue recognition (matching), but not always.
    - When there is a direct association between the expenses incurred and the generation of revenue, expenses are matched to revenues.
    - Otherwise, expenses are recognized in the period the related liability arises.
    - Called the **MATCHING PRINCIPLE**.

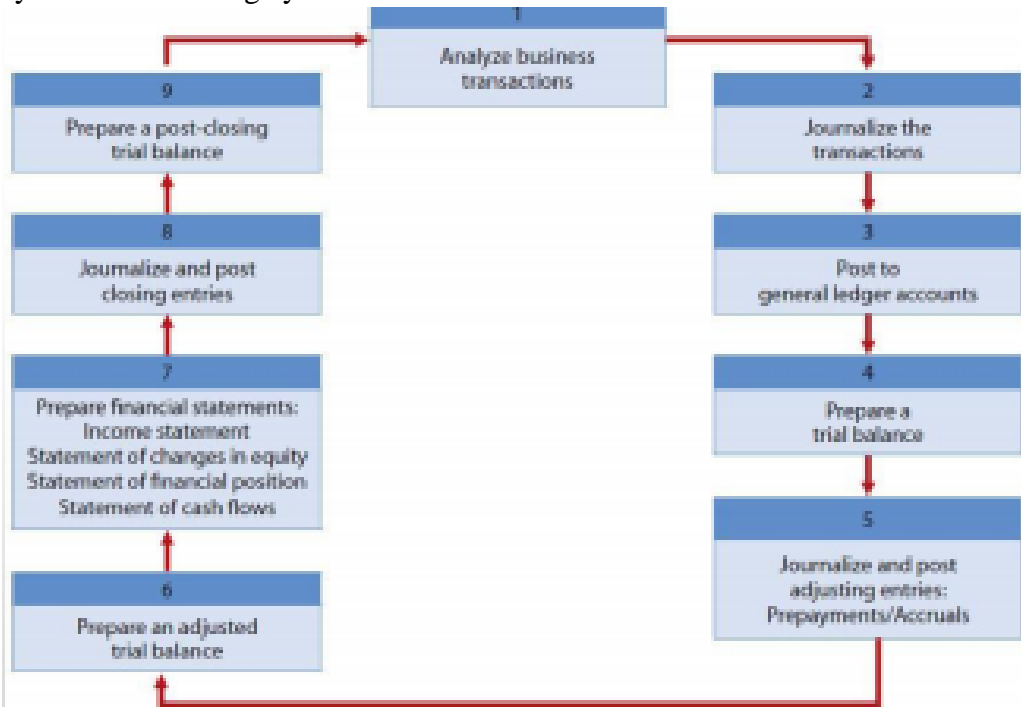
- Adjusting Entries.
  - To allocate revenues and expenses to the period in which they actually are applicable, we need to make some adjusting entries.
  - Some events are not recorded daily.
  - Some costs don't result from recurring daily transactions.
  - Some items may be unrecorded.
  - Record adjusting entries to update accounts at the end of the accounting period.
  - Adjusting entries ensure that revenue recognition and expense recognition are properly applied.
- Types of adjusting entries:
  - 1. Prepayments.
    - Prepaid expenses (expenses are already paid)
    - Unearned revenue (revenue cash is already received)
  - 2. Accruals.
    - Accrued expenses (incurred but not yet paid in cash or recorded).
    - Accrued revenues (earned but not yet received in cash or recorded).
- Prepaid Expenses
  - Are paid for in cash before they are used.
  - Expire with the passage of time (insurance, depreciation) or through use (supplies).
    - It is not practical to record this expiration on a daily basis.
  - Original entry.
    - Dr. Asset account.
      - Cr. Cash.
  - Adjusting Entry.
    - Dr. Expense account.
      - Cr. Asset account.
  - Until the adjustment is made:
    - Assets are overstated.
    - Expenses are understated.
    - Profit is overstated.
- Depreciation.
  - Depreciation is the process of allocating the acquisition cost of a long-lived or non current asset to expense over its useful life.
  - It is NOT A VALUABLE CONCEPT.
  - Is a contra-asset account.
  - Adjusting entry for depreciation:
    - Dr. Depreciation expense.
      - Cr. Accumulated Depreciation.
  - Straight line method of depreciation:
    - $\text{Depreciation} = (\text{cost} - \text{residual value}) / \text{estimated useful life}.$
- Unearned Revenue.

- Cash has already been received before revenue is earned.
- Unearned revenues are later earned when the service is provided to the customer.
  - Not practical to make daily journal entries as the revenue is earned.
- Original entry.
  - Dr. Cash.
    - Cr. Unearned Revenue.
- Adjusting Entry:
  - Dr. Unearned Revenue.
    - Cr. Revenue Account.
- Until the adjustment is made:
  - Assets are overstated.
  - Liabilities are overstated.
  - Profit is understated.
- Accrued Revenues
  - Revenues that have been earned but not yet received on cash or recorded.
    - May accumulate with the passing of time (ex. Interest revenue).
    - May result from services that have not yet billed or collected (ex. Fees).
  - No original entry.
  - Adjusting entry:
    - Dr. Asset Account.
      - Cr. Revenue Account.
  - Until the adjustment is made:
    - Assets and revenues are understated.
    - Profits and shareholders' equity are understated.
- Accrued Expenses.
  - Expenses incurred but not yet paid or recorded at the statement date.
  - Examples: Interest, rent, salaries, property tax, income taxes.
  - An accrued expense on the book of one company is an accrued revenue to another company.
  - No original entry.
  - Adjusting entry:
    - Dr. Expense account.
      - Cr. Liability account.
  - Interest always an annual basis.
    - Divide interest rate by 12 to get monthly rate.
- ADJUSTING JOURNAL ENTRIES NEVER INCLUDE CASH.

	Type of Adjustment	Reason for Adjustment	Accounts before Adjustment	Adjusting Entry
Prepayments	Prepaid expenses	Prepaid expenses, originally recorded in asset accounts, have been used.	Assets overstated; expenses understated	Dr. Expense Cr. Asset
	Unearned revenues	Unearned revenues, initially recorded in liability accounts, have been earned.	Liabilities overstated; revenues understated	Dr. Liability Cr. Revenue
Accruals	Accrued revenues	Revenues have been earned but not yet received in cash or recorded.	Assets understated; revenues understated	Dr. Asset Cr. Revenue
	Accrued expenses	Expenses have been incurred but not yet paid or recorded.	Expenses understated; liabilities understated	Dr. Expense Cr. Liability

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- Adjusting Entries
  - The adjusting journal entries are then posted to the general ledger.
  - After that, we make the adjusted trial balance.
- Adjusted trial balance.
  - After all adjusting entries have been journalized and posted, another trial balance is prepared from the general ledger accounts. This trial balance is called an adjusted trial balance.
  - It shows the balances of all accounts at the end of the accounting period, including those that have been adjusted.
  - The adjusted trial balance is the main source for the preparation of financial statements.
- Closing the books.
  - Temporary / permanent accounts:
    - Temporary:
      - Revenues.
      - Expenses.
      - Dividends.
    - Permanent:
      - Assets
      - Liabilities
      - Shareholders' equity.
  - At the end of each period the temporary account balances are transferred to the permanent shareholders' equity account retained earnings through the preparation of closing entries.
  - The Closing Entries (REID0).
    - 1. Close the Revenue accounts.
      - Dr. Revenue accounts.
        - Cr, Income summary.
    - 2. Close the expense accounts.
      - Dr. Income summary.
        - Cr. Expense accounts.
    - 3. Close the Income Summary.
      - Dr. Income summary.

- Cr. Retained earnings.
- 4. Close the dividends account.
  - Dr, Retained earnings.
  - Cr,Dividends.
- Closing the books yet again.
  - Post closing trial balance.
    - Lists all permanent accounts their balances after closing entries are journalized and posted.
    - Proves the equality of total debit balance and total credit balances after the closing entries have been made.
- Summary of the accounting cycle.



- 1. Analyze business transactions.
- 2. Journalize the transactions.
- 3. Post to general ledger.
- 4. Prepare trial balance.
- 5. Adjusting entries.
- 6. Prepare adjusted trial balance.
- 7. Closing entries.
- 8. Prepare post closing trial balance.
- Comparing IFRS and ASPE
  - IFRS
    - Every month adjustments must be made.
    - At very least every quarter.
    - Used the term depreciation for PPE.
    - Used the term amortization for Intangible assets.

- ASPE
  - At least, at the end of every year.
    - Amortization used for both PPE and Intangible assets.