Refresher Module

Financial Accounting

Financial Statements

Companies prepare four financial statements :

- Income Statement
- Retained Earnings Statement
- Balance Sheet
- Statement of Cash Flows

Balance Sheet

- Reports the assets, liabilities, and stockholders' equity at a specific date (i.e., for *one day in time*).
- Lists assets at the top, followed by liabilities and stockholder's equity.
- Total assets must equal total liabilities and stockholder's equity.
- Is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

Income Statement

- Reports the profitability of the company's operations over a specific period of time (e.g., by month, quarter, year).
- Lists revenues first, followed by expenses.
- Shows net income (or net loss).
- Does not include investment and dividend transactions between the stockholders and the business

Alternative Terminology
The income statement is sometimes referred to as the *statement of operations*, *earnings statement*, or *profit and loss statement*.

Financial Statements

Net income is needed to determine the ending balance in retained earnings.

SOFTBYTE INC.
Income Statement
For the Month Ended September 30, 2019

Revenues		
Service revenue		$ 4,700
Expenses		
Salaries and wages expense	$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		**$2,750**

1

SOFTBYTE INC.
Retained Earnings Statement
For the Month Ended September 30, 2019

Retained earnings, September 1	$ 0
Add: Net income	**2,750**
	2,750
Less: Dividends	1,300
Retained earnings, September 30	**$1,450**

Financial Statements

SOFTBYTE INC.
Retained Earnings Statement
For the Month Ended September 30, 2019

Retained earnings, September 1	$ 0
Add: Net income	**2,750**
	2,750
Less: Dividends	1,300
Retained earnings, September 30	**$1,450**

1

Balance in retained earnings is needed in preparing the balance sheet.

SOFTBYTE INC.
Balance Sheet
September 30, 2019

Assets		
Cash		**$ 8,050**
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		$18,050
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable		$ 1,600
Stockholders' equity		
Common stock	**$15,000**	
Retained earnings	**1,450**	**16,450**
Total liabilities and stockholders' equity		$18,050

2

Financial Statements

Balance sheet and income statement are needed to prepare statement of cash flows.

SOFTBYTE INC.
Balance Sheet
September 30, 2019

Assets		
Cash		$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		$18,050
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable		$ 1,600
Stockholders' equity		
Common stock	$15,000	
Retained earnings	1,450	16,450
Total liabilities and stockholders' equity		$18,050

2

SOFTBYTE INC.
Statement of Cash Flows
For the Month Ended September 30, 2019

Cash flows from operating activities		
Cash receipts from revenues		$ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of common stock	$15,000	
Payment of cash dividends	(1,300)	13,700
Net increase in cash		8,050
Cash at the beginning of the period		0
Cash at the end of the period		$8,050

3

Characteristics of Plant Assets

- Plant assets are long-term assets (i.e., plant assets are expected to be of use to the company for a number of years).
- Plant assets have three characteristics:
  1. physical substance (a definite size and shape),
  2. used in the operations of a business,
  3. not intended for sale to customers (e.g., inventory items are *not* plant assets)

Plant Assets

- Plant assets are referred to as:
  - Property, plant, and equipment (PPE)
  - Plant and equipment
  - Fixed assets

Types of Plant Assets

- **Land**:
  - has an unlimited useful life
  - is never depreciated
- **Buildings:**
  - facilities used in operations (e.g., factories, offices, warehouses, stores)
  - are depreciated over the course of their estimated useful life
- **Equipment:**
  - assets used in operations (e.g., office furniture, planes, delivery trucks, store check-out counters)
  - are depreciated over the course of their estimated useful life

Determining the Cost of Plant Assets

- Plant assets are recorded at historical cost (i.e., the cost of an asset is what you pay for it).
- Depreciated over the course of their estimated useful life (with the exception of land).
- The recorded value of a plant asset (its cost) includes *all costs* business incurs to acquire and used the asset.

Determining the Cost of Plant Assets: Land

- All necessary expenditures to acquire/make the land ready for its intended use increase (debit) the Land account.
- Costs typically include:
  1. cash purchase price *(not* the listing price- these are different)*,*
  2. closing costs (e.g., title and attorney's fees),
  3. real estate agent/brokers' commissions, and
  4. any accrued property taxes and/or other liens on the land assumed by the purchaser.

Determining the Cost of Plant Assets: Land

Assume Colson Company acquires real estate with an asking price of $125,000 for a cash cost of $100,000. The property contains an old building that is demolished at a net cost of $6,000 ($7,500 in costs less $1,500 proceeds from salvaged materials). Additional costs associated with the purchase of the land are the attorney's fee, $1,000, and the real estate broker's commission, $8,000.

The cost of the land is $115,000 calculated as follows:

Land:	
Cash Price	$100,000
Net removal cost of warehouse ($7,500-$1,500)	1,500
Attorney's fees	1,000
Real estate broker's commission	8,000
Recorded cost of the Land	$115,000

Note: The cash price of $100,000 is used as the cash price, not the $125,000 asking price. Real estate is often purchased for less than the listing price.

Plant Assets: Land Improvements

- Land improvements are structural additions made to land.
- Cost includes all expenditures necessary to make the improvements ready for their intended use.
- Land improvements:
  - have limited useful lives.
  - are expensed (depreciated) over the course of their useful lives.

- Examples of land improvements:
  - driveways
  - parking lots
  - fences
  - landscaping
  - underground sprinklers.

Determining the Cost of Plant Assets: Equipment

- Include all costs incurred in acquiring the equipment and preparing it for use.
- Costs typically include:
  - Cash purchase price.
  - Sales taxes.
  - Freight charges.
  - Insurance during transit paid by the purchaser.
  - Expenditures required in assembling, installing, and testing the unit.

Example: Determining the Cost of Equipment

Assume Colson Company acquires a new delivery van on January 1, 20XX at a cash price of $60,000. Related expenditures are for sales taxes $1,500, painting and lettering $800, motor vehicle license $60, and a two-year accident insurance policy $2,400. The cost of the delivery van is $62,300 calculated as follows:

Delivery Van:	
Cash Price	$60,000
Sales Taxes	1,500
Painting & Lettering	800
Cost of Delivery Van	$62,300

Note: The recorded cost of the van only includes the purchase price and all expenditures necessary to acquire & ready it for its intended use. The accident insurance policy and motor vehicle license are recurring expenses/do not benefit future periods. These costs are expensed as incurred.

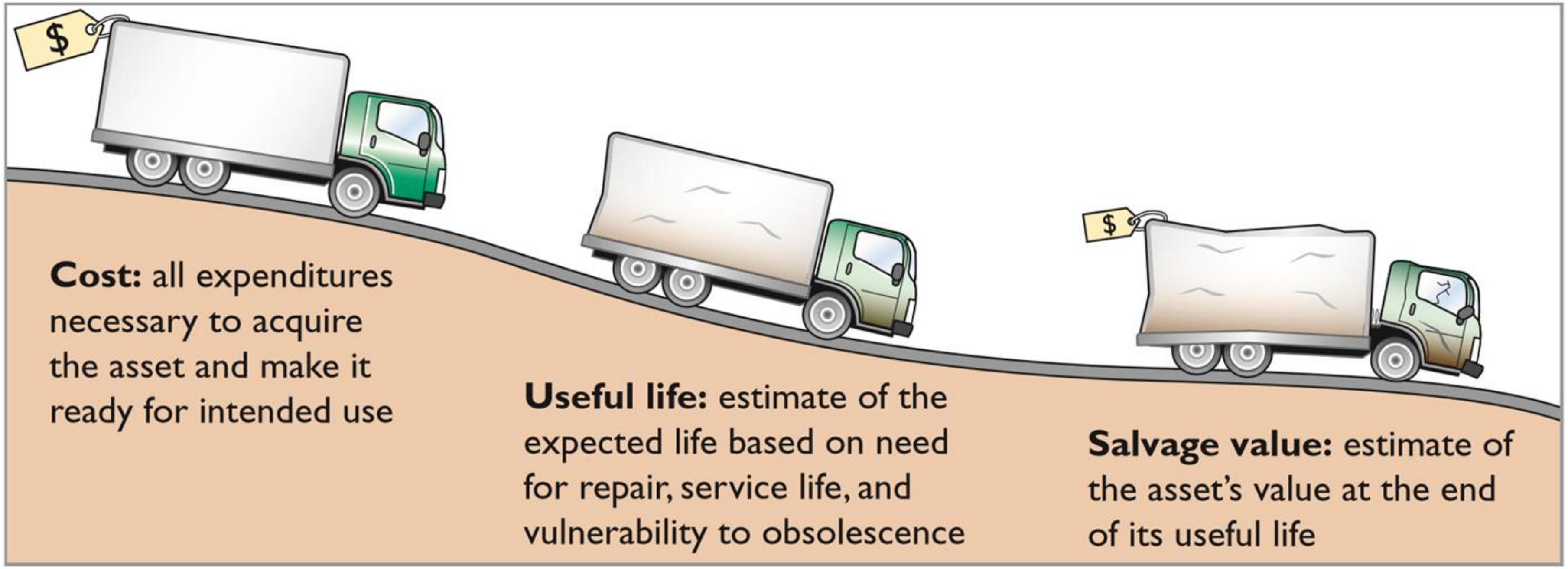
Depreciation

- Process of allocating to expense the cost of a plant asset over its useful (service) life in a rational and systematic manner.
  - Depreciation is about *cost allocation*, **not** *asset valuation*.
  - Applies to land improvements, buildings, and equipment, not land.
  - Plant assets are "depreciable" because the revenue-producing ability of an asset will decline over its useful life.

Factors in Computing Depreciation

There are three factors in computing depreciation. These are an asset's:

1. Original Cost
2. Useful life
3. Salvage Value



Alternative Terminology
Another term sometimes used for salvage value is *residual value*.

Helpful Hint
Depreciation expense is reported on the income statement. Accumulated depreciation is reported on the balance sheet as a deduction from plant assets.

Depreciation: Straight-Line Method

- Expense is same amount for each year.
- Formula to compute straight-line depreciation:

Annual Depreciation Expense = (Original Cost – Salvage Value) ÷ Estimate Useful Life

Example of straight-line depreciation calculation:

Cost	**–**	**Salvage Value**	**=**	**Depreciable Cost**
$13,000	–	$1,000	=	$12,000
Depreciable Cost	**÷**	**Useful Life (in years)**	**=**	**Annual Depreciation Expense**
$12,000	÷	5	=	$2,400

Illustration: Calculating & Recording Straight-Line Depreciation

Year	Depreciable Cost	x	Rate	=	Annual Depreciation Expense	Accumulated Depreciation	Book Value
2019	$ 12,000		20%		$ 2,400	$ 2,400	$ 10,600 *
2020	12,000		20		2,400	4,800	8,200
2021	12,000		20		2,400	7,200	5,800
2022	12,000		20		2,400	9,600	3,400
2023	12,000		20		2,400	12,000	1,000

2019 Journal Entry

	Debit	Credit
Depreciation Expense	2,400	
Accumulated Depreciation		2,400

* Book value = Cost - Accumulated depreciation = ($13,000 - $2,400).

Plant Assets: Book Value

- Book value is the difference between an asset's cost and its accumulated depreciation.

Example of balance sheet presentation of PPE:

TESLA MOTORS, INC BALANCE SHEET (PARTIAL) (in thousands)	
Property, Plant, and Equipment	
Equipment	$322,394
Less: Accumulated Depreciation, Equipment	(50,000)
Total	$272,394

This is the "book value" of the equipment.

Accounts Receivable- Uncollectible Accounts

- **Valuing Accounts Receivable**
  - Current asset.
  - Valuation (cash realizable value).
- **Uncollectible Accounts Receivable**
  - Sales on account raise the possibility of accounts not being collected.
  - Companies record credit losses as debits to **Bad Debt Expense**.

Alternative Terminology
You will sometimes see *Bad Debt Expense* called *Uncollectible Accounts Expense*.

Valuing Accounts Receivable

Methods of Accounting for Uncollectible Accounts

Direct Write-Off

Theoretically undesirable:

- No matching.
- Receivable not stated at **cash realizable value**.
- Not acceptable for financial reporting.

Allowance Method

Losses are estimated:

- Better matching.
- Receivable stated at **cash realizable value**.
- Required by GAAP.

Valuing Accounts Receivable

DIRECT WRITE-OFF METHOD FOR UNCOLLECTIBLE ACCOUNTS

Illustration: Assume that Warden Co. writes off M. E. Doran's $200 balance as uncollectible on December 12. Warden's entry is:

Bad Debt Expense	200	
Accounts Receivable		200

Theoretically undesirable:

- No matching.
- Receivable not stated at cash realizable value.
- Not acceptable for financial reporting.

Accounts Receivable

ALLOWANCE METHOD FOR UNCOLLECTIBLE ACCOUNTS

1. Companies **estimate** uncollectible accounts receivable.
2. Debit **Bad Debt Expense** and credit **Allowance for Doubtful Accounts** (a contra-asset account).
3. Companies debit **Allowance for Doubtful Accounts** and credit **Accounts Receivable** at the time the specific account is **written off** as uncollectible.

Allowance Method

ESTIMATING THE ALLOWANCE

For example, assume the unadjusted trial balance shows Allowance for Doubtful Accounts with a credit balance of $528. Prepare the adjusting entry assuming $2,228 is the estimate of uncollectible receivables from the aging schedule.

Dec. 31	Bad Debt Expense	1,700	
	Allowance For Doubtful Accounts		1,700

Bad Debt Expense

Debit	Credit
Dec. 31 Adj. **1,700**	

Allowance for Doubtful Accounts

Debit	Credit
	Dec. 31 Unadj. Bal. 528
	Dec. 31 Adj. **1,700**
	Dec. 31 Bal. 2,228

Allowance Method

ESTIMATING THE ALLOWANCE

Assume now the unadjusted trial balance shows Allowance for Doubtful Accounts with a debit balance of $500. Prepare the adjusting entry assuming $2,228 is the estimate of uncollectible receivables from the aging schedule.

Dec. 31	Bad Debt Expense	2,728	
	Allowance For Doubtful Accounts		2,728

Bad Debt Expense

Dec. 31 Adj. **2,728**	

Allowance for Doubtful Accounts

Dec. 31 Unadj. Bal. 500	Dec. 31 Adj. **2,728**
	Dec. 31 Bal. 2,228

Allowance Method

RECORDING ESTIMATED UNCOLLECTIBLES

Illustration: Hampson Furniture has credit sales of $1,200,000 in 2019, of which $200,000 remains uncollected at December 31. The credit manager estimates that $12,000 of these sales will prove uncollectible.

Dec. 31	Bad Debt Expense	12,000	
	Allowance for Doubtful Accounts		12,000

LO 2

Allowance Method

RECORDING WRITE-OFF OF AN UNCOLLECTIBLE ACCOUNT

Illustration: The vice-president of finance of Hampson Furniture on March 1, 2020, authorizes a write-off of the $500 balance owed by R. A. Ware. The entry to record the write-off is:

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable		500

Accounts Receivable

Debit			Credit	
Jan. 1	Bal.	200,000	Mar. 1	**500**
Mar. 1	Bal.	199,500		

Allowance for Doubtful Accounts

Debit		Credit		
Mar. 1	**500**	Jan. 1	Bal.	12,000
		Mar. 1	Bal.	11,500

Types of Adjusting Entries

Deferrals	Accruals
1. **Prepaid Expenses.** Expenses paid in cash before they are used or consumed.	1. **Accrued Revenues.** Revenues for services performed but not yet received in cash or recorded.
2. **Unearned Revenues.** Cash received before services are performed.	2. **Accrued Expenses.** Expenses incurred but not yet paid in cash or recorded.

Prepare Adjusting Entries for Deferrals

Deferrals are **expenses or revenues** that are recognized at a date later than the point when cash was originally exchanged. There are **two types**:

- Prepaid expenses and
- Unearned revenues.

LO 2

Unearned Revenues

Receipt of cash that is recorded as a liability because the service has not been performed.

Cash Receipt **BEFORE** Revenue Recorded

Unearned revenues often occur in regard to:

- Rent
- Airline tickets
- Magazine subscriptions
- Customer deposits

LO 2

Unearned Revenues

Illustration: Pioneer Lease Management received an advanced payment of $3,000 on September 15 from R. Knox to satisfy his October, November, and December rent amount. Unearned Rent Revenue was credited for $3,000. Pioneer should make the following adjusting journal entry to recognize rent revenue and reduce the balance in the unearned revenue account.

Oct. 31	Unearned Rent Revenue	$1,000	
	Rent Revenue		1,000

Unearned Revenues

ACCOUNTING FOR UNEARNED REVENUES			
Examples	**Reason for Adjustment**	**Accounts Before Adjustment**	**Adjusting Entry**
Rent, magazine subscriptions, customer deposits for future service	Unearned revenues recorded in liability accounts are now recognized as revenue for services performed.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues

Notes Receivable

Companies may grant credit in exchange for a promissory note. A **promissory note** is a written promise to pay a specified amount of money on demand or at a definite time.

Promissory notes may be used

1. when individuals and companies lend or borrow money,
2. when amount of transaction and credit period exceed normal limits, or
3. in settlement of accounts receivable.

LO 3

Recognizing Notes Receivable

Illustration: Calhoun Bank & Trust loaned $10,000 to Broke & Broke, LLC, by issuing a twelve-month, 12% promissory note dated May 1. Broke & Broke, LLC would record the following entry to recognize the proceeds and issuance of the note.

May 1	Cash	10,000	
	Notes Payable		10,000

Current Liabilities

Sales Taxes Payable

- Sales taxes are expressed as a stated percentage of the sales price.
- Selling company (retailer)
  - collects tax from the customer.
  - enters tax separately in cash register or includes in total receipts.
  - remits the collections to the state's department of revenue.

Sales Taxes Payable

Illustration: The March 25 cash register reading for Cooley Grocery shows sales of $10,000 and sales taxes of $600 (sales tax rate of 6%), the journal entry is:

Mar. 25	Cash	10,600	
	Sales Revenue		10,000
	Sales Taxes Payable		600

LO 1

Sales Taxes Payable

Sometimes companies do not enter sales taxes separately in the cash register.

Illustration: Cooley Grocery enters total receipts of $10,600. Because the amount received from the sale is equal to the sales price 100% plus 6% of sales, (sales tax rate of 6%), the journal entry is:

Mar. 25	Cash	10,600	
	Sales Revenue		10,000 *
	Sales Tax Payable		600

* $\$10,600 \div 1.06 = \$10,000$

Some information contained in slides from:

Weygandt, J. J., Kimmel, P. D., & Kieso, D. E. (2009). *Financial accounting*. John Wiley & Sons.