ACT 1600 Fundamental of Financial Accounting

Chapter 1

The Basic Accounting Equation

Asset = Liabilities + Equity

Asset

Assets are resources a business owns. The common characteristic possessed by all assets is the capacity to provide future services or benefits. For example, a local restaurant, buildings , equipment and etc.

Liabilities

Liabilities are existing debt and obligations. Business of all sizes usually borrows money and purchase merchandise on credit. For example, note payable , accounts payable , salaries and wages payable and etc.

Equity

The remainder is the shareholders' claim on the assets-equity. It is often referred to as residual equity.

Share capital – ordinary

Share capital-ordinary is the term used to describe the amounts paid in by shareholders for the ordinary shares they purchased.

Retained earnings

Retained earnings is determined by three items : revenues, expenses, and dividends.

Revenues

Revenues are the gross increase in equity resulting from business activities entered into for the purpose of earning income.

Expenses

Expenses are the cost of assets consumed or services used in the process of earning revenue.

Dividends

Net income represents an increase in net assets which is then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a dividends.

Transactions

Transactions are a business's economic events recorded by accountants. Transactions may be external or internal.

Transaction analysis

We use the basic accounting equation to study transaction analysis.

There are 10 differences transaction

1.Investment by shareholders

The asset cash increases $15,000 ,and equity identified as Share Capital-ordinary increase $15,000

2.Purchase of equipment for cash

Cash decreases $ 7,000 ,and the asset Equipment increases $7,000

3.Purchase of supplies on credit
The asset Supplies increases $ 1,600 , and the liability Accounts Payable increases by $1,600

4.Services provide for cash
Cash increases $1,200 , and revenues increases $1,200

5.Purchase of advertising on credit
Accounts Payable increases $ 250 ,and equity decreases $250 due to advertising expense

6.Services provided for cash and credit
Three specific items are affected: Cash increases $ 1,500 , Accounts Receivable increases $2,000, and service revenue increases $3,500

7.Payment of expenses
Cash decreases $ 1,700 ,and the specific expense categories decrease equity by the same amount.

8.Payment of Accounts payable
This cash payment "on account" decrease the asset cash by $250 and also decreases the liability accounts payable by $ 250

9.Receipt of cash on account
Cash increases $ 600 ,and Accounts receivable decreases $ 600

10.Dividends
Cash decreases $ 1,300 ,and equity decreases $1,300 due to dividends

There are four financial statements from summarized accounting data

1. **An income statement** - the revenues and expenses and resulting net income or net loss
2. **A retained earnings** - summarizes the change in retained earnings
3. **A statement of financial position** **-** reports assets, liabilities, and equity
4. **A statement of cash flows** **-** summarizes information about the cash flows

This is the example of the financial statements

Legal Services Company was incorporated on July 1, 2014. During the first month of operations, the following transaction occurred

1. Shareholders invested $10,000,000 in cash in exchange for ordinary shares of Legal Services Company
2. Paid $ 800,000 for July rent on office space.
3. Purchased office equipment on account $3,000,000
4. Provided legal services to clients for cash $ 1,500,000
5. Borrowed $ 700,000 cash from a bank on a note payable
6. Performed legal services for client on account $ 2,000,000
7. Paid monthly expenses: salaries $500,000 , utilities $ 300,000 , and advertising $ 100,000

Prepare the income statement, retained earnings statement, and statement of financial position at July 31 for Legal Services Company.

Legal Services Company
Income Statement
For the Month Ended July 31,2014

Revenues		
Service revenue		$3,500,000
Expense		
Rent expense	($800,000)	
Salaries and wages expense	($500,000)	
Utilities expense	($300,000)	
Advertising expense	($100,000)	
Total expense		$1,700,000
Net income		$1,800,000

Legal Services Company **Retained Earnings Statement** **For the Month Ended July 31,2014**		
Retained earnings , July 1		$0
Net income		$1,800,000
Retained earnings , July 31		$1,800,000

Legal Services Company **Statement of Financial Position** **July 31,2014**		
Assets		
Equipment		$3,000,000
Accounts receivable		$2,000,000
Cash		$10,500,000
Total assets		$15,500,000
Equity and Liabilities		
Equity		

Share capital - ordinary	$10,000,000	
Retained earnings	$1,800,000	$11,800,000
Liabilities		
Notes payable	$70,000	
Accounts payable	$3,000,000	$3,700,000
Total equity and liabilities		$15,500,000

From the equation Assets = Liabilities + Equity
So it means that you do it correctly

Chapter 2

The Recording Process

An account in an individual accounting record of increases and decreases in a specific asset, liability, or equity item.

Debits and Credits

Debit(Dr) indicates left side of an account , and credit (Cr) indicates right side. We use the terms debit and credit repeatedly in the recording process to describe where entries are made in accounts.

Debits and Credits Procedure

From Chapter 1 , we know that both sides of the basic equation (Assets = Liabilities + Equity) must be equal. It therefore follows that increases and decreases in liabilities will have to be recorded opposite from that increases and decreases in assets. Thus, increases in liabilities must be entered on the right or credit side, and decreases in liabilities must be entered on the left or debit side.

Debits	Credits
Increases assets	Decreases assets
Decreases liabilities	Increases liabilities

Equity

Share Capital – Ordinary→ Companies issues share capital – ordinary in exchange for owners' investment paid in to the company. Credits increase the Share Capital – Ordinary account, and debit decrease it.

Debits	**Credits**
Decreases Share Capital – Ordinary	Increases Share Capital – Ordinary

Revenues and expenses

Credits increase revenue accounts and debits decrease them. Expenses are the reverse of the revenues so, debit increase expenses accounts , and credits decrease them.

Debits	**Credits**
Increases expenses	Decreases expenses
Decreases revenues	Increases revenues

The Journal

The journal is referred to as the book of original entry in order to record transactions.Companies use various kinds of journals; a basic form of journal is a **general jounal**.

This is the example of General Journal

General Journal				**J1**
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**
Sept,1	Cash	101	8,000	
	Share Capital - Ordinary	490		8,000
	(Issues shares for cash)			
Sept,2	Equipment	295	7,000	
	Cash	101		7,000
	(Purchased equipment for cash)			

The Ledger

The entire group of accounts maintained by a company is the Ledger.Companies use various kinds of journals; a basic form of ledger that every company use is a general ledger.

This is the example of General Ledger

Cash
101

Date	Accounts Titles and Explanation	Ref.	Debit	Credit	
Sept,1			8,000		
3				1,000	
6			4,000		
12			7,000		
14				3,000	
30			1,000		16,000

The Trial Balance

A trial balance is a list of accounts and their balances at a given time. The trial balance proves the mathematical equity of debits and credits after posting.

The step for preparing trial balances

1. List the accounts titles and their balances
2. Total the debit and credit columns
3. Prove the equality of the two columns.

This is the example of the trial balance

Pioneer Advertising Company Trial Balance August 31,2014		
	Debit	**Credit**
Cash	15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Share Capital - Ordinary		10,000
Dividends	500	
Service Revenue		10,000

Salaries and Wages Expense	4,000	
Rent Expense	900	
	28,700	28,700

Transactions

A group of student investors in Hong Kong opened Campus Laundromat Inc. on September 1, 2014. During the first month of operations , the following transactions occurred

Sept.	1	Shareholders invested HK$200,000 cash in the business in exchange for Ordinary shares
	2	Paid HK $10,000 cash for store rent for the month of September.
	3	Purchased washers and dryers for HK$ 250,000 , paying HK $100,000 in cash And singing a HK$150,000 , 6-month, 12% note payable
	4	Paid HK $12,000 for a one-year accident insurance policy.
	10	Received a bill from the Daily News for advertising the opening of the Laundromat HK $2,000
	20	Declared and paid a cash dividend to shareholders HK$7,000
	30	Determined that cash receipts for laundry fees for the month were HK$ 62,000

Instructions

(a) Journalize the September transactions (J1 for the journal page number)
(b) Open ledger accounts and post the September transactions
(c) Prepare a trial balance at September 30,2014

General Journal

General Journal				**J1**
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**
Sept,1	Cash	101	200,000	
	Share Capital - Ordinary	311		200,000
	(Shareholders' investment of cash in business)			
Sept,2	Rent expense	729	10,000	
	Cash	101		10,000
	(Paid September rent)			
Sept,3	Equipment	157	250,000	
	Cash	101		100,000
	Notes payable	200		150,000

	(Purchased equipment for cash and 6-month,12% note payable)			
Sept,4	Prepaid Insurance	130	12,000	
	Cash	101		12,000
	(Paid one –year insurance policy)			
Sept,10	Advertising expense	610	2,000	
	Accounts payable	201		2,000
	(Received bill from Daily News for advertising)			
Sept,20	Dividends	332	7,000	
	Cash	101		7,000
	(Declared and paid a cash dividend)			
Sept,10	Cash	101	62,000	
	Service revenue	400		62,000
	(Received cash for services provided)			

General Ledger

Cash

101

Date	Accounts Titles and Explanation	Ref.	Debit	Credit	
Sept,1		J1	200,000		
2		J1		10,000	
3		J1		100,000	
4		J1		12,000	
20		J1		7,000	
30		J1	62,000		133,000

Prepaid Insurance 130					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,4		J1	12,000		12,000

Equipment 157					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,3		J1	250,000		250,000

Notes Payable 200					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,3		J1		150,000	150,000

Accounts Payable 201					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,10		J1		2,000	2,000

Share Capital - Ordinary 311					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,10		J1		200,000	200,000

Dividends 332

Date	Accounts Titles and Explanation	Ref.	Debit	Credit	
Sept,20		J1	7,000		7,000

Service Revenue 400					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,30		J1		62,000	62,000

Advertising Expense 610					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,10		J1	2,000		2,000

Rent Expense 729					
Date	**Accounts Titles and Explanation**	**Ref.**	**Debit**	**Credit**	
Sept,2		J1	10,000		10,000

A trial balance

Campus Laundromat Inc. Trial Balance September 30,2014		
	Debit	**Credit**
Cash	133,000	
Prepaid Insurance	12,000	

Equipment	250,000	
Notes Payable		150,000
Accounts Payable		2,000
Share Capital - Ordinary		200,000
Dividends	7,000	
Service Revenue		62,000
Advertising Expense	2,000	
Rent Expense	10,000	
	414,000	414,000

Chapter 3

Adjusting the accounts

Table of contents

Adjusting entries

The meaning is that the improvement of balance to be a correct one, ending of balance for each periods are correct for sure.

Accounting period divided into 4 type

1. Monthly (1 month period)
2. Quarterly (3 months period)
3. Semiannually (6 months period)
4. Annually (12 months period)

For adjusting entries

1. Prepaid expense – The money that we pay for a future likes a rent sush as in groups as a office supplies,prepaid insurance ,prepaid advertising

Example:

The office supplies showed a debit balance of $1300 on Jan 1, 1999. On dec 31 a physical count of supplies showed the balance valued as $400.

Account title	Dr	Cr
Supplies expense	900	
Office supplies		900

2. Unearned revenue – The money that you earn from customer before taking a goods.

Example:

$7000 received in advance from customer for rendering service. This was initially credited to unearned revenue. As of Mar 31, 1999. 60% was not earned.

Account title	Dr.	Cr.
Unearned revenue	2,800	
Service revenue		2,800

3. Accrued revenue – the occur that already happened but don't earn a money yet,but it will receiving in a future

Example:

Invoices representing $5000 of service performed during the month have not been record as of Jun 30.

Account title	Dr.	Cr.
Accounts receivable	5,000	
Service revenue		5,000

4. Accured expense – The cost of happening but not paid yet

Example:

FF company hired a worker $255 for a 5 evening week, payable each Friday,Jan 1,fell on Thursday what will be on Dec 31

Account title	Dr.	Cr.
Salaries expense (255/5*4)	180	

Salaries payble		180

Correction entries

Step to solve

1. Write a correct Journal entires
2. Write a wrong one in a question
3. Improving a accounts by replacement a values with correct one

Method of depreciation

1. Straight line

Note that; how to counts a month: buying in 1-15 of months → count that

Buying in 16-31 of months →not count that month

Depreciation / year = Cost – salvage value/useful life

Ex. An equipment was purchased on March 16,1999 at cost of $2,000,000 , useful life is 5 years and salvage value is $200,000.Straight line of depreciation was used.Record on December 31,2000 (1 year)

Use formula = 2,000,000 – 200,000 / 5 = 360,000

Account title	Dr.	Cr.
Depreciation expense	360,000	
Accumulated equipment		360,000

2.Unit of activity

Depreciation = Cost – salvage value / Total units of activity x unit of act during a year

Ex. An automobile cost $15,400, estimated value $1,400 useful life 200,000 miles, Accmulated at Jan 1,1999,during the year is 20,000 miles

Use formula = 15,400 – 1,400 / 200,000 x 20,000 = 1400

Account title	Dr.	Cr.
Depreciation automobile	1,400	
Accumulated automobile		1,400

3.Double declining balance

Depreciation / year = (Cost – accumulated depreciation) x 2 / useful life

Ex. An equipment was purchased on September 17,2000 at a cost a of $500,000 and an estimated useful of 5 years. The scrap value was estimated to be $60,000. Compute depreciation expense of the equipment for the year

Use formula = (500,000 – 60,000) x 2/5 = 176,000

Account title	Dr.	Cr.
Depreciation equipment	176,000	
Accumulated equipment		176,000

An analysis of the accounts show the following

1. insurance expires at the rate of $100 per month
2.Office supplies on hand total $800
3.The office equipment depreciates $200 a month
4.One-half of the unearned revenue was earned in March

No	Account title	debit	credit
1.	Insurance expense	100	
	Prepaid insurance		100
2.	Office expense	2,000	
	Office supplies		2,000
3.	Depreciation equipment	200	
	Accumulated		200
4.	Unearned revenue	4,600	
	Service revenue		4,600

Chapter 4

Completion of the accounting cycle

Income statement

Single step income statement (for Service Company)

…….(Name of company)……
Service company
For the…. Ended…..

Revenue :		
________	xx	
________	xx	
Expenses :		
_______	xx	
_______	xx	
ToTal expenses		xx
Net income/Net loss		xx

Multiple-step income statement (for Merchandise Company)

…….(Name of company)……
Income statement
For the…. Ended…..

Sales
    Sale Revenue & Allowances
    Sale discount
Net sales
Cost of goods sold
Beginning inventory
Purchase
    Purchase returns & allowances
    Purchase discount
Net purchase
Freight in
Cost of goods purchased
Cost of goods available for sales
Ending inventory
Gross profit

Operating expenses :
Selling Expense :
____
____
    Total selling expense
Income from operations
Other revenue:
Interest revenue
dividend revenue
rent revenue
gain……

Other expenses :

Interest expense

Loss………

Net income/Net loss

Retained Earnings statement (both service and merchandise company)

….(Name of company)	
Retained Earnings statement	
For the ……. Ended ………	
Retained Earnings,BB	xx
Net income (Loss / profit)	xx
Dividends	xx
Retained Earnings,BB	xx

Statement of financial position (both service and merchandise company)

…….(Name of company)……	
Statement of financial statement	
Dec 31,2010	
Assets	
<u>Property,Plant and Equipment</u>	
Land	
Accumulated depreciation-building	xx
Total property,Plant and Equipment	xx
<u>Current Assets</u>	
Merchandise Inventory	xx
Prepaid insurance	xx
Supplies	xx
Notes receivable	xx
Accounts receivable	xx
Cash	xx
Total current assets	xx
Total Assets	xx
Stockholder's Equity and liabilities	
<u>Stockholder's Equity</u>	
Common stock	xx
Retained Earnings	xx
Total stockholders' Equity	
<u>Non-current liabilities</u>	
Mortgage payable	xx
Notes payable	xx
Total Non-current liabilities	

Current liabilities

Notes payable	xx
Accounts payable	xx
Unearned revenue	xx
Total current liabilities	xx
Total liabilities	xx
Total stockholders' Equity and liabilities	xx

Closing entries

1.Close summary of revenue accounts into income summary

2. Close summary of expense accounts into income summary

3. Close income summary into retained earnings

4. Close dividend accounts into retained earnings

Example of this chapter 4

Oppai Company
Work sheet
For the month ended Jan 31,2557

Account Titles	Trial Balance		Adjustment		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	5,000				5,000	
Accounts receivable	1,400		800		2,200	
Inventory	1,300			100	1,200	
Land	200,000				200,000	
Equipment	6,000				6,000	
Accu.depreciation		300		100		400
Unearned rev.		4,000	1,000			3,000
Share capital		102,500				102,500
Retained earning		100,000				100,000
Sales revenue		60,000		800+1000		61,800
Sales returns and all	5,000				5,000	

Cost of goods sold	41,000		100		41,100	
Freight-out	800				800	
Salaries expense	6,000		500		6,500	
Utilities expense	300				300	
Total	266,800	266,800				
Depreciation exp			100		100	
Salaries payable				500		500
			2,500	2,500	268,200	268,200

Data for adjusting entries

1.Useful life of equipment is 5 years
2.Sales revenue earned but not yed received in cash from Mr.Than $800
3.One fourth of Unearned account is earned in Jan 2013.
4.Accrued salaries expense not yet paid $500
5.Inventory value on hand is only $1,200

Multiple – steps income statement for merchandising company using Perpetual sys.

Sales revenue		61,800
Sales returns and allowances		(5,000)
Net sales		56,800
Cost of goods sold		(41,100)
Gross profit		15,700
Operating expenses		
Freight-out	800	
Salaries expense	6,500	
Utilities expense	300	
Depreciation expense	100	
Total operating expenses		(7,700)
Net income		8,000

Statement of financial position

Asset			

Non-current asset			
Plant asset			
Land			
Equipment		200,000	
Accu. Depreciation	6,000		
Total Plant asset	(400)	5,600	
Total non-current asset		205,600	
Current asset			205,600
Inventory			
Accounts receivable		1,200	
Cash		2,200	
Total current asset		5,000	
Total asset			8,400
Shareholder's equity and liabilities			214,000
Shareholder's equity			
Share capital			
R/E (bb+net income - dividends)		102,500	
Total shareholder's equity		108,000	
Liabilities			210,500
Current liabilities			
Unearned revenue	3,000		
Salaries payable	500		
Total Current liabilities		3,500	
Total liabilities			3,500
Total Shareholder's and liabilities			214,000

Closing entries

Dec31.	Sales revenue	61,800	
	Income summary		61,800
Dec31.	Income summary	53,800	
	Sales returns and allowances		5,000
	Cost of goods sold		41,100
	Freight-out		800
	Salaries expense		6,500
	Utilities expense		300
	Depreciation expense		100
Dec31.	Income summary	8,000	
	R/E		8,000

CHAPTER 5

ACCOUNTING FOR MERCHANDISING OPERATIONS

Merchandising companies buy and sell merchandising rather than perform services and their primary source of revenue.

The primary source of revenues for merchandising companies is the sale merchandise, often referred to simply as **SALES REVENUE** or SALES.

COST OF GOOD SOLD is the total cost of merchandise sold during the period.

Companies use one of two systems to account for inventory :

- Perpetual inventory system

- Periodic inventory system

PERPETUAL SYSTEM – big company

Keep detailed records of the cost of each inventory purchase and sale. A company determines the cost of goods sold **each time a sale occurs.**

PERIODIC SYSTEM – small company

Do no keep detailed inventory records of the goods on hand throughout the period. They determine the cost of goods sold **only at the end of the accounting period.**

- Determine the cost of goods on hand at the beginning of the accounting period.
- Add to it the cost of goods purchased
- Subtract the cost of goods on hand at the end of the accounting period.

Recording Purchased of Merchandise

Companies purchase using cash or credit (on account). They normally record purchases when they receive the goods from the seller.

Under the perpetual inventory system, companies record purchases of merchandise for sale in the Inventory account.

Freight Costs – FOB (free on board)

- FOB Shipping Point : **Buyer pays freight costs.**
- FOB Destination : **Seller pays freight costs.**

Purchase Returns and Allowances

The purchaser may return the goods to the seller for credit if the sale was made on credit, or for a cash refund if the purchase was for cash. The transaction is known as **purchase return.** Alternatively, the purchaser may choose to keep the merchandise if the seller is willing to grant an allowance(deduction) from the purchase price. This transaction is known as a **purchase allowance.**

Purchase Discounts

Permit buyer to claim a cash discount for prompt payment. The buyer calls this cash discount a **purchase discount.**

Credit terms specify the amount of the cash discount and time period in which it is offered.

Ex. 2/10,n/30 "two-ten, net thirty"

This means that the buyer may take a 2% cash discount on the invoice price less any returns or allowances, if payment is made within 10 day

JOURNAL ENTRIES FOR THE BUYER						
	PERPETUAL			PERIODIC		
1	**Purchase of merchandise**					
	Inventory	xx		Purchase	xx	
	Cash / A/P		xx	Cash / A/P		xx
2	**Return of merchandise purchased**					
	Cash / A/P	xx		Cash / A/P	xx	
	Inventory		xx	Purchase Returns & Allowances		xx

3	**Paid the Freight Cost (FOB Shipping Point)**	
	Inventory xx Cash xx	Freight-In Cash xx
4	**Payment during the discount period**	
	Accounts Payable xx Cash xx Inventory xx	Accounts Payable xx Cash xx Purchase Discount xx

JOURNAL ENTRIES FOR THE SELLER		
	PERPETUAL	PERIODIC
1	**Sale of merchandise**	
	Cash / A/R xx Sales Revenue xx	Purchase xx Sales Revenue xx
	Cost of Goods Sold xx Inventory xx	NO ENTRY
2	**Customer returned the merchandise sold**	
	Sales Returns & Allowances xx Cash / A/R xx	Sales Returns & Allowances xx Cash / A/R xx
	Inventory xx	NO ENTRY

	Cost of goods sold xx	
3	**Paid the Freight Cost (FOB Destination)**	
	Delivery expense / Freight-out xx Cash xx	Delivery expense / Freight-out xx Cash xx
4	**Receive the money during the discount period**	
	Cash xx Sale discount xx A/R xx	Cash xx Sales discount xx A/R xx

Adjusting Entries

The perpetual inventory records may be incorrect due to recording errors, theft, or waste. Thus, the company needs to adjust the perpetual records to make the recorded inventory amount agree with the inventory on hand. **This involves adjusting Inventory and Cost of Goods Sold.**

Ex. PW Audio Supply has an unadjusted balance of $40500 in Inventory. Through a physical count, PW Audio Supply determines that its actual merchandise inventory at year-end is $40000. The company would make an adjusting entry as follows.

Cost of Good Sold	500	
Inventory		500
(to adjust inventory to physical count)		

Closing Entries

A merchandising company closes to Income Summary all accounts that affect met income. In journalizing, the company credits all temporary accounts with debit balances, and debits all temporary accounts with credit balances.

1) Close Revenue to Income summary

Sales Revenue	xxx	
Income summary		xxx

2) Close Expense to Income summary

Income summary	xxx	
Sales Returns & Allowances		xxx
…		xxx
…		xxx

3) Close Income summary to Retained earnings

Income summary	xxx	
Retained earning		xxx

4) Close Dividends to Retained earnings

Retained earnings	xxx	

Dividends	xxx

*** Multiple-Step Income Statement Under a Perpetual System

: Net sales = Sales Revenue – Sales Return & Allowances – Sales discount

: Gross Profit = Net sales – Cost of goods sold

: Income from operations = Gross Profit – Total operating expense

Chapter 6: Inventories

Inventories

- Classifying Inventory
- Determining Inventory Quantities
- Inventory Costing
- Inventory Errors
- Statement Presentation and Analysis

Classifying Inventory

Accounting across the organization for e.g. A Big Hiccup

Determining Inventory Quantities

Taking a Physical Inventory

- Ethics Insight for e.g. Falsifying Inventory to Boost Income

Determining Ownership of Goods

- Goods in Transit
- Consigned Goods

Inventory Costing

- Specific Identification

- Cost Flow Assumptions

    1. First-in, first-out(FIFO)
    2. Average-cost

Financial Statement and Tax Effects of Cost Flow Methods

- Income Statement Effects
- Statement of Financial Position Effects
- Tax Effects

Using Inventory Cost Flow Methods Consistently

- International Insight (Is LILO Fair?)

Lower-of-Cost-or-Net Realizable Value

Inventory Errors

Income Statement Effects

Beginning Inventory + Cost of Goods Sold – Ending Inventory = Cost of Goods Sold

Statement Presentation and Analysis

- Presentation
- Analysis

Cost of Goods Sold / Average Inventory = Inventory Turnover

Accounting across the Organization

- Improving Inventory Control with RFID

Summary of Learning Objectives

1. Describe the steps in determining inventory quantities.
2. Explain the accounting for inventories and apply the inventory cost flow methods.
3. Explain the financial effects of the inventory cost flow assumptions.
4. Explain the lower-of-cost-or-net realizable value basis of accounting for inventories.
5. Indicate the effects of inventory errors on the financial statements.
6. Compute and interpret the inventory turnover ratio.

EXAMPLES

Tempo Ltd. is a retailer operating in Dartmouth, Nova Scotia. Tempo uses the perpetual inventory method. All sales returns from customers result in the goods being returned to inventory; the inventory is not damaged. Assume that there are no credit transactions; all amounts are settled in cash. You are provided with the following information for Tempo Ltd. for the month of January 2014.

Dec 31 Ending Inventory Q=150, P=$19

Jan 2 Purchase Q=100, P=$21

Jan 6 Sale Q=150, P=40

Jan 9 Sale return Q=10, P=$40

Jan 9 Purchase Q=75, P=$24

Jan 10 Purchase return Q= 15, P=$24

Jan 10 Sale Q=50, P=$45

Jan 23 Purchase Q=100, P= 26

Jan 30 Sale Q=160, P=50

Instruction

Calculate a) Cost of goods Sold

b) Ending Inventory

c) Gross Profit

Using two methods i) FIFO ii) Moving-average cost

CHAPTER 7: Fraud, Internal Control, and Cash

- Fraud and Internal Control
- Cash Controls
- Control Features: Use of a Bank
- Reporting Cash

Fraud and Internal Control

Fraud is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employee.

Internal Control consists of

- A control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Principles of Internal Control Activities

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical controls
- Independent internal verification
- Human resource controls

Establishment of responsibility – control is most effective when only one person is responsible for a given task.

Segregation of duties – the work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee.

Segregation of related activities – Making one individual responsible for related activities increases the potential for errors and irregularities.

Segregation of record-keeping from physical custody – The custodian of the asset is not likely to convert the asset to personal use when one employee maintains the record of the asset, and a different employee has physical custody of the asset.

Documentation procedures – prenumbered documents, and all documents should be accounted for. Promptly forward source documents for accounting entries to the accounting department. This control measure helps to ensure timely recording of the transaction.

Physical controls – relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records.

Independent internal verification – involves the review of data prepared by employees.

Human Resource Control

1. Bond employees who handle cash
2. Rotate employees' duties and require employees to take vacations.
3. Conduct thorough background checks.

Limitations of Internal Control – reasonable assurance, human element, and collusion.

Cash Controls

Over-the-counter receipts

Mail receipts

Cash Disbursements Controls

Voucher System Controls

Petty Cash Fund Controls

Establishing the petty cash fund

Making payments from the petty cash fund

Replenishing the petty cash fund

Control Features: Use of a Bank

The use of a bank contributes significantly to good internal control over cash.

Making Bank Deposits

Writing Checks

Bank Statements

Debit Memorandum

Credit Memorandum

Reconciling the Bank Account

1. Time lags
2. Errors

Reconciliation procedure – The bank reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.

Step1: Deposits in transit.

Step2: Outstanding checks.

Step3: Errors.

Step4: Bank memoranda.

Bank Reconciliation Illustrated – same steps as Reconciliation procedure

Entries from Bank Reconciliation

Collection of note receivable

Book error

NSF check

Bank service charges

Electronic Funds Transfer (EFT) System

Investor insight – Madoff's Ponzi scheme

<u>Reporting Cash</u>

Cash Equivalents

Restricted Cash