

# Financial accounting summary assignment

Business



Financial Accounting Summary Financial Accounting ??? Summary Notes  
Financial Accounting ??? Summary Notes<sup>1</sup> Financial Statement Basics<sup>3</sup>  
Understanding of the 3 financial statements ??? (balance sheet, income statement and statement of cash flows). What does each financial statement represent? <sup>3</sup> What is the structure of each statement? <sup>3</sup> What is the link between the three statements? <sup>4</sup> Understanding of the basic mechanics of financial accounting ??? (debits, credits, transaction journal entries, adjusting entries, closing entries, t-accounts, trial balances and financial statements)<sup>4</sup>  
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statement of cash flows<sup>42</sup> Ratio Analysis<sup>45</sup> What are ratios? What should you understand about ratios? <sup>45</sup> What are the major ratios? <sup>45</sup> What is the DuPont equation?

What information does it provide? <sup>45</sup> What are common size income statements and common size balance sheets? <sup>45</sup> How do you identify industries based on the ratios? <sup>45</sup> Financial Statement Basics Understanding of the 3 financial statements ??? (balance sheet, income statement and statement of cash flows). What does each financial statement represent? The Balance Sheet (BS) presents a firm's investments and financing at a moment in time. ? What is the financial position, or financial health, of a firm? The Income Statement indicates the net income for a period of time (profit margin = net income / revenues). How profitable is the firm? The Statement of Cash Flow reports the net cash flows derived from operating, investing and financing activities for a time period ? Is the firm generating sufficient cash flows from its customers to finance operations and to acquire buildings and equipment or must it seek new funds from lenders or owners? What is the structure of each statement? Balance Sheet Investing Financing Assets = Liabilities + Shareholders' Equity Assets are economic resources with the ability or potential to provide future benefits to a firm.

Current assets (e. g. cash, short term securities, accounts receivable, inventories) are consumed or turned into cash within one year of the date of the balance sheet. Liabilities are creditors' claims on the assets of a firm and show the sources of the funds used to acquire the assets. Current liabilities require payment within one year, long-term debt within more than one year. Firms typically finance current assets with current liabilities and vice versa.

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Shareholders' equity shows the amounts of funds owners have provided and their claims on the assets.

Shareholders' equity comprises contributed capital (e. g. common stock, additional paid in capital) and retained earnings. Income Statement Revenue  
??? Expenses = Net Income Cash Flow Statement 3 sections: Operating  
Investing Financing What is the link between the three statements? Relation  
of Income Statement to Balance Sheet Income Statement links the balance  
sheet at the beginning of the period with the balance sheet at the end of the  
period. Balance sheet amount for retained earnings represents the sum of  
prior earnings of a firm in excess of dividends.

The amount of net income helps explain the change in retained earnings for  
the period. Retained Earnings (Start of Period) + Net Income for Period ???  
Dividends Declared and Paid = Retained Earnings (End of Period) Relation of  
Cash flow Statement to Income Statement and Balance Sheet CFS explains  
the change in cash between the beginning and the end of the period. The  
statement of cash flows also sets forth the major investing and financing  
activities for the period. Thus the statement of cash flows also helps explain  
changes in various items on the comparative balance sheet.

The statement of cash flows parallels the income statement by showing the  
relationship between net income and cash flow from operations. Income can  
be rising but cash flow can still decline if the business does not collect cash  
from its customers. Summary Financial Position ??? Balance Sheet  
Profitability ??? Income Statement Cash generating ability ??? Statement of  
Cash Flows Understanding of the basic mechanics of financial accounting ???

(debits, credits, transaction journal entries, adjusting entries, closing entries, t-accounts, trial balances and financial statements) Accounting Process  
Journalizing in General Journal ? Periodic Posting to Appropriate Accounts ?  
Preparation of unadjusted trial balance ? Correction and adjustment of trial balance ? Preparation of financial statements Typical Journal Entry Date  
Account Debited\$Debit Account Credited\$Credit Explanation of transaction or event being journalized e. g Date Cash\$Debit Equipment\$Credit Purchase equipment costing \$X in cash. Posting happens periodically (e. g. weekly or monthly). Amounts from General Journal are posted to the General Ledger. T-Accounts are used.

Trial Balance Preparation: Lists accounts in general ledger with a trial balance as of a particular date. Equality between sums of debit account balances and credit account balances helps check the accuracy of arithmetic. Trial Balance After Adjustment and Correction: Errors and omissions. Unrecorded events. E. g pre-paid items such as insurance, the costs of which are accrued over the life of the policy. Normally done by preparing a journal entry. Financial Statement Preparation: Can be done after corrections and adjustment. Balance sheet How are assets and liabilities valued on the balance sheet?

Asset valuation Methods: Acquisition (historical) cost; current replacement cost, current net realizable value, present value. Monetary assets generally appear on the balance sheet at their net present value, their current cash or cash equivalent value. E. g. cash, marketable securities, accounts receivable. Noncurrent monetary assets are therefore discounted.

Nonmonetary assets (e. g. merchandise inventory, PPE) generally appear at  
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acquisition cost, in some cases adjusted downward to reflect that the firm has consumed some of the assets' services and, in others, to recognize some declines in market value.

Note impairments, depreciation or holdings losses or mark-to-market.

Liability valuation Most liabilities are monetary. Those due within one year or less appear at the amount of cash the firm expects to pay to discharge the obligation. If long term (due in more than one year), e. g long term bonds appears at the present value of the future cash outflows. Nonmonetary liabilities: a liability that involves delivering goods or services other than cash. E. g. a warranty, cash advance. Such a liability appears on the balance sheet at the estimated cost, a cash advance appears at the amount of cash received.

What are the components of stockholders' equity section? Common Stock: amounts received equal to the par or stated share value Preferred Stock: amounts received for stock that has some preferences Additional Paid-in Capital: received amounts in excess of par or stated value Retained Earnings: increase in net assets due to generated earnings. Treasury Shares: the cost of shares reacquired by the firm itself. How is US GAAP different from other countries? Structure of the balance sheet US GAAP Other countries  
Current assets Noncurrent assets Noncurrent assets Current assets Current liabilities

Long-term debt / liab. Shareholders equity Shareholders equity Long-term debt / liab. Current liabilities Terms used for accounts US Other countries - Property, Plant Equipment - Investment in securities - Accounts receivable -



Cash -Common Stock -Additional paid-in capital -Retained earnings -Bonds payable -Notes payable to Banks -Accounts payable-Tangible Fixed Assets - Financial Assets -Trade receivables -Liquid funds -Subscribed capital -Capital reserve -Profit reserves, Net income available for distribution -Bonds -Due to Banks -Trade payables Mark to Market versus Historical Cost

Some countries allow firms to mark fixed assets (PPE) to market whilst in the US this is only allowed for Marketable Securities (Trading Securities and Available for Sale). Income Statement What is the difference between cash and accrual accounting? Cash accounting: measures the performance of a business from the selling and provision of goods and services based on the cash received from customers. Problems with cash accounting: ?

Inadequately matches inflows and with the outflows and efforts associated with them. ? Unnecessarily delays the recognition of revenues (revenue is recognized only when cash is received). Provides opportunity to distort the measurement of operating performance (by delaying payments to suppliers at the end of an accounting period, for example) Hence, we use accrual accounting, which recognizes revenue when a firm sells goods or renders services. Expenses are measured using the matching principle, whereby cost expirations are matched to revenues (or economic benefits). When do I record revenues under accrual accounting? Revenues are recorded when they are earned and realizable. This is defined as follows: Earned: A firm has performed all, or most of, the services it expects to provide.

Realizable: The firm has received cash or some other asset such as a receivable, whose cash equivalent can be measured with reasonable precision. The above is taken from Stickney and Weil. Another variation of <https://assignbuster.com/financial-accounting-summary-assignment/>

the definition is that revenues are recognized when it is ‘ realized or realizable and earned’. To achieve this standard the following criteria must be met: ? Persuasive evidence of a sales agreement exists ? Delivery has occurred or services have been rendered ? The selling price is fixed or determinable ? Collection is reasonably assured. The above points come from SEC Staff Accounting Bulletin 101, which was issued in 1999.

When I record revenue should I record other things as well? If a firm recognizes revenues in a period before it receives cash it should also take the following factors into account in determining how much of the total revenue to recognized. Uncollectible accounts; i. e. some people will not pay ??? estimate how many will likely not pay based on previous experience. Sales Discounts and Allowances ??? Some customers may be provided with discounts for prompt or early payment. Sales returns ??? Some customers may return the goods for refund. Each of the above must be reliably estimated and the amount of revenue recognized is reduced as appropriate.

When do I record expenses under accrual accounting? As assets provide future benefits to a firm, expenses measure the assets consumed in generating revenue. Expenses are ‘ expired costs’ or gone assets. Criteria for expense recognition: ? Matching principle ??? If particular revenue causes an asset to expire, that expiration becomes an expense in the period when the firm recognizes the revenue. This treatment ??? the matching principle ??? matches cost expirations with revenues. ? If no particular revenue causes an asset to expire, that expense becomes an expense of the period in which the firm consumes the benefits of that asset in its operations.

Examples... Product costs: Cost of goods sold is recognized as an expense when a firm sells the goods. A firm which buys raw materials and through its operations transforms them into a finished product only recognizes the direct material cost, direct labor cost and manufacturing overhead cost as expenses when the goods are sold, not when they are purchased and paid for. (Matching principle. ) Marketing costs: Relate primarily to the revenues of the period and these are thus recognized as expenses in the period that they occur. They are thus referred to as period expenses. It could be argued that certain marketing costs (e. . advertising) produce a future benefit and should thus be treated as an asset (AOL famously did this in the mid 1990's and was later sued by the SEC). Hence most accountants have a problem to quantify the future benefit (if there is one at all), hence in normal situations marketing costs are recognized as expenses in the period in which they are incurred. They are normally classified under Sales and General Administrative Expenses (SG & A) by US listed companies. Administrative costs: E. g. presidents salary, accounting and IT system costs are recognized in the same way as marketing, i. . as period expenses and are also generally classified under SG. When do I record asset impairment charges under accrual accounting? Asset impairment ??? GAAP require a three-step measurement process for measuring impairment on assets other than intangibles not requiring amortization. 1. Compare undiscounted future cash flows from the assets with their book value (e. g. a property which is rented out). The impairment loss is the amount of the book value, which exceeds their fair value (either present value of the future cash flows or market value). . Compare book value to market value. Impairment loss is the excess of book value over market value. 3. At the time the firm judges an

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impairment loss has occurred, the firm writes down the book value of the asset to fair value. Fair value being 1) market value or 2) if the firm cannot assess market value, the net present value of the expected future cash flows. The journalizing process is as follows: Date Accumulated depreciation \$ Total amount of Accumulated Depreciation attributed to the asset since acquisition Asset e. g.

Building ??? (New Valuation) \$ New value of the building Loss on impairment \$ Difference between book value and fair value Asset e. g.

Building ??? (Book Valuation) \$ Current book value of asset (normally acquisition cost of asset minus any impairment losses recognized previously)

Effect on different statements: Balance Sheet Decreases assets by amount of impairment loss Decreases shareholders equity. (Retained earnings? )

Income statement Appears a loss on income statement Cash flow statement Need to increase net income by amount of impairment loss since its not a cash flow

When do I record restructuring charges under accrual accounting?

Restructuring charges are constructive liabilities. A constructive liability arises not from an obligation but from management intent. For example, intent to close a plant, layoff employees and to make severance payments in amounts not yet determined. These are often referred to as restructuring charges and journalized as follows: When liability is recognized: Date Restructuring Charges \$ Total amount expected to be incurred in the event Liability for severance pay to employees \$ Total amount expected to be incurred in the event

When liability is incurred (i. e. paid) Date Liability for severance pay to employees \$Total amount consumed by the event Cash \$Total amount consumed by the event Sometimes, a constructive liability may be overestimated. In that case, the following is done to reverse part of the initial charge. Date Liability for severance pay to employees \$Total amount expected to be incurred in the event Reversal of Restructuring Charges \$Total amount expected to be incurred in the event Reversal appears in income at the end of the year and is hence open to abuse by management.

Some companies take a ‘big bath’ by overestimating restructuring charges associated with a planned event and afterwards reverse the amount not required in the restructure to boost income in a subsequent period. Analysts and investors hence do not like to see companies do this and are generally pleased to see a company make accurate estimates of restructuring charges.

Effect on different statements of constructive liabilities can be summarized as follows: Statement At estimation of liability When liability is incurred At estimation of liability Balance Sheet Increase liabilities by amount estimated

Decreases shareholders equity (through retained earnings) Decreases liabilities Decreases cash Decreases liabilities Decreases shareholders equity (through retained earnings) Income statement Appears a loss on income statement No effect (already accounted for as an expense when estimated) Increases net income Cash flow statement Need to increase net income by amount of estimated. Need to decrease net income by actual amounts of cash paid. Need to increase decrease net income by amount of reversal. Statement of cash flows What is the purpose of this statement?

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Net income for a particular period does not equal cash flow from operations (due to accrual based accounting; recognition of revenue on sale (not receipt of cash)). The use of accrual accounting therefore creates a need for a separate statement that reports the impact of operations on cash flows. Firms experience cash inflows and outflows from investing that do not appear directly on the income statement. E. g. capital expenditure, The statement of cash flows, hence explains how firms obtain and use their cash. What is the format of the statement? Direct format: Always start with ' Cash received from customers' ??? Looks more like a summary of from operating cash B/S account ??? Few companies use this method, since they are required to also present a statement describing reconciliation to indirect format Indirect format: ??? Always starts with ' Net Income' ??? Needs to be adjusted to account for non-cash revenues and expenses (see below for details) What sections does it contain? Where do certain items go on the statement? The statement explains the reasons for the change in cash between balance sheet dates. Includes cash and cash equivalents.

Cash equivalents are short-term highly liquid investments; such as stocks and shares of publicly traded companies. The reasons for changes in cash are classified as operating, investing or financing activity. Cash Flows from Operations: Cash flow from operations (selling goods and providing services). Excess cash from operations can be used to acquire long-term assets, retire long-term debt and conduct other investing and financing activities. Cash flows from Investing: Acquisition of non-current assets, especially PPE (CAPEX). Buying and selling of securities and notes receivable.

Growing firms will often need to borrow funds to finance acquisitions of non-current assets. Cash flows from Financing: Cash from short and long-term borrowing and from issues of common or preferred stock. Payment of dividends. Interest payments on debt. Re-acquisition of shares of common or preferred stock (treasury shares). Structure of cash flow statement Company X Comparative Statement of Cash Flows Year Ended 31 January 1998/1999

Operations Net Income Depreciation (Increase) in accounts receivable (Increase) in Inventories (Increase) in prepayments Increase in Accounts Payable Increase in other current liabilities

Cash flow from operations Investing Acquisition of property plant and equipment Acquisition of property plant and equipment Realized Gains (Losses) on Investments Cash flow from Investing Financing Increase (decrease) in short-term borrowing Increase (decrease) in long-term borrowing Increase in common stock Acquisition of common stock Dividends Cash flow from financing Change in cash Cash, Beginning of year Cash, End of year

How does US GAAP differ from other GAAP? IAS specifies using same 3 classifications of usage of cash. In US GAAP interest payments are included in Operating section.

In US interests on large construction projects are capitalized, therefore appear in investment section (they are considered as costs to get the asset ready). As a consequence: i) those interests appear on investing sections and ii) some of those interests can be moved to Income Statement through depreciation of the capitalized costs. How do I reconcile net income to operating cash flows? What is the intuition behind each adjustment? Net income is adjusted by the amount of non-cash transactions that either

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reduce or increase net income to the net amount of cash generated from operations in a given period.

Cash Change Equation:  $\Delta \text{Cash} = \Delta \text{Liabilities} + \Delta \text{Shareholders Equity}$  ? ? ? ?

Non-cash Assets Indirect method CFS starts with 'Net Income'. We must adjust for all non-cash revenues and expenses included in I/S, i. e. : ? ? ? Add back depreciation =; non-cash item ? ? ? Add provisions/reserves =; no cash out ? ? ? Subtract increase in Working Capital Requirement (WCR = AR + Invent + Op. cash + prepaid exp - AP - deferred exp / payables) =; these revenues and expenses were recorded in the I/S (revenues when earned and realized / expenses to match those revenues) but: oSome revenues in Net Income included sales not yet paid for: ?

AR ? no cash in oSome expenses (COGS) included stuff bought on credit: ? (Inv - AP) ? no cash out ? ? ? Add all other ? accrued expense =; no cash out ? ? ? Subtract all other ? accrued revenue =; no cash in Direct Method: Obtain Balance Sheets for the start and end of the period covered by the statement of cash flows Prepare a T-Account Work Sheet Explain the change in the master cash account between the beginning and end of the period by accounting for the change in each non-cash account in the period. Use T-Accounts to prepare formal statement of cash flows.

Analyze companies based on their statement of cash flows SCF helps to illustrate: 1) Impact of Operations on Liquidity 2) Relations among cash flows from Operations, Investing and Financing section Explanations of each follow: 1) Growing firms often have a lag between cash outflows and cash inflows (and hence a lag between earnings and cash flows). Successful



growing businesses hence need constant financing from debt or equity to cover perpetual short-term needs. The more successful the firm becomes the more sources of long term funds it will need.

Sometimes a firm which is reducing the scope of its activities can experience an increase in cash flows due to collection of accounts receivable from prior periods without the need to replace inventory, thus saving cash.

2) Relationships on each of the 3 business activities differ depending on the nature of its business and maturity of its industry.

a. Rapidly growing firm:

- i. Negative cash flow from operations due to build up of inventory and accounts receivable.
- ii. Heavy investments in PPE to sustain growth, hence negative cash flow from investing.
- iii. Sources of cash from external financing (debt and equity)

b. Steadily growing firm . Profitable as growth has begun to slow, hence positive cash flow from operations

- ii. But cash flow from operations falls short of the amount required to finance investments in PPE.
- iii. The firm hence requires sources of external financing.

c. Mature Stable Firm

- i. Healthy cash flow from operations
- ii. Cash flow from operations sufficient to cover expenditures on PPE (investing).
- iii. Excess cash used to repay financing from earlier period and perhaps to pay dividends

d. Firm in early stages of decline

- i. Cash flow from operations has begun to decrease but remains positive due to decreases in accounts receivable and inventory. In the latter stages of decline cash flow may turn negative due to falling sales.
- ii. It cuts back significantly on capital expenditure.
- iii. Extra cash used to repay financing and the remainder is available for investment in new products or industries.

Relationship of cash flow statement to phase of growth cycle

Introduction phase ? Negative cash flow from operations ?

Negative cash flow from investing (building capacity) ? Reliance on external finance (likely more equity than debt) Growth phase ? Net income turns positive, but due to increased working capital requirements, cash flow from operations is still negative. Investing continues ? Reliance on financing from equity and long-term debt. Mature phase ? Net income peaks and working capital stops growing, hence positive cash flows from operations. ? Investments in PPE are financed from cash flow from operations. ? Excess cash used to repay borrowing and dividends to shareholders. Weakening profitability/decline ? Cash flow from operations can still be positive as accounts receivable and inventories decrease ? Cash flow from investing turns positive as assets are liquidated ? Excess cash used to repay borrowing or for diversification into other areas of business.

Other information on cash flow statement analysis Operating Section

oOperating activity is the engine of the company. Therefore we expect it to be positive. In healthy, growing company, we expect ? WCR to be positive to cover growth in sales even if there can be short-term variations. oOperating CF can be negative in startups (engine not up to speed) or in ‘down’ year of cyclical business ??? Firstly, look at sign of CF (positive, null or negative) and trend (increasing, flat, decreasing) ??? Secondly, check if operating cash covers needs for investments ??? capex- and interest payments (tempered by understanding of company and situation, eg startup).

Investing section oHealthy companies are expected to continually invest in PP, land and other FAs to expand and grow. Even if they often sell assets, we expect Investing section CF to be negative. oTemporary exceptions can occur when firms divest businesses or subsidiaries. ??? Firstly, consider <https://assignbuster.com/financial-accounting-summary-assignment/>

amount of cash invested. In healthy, mature business, firms invest enough to keep company “ whole” (ie to replace assets that are used up). Very rough surrogate for FA replacement needs is amount of yearly depreciation.

However since prices are rising, we would expect investing activities to exceed depreciation. Secondly, look at other major cash needs or discretionary items. Do they fit with availability of cash? Is the company likely to be able to continue funding? Could it hurt the company? Financing section: oFinancing CF can be either positive or negative and is expected to go back and forth, depending on need for companies to get raise funds through debt or equity issuance to finance operating activities. ??? Firstly, look how financing CF fits with the rest of activities: How does the company finance its cash needs? How does it invest excess cash? Secondly, analyze how cash shortfalls could be better funded (stock issuance, borrowing, sell of assets...)? Consider sustainability of this solution (ability to continue raising debt, impact on ratios...) Overall remarks: Use all evidence to build big picture. Not all news will be positive or negative. Assess importance of each piece of evidence relative to big picture. Ambiguities in Classifying Cash Flows Cash received from interest and dividends might be classified as an operating activity. This is because these items appear as revenue in the income statement.

But cash from interest and dividends might also be in the investing section. Logic: cash flows from investments should be classified as investing activities. FASB Statement of Accounting Standards 95 requires that firms classify the receipt of cash from interest and dividend revenues as an operating activity but the cash related to the purchase and sale of

investments in securities as an investing activity. Similarly, interest expense is treated as an operating activity but the issue and redemption of debt as a financing activity. Dividends that a firm pays are classified as financing activity.

Rationale: accountants treat interest as an expense when computing net income whereas dividends represent a distribution of assets generated by net income, not an expense reducing net income. Revenue Recognition Operating Process for a Manufacturing Firm Acquire raw materials, plant and equipment Acquire labor and other manufacturing services and convert raw materials into products Sell product Collect cash Returns and warranty periods expire Period of holding receivable Period of production Periods of returns and warranty services Revenue & Expenses vs.

Gains & Losses Primary operating activity Recurring (Creation and sale of firm's regular products) Revenue / Expenses Nonrecurring (Income from sales of product or lines of business that the firm intends to discontinue) Gains / Losses Peripheral to primary operating activity Recurring (e. g. periodic sales of equipment previously used in manufacturing) Nonrecurring (e. g. losses from earthquakes or hurricanes) Earned / Realized or Realizable? Revenues get recorded when: EARNED: Performed or substantially performed responsibility.

In the case of goods, legal title has been, or is on the verge of being, transferred to a willing buyer; in the case of service, the service in question has been rendered. Payments REALIZED or REALIZABLE: Collection of money reasonably assured. Revenue recognition at time of sale Accounting for

uncollectible accounts as expenses: ? The amount of uncollectible accounts is estimated by the percentage-of-sales procedure or the aging-of-accounts-receivable procedure (SW p. 327... ) ? Direct Write-Off Method recognizes losses from uncollectible accounts in the period when a firm decides that a specific customers' are uncollectible. Allowance Method involves estimating the amount of uncollectible accounts; the firm recognizes this amount as an expense in the period of the sale, thereby matching expenses with associated revenues. The amount of sales discounts the seller expects the customers to take appears as an adjustment in measuring net sales revenue. In case of sales returns GAAP do not allow a firm to recognize revenue from sales when the customers have the right to return goods unless the firm can reasonably estimate the amount of returns and uses an allowance method to do so.

When delivered goods are unsatisfactory or damaged the price charged to the customer might be reduced by sales allowances; the resulting revenue reductions are recorded as an adjustment in a separate sales revenue contra account, Sales Allowances. Income recognition at times different from sale Percentage-of-completion method bases the amount of revenue, expenses, and income on the proportion of total work performed during the accounting period; the actual schedule of cash collections does not affect the revenue recognition process. When the construction period does not span several accounting periods firms use the completed contract method. Because of the more timely reporting of operating performance in the percentage-of-completion method, GAAP require the use of this method whenever firms can make reasonable estimates of revenues and expenses; on the other hand

most analysts view earnings reported under the completed contract method as more accurate. Most insurance companies recognize revenues and expenses during each period of insurance coverage. The receipt of cash from policyholders and from investments creates a relatively high degree of certainty regarding the amount of revenue.

Insurance companies must, however, match against this revenue each period a portion of the ultimate cash outflow to satisfy claims. If the seller cannot reasonably estimate the amount of cash it will receive it may use one of the following two reporting methods. Installment method recognizes revenue as the seller collects parts of the selling price in cash; in parallel, this method recognizes as expenses each period the same portion of COGS as the portion of total revenue recognized. The cost-recovery-first method allows income to appear in the income statement only if accumulative cash receipts exceed total costs.

If I record the revenues, should I record other items as well? When revenues include future commitments, e. g. warranty, they can only be recorded in whole when the estimated amount of outstanding provisions is booked at the same time. This account includes the accrued expenses for e. g. sales discounts, returns or allowances that will appear in future periods. “ Profits you can trust”, chapter 3 ??? Revenue recognition Companies tend to report unrealistic high revenues in order to demonstrate a big volume of business and to appear attractive for investors; bonus for sales men often depend on their amount of revenues.

The following describes ways taken from real examples how companies have handled revenues:

- ? Manufacturers record revenues for a completed product and expenses for the inventory. But Goods shipped on consignment cannot be booked as revenue!
- ? Channel stuffing: Retailer used as a warehouse, shipped goods recorded as sold.
- ? Grossing up: If an agent records as revenues the gross booking and not only his earned fees; this happened a lot during the New Economy boom phase when the “critical mass” a large customer base corresponding to high revenues was more important than profit. According to SEC revenue should be matched against costs associated with it; if a product is sold including a long-term service contract revenue for the service should not be booked before the service is rendered.
- ? The expansive effect of low interest rates on present value; lower interest rates result in higher present values of lease contracts and the related revenues.
- ? Unused capacities can be sold to related companies and bought again, recording the sale as revenue and capitalizing the purchase, this happened e. g. in the telecom sector with fiber-optic overcapacities.
- ? The Percentage of completion method was misused by construction companies when increased fees encountering unexpected costs were reported without the clients approval.
- ? Booking of revenue from software upgrades that have not even been produced yet.
- ? Concurrent transaction, i. e. when two companies would trade banner spots on each other’s Web site, recording the deal as both revenue and expense but blowing up the company’s outlook.
- ? Revenue resulting from advertising fees paid by own divisions e. . happened at AOL.
- ? Classifying one-time gains as gains from selling real estate or other corporate assets as operating income and operating cash flow (not investing cash flows).

Inventory Accounting What is inventory? And basic

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definitions. Inventory is stock of goods of another item that a firm holds for sale or for further processing as part of its operations. Examples: ? Tools are part of inventory for a HW store but not for a carpenter. ? Marketable securities are inventory for a securities dealer but not a manufacturing firm.

Definitions:

Merchandise Inventory ??? goods held for sale by a retail/wholesale business

Finished goods inventory ??? goods held for sale by a manufacturing firm

Manufacturing firms will also hold: Raw materials inventory ??? materials

being stored that will become part of a good to be produced Work-in-

progress inventory ??? partially completed products in the factory Inventory

Equation What are the various methods of inventory accounting? 1. First-in,

First-out (FIFO) or (Last in Still Here = LISH) 2. Last-in, First-out (LIFO) or

(First in Still Here = FISH) 3. Weighted Average

What is the difference between periodic and perpetual inventory systems?

When the firm computes the cost of goods sold each time it sells an

inventory item, it uses a perpetual inventory system. When the firm

computes the cost of goods sold at the end of each period by taking a

physical inventory and presuming that any items not in ending inventory

were sold, it uses a periodic inventory system. Be able to explain LIFO and

FIFO? FIFO (LISH) FIFO assigns the costs of the earliest units acquired to the

withdrawals and assigns the costs of the most recent acquisitions to the

ending inventory.

The assumption is that the firm uses the oldest materials and goods first.

(Like a conveyor belt). ? FIFO results in balance sheet figures that are closest



to cost because the latest purchases dominate the ending inventory figures. ? But COGS expense out of date because FIFO assumes that the earlier purchases of beginning inventory become expenses. ? If purchase prices are rising, FIFO will report higher net income. LIFO (FISH) LIFO assigns the costs of the latest units acquitted to the withdrawals and assigns the cost of the oldest units to the ending inventory.

Assumes that the units acquired most recently are used first. (Like a pile of coal). Some theorist argue that LIFO matches current costs to current revenues and therefore that LIFO better measures income. ? LIFO ending inventory can include items acquired many years ago. ? If purchases prices are rising, LIFO computes balance sheet figures for inventory well below current costs. ? But LIFO's cost of goods sold figures more closely approximates current costs. ? LIFO hence results in smaller net income if purchases are rising (highest COGS) and lowest net income if prices falling (lowest COGS). LIFO results in least fluctuation in gross margins of businesses where selling prices change as current inventory prices change.

Summary Cost Flow Assumption	Income Statement	Tax payments	Balance Sheet
Inventory on hand assumption FIFO	COGS reflects old purchase prices	Net income higher (if purchase prices increasing)	Higher (if purchase prices increasing)
LISH LIFO	COGS reflects new purchase prices	Net income lower (if purchase prices increasing)	Lower (if purchase prices increasing)
Old purchase prices FISH	What is the LIFO conformity rule	and how does this differ from depreciation methods?	

Since it reduces tax payments, if a company uses LIFO in its income tax return, it must use LIFO in financial statements. This differs from

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depreciation rules since a company can use different depreciation methods in financial statements and in tax reports. For example, a company can use straight-line depreciation in financial statement while using accelerated depreciation in tax reports. What is the LIFO reserve? The current cost over LIFO costs of inventories is LIFO reserve. If I was on FIFO, my balance sheet will look different by this much.

LIFO layers: In a year, when purchases exceed sales, the amount added to inventory that year is the LIFO layer. What does it mean to liquidate LIFO layers? What will be the impact on the financial statements? Why? Explain, “holding gains”. Liquidate LIFO layers means to sell more inventory than purchases in a given year. The amount of inventory is hence decreased. It must hence reduce inventory by liquidating LIFO layers: LIFO layers hence leave the balance sheet and become expenses. COGS hence reflect current purchase prices, PLUS a portion of the older (and likely lower) costs recorded in inventory.

COGS is thus lower (assuming rising prices) and tax payments will be higher. LIFO affords management with an opportunity to manage their earnings. To boost net income, a company can reduce inventory, liquidate LIFO layers, which reduces COGS. This hence increases net income. If the price of inventory is increasing, liquidating LIFO layers will decrease the cost of good sold and increase net income. Because the book value of deep LIFO layers is less than current value of inventory. If the price of inventory is increased, use LIFO will increase the COGS and decrease the net income.

Realized holding gain is the difference between the current replacement cost of an item at time of sale and its acquisition cost. It reflects the change in cost during the time that an item was held. Unrealized holding gain is the difference between the replacement cost of current inventory and its acquisition cost. How do we adjust financials of two companies that might be on different methods? Most international companies are not allowed to use LIFO but its widely used in the US (two thirds of companies in the US use LIFO).

Analysts comparing a firm might want to compute COGS and inventories on FIFO basis in order to make an apples-to-apples (more valid) comparison between the firms. SEC requires firms to disclose in notes to the financial statements the amounts by which inventories based on a FIFO or current cost basis exceed the amounts reported on a LIFO basis. E. g. “ If FIFO inventory accounting had been used to value all inventories, they would have been \$XXX higher at the start of the year and \$xxx higher at the end of the year” To convert need to calculate the difference in COGS based on the changes in starting inventories under the FIFO method.

We use the inventory equation:  $COGS = \text{Begin Inventory} + \text{Purchases} - \text{Ending Inventory} + \text{Beginning Inventory (LIFO)}$

$\text{Ending Inventory (FIFO)} = \text{Beginning Inventory (LIFO)} + \text{Reported difference}$

$\text{Ending Inventory (FIFO)} = \text{Ending Inventory (LIFO)} + \text{Reported difference}$

$\text{Purchases (FIFO)} = \text{Purchases (LIFO)} + \text{Reported difference}$

As Purchases and Sales/Revenues are the same in both methods, we calculate the COGS as if we had used FIFO.  $COGS (FIFO) = \text{Begin Inventory (FIFO)} + \text{Purchases (FIFO)} - \text{Ending Inventory (FIFO)}$

$\text{Gross margin on sales (FIFO)} = \text{Sales} - \text{COGS}$

(FIFO) (Note: Cost of Goods Available for Sale = Purchases + Beginning Inventories) What is the impact of LIFO versus FIFO on cash?

Revenues? COGS? The LIFO and FIFO will not affect cash directly. However, it will affect the income taxes and affect cash by income taxes. LIFO and FIFO only affect COGS and will not affect Revenues. If the price increases, the COGS in LIFO will larger than COGS in FIFO and hence gross margin will be higher. What happens if prices are decreasing? If prices are decreasing, the COGS in LIFO will be smaller than COGS in FIFO. And net income is LIFO will larger the in FIFO. The increments of LIFO reserve is negative, The LIFO reserve will decrease. Depreciation Accounting

What are the different methods of accounting? 1. Straight-line (time) method. (95% of companies use this method in financial books) 2. Production or use (straight-line use) method 3. Accelerated depreciation (Nearly everybody uses this method in the tax books) a. Declining-balance method b. Sum-of-the-years' digits method c. Modified Accelerated Cost Recovery System for income tax reporting Why do companies pick one over the other?

What is the relationship of depreciation methods to taxes? The acquisition cost of a long-lived asset is the cost of a series of future services.

As the firm uses the asset in each accounting period, it treats a portion of the cost of the asset as the cost of the service received. Therefore, the companies should choose method of depreciation based on how the asset generated revenue in different periods. For example, if the earning power of the asset is constant in different periods the company should use straight-line method. Because a company can use different depreciation method to

taxes and financial reports, there is no direct relationship to the depreciation method to taxes. 0% of companies use straight-line method. How is depreciation calculated? 1. Measure the depreciable or amortizable basis of the asset (acquisition cost ??? salvage value) 2. Estimate its service life 3. Choose the method of depreciation 4. Calculate Salvage Value. 5. Calculate Depreciation Acquisition cost includes all costs associated with acquiring the asset. E. g. invoiced purchase price (less discounts), transportation costs, installation charges, and any other costs incurred before the asset is ready for use. What is straight line?

The straight-line method divides the acquisition cost of the assets, less an estimated salvage value, by the number of years of its expected service life, to calculate the annual depreciation or amortization. Estimated life does not equal total life of the asset, just the number of years, for which the firm expects to use the asset. What is an accelerated method? What are some examples? In some cases, the earning power of some depreciable assets declines, as they grow older. These cases justify accelerated depreciation methods, which recognize larger depreciation charges in early years and smaller depreciation charges in later years.

Some examples: Declining-Balance Methods, Sum-of-the-Years'-Digits Method, Modified Accelerated Cost Recovery System for Income Tax Reporting (MACRS). What is the units of production method? Firm do not use all assets uniformly over time, they should use the units of production method.  $\text{Depreciation Cost per Unit} = \frac{\text{Cost Less Estimated Salvage Value}}{\text{Estimated Number of Units}}$  How does the company decide on useful life? Is it the same as physical life? Could it be? In making the estimate of <https://assignbuster.com/financial-accounting-summary-assignment/>

useful life, the accountant must consider both physical and functional factors that limit the life of the assets.

The most important factor is obsolescence. The useful life is not the same as physical life, For example, although a plane can use for 30 years, but Singapore Airline decides to sell the plane after 10 years, the useful life is only 10 years. It can however be the same if the firm decides to use the asset for its full physical life. What is residual value? What is salvage value? Could the salvage value be negative? Explain. The residual value is the estimated proceeds on the disposition of an asset. The salvage value and net residual value is proceeds on the disposition of an asset less all removal and selling costs.

The salvage value could be negative when the all removal and selling cost is larger than the proceeds on the disposition. For example, the salvage value of a nuclear plant is possibly negative. Sample Journal Entry Date  
Depreciation Expense \$Amount of period depreciation Accumulated  
Depreciation \$Amount of periodic depreciation To record periodic  
depreciation expense for asset X. Accumulated depreciation is a contra-  
assets account. Depreciation expense flows through to the income statement  
and serves to reduce net income and retained earnings. What happens when  
a company changes its depreciation estimates?

Examples: ? Changes in expected service lives or salvage values ? Additional  
expenses to maintain or improve the asset ? Changes in market value of the  
asset Changes in service life or salvage value Generally only affect future  
depreciation. Depreciation to date is not changed. The general accepted

procedure makes no adjustment for the past misestimate but spreads the remaining book value less the new estimate of salvage value over the new estimate of the remaining service life of the asset. The change will be mentioned in the footnotes. Additional expenses to maintain or improve the asset

Repairs do not extend the life on asset hence do not affect depreciation estimates. Improvements however (which can also be called improvements or betterments) do either extend the life or increase the salvage value of the asset. An example of an entry is as follows: Date Building \$Amount spent to improve asset Asset (name) ??? New Valuation \$Amount spent to improve asset To record expenditures on building Changes in market value If asset value increases in value, the financial statements are not changed. Under US GAPP, assets are valued at the lower of book or market value.

Conservatism. ) If asset is tested for impairment however and is found to have a reduced value, this is reflected in the financial statements. The entries would be as follows: Date Accumulated Depreciation \$Total amount of acc dep to date (for the impaired asset) Asset (name) ??? New Valuation \$New value Loss of impairment \$(Book value ??? Accumulated depreciation) ??? New Value Asset (name) ??? New Valuation \$Acquisition Cost Revalue of asset following impairment. Effect on different statements: Balance Sheet Decreases assets by amount of impairment loss Decreases shareholders equity. Retained earnings? ) Income statement Appears a loss on income statement Cash flow statement Need to increase net income by amount of impairment loss since its not a cash flow What happened when a company changes its depreciation methods? No restatements, but the

overcharged (undercharged) depreciation accumulated in previous periods has to be booked as Gain (Loss) from too much depreciation and goes into the Income statement. NEED TO GATHER MORE INFO AND EXPAND THIS!

Contingent Liabilities What are liabilities? Liabilities are generally classified as follows: )The obligation involves a probable future sacrifice of resources at a specified or attainable date. The firm can measure, with reasonable precision, the cash equivalent value of the resources needed to satisfy the obligation. b)The firm has little or no discretion to avoid the transfer. c)The transaction or event-giving rise to the liability has already occurred. (i. e. something other than an executory contract). Two types of liabilities: ??? Current liabilities are due during the current operating cycle, usually one year. ??? Non-current or future liabilities are due after one year What are contingent liabilities?

Contingent liabilities are potential obligations, i. e. liabilities that arise from the past but we are not yet sure they will be happening. Contingent liabilities are recognized only when they are probable and estimable, as defined below: a)Information available before the issuance of financial statements indicates that it is probable that an event has impaired an asset or caused the firm to incur a liability and b)The firm can reasonable estimate the amount of the loss. If there's a range of values, which may represent the loss, the firm should select the value at the lowest end of the range.

When do you record a contingent liability on the balance sheet? Contingent liabilities are recorded on B/S when: ? Probable (certainty of payment is high) ? Estimable Note that contingent liabilities are booked at FV (no discount), until settlement has been done and they become ' normal' liabilities. When <https://assignbuster.com/financial-accounting-summary-assignment/>



do you record a contingent liability in the financial footnotes? There are 3 levels of probability: 1. Probable, 2. Reasonably possible and 3. Remotely possible. Contingent liabilities are recorded on footnotes when: ? Probable and not estimable Reasonably possible, even if estimable Note that remotely possible contingent liabilities are not recorded at all. What are the most common examples of contingent liabilities? Future obligations relating to: ? Law suits or other legal actions ? Future products recalls Other liabilities on the company's books ??? Current liabilities (recorded at FV): oAccounts payable oShort-term notes payable oPayroll accrual oTaxes payable oCurrent portion of long-term debt ??? Non-current or long-term liabilities (recorded at PV); oMortgage oNotes oBonds oLeases Details on many of these follow: Accounts payable: Amount not paid to creditors/suppliers when buying goods or services (i. e. bought on credit). ??? Accrued expenses: Expenses that have been recorded in I/S but not yet paid (ie electricity bill) ??? Interest payable: Remaining interests due on borrowings. Adjusting entries are made when payments of interest are done (debit Interest Expense / credit Interest payable). ??? Dividends payable: Account used to record amount that will be paid as dividends (once paid, cash is credited and Dividends payable is debited). ??? Tax payable: Amount due to tax collector Deferred tax asset or liability: Account that records the temporary difference between actual tax due to tax collector vs. taxes calculated by firm. Difference can be explained by difference of depreciation methods for instance. ??? Lease obligation: Non-cancelable lease (contract bonding lessee and lessor for the use of an asset) are usually recorded as liabilities. Due amount is recorded under lease obligation. Capital leases versus operating leases What is a capital lease? In a capital lease, the lessee (the user) enjoys the rewards and bears most of

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the risk of ownership, e. g. f the periodic rental payments vary with changes in interest rates. The signing of the lease is treated as a simultaneous acquisition of a long-term asset and a incurring of a long-term liability for the lease payments at present value. (p. 540) Example journal entries at signing of lease

Date Leased Asset ??? Computer \$PV of future lease payment Lease liability \$PV of future lease payment To recognize acquisition of asset and related liability. At the end of the period, the asset is depreciated: Date Depreciation expense ??? on computer \$Amount of depreciation Accumulated depreciation – Computer \$Amount of depreciation

To record periodic depreciation on computer. AND the debt service payment is recorded which pays off interest and also reduces the amount of the liability. Date Interest expense \$Amount of interest paid Lease

liability \$Amount of liability paid off Cash \$Total of the above/Total payment

To record periodic payments on lease of computer. What is an operating lease? In an operating lease, the lessor (the owner) enjoys the rewards and bears most of the risks of ownership, because the amount of each payment is fixed and cannot be adapted to changes of interest rates. The lessor therefore has to record an asset in his books. p. 539). Recording the lease is straightforward: Date Rent expense ??? Computer \$Amount of periodic payment Cash \$Amount of periodic payment To recognize periodic expense of leasing computer. When do we record one versus the other? There is a test of 4 bright line rules to determine if a lease is a capital lease: 1. The Lessee becomes the owner of the asset at the end of the lease 2. The Lessee can buy the asset at a very low price compared to the fair market value at

the end of the lease 3. The Lease life is at least 75% of the total physical (equivalent to useful in this case) life of the asset 4.

If the Net Present Value of the lease is at least 90% of the fair market value of the asset If the lease fulfills any one of the above requirements the lessee must treat it as capital lease. What is the impact on the company's financials of recording a lease? Balance sheet? Income Statement? Cash Flow Statement? LeaseBalance SheetIncome StatementStatement of Cash Flows Operating LeaseNot on balance sheetFixed expense (thus reduces Net Income by a fixed amount) throughout term of leaseNo impact. Net income includes only the cash flows for the expenses. Capital LeaseOn balance sheet.

Bigger expense in early years. Lower expense in later years. Reduces net income more in early years and less in later years. In operating, add back the depreciation. In Financing, subtract the decrease in the lease liability. Q: Why wouldn't the lease liability affect the operating section? How can we compare companies that have a lot of operating leases to those that have a lot of capital leases? We have to make the Assets and the operating cash flow look alike (see table below). In capital leases, Assets are higher (hence a lower ROA) and the operating cash flow is higher (captures only interest payment).

The lease liability reimbursement goes into financing) than in operating. In operating lease we have a constant expense during the life of the lease. In capital lease the expense is decreasing: it is equal to the depreciation (constant) + the interest (constantly decreasing = lease liability of  $n-1$  \*

Interest rate). EventStatementCapital LeaseOperating Lease Signing a  
 leaseBalance SheetAsset = + NPV of lease Liabilities = + NPV of  
 leaseNothing Income StatementNothingNothing Cash FlowNothingNothing  
 Making a yearly paymentBalance SheetAsset = - (NPV of lease / number of  
 years of lease) Expenses:

Depreciation = see assets Interest expense =  $I\% * \text{Lease liability of } n-1$  Cash  
 = amount paid according to contract Lease liability decrease = (Cash ???  
 interest paid) Nothing (the expense is taken into account in the Retained  
 Earnings) Income StatementInterest expense =  $I\% * \text{lease liability of } n-1$   
 Depreciation =  $\text{NPV of lease} / \text{number of years of lease}$  Lease Rent = Expense  
 Cash Flow StatementIn operating, add back the depreciation In Financing,  
 subtract the decrease in the lease liabilityNothing (Captured in the Net  
 Income) Why does a company lease instead of buy?

Better ratios, no need to take on extra debt if it cannot auto-finance the  
 acquisition, more flexible (potentially), etc. Might not have available cash (or  
 be able to raise the cash required) to purchase the item outright. Do not  
 want to take the risk of ownership. I. e. if products become out of date.

Income tax considerations: some users of depreciable assets such as  
 computers and airplanes do not have sufficient taxable income to take  
 advantage of accelerated depreciation deductions. Many lessors have  
 sufficient income to take advantage of income tax reductions and hence  
 these ompanies have become lessor for that purpose (e. g. GE Capital).

Leases are often structured as operating leases for income tax purposes, so  
 that the lessor claims depreciation deductions and saves taxes. Rule based  
 versus principles based accounting treatments? Rule based principles (as in  
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US GAAP) check only if the rule is applied. Hence if the rule says 75% of useful life and the lease duration is 74, 95% the rule does not apply. In principles based accounting (IAS), we check for principles... Are they enjoying full usage of the asset?

Is the lease in fact an acquisition with financing or a rent? READ FINAL CHAPTER OF PROFITS YOU CAN TRUST. Stockholders' Equity What is c/s and APIC? What is par value? ? Common stock ??? shares in the company that have been authorized to be sold to investors. In the event of bankruptcy, common stockholders have a claim on the assets of the company after creditors and preferred stock holders have received amounts due to them. ? Additional Paid in Capital ??? The excess of the price received for a share from an investor over the Par Value of the share. Par Value ??? The par value represents the amount of the shareholders claim on the assets of the company (after creditors and preferred stockholders have been paid). The par value of a share (for common stock) is generally lower than the issue price of the share. What is Retained Earnings? What is Accumulated Deficit? Retained Earnings ??? The cumulative net income generated by the firm minus any dividends that have been declared (and one can assume have been paid out). This is cumulative and hence would be expected to grow over time (assuming that the firm does not pay 100% of its net income as a dividend to share holders).

The addition to retained earnings for any period will be the net income for that period minus any dividend declared during that period. Not: Sure 100% of this. Have found the following definitions: Accumulated deficit ??? Can be viewed as the opposite of retained earnings. This account captures the  
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accumulative loss for the company. If in any given period, the net income of the company is negative, this account is credited by the amount of the loss. Retained earnings is thus not increased or decreased if net income is negative.

Accumulated deficit (surplus) at year-end The difference between the net expenditures of any year and the amounts received to finance these expenditures is carried forward to the following year to either increase or reduce the net revenue requirement. What is Treasury Stock? How does the purchase and resale of treasury stock get recorded? On the B/S? On the Income Statement? On the Statement of Cash flows? Treasury Stock ???

shares of the firm bought back from the market. Journalizing and recording process: Upon purchase of treasury stock Date Treasury Shares – Common \$ Total amount paid for shares Cash \$ Total amount paid for shares

To record \$X paid to acquire x common shares at \$X per share. Treasury shares – Common is a contra account to shareholders equity. Treasury shares are thus a subtraction from shareholders equity on the balance sheet.

Effect on different statements: Balance Sheet Decreases assets (cash).

Decreases shareholders equity (treasury shares ??? common / preferred which is contra account to SHE). Income statement No effect. Cash flow

statement Need to reduce net income by the cash paid for treasury shares in the financing section. If treasury shares are sold at a later date the journalizing process is as follows: Date

Cash \$ Total Amount received for selling shares Treasury Shares ???

Common \$ Total (Market) Value of shares when they were bought (not current

market value or amount received) Additional Paid in Capital\$ Plug Difference  
in Amounts debited to cash To reissue x shares of treasury stock for \$x per  
share. If shares are sold for a loss, Additional Paid in Capital is debited. Effect  
on different statements (assume sold for a gain) Balance SheetIncreases  
assets (cash) Increases shareholders equity (by reducing treasury shares ???  
common / preferred which is contra account to SHE) Income statementNo  
effect.

Cash flow statementNeed to increase net income by the cash received for  
treasury shares in the financing section. Why do companies repurchase their  
shares? Firms might purchase their stock for the following reasons: ? Use if  
share option agreements with key staff and management ? Serve as a  
worthwhile investment of cash (i. e. management considers shares und