

Financial Accounting Recitation: Midterm

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Road Map

12:00 pm - 13:25 pm

- ▶ A high-level review of the key aspects covered in the course so far (15 min)
- ▶ Sample midterm Question 1 (35 min)
- ▶ Sample midterm Question 2 (25 min)
- ▶ Sample midterm Questions 3 & 4 and other general questions (10 min)

13:30 pm - 14:15 pm

- ▶ Office hour for individual questions

Overview

Overview

Balance Sheet

Income Statement

Basic Procedures

Cash Flow Statement

Revenue Recognition

Disclaimer: This review is not intended to be comprehensive but instead to be a high-level summary of the key parts covered in the course so far

Overview

- ▶ Accounting standard: US GAAP by FASB and IFRS by IASB
- ▶ Financial statements: Balance sheet, income statement (reconciles retained earnings across years in B/S), cash flow statement (explains the change in cash in B/S)
- ▶ Accounting equation: $\text{Assets} = \text{Liabilities} + \text{Equity} (+ \text{Revenue} - \text{Expense})$
- ▶ Basic principles: revenue recognition, matching principle, historical cost, conservatism
- ▶ Fundamental characteristics of decision-useful information: relevance, faithful representation, comparability, verifiability, timeliness, understandability

Balance Sheet

- ▶ Accounting equation: $\text{Assets} = \text{Liabilities} + \text{Equity}$ (use of funds = sources)
- ▶ Balance sheet items: Assets (current, non-current), liabilities (current, non-current), owners' equity (paid-in capital, retained earnings)
- ▶ Intertemporal relationship: $\text{EB} = \text{BB} + \text{inflow} - \text{outflow}$
 - ▶ $\text{Ending A/R} = \text{Beginning A/R} + \text{Credit Sales} - \text{Collections}$
 - ▶ $\text{Ending A/P} = \text{Beginning A/P} + \text{Credit Purchases} - \text{Cash Payments}$
 - ▶ $\text{Ending Inventory} = \text{Beginning Inventory} + \text{Purchases of Inventory} - \text{COGS}$
 - ▶ $\text{Ending W/P} = \text{Beginning W/P} + \text{Wage Expense} - \text{Cash Payments}$
 - ▶ $\text{Ending T/P} = \text{Beginning T/P} + \text{Tax Expense} - \text{Cash Payment}$
 - ▶ $\text{Ending Dep} = \text{Beginning Dep} + \text{Dep Expense} - \text{Realized Dep in Sale of PP\&E}$
 - ▶ And more...
- ▶ Two sides of the same coin: wage payable vs wage prepaid, rent payable vs rent prepaid, unearned revenue vs advances from customers, ...

Income Statement

- ▶ Reconcile R/E in B/S: ending R/E = beginning R/E + N/I - dividends
- ▶ The standard hierarchy: sales revenue - cost of sales -> gross profit - operating expense -> operating profit +/- other income -> net income before income taxes - tax provisions -> net income
- ▶ Two approaches to aggregate expenses: by nature/by function
- ▶ Statement of changes in owners' equity: summarizes the changes to equity (including net income) to reconcile the beginning and ending equity balances
- ▶ Accrual-basis income: revenue recognition, matching principle

Journal Entries

- ▶ Double-entry accounting: the recording of any economic event must affect at least two accounts
- ▶ Identify the accounts \rightarrow identify the effects \rightarrow balance the accounting equation
- ▶ Adjusting entries: accrued expenses (L), prepaid expenses (A), accrued revenue (A), deferred revenue (L)
- ▶ Debits (+A/-L/-OE) and credits (-A/+L/+OE): recall the accounting equation...
- ▶ T-accounts: DEBITS on the left, CREDITS on the right

An Example: the Life-Cycle of a Product

When the company purchases

Caution: An expense is not incurred (only a conversion from cash asset to inventory)

- ▶ Recognize the value of the inventory the same as what's paid (historical cost)

Bonus question: What about inventories produced in-house?

When the company sells

Caution: Always differentiate between revenue and cost

- ▶ Revenue side: Recognize the revenue as the cash (expected to be) received
- ▶ Cost side: Recognize the cost of goods sold as the historical cost of inventory

Bonus question: what would happen going forward?

Cash Flow Statement

- ▶ Structure/components: operating, investing, financing
- ▶ Approaches: direct, **indirect**
- ▶ How to operationalize (takes practice...)
 - ▶ Operating: (+) dep. and amor. -> (-) non-cash or non-operating income items -> (-) change in operating assets -> (+) change in operating liabilities
 - ▶ Investing: adjust for changes in long-term assets (e.g., PP&E, intangibles), purchases/sales of other firms' securities/debts, etc.
 - ▶ Financing: Issuance of common stock, payment of dividends, issuance of bonds, stock repurchases, etc.
- ▶ Under GAAP:
 - ▶ Loans: principles (financing/investing), interests paid and received (operating)
 - ▶ Dividends: received (operating), paid (financing)

Revenue Recognition

Accrual-basis accounting: Recognize the revenue when the transaction is earned AND realized/realizable instead of when the cash flow is incurred

- ▶ Step 1: Identify the contract
- ▶ Step 2: Identify the distinct performance obligations
- ▶ Step 3: Determine the contract price
- ▶ Step 4: Allocate the contract price
- ▶ Step 5: Recognize revenue

The topic of receivables will not be in the midterm...