ACC531: Auditing and Assurance Services
Background-Part I

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This slide deck...

- includes background knowledge for auditing and assurance services.
- is not comprehensive.
- is also tested on the exam 1.

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- Accounting is the **language of business**.

Accounting for Business Decisions

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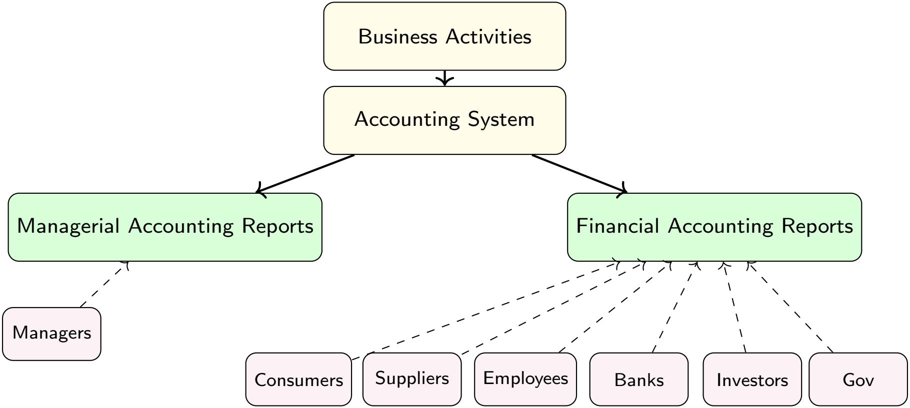

Accounting for Business Decisions

- **Managers:** Use accounting information to help run the business.
- **Consumers:** Decide whether to buy the business's products or services.
- **Suppliers:** Check if the business can pay for goods and services.
- **Employees:** Look at the business's finances for job security and pay.
- **Banks:** Decide whether to lend money to the business.
- **Investors:** Decide whether to buy or sell shares in the business.
- **Governments:** Use information to set taxes and check rules are followed.

Usefulness of Accounting

Accounting is used to help stakeholders make decisions.

1. Accounting for Business Decisions

2. Basic Accounting Equation: A= L + SHE
   - Transactions
   - Assets
   - Liabilities
   - Shareholders' Equity

3. Accrual Accounting
   - R, E, and NI
   - Expansion of Accounting Equation
   - Adjustments

Basic Accounting Equation

- Assets (A) = Liabilities (L) + Stockholders' Equity (SHE)
  (Resources) = (Sources of Resources)

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Liabilities (L) **Obligations** of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

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Assets (A) **Resources** owned or controlled by a company that are expected to provide future economic benefits.

Liabilities (L) **Obligations** of a company arising from past transactions, the settlement of which is expected to result in an outflow of resources.

SHE **Residual interest** in the assets of a company after deducting liabilities; represents the owners' claims on the business; **Defined by A - L.**

Transactions

Transactions

Financial activities that involve the exchange of goods, services, or money.

- All transactions affect the basic accounting equation: **A= L + SHE**.
- Two types:
  - **Operating** activities: Affect NI (mainly covered in Ch3).
  - **Financing** and **Investing** activities: Do not affect NI (covered in Ch2).
- **Acitivites but not transactions**:
  - Promising to hire employees
  - Exchange of stocks between shareholders

Assets

Assets (A)

Resources owned by a company that are expected to provide future economic benefits.

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Resources owned by a company that are expected to provide future economic benefits.

Examples:

- Cash: \$10,000
- Equipment: \$20,000
- Inventory: \$10,000

EX 1. What assets do you have after the following transactions?

- You opened a lemonade stand after investing \$50,000 in cash.
- You bought \$20,000 of equipment - paid in cash.
- Your employees worked for your business and you owe them \$10,000.
- Your revenues are \$30,000 and all collected in cash.

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Cash:	$60,000 (50,000 - 20,000 - 0 + 30,000)
Equipment:	$20,000
Total Assets:	$80,000

EX 2. What assets do you have after the following transactions?

- You opened a lemonade stand after investing $50,000 in cash.
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Total Assets:	\$100,000

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Examples:

- Accounts Payable: \$10,000 (owed to suppliers)
- Salaries Payable: \$10,000 (owed to employees)
- Notes Payable: \$20,000 (owed to banks)

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Shareholders' Equity

Stockholders' Equity (SHE)

The residual interest in the assets of a company after deducting liabilities; represents the owners' claims on the business.

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Stockholders' Equity (SHE)

The residual interest in the assets of a company after deducting liabilities; represents the owners' claims on the business.

- SHE consists of 2 components:
  - Contributed Capital (a.k.a. Paid-in Capital or Common Stock)
  - Retained Earnings (a.k.a. Earned Capital)

Retained Earnings

Retained Earnings (Earned Capital, Equity)

The cumulative amount of net income retained in the business after dividends are paid.

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The cumulative amount of net income retained in the business after dividends are paid.

Retained Earnings Equation

End. RE = Beg. RE + Net Income - Dividends

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Accrual Accounting

1. Your company has sold a product to a customer on cash in December. The product was delivered and cash collected in December.

- Revenues: ________
- Cash inflows: ________

2. Your company has sold a product to a customer on cash in December. The product was delivered in December but cash collected in January.

- Revenues: ________
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Revenue Recognition Principle

Revenue is recognized when products & services are delivered, regardless of when cash is received.

How much revenue should Noodlecake recognize in September?

1. In September, Noodlecake sold $3,000 of apps online. Cash collected in September.
2. Noodlecake issued three $100 gift cards at the beginning of September. These gift cards have not been used at the end of September.
3. Noodlecake sold $9,000 of apps in the App Store and on Google Play in September. Cash will be collected in October.

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- Cash flow timing isn't important for revenue recognition.

Expenses

Matching Principle

- Expenses should be recognized **in the same period as the revenues** they help to generate, regardless of when cash is paid. In other words,
- Expenses should be recognized when the resources are **used up** to generate the revenues.

EX. When to recognize expenses?

1. Noodlecake bought $1,000 of supplies in September.
2. Noodlecake used up the supplies in October.

Answer: ________

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Answer: October.

Expenses - Examples

How much expenses should Noodlecake recognize in September?

1. Noodlecake wrote checks to employees totaling $7,800 for wages related to hours worked in September.
2. Noodlecake displayed online ads in Sep and received a bill for $500 to be paid in October.
3. Noodlecake was notified by its bank that an automatic monthly payment of $600 was transmitted to its utility company for electricity use in September.

- Expenses: ____________________

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- Cash flow timing isn't important for expense recognition.
- Expenses should be recognized in the period when the goods or services are **used up**.

Net Income (NI)

Revenues - Expenses.

- Net Income is a measure of a company's profitability.
- Net Income is **NOT** an account.
- Net Income is **NOT** the same as cash flows from operating activities.

Expansion of Accounting Equation

$$A_t = L_t + SHE_t$$

A	Assets
L	Liabilities
SHE	Stockholders' Equity
CC	Contributed Capital
RE	Retained Earnings
R	Revenues
E	Expenses
NI	Net Income
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Expansion of Accounting Equation

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Adjustments

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- Adjustment journal entries (AJEs) are needed at the end of each reporting period to ensure that all of the accounts (A,L, SHE, R, and E) have the correct balance.
- Adjustments are required because of mismatch between the timing of the recognition of revenues or expenses and the timing of the payment of cash.
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To figure out how much to adjust, we need to compare:

- **where we were** before the adjustment.
- **where we are supposed to be** after the adjustment.

EX. Adjustment to Prepaid Rent:

- Paid \$7,200 for September, October, and November's rent in advance.
- Recorded as **Prepaid Expense (Asset!)** initially.

How much do we need to adjust at the end of the september?

- Where we were before the adjustment: .
- Where we are supposed to be after the adjustment: .
  $\rightarrow$ We need to adjust .

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- Where we are supposed to be after the adjustment: **$4,800**.

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- Where we were before the adjustment: **\$7,200**.
- Where we are supposed to be after the adjustment: **\$4,800**.
  → We need to adjust **\$2,400**.

- ABC corp. purchased supplies for $2,000 in January and used the half of them in February.

January:

February (Adjustment Journal Entry):

Due to the adjustment in February,

- ABC corp. purchased supplies for $2,000 in January and used the half of them in February.

January:

Supplies (+A)	2,000	
Cash (-A)		2,000

February (Adjustment Journal Entry):

Due to the adjustment in February,

- ABC corp. purchased supplies for $2,000 in January and used the half of them in February.

January:

Supplies (+A)	2,000	
Cash (-A)		2,000

February (Adjustment Journal Entry):

Supplies Expense (+E)	1,000	
Supplies (-A)		1,000

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- ABC corp. purchased supplies for \$2,000 in January and used the half of them in February.

January:

Supplies (+A)	2,000	
Cash (-A)		2,000

February (Adjustment Journal Entry):

Supplies Expense (+E)	1,000	
Supplies (-A)		1,000

Due to the adjustment in February,

- The balance of Supplies becomes **\$1,000**.
- \$1,000 of Supplies are recognized as Supplies Expense.

Adjustments to Prepaid Expenses

- ABC corp. purchased a 12-months insurance plan ($12,000) at the beginning of January.

January 1:

January 31 (Adjustment Journal Entry):

Due to the adjustment in January,

Adjustments to Prepaid Expenses

- ABC corp. purchased a 12-months insurance plan ($12,000) at the beginning of January.

January 1:

Prepaid Insurance (+A)	12,000	
Cash (-A)		12,000

January 31 (Adjustment Journal Entry):

Due to the adjustment in January,

Adjustments to Prepaid Expenses

- ABC corp. purchased a 12-months insurance plan ($12,000) at the beginning of January.

January 1:

Prepaid Insurance (+A)	12,000	
Cash (-A)		12,000

January 31 (Adjustment Journal Entry):

Insurance Expense (+E)	1,000	
Prepaid Insurance (-A)		1,000

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- ABC corp. purchased a 12-months insurance plan ($12,000) at the beginning of January.

January 1:

Prepaid Insurance (+A)	12,000	
Cash (-A)		12,000

January 31 (Adjustment Journal Entry):

Insurance Expense (+E)	1,000	
Prepaid Insurance (-A)		1,000

Due to the adjustment in January,

- The balance of Prepaid Insurance becomes **$11,000**.
- $1,000 of Prepaid Insurance are recognized as Insurance Expense.