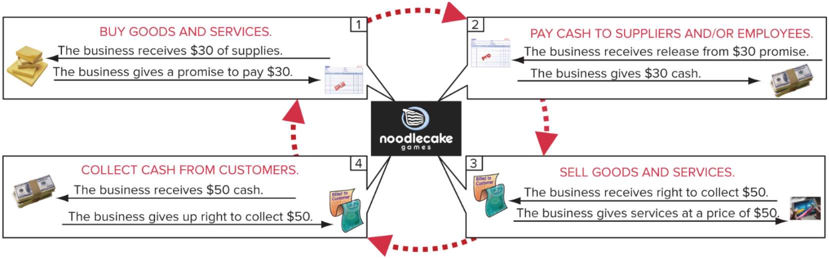
ACC531: Auditing and Assurance Services
Background-Part II

Jaeyoon Yu, Ph.D.
Central Michigan University

Operating Cycle

The period from the purchase of goods & services to cash collection from customers.

1. Purchase of goods & services from suppliers
2. Payment to suppliers
3. Sale of goods & services to customers
4. Collection of cash from customers



Accounts Receivable (Assets)

Accounts Receivable (A/R, Asset)

Amounts customers owe you for products and services sold on credit.

Date 1 - Sold on credit

Date 2 - Collected cash

Accounts Payable (Liabilities)

Accounts Payable (Liability)

Amounts owed to suppliers for products and services purchased on credit.

Date 1 - Purchased on credit

Date 2 - Paid cash

Deferred Revenues (Unearned Revenues, Liabilities)

Deferred (Unearned) Revenues (Liability)

Cash received before the service is performed or the product is delivered.

Date 1 - Received cash

Date 2 - Delivered products & services

Prepaid Expenses (Assets)

Prepaid Expenses (Asset)

Amounts paid in advance for products and services that will be received in the future.

Date 1 - Paid cash for 12 month insurance policy

Date 2 - At the end of month 1: Recognize 1 month of expense (as used up)

1. Important Accounts
   - Accounts Receivable (Assets)
   - Accounts Payable (Liabilities)
   - Deferred Revenues (Unearned Revenues, Liabilities)
   - Prepaid Expenses (Assets)
2. Financial Statements
   - Income Statement
   - Statement of Retained Earnings
   - Balance Sheet
   - Statement of Cash Flows
   - Relationship between Financial Statements
3. Accounts Receivable, Bad Debt Expense, Allowance for Doubtful Accounts
4. Property, Plant, and Equipment
5. Miscellaneous
   - Inventory
   - FOB shipping terms
   - Relationship between Assets and Expenses
   - Net Sales

Financial Statements

1. Public companies are required to report financial statements to the Securities and Exchange Commission (SEC).
2. Each company has its own **fiscal-year end** and **fiscal-year period**.
3. For example, Crocs' fiscal-year end is **December 31st**.
4. The company reports financial statements for the fiscal year ended **December 31st**.
5. In addition to the annual reports, quarterly reports are also required.
    - **Q1**: Jan 1st to Mar 31st
    - **Q2**: Apr 1st to Jun 30th
    - **Q3**: Jul 1st to Sep 30th
    - **Q4**: Oct 1st to Dec 31st (i.e., **annual**)

1. Income Statement

Income Statement

A financial statement that reports a company's revenues, expenses, and net income over a period of time.

Lemonade Stand, Inc.
Income Statement
For the Year Ended December 31, 2025

Revenues	\$500
Salaries Expense	\$200
Supplies Expense	\$100
Net Income	**\$200**

2. Statement of Retained Earnings

Statement of Retained Earnings

A financial statement that shows changes in retained earnings over a period, including net income and dividends.

Lemonade Stand, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2025

Beg. Retained Earnings	$0
+) **Net Income**	**$200**
-) Dividends	($100)
End. Retained Earnings	**$100**

3. Balance Sheet

Balance Sheet

A financial statement that shows a company's assets, liabilities, and equity at a specific point in time.

Lemonade Stand, Inc.
Balance Sheet
As of December 31, 2025

Assets	
Cash	$300
Equipment	$300
Total Assets	**$600**
Liabilities	
Accounts Payable	$100
Salaries Payable	$0
Shareholders' Equity	
Contributed Capital	$400
Retained Earnings	**$100**
Total Liabilities & Equity	**$600**

4. Statement of Cash Flows

Statement of Cash Flows

A financial statement that summarizes the cash inflows and outflows from operating, investing, and financing activities over a period.

Lemonade Stand, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2025

Operating Cash	$300
Investing Cash	($300)
Financing Cash	$300
Net Cash Change	$300
Beg. Cash	**$0**
End. Cash	$300

- The ending balance of cash should be the same as the ending balance of cash in the balance sheet.

Relationship between Financial Statements

Income Statement Equation

Net Income = Revenues - Expenses

Retained Earnings Equation

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

Balance Sheet Equation

Assets = Liabilities + Shareholders' Equity

Relationship between Financial Statements

Cash Balance from Cash Flows Statement

Lemonade Stand, Inc.
Income Statement
For the Year Ended December 31, 2025

Revenues	$500
Salaries Expense	$200
Supplies Expense	$100
Net Income	**$200**

Lemonade Stand, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2025

Beg. Retained Earnings	$0
+) **Net Income**	**$200**
-) Dividends	($100)
End. Retained Earnings	**$100**

Lemonade Stand, Inc.
Balance Sheet
As of December 31, 2025

Assets	
Cash	$300
Equipment	$300
Total Assets	$600
Liabilities	
Accounts Payable	$100
Salaries Payable	$0
Shareholders' Equity	
Contributed Capital	$400
Retained Earnings	**$100**
Total Liabilities & Equity	$600

Accounts Receivable

- In practice, companies keep multiple A/R accounts for different customers. See below an example with A/Rs for three customers (A, B, and C).

A/R for A

5,000	3,000
2,000	
EB. 4,000	

A/R for B

5,000	
2,000	
EB. 7,000	

A/R for C

11,000	2,000
EB. 9,000	

- Merged into A/R general ledger account.
  - **Total A/R**: \$4,000 + \$7,000 + \$9,000 = \$20,000
- **Collection risk exists.**

Gross and Net A/R

- **Gross A/R**: The total amount owed to a company by its customers for goods/services sold on credit.
- **Net A/R**: The amount of A/R a company expects to actually collect **after adjusting uncollectible A/R**.

EX. Gross Accounts Receivable: $20,000 but we expect that $1,000 is uncollectible.

Gross A/R	$20,000
Less: Allowance for Doubtful Accounts (xA)	$1,000
Net A/R	$19,000

Bad Debt Expense

Bad Debt Expense (BDE, Expense)

Operating expense resulting from credit sales that become uncollectible.

- Usually included in SG&A Expense.[a]
- Doesn't affect gross profit.
- Affects **operating income** and **net income**.

[a] SG&A stands for Selling, General, and Administrative Expenses, including a variety of operating expenses such as salaries and wages, utilities, and rent.

Simplified Income Statement

Revenue	$5,000
CGS	3,000
Gross Profit	$2,000
SG&A Expense	800
Operating Income	1,200
Interest Expense	150
Marketing Expense	50
Pretax Income	1,000
Income Tax (20%)	200
Net Income	$800

Bad Debt Expense

Balance Sheet Equation

Assets = Liabilities + Shareholders' Equity

Higher Bad Debt Expense

1. Higher SG&A Expense
2. Lower Operating Income
3. Lower Net Income
4. Lower Retained Earnings
5. Lower Shareholder's Equity

Higher Bad Debt Expense

1. Lower Net A/R

Note: Financial Statement Example: Crocs, Inc.

Figure: Balance Sheet

CROCS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and par value amounts)

	December 31,	
	2024	**2023**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 180,485	$ 149,288
Restricted cash — current	—	2
Accounts receivable, net of allowances of $31,579 and $27,591, respectively	257,657	305,747

Figure: Disclosures in Note

Accounts Receivable, Net

Accounts receivable are recorded at invoiced amounts, net of reserves and allowances. We reduce the carrying value for estimated uncollectible accounts based on a variety of factors including the length of time receivables are past due, economic trends and conditions affecting our customer base, and historical collection experience. Specific provisions are recorded for individual receivables when we become aware of a customer's inability to meet its financial obligations. We write off accounts receivable to the reserves when they are deemed uncollectible or, in certain jurisdictions, when legally able to do so. See Schedule II in Item 15. *Exhibits, Financial Statement Schedule* of this Annual Report on Form 10-K for more information.

Relationship between ADA and BDE

Allowance for Doubtful Accounts (ADA, Contra Asset, xA)

The estimated amount of uncollectible A/R.

Bad Debt Expense (BDE, Expense)

Operating expense resulting from credit sales that become uncollectible.

To get the ending balance of ADA:

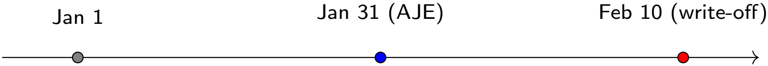
- Start with the beginning balance of ADA.
- Add the BDE for the period. (ADA increases)
- Subtract the Write-off for the period. (ADA decreases)

Allowance for Doubtful Accounts Equation

$$\mathrm{ADA}_{t+1} = \mathrm{ADA}_t + \mathrm{BDE}_{t+1} - \text{Write-off}_{t+1}$$

Illustration

EX. On Jan 1, a company made $10,000 in credit sales. It estimates 5% of sales will be uncollectible. The cost of goods sold (CGS) for these sales is $6,000. On Feb 10, $300 of A/R deemed uncollectible.



- Step 1: Record Credit Sales and CGS
- Step 2: Estimate Bad Debt Expense
- Step 3: Write-off of bad debts

Table: Partial Income Statement for January

Sales Revenue	\$10,000
Cost of Goods Sold	\$6,000
Bad Debt Expense	\$500
Net Income:	\$3,500

Table: Net A/R as of Jan 31

Gross A/R	\$10,000
Less: ADA	\$500
Net A/R	**\$9,500**

Table: Net A/R as of Feb 10

Gross A/R	\$9,700
Less: ADA	\$200
Net A/R	**\$9,500**

Note: It is possible that A/R deemed uncollectible earlier can be collected later! Accounting for this recovery of uncollectible A/R goes beyond this course.

PPE: Disclosures

PPE and Accumulated Depreciation

Balance Sheet
As of Dec 31, 2025

Assets	
....	...
....	...
PPE (at cost)	$100,000
Less: Acc.Dep.Exp	($40,000)
PPE, net	**$60,000**
....	...
Total Assets	$200,000

Depreciation Expense

Income Statement
For the Year Ended Dec 31, 2025

Revenues	$220,000
Cost of Goods Sold	($120,000)
Gross Profit	$100,000
Dep.Exp	($20,000)
Net Income	**$80,000**

PPE: Acquisition

Cost Principle

Assets are initially recorded at their **acquisition cost**, which includes all costs necessary to acquire the asset and prepare it for its intended use.

Acquisition cost is the total cost incurred to acquire an asset and prepare it for its intended use. It includes:

- Purchase price
- Sales tax
- Delivery and installation costs
- Legal fees
- Discounts (deduction)

EX. ABC paid $100,000 for a machine. Additional costs (all paid by cash) include Sales tax: $10,000; Delivery: $5,000; and Installation: $3,000. How much to recognize as the acquisition cost of the machine?

PPE: Acquisition

Note that expenditures such as sales tax and delivery costs are **capitalized** as part of the asset's acquisition cost.

Capitalization

The process of recording an expenditure as an asset rather than an expense.

- Capitalized costs are added to the asset's acquisition cost.
- So it's part of the asset's value on the balance sheet.
- Not expensed immediately on the income statement.
- Instead, the costs are depreciated over the asset's useful life.

EX. On Jan 1, 2026, A company purchases machinery for $50,000 by cash.

Questions:

1. Journal entries on Jan 1, 2026:

EX. On Jan 1, 2026, A company purchases machinery for \$50,000 by cash. Additional costs (all paid by cash) include Sales tax: \$5,000; Delivery: \$3,000; and Installation: \$2,000.

Questions:

1. Total acquisition cost:

2. Journal entries on Jan 1, 2026:

PPE: Depreciation

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.

- Long-term assets contribute the revenue generation over multiple periods.
- So it is not expensed in the period of acquisition.
- Instead, the cost is allocated over the asset's useful life.
- The allocation process is called "depreciation".

PPE: Depreciation

Depreciation

The process of allocating the cost of a long-term, tangible asset over its useful life.

- Depreciation expense is recorded on the income statement.
- Accumulated depreciation is recorded on the balance sheet as a contra asset account.

PPE: Depreciation

Depreciation Expense (DepExp, Expense)

The amount of the tangible asset's cost that is allocated to the current accounting period.

Accumulated Depreciation (AccDep, Contra Asset, xA)

The total amount of depreciation expense that has been recorded against the asset since it was acquired.

1. Important Accounts
   - Accounts Receivable (Assets)
   - Accounts Payable (Liabilities)
   - Deferred Revenues (Unearned Revenues, Liabilities)
   - Prepaid Expenses (Assets)
2. Financial Statements
   - Income Statement
   - Statement of Retained Earnings
   - Balance Sheet
   - Statement of Cash Flows
   - Relationship between Financial Statements
3. Accounts Receivable, Bad Debt Expense, Allowance for Doubtful Accounts
4. Property, Plant, and Equipment
5. Miscellaneous
   - Inventory
   - FOB shipping terms
   - Relationship between Assets and Expenses
   - Net Sales

Inventory

Inventory (Asset)

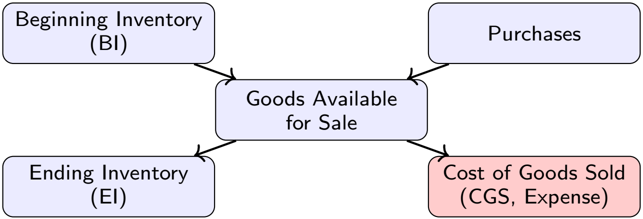
The total value of the goods held for sale in the ordinary course of business.

Inventory Equation

End. Inventory = Beg. Inventory + Purchases - Cost of Goods Sold

Inventory is

- increased when purchased;
- decreased when sold.



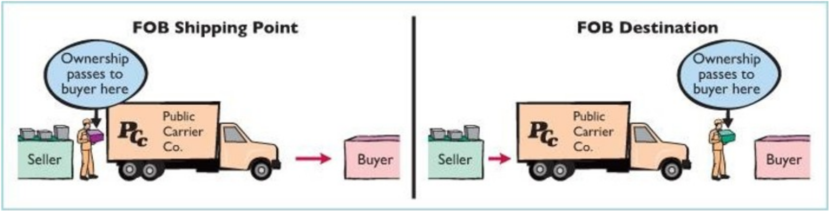
FOB shipping terms

FOB shipping point

- Ownership transfers to the buyer when goods leave the **seller's location**.
- The **buyer** is responsible for shipping costs.

FOB destination

- Ownership transfers to the buyer when goods arrive at the **buyer's location**.
- The **seller** is responsible for shipping costs.



Relationship between Assets and Expenses

Assets vs Expenses:

- Assets are resources that a company owns or controls.
- Expenses are resources that a company has used up to generate revenues.

Assets are turned into expenses when they are used up to generate revenues.

- **Inventory** is turned into **Cost of Goods Sold** when it is sold.
- **Supplies** are turned into **Supplies Expense** when they are used.
- **Equipment** is turned into **Depreciation Expense** when it is used.
- **Prepaid Rent** is turned into **Rent Expense** when it is used.

Net Sales

- Some customers (e.g., 3%) return the products they purchased.
- Firms record the estimated returns as **Sales Returns and Allowances**.[1]
- Firm's **Net Sales** is the total sales revenue minus the sales returns and allowances.
- Income Statement usually starts with **Net Sales**, but it depends on the firm's policy.

ABC, Inc.
Net Sales Calculation
For the Years Ended Dec 31
(amounts in millions)

Account	**2027**	**2026**
Sales Revenue	12,300	11,200
Less: Sales Returns & Allowances	300	200
Net Sales	**12,000**	**11,000**
Cost of Goods Sold	7,800	7,200
Gross Profit	4,200	3,800
...	...	...
...	...	...
Net Income	1,470	1,295

[1] **Sales Returns and Allowances** is a contra account that is used to record the estimated returns of sales. This goes beyond the scope of this course. We do not cover Sales Returns and Allowances in detail and the related journal entries.