Final Exam Administration

- Cheat sheet: “Two sides of a single sheet of size A4 paper”.
  - Size A4 is what your handouts are printed on.
- You may put down anything you wish, including latest Red Sox scores.
- No other reference material is allowed, including cheat sheets of neighboring students.
- Calculators are allowed, laptops are not.
- Students writing Final Exam must have name tags in front of them.

Exam Structure

- Exam structure will be somewhat similar to Practice Final 1
- Approximately 30% of Total Final Exam points on Managerial Accounting
- Rest on Financial Accounting
- What to expect
  - Anything discussed in class, unless explicitly excluded.
  - Exam is primarily computational.
  - But expect questions on concepts and issues.
Exam Structure

- What not to expect
  - Any question on a case not discussed in class.
  - Detailed numerical questions on Destin Brass or Seligram.
  - Questions directly asking to set up T-accounts. (Knowing T-accounts will make it easy to answer many of the questions asked.)
  - Multiple choice questions as in Practice Final 2 – but they are still useful in clearing up concepts.

Practice Exams

- Best practice exams for Financial Accounting Section
  - Midterm 1
  - Midterm 2

- Best practice exams for Managerial Section
  - Practice Final 1
  - Destin Brass & Highlighted Issues in Seligram

- Additional practice
  - Practice Final 2

Issues Common to Financial and Managerial Accounting

- Both involve allocations
  - Financial: allocations of revenues and expenses across periods
  - Managerial: primarily allocations of costs across cost objects (e.g., products, departments)

- Allocations are always both:
  - Systematic and rational
  - Arbitrary and subjective

- There is no substitute for human judgment.
Financial Accounting Overview

Financial Accounting = translates events into financial statements

- Events
  - Rules & Management choice
    - Generally Accepted Accounting Principals (GAAP)
    - Management selects from alternative rules and from allowable estimates under GAAP
  - Financial Statements

Approach in Financial Accounting

- First, we identified the key Balance Sheet Equation
- Next, we understood the accrual process to determine income on Income Statement.
- Subsequently, we spent time understanding key accounts that appear under different Balance Sheet headers and how they interact with the Income Statement.
- We also examined the Cash Flow Statement – the information it contains and how it relates to the Income Statement and Balance Sheet items
Balance Sheet Equation

- **Assets = Liabilities + Owners equity**
- Assets = probable future economic benefits owned by the firm
- Liabilities = probable future economic sacrifices
- Owners’ Equity = Assets – Liabilities
  - owners’ claim = “own” – “owe”
  - (Owners’ Equity is sometimes also called shareholders’ equity, net book value, or the “residual claim”)

Changes in Shareholders’ Equity

<table>
<thead>
<tr>
<th>Beginning of year:</th>
<th>S. E.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Paid in Capital + new paid in capital</td>
<td>Ending Paid in Capital</td>
</tr>
<tr>
<td>Beginning Retained Earnings + Net Income - Dividends</td>
<td>Ending Retained Earnings</td>
</tr>
</tbody>
</table>

Approach in Financial Accounting

- First, we identified the key Balance Sheet Equation
- Next, we understood the accrual process.
- Subsequently, we spent time understanding key accounts that appear under different Balance Sheet headers and how they interact with the Income Statement.
- We also examined the Cash Flow Statement – the information it contains and how it relates to the Income Statement and Balance Sheet items
Basic Principles of Accrual Accounting

- Determine what net income has been earned during a period, not just what cash has been generated during the period from operations
  - Why? To capture the economic events that have occurred during the period
- Determine revenues applying the revenue-recognition principles
- Report as expenses those costs that have been or will be incurred to generate those revenues

Revenue Recognition

- Revenue recognition principles: Service has been provided by the company, customer has been billed and there is reasonable certainty of cash collection
- Issues in revenue recognition
  - Credit sales
  - Warranties and returns
  - Bill & hold sales, SAB 101

Accruals and Cash flows: Four Cases

1) Cash precedes expense

<table>
<thead>
<tr>
<th>Pay Cash</th>
<th>Recognize Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>(b)</td>
</tr>
</tbody>
</table>

Time: Balance Sheet Date

Examples: Rent paid in advance, Prepaid Insurance, PP&E, Inventory

Associated entries:

\[
\begin{align*}
\text{Cash} & \quad (A) & \quad \text{Prepaid Rent} & \quad (SE) \\
(a) & \quad -$ & \quad +$ & \quad \text{Ret. Earn.} \\
(b) & \quad -$ & \quad -$ & \quad \text{(rent expense)}
\end{align*}
\]
Accruals and Cash flows: Four Cases

2) Cash follows expense

<table>
<thead>
<tr>
<th>Recognize Expense</th>
<th>Pay Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time</td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b)</td>
</tr>
<tr>
<td>Balance Sheet Date</td>
<td></td>
</tr>
</tbody>
</table>

Examples: Taxes paid after yearend, Salaries paid on the 15th of the month, bad debt expense, warranty expenses

Associated entries:

\[
\begin{align*}
(A) & = (L) \quad (SE) \\
(Cash) & +$ \quad Salaries Payable* \quad Ret. Earn. \\
(a) & -$ \quad -$ \\
(b) & +$ \quad -$ \\
* & \text{sometimes also called “accrued salaries”}
\end{align*}
\]

Accruals and Cash flows: Four Cases

3) Cash precedes revenue

<table>
<thead>
<tr>
<th>Receive Cash</th>
<th>Recognize Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time</td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b)</td>
</tr>
<tr>
<td>Balance Sheet Date</td>
<td></td>
</tr>
</tbody>
</table>

Examples: Airplane tickets sold in advance, Newspaper subscriptions sold in advance

Associated entries:

\[
\begin{align*}
(L) & \quad (SE) \\
Cash & +$ \quad Unearned Revenue* \quad Ret. Earn. \\
(a) & +$ \quad -$ \\
(b) & -$ \quad +$ \\
* & \text{sometimes also called “deferred revenue”}
\end{align*}
\]

Accruals and Cash flows: Four Cases

4) Cash follows revenue

<table>
<thead>
<tr>
<th>Recognize Revenue</th>
<th>Receive Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time</td>
<td></td>
</tr>
<tr>
<td>(a)</td>
<td>(b)</td>
</tr>
<tr>
<td>Balance Sheet Date</td>
<td></td>
</tr>
</tbody>
</table>

Examples: Accounts Receivable, Goods shipped but cash not yet received, Services provided but cash not yet received

Associated entries:

\[
\begin{align*}
(A) & = (A) \quad (SE) \\
(Cash) & +$ \quad Accounts Receivable \quad Ret. Earn. \\
(a) & -$ \quad -$ \\
(b) & +$ \quad +$(revenue)
\end{align*}
\]
Approach in Financial Accounting

- First, we identified the key Balance Sheet Equation
- Next, we understood the accrual process.
- Subsequently, we spent time understanding key accounts that appear under different Balance Sheet headers and how they interact with the Income Statement.
- We also examined the Cash Flow Statement – the information it contains and how it relates to the Income Statement and Balance Sheet items.

Balance Sheet - Assets

- Current assets
  - Cash
  - Marketable Securities
  - Accounts Receivable, less: Allowance For Doubtful Accounts
  - Inventories
  - Prepaid Rent
- Long term assets
  - Fixed assets, less: Accumulated Depreciation
  - Long-term Investments
  - Goodwill

Balance Sheet – Liabilities and Stockholders Equity

- Current Liabilities
  - Accounts Payable
  - Salaries Payable
  - Deferred Tax Liabilities
- Long term liabilities
  - Bonds Outstanding
  - Lease Obligations
- Stockholders equity
  - Capital Stock
  - Retained Earnings
  - Other Equity
Prior Review Slides

- Please look at review slides for Midterms 1 & 2 for key issues under each major header

Approach in Financial Accounting

- First, we identified the key Balance Sheet Equation
- Next, we understood the accrual process.
- Subsequently, we spent time understanding key accounts that appear under different Balance Sheet headers and how they interact with the Income Statement.
- We also examined the Cash Flow Statement – the information it contains and how it relates to the Income Statement and Balance Sheet items

Cash Flow Statements

- Change in net cash = Operating cash flows + Investing cash flows + Financing cash flows
- Given two, you should be able to work out the third
- Two methods: Indirect and Direct
- For the exam: Only Indirect
The Indirect Method

- Operating
  - Start with Net Income
  - Make adjustments to arrive at CFO (cash flow from operations or operating cash flows)

- Investing
  - Purchase of PPE and/or other long-term assets (outflows)
  - Proceeds from sale of PPE and/or other long-term assets (inflows)

- Financing
  - Dividends paid (outflows)
  - Issuance of securities (inflows)
  - Retirement of securities (outflows)

Operating Cash Flows (CFO)

- Net Income includes non-cash revenues and non-cash expenses
- These non-cash revenues/expenses usually are captured in changes in operating current assets and operating current liabilities (recall the two-sidedness of all entries)
- Step 1: Identify operating non-cash current assets and operating current liabilities
- Step 2: Identify non-cash revenues or expenses that do not affect operating current assets or operating current liabilities (example: Depreciation Expense)
- Step 3:
  - Start with net income
  - Add (subtract) to/from any non-cash expense/revenue that does not affect operating current assets or operating current liabilities
  - Subtract (add) any increase (decrease) in non-cash operating current assets
  - Add (subtract) any increase (decrease) in operating current liabilities
  - Arrive at CFO

** Sometimes transactions that have cash consequences are similarly adjusted out of the operating section because they are not considered a result of operating activities.

Managerial Accounting

- The focus of the Managerial Accounting Section has been on
  Cost Accounting for decision-making

- Allocation of costs is an important factor that affects product profitability and pricing decisions

- Two major allocation systems have been covered in class:
  Traditional Costing System and Activity-Based Costing (ABC) Systems

- The major issue in traditional costing systems is their continuous evolution as business realities change.

- The major issue in ABC is the identification of objective cost drivers.
Pitfalls To Watch Out For In Costing Systems

- With traditional costing
  - Death spirals – a direct result of using an allocation system that is “incorrect” either because it is outdated or excessively simple.

- With ABC
  - The sensitivity of cost allocations to choice of cost drivers.
  - The lack of acceptance by internal managers, especially if ABC shows them in a poor light
  - The tendency to accept easier solutions than the ones demanded as a result of ABC analysis.