

Provided by APF

Academy of Professional Finance 专业金融学院



CFA Level I

**Financial Reporting and Analysis
(FRA)**

R23: Financial Reporting Mechanics

CFA Lecturer: Juyun Lu





Reading 23. Financial Reporting Mechanics

Exam Focus

- Candidates should focus on the financial statement elements (assets, liabilities, equity, revenues, and expenses) and be able to classify any account into its appropriate element.
- Candidates should also learn the basic and expanded accounting equations and why every transaction must be recorded in at least two accounts.
- The types of accruals, when each of them is used, how changes in accounts affect the financial statements, and the relationships among the financial statements, are all important topics.



Reading 23. Financial Reporting Mechanics

LOS 23 .a: Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.

- Financial statement elements - the major classifications of **assets, liabilities, owners' equity, revenues, and expenses**.
- Accounts - the specific records within each element where various transactions are entered.
- Contra accounts - are used for entries that offset some part of the value of another account.
Eg. accumulated depreciation, allowance for bad debt expense





Reading 23. Financial Reporting Mechanics

Figure 2: Balance Sheet for 20X7 and 20X8

	20X8	20X7
Assets		
Current assets		
Cash	\$33,000	\$9,000
Accounts receivable	10,000	9,000
Inventory	5,000	7,000
Noncurrent assets		
Land	\$35,000	\$40,000
Gross plant and equipment	85,000	60,000
less: Accumulated depreciation	(16,000)	(9,000)
Net plant and equipment		\$51,000
Good will		10,000
Total assets	\$162,000	\$126,000
Liabilities and Equity		
Current liabilities		
Accounts payable	5,000	\$5,000
Wages payable	3,000	8,000
Interest payable	5,500	3,000
Taxes payable	5,000	4,000
Dividends payable	6,000	1,000
Noncurrent liabilities		
Bonds	\$15,000	\$10,000
Deferred taxes	20,000	15,000
Stockholders' equity		
Common stock	\$40,000	\$50,000
Retained earnings	59,000	30,000
Total liabilities & stockholders' equity	\$162,000	\$126,000

Economic Resources

creditor claims

residual claim





Reading 23. Financial Reporting Mechanics

Figure 1: Income Statement for 20X8

Sales	→	inflows of economic resources	100,000
Expenses	→	outflows of economic resources	
Cost of goods sold			40,000
Wages			5,000
Depreciation			7,000
Interest			500
Total expenses			\$52,500
Income from continuing operations			47,500
Gain from sale of land			10,000
Pretax income			\$57,500
Provision for taxes			20,000
Net income			\$37,500





Reading 23. Financial Reporting Mechanics

LOS 23 .a: Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.

Which of the following is *least likely* to be classified as a financial statement element?

- A. Asset.
- B. Revenue.
- C. Net income.

C is correct. Net income is not an element of the financial statements, but the net result of revenues less expenses. The elements are: assets, liabilities, owners' equity, revenue and expenses.





Reading 23. Financial Reporting Mechanics

LOS 23 .a: Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.

Under IFRS, which of the following financial statement elements *most* accurately represents inflows of economic resources to a company?

- A. Assets.
- B. Equity.
- C. Revenues.

C is correct. The financial statement elements under International Financial Reporting Standards (IFRS) are: Assets, Liabilities, Owners' Equity, Revenue, and Expenses. Revenues are inflows of economic resources.

A is incorrect. Assets are the firm's economic resources.

B is incorrect. Equity is the owners' residual claim of a firm's resources, which is the amount by which assets exceed liabilities.





Reading 23. Financial Reporting Mechanics

LOS 23 .a: Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.

Accounts receivable and accounts payable are most likely classified as which financial statement elements?

- | | |
|---------------------|------------------|
| Accounts receivable | Accounts payable |
| A. Assets | Liabilities |
| B. Revenues | Liabilities |
| C. Revenues | Expenses |

A is correct. Accounts receivable are an asset and accounts payable are a liability.





Reading 23. Financial Reporting Mechanics

LOS 23 .a: Explain the relationship of financial statement elements and accounts, and classify accounts into the financial statement elements.

Annual depreciation and accumulated depreciation are *most likely* classified as which financial statement elements?

- | | |
|----------------|--------------------------|
| Depreciation | Accumulated depreciation |
| A. Expenses | Contra liabilities |
| B. Expenses | Contra assets |
| C. Liabilities | Contra assets |

B is correct. Annual depreciation is an expense. Accumulated depreciation is a contra asset account that typically offsets the historical cost of property, plant, and equipment.





Reading 23. Financial Reporting Mechanics

LOS 23 .b: Explain the accounting equation in its basic and expanded forms.

assets = liabilities + owners' equity

assets = liabilities + contributed capital + ending retained earnings

assets = liabilities + contributed capital
+
beginning retained earnings + revenue - expenses - dividends





Reading 23. Financial Reporting Mechanics

LOS 23 .b: Explain the accounting equation in its basic and expanded forms.

The accounting equation is *least accurately* stated as:

- A. owners' equity = liabilities - assets.
- B . ending retained earnings = assets - contributed capital - liabilities.
- C. assets = liabilities + contributed capital + beginning retained earnings + revenue - expenses - dividends.

A is correct. Owners' equity is equal to assets minus liabilities.

$$\text{assets} = \text{liabilities} + \text{owners' equity}$$





Reading 23. Financial Reporting Mechanics

LOS 23 .b: Explain the accounting equation in its basic and expanded forms.

A decrease in assets would least likely be consistent with a(n):

- A. increase in expenses.
- B. decrease in revenues.
- C. increase in contributed capital.

$$\begin{aligned} A &= L + E \\ &= L + CC + \text{ending RE} \\ &= L + CC + \text{beg RE} + \text{Rev} - \text{Exp} - \text{Div} \end{aligned}$$

C is correct. A decrease in assets is consistent with an increase in expenses or a decrease in revenues but not with an increase in contributed capital.





Reading 23. Financial Reporting Mechanics

LOS 23 .b: Explain the accounting equation in its basic and expanded forms.

An analyst gathers the following information from a company's accounting records (all figures in thousands):

Assets, 31 December 2008	\$5,250
Liabilities, 31 December 2008	2,200
Contributed capital, 31 December 2008	1,400
Retained earnings, 1 January 2008	800
Dividends declared during 2008	200

The analyst's estimate of net income (\$ thousands) for 2008 is *closest* to:

- A. 650.
- B. 850.
- C. 1,050.

$$\begin{aligned} A &= L + E \\ &= L + CC + \text{ending RE} \\ &= L + CC + \text{beg RE} + \text{Rev} - \text{Exp} - \text{Div} \end{aligned}$$

$$\begin{aligned} \$5,250 &= \$2,200 + \$1,400 + \$800 + \text{NI} - \$200 \\ \rightarrow \text{NI} &= \$1,050. \text{ C is correct.} \end{aligned}$$





Reading 23. Financial Reporting Mechanics

LOS 23 .c: Explain the process of recording business transactions using an accounting system based on the accounting equation.

Double-entry accounting - a transaction has to be recorded in at least two accounts.

<p>Normal Balance — Debit</p> <p>Asset Accounts</p> <table border="1"><tr><td>Debit + (Increase)</td><td>Credit - (decrease)</td></tr></table>	Debit + (Increase)	Credit - (decrease)	<p>Normal Balance — Credit</p> <p>Liability Accounts</p> <table border="1"><tr><td>Debit - (decrease)</td><td>Credit + (Increase)</td></tr></table>	Debit - (decrease)	Credit + (Increase)
Debit + (Increase)	Credit - (decrease)				
Debit - (decrease)	Credit + (Increase)				
<p>Expense Accounts</p> <table border="1"><tr><td>Debit + (Increase)</td><td>Credit - (decrease)</td></tr></table>	Debit + (Increase)	Credit - (decrease)	<p>Stockholders' Equity Accounts</p> <table border="1"><tr><td>Debit - (decrease)</td><td>Credit + (Increase)</td></tr></table>	Debit - (decrease)	Credit + (Increase)
Debit + (Increase)	Credit - (decrease)				
Debit - (decrease)	Credit + (Increase)				
	<p>Revenue Accounts</p> <table border="1"><tr><td>Debit - (decrease)</td><td>Credit + (Increase)</td></tr></table>	Debit - (decrease)	Credit + (Increase)		
Debit - (decrease)	Credit + (Increase)				





Reading 23. Financial Reporting Mechanics

LOS 23 .c: Explain the process of recording business transactions using an accounting system based on the accounting equation.

1. Owners invest \$40,000 in exchange for common stock.



2. Disburse \$600 cash for secretarial wages.



3. Purchase office equipment priced at \$5,200, giving a 10 percent promissory note in exchange.



4. Receive \$4,000 cash for services rendered.





Reading 23. Financial Reporting Mechanics

LOS 23 .c: Explain the process of recording business transactions using an accounting system based on the accounting equation.



➤ Purchase equipment for \$10,000 cash.

PP&E \$10,000
Cash \$10,000

➤ Borrow \$10,000 to purchase equipment.

PP&E \$10,000
Notes payable \$10,000

➤ Buy office supplies for \$100 cash.

Supply expense \$100
Cash \$100

➤ Buy inventory for \$8,000 cash and sell it for \$10,000 cash.

Inventory	\$8,000	Cash	\$10,000	Cost of good sold	\$8,000
Cash	\$8,000	Revenue	\$10,000	Inventory	\$8,000





Reading 23. Financial Reporting Mechanics

LOS 23 .c: Explain the process of recording business transactions using an accounting system based on the accounting equation.

What is the *most likely* effect on the accounting equation when a company purchases office equipment with cash?

- A. Assets increase, and liabilities increase.
- B. There is no effect on the accounting equation.
- C. Assets decrease, and owners' equity decreases.

Purchase equipment for \$10,000 cash.

PP&E	\$10,000
Cash	\$10,000

B is correct. There would be no effect on the accounting equation because the company has exchanged one asset for another. Cash has decreased, and office equipment, a capital asset, has increased.





Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

The principle of accrual accounting requires that revenue is recorded when the firm **earns it** and expenses are recorded as the firm **incurs them**, regardless of whether cash has actually been paid.



Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

- Unearned revenue - The firm receives cash before it provides a good or service to customers. (**liability**)

Eg. a newspaper or magazine subscription

Cash	\$1,000	Unearned revenue	\$1,000
Unearned revenue	\$1,000	Revenue	\$1,000

- Accrued revenue - The firm provides goods or services before it receives cash payment.

Eg. a manufacturer that sells goods to retail stores "on account."

AR	\$1,000	Cash	\$1,000
Revenue	\$1,000	AR	\$1,000





Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

- Prepaid expenses - The firm pays cash ahead of time for an anticipated expense. (**asset**)

Eg. a retail store that rents space in a shopping mall

Prepaid expense	\$1,000	Rent expense	\$1,000
Cash	\$1,000	Prepaid expense	\$1,000

- Accrued expenses - The firm owes cash for expenses it has incurred.

Eg. wages

Wages expense	\$1,000	Wages payable	\$1,000
Wages payable	\$1,000	Cash	\$1,000





Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

➤ Other Adjustments

Historical vs Current costs

→ valuation adjustments

→ gains or losses recorded on the income statement or in "other comprehensive income ."





Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

An electrician repaired the light fixtures in a retail shop on October 24 and sent the bill to the shop on November 3. If both the electrician and the shop prepare financial statements under the accrual method on October 31, how will they each record this transaction?

- | Electrician | Retail shop |
|---------------------|-----------------|
| A. Accrued revenue | Accrued expense |
| B. Accrued revenue | Prepaid expense |
| C. Unearned revenue | Accrued expense |

A is correct. The service is performed before cash is paid. This transaction represents accrued revenue to the electrician and an accrued expense to the retail shop. Since the invoice has not been sent as of the statement date, it is not shown in accounts receivable or accounts payable.





Reading 23. Financial Reporting Mechanics

LOS 23 .d: Explain the need for accruals and other adjustments in preparing financial statements.

Under U.S.GAAP, differences between accrued revenue and expenses and cash flows result in the creation of assets and liabilities. Would each of the following revenue events result in the creation of an asset or a liability when the event originally occurs?

	Revenue is recognized before the cash is received	Cash is received before the revenue is recognized
A	Asset	Asset
B	Asset	Liability
C	Liability	Liability

B is correct. Revenue recognized before the cash is received will result in the creation of an accounts receivables, an asset, whereas when the cash is received before the revenue is recognized a liability, unearned revenue, is created.

Eg. a manufacturer that sells goods to retail stores "on account."

AR	\$1,000	Cash	\$1,000
Revenue	\$1,000	AR	\$1,000

Eg. a newspaper or magazine subscription

Cash	\$1,000	Unearned revenue	\$1,000
Unearned revenue	\$1,000	Revenue	\$1,000





Reading 23. Financial Reporting Mechanics

LOS 23 .e: Explain the relationships among the income statement, balance sheet, statement of cash flows, and statement of owners' equity.

[Figures 1 through 4: the financial statements for a sample corporation.](#)





Reading 23. Financial Reporting Mechanics

LOS 23 .f: Describe the flow of information in an accounting system.

Information flows through an accounting system in four steps:

1. **Journal entries** record **every transaction**, showing which accounts are changed and by what amounts. A **listing of all the journal entries** in order of their **dates** is called the **general journal**.

2. The **general ledger** sorts the entries in the general journal **by account**.

3. At the end of the accounting period, an **initial trial balance** is prepared that shows **the balances in each account**. If any adjusting entries are needed, they will be recorded and reflected in an **adjusted trial balance**.

4. The account balances from the adjusted trial balance are presented in the financial statements.





Reading 23. Financial Reporting Mechanics

LOS 23 .f: Describe the flow of information in an accounting system.

The segment of an accounting system that reports business transaction by account is the:

- A. Trial balance.
- B. General ledger.
- C. Financial statements.

B is correct. The general ledger contains all the journal entries that are posted to the general journal and other specialized journals, except that the general ledger sorts the data by account where the general journal and the specialized journal records the transactions by date. The general ledger is considered the core of an accounting system.

A is incorrect. A trial balance is prepared at the end of an accounting period prior to the financial statements. A trial balance reports only ending balances (and not transactions) for each account. Adjusting entries are then made, if required, and then an adjusted trial balance can be prepared, for as many cycles as are necessary.

C is incorrect. Financial statements are prepared from an adjusted trial balance and provide a picture of the firm's financial status. However, the financial statements do not report business transactions by account; they are much to summarized for that.





Reading 23. Financial Reporting Mechanics

LOS 23 .f: Describe the flow of information in an accounting system.

Which of the following statements *best* describes a trial balance? A trial balance is a document or computer file that:

- A. shows all business transactions by account.
- B. lists account balances at a particular point in time.
- C. contains business transactions recorded in the order in which they occur.

B is correct. A trial balance is a document that lists account balances at a particular point in time. At the end of the accounting period, an initial trial balance is prepared that shows the balances in each account. If any adjusting entries are needed, they will be recorded and reflected in an adjusted trial balance.

A is incorrect. General ledger show all business transactions by account.

C is incorrect. A listing of all the journal entries in order of their dates is called the general journal.





Reading 23. Financial Reporting Mechanics

LOS 23 .f: Describe the Row of information in an accounting system.

An auditor needs to review all of a company's transactions that took place between August 15 and August 17 of the current year. To find this information, she would most likely consult the company's:

- A. general ledger.
- B. general journal.
- C. financial statements.

B is correct. The general journal lists all of the company's transactions by date. The general ledger lists them by account.





Reading 23. Financial Reporting Mechanics

LOS 23 .g: Explain the use of the results of the accounting process in security analysis.

Since financial reporting requires choices of method, judgment, and estimates, an analyst must understand the accounting process used to produce the financial statements in order to understand the business and the results for the period. Analysts should be alert to the use of accruals, changes in valuations, and other notable changes that may indicate management judgment is incorrect or, worse, that the financial statements have been deliberately manipulated.





Reading 23. Financial Reporting Mechanics

Summary of Equations

$$\text{assets} = \text{liabilities} + \text{owners' equity}$$



$$\text{assets} = \text{liabilities} + \text{contributed capital} + \text{ending retained earnings}$$



$$\begin{aligned} \text{assets} &= \text{liabilities} + \text{contributed capital} \\ &+ \\ &\text{beginning retained earnings} + \text{revenue} - \text{expenses} - \text{dividends} \end{aligned}$$





Thank You!

