Financial Accounting:

Tools for Business Decision Making, 4th Ed.

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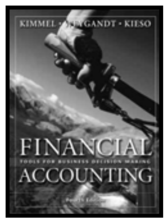
CHAPTER 4



Chapter 4
Accrual Accounting Concepts

KEY THINGS WE'LL DO:

- Refresh and expand Ch.3 concepts.
- Differentiate between the cash basis and the accrual basis of accounting.
- Learn and use adjusting AND closing entries.
- .

1

Periodicity Assumption...

Divides the economic life of a business into artificial time periods

WHY?

to provide immediate feedback on how the business is doing.

Time Period Assumption...

Generally a month, a quarter, or a year.

An accounting time period that is one year long is called a <u>fiscal year.</u>

An accounting time period that starts on January 1 and ends December 31 is called a <u>calendar year.</u>

Revenue Recognition Principle…

- Dictates that revenue be recognized in the accounting period in which it is earned.
- Is considered earned
  - when the service has been provided or
  - when the goods are delivered.

NOT THAT FUNNY

Matching Principle… (Now they call it the "Expense recognition principle)

Requires that expenses be recorded in the same period in which the revenues they helped produce are recorded.

Review

Which principle dictates that efforts (expenses) be recorded with accomplishments (revenues)?

a. Cost Principle.

b. Expense Recognition Principle

c. Periodicity Principle

d. Revenue Recognition Principle

Review

Which principle dictates that efforts (expenses) be recorded with accomplishments (revenues)?

a. Cost Principle.

b. Matching Principle

c. Periodicity Principle

d. Revenue Recognition Principle

Review

When would revenue be recorded for the following scenario . . .

Ad agency is hired for a project in May, does the work in June and is paid in July?

June

Review

When would expenses be recorded for this companion scenario ?

The Ad agency on this project incurs $1,500 of expenses in May, $3,000 in June, and none in July?

The answer is June! Matching says the expenses should follow the revenue.

Review

When would revenue be recorded for the following scenario . . .

Sell plane ticket on September 1 for a flight on October 15?

The answer is October – when the service is provided!

Review

When would expenses be recorded for the following scenario . . .

The airline pays pilot salaries on October 7th for the week ended September 30th?

The answer is September – the pilots provided labor services for September flights during that month.

CONTRA-ASSET ACCOUNTS

CURRENT:
Cash
Accounts receivable ← **Allowance for doubtful accounts**
Accrued revenue
Inventory
Prepaid expenses
LONG TERM:
Fixed assets ← **Accumulated depreciation**

ASSET MINUS THE ASSOCIATED CONTRA-ASSET

=

"NET BOOK VALUE"

STOP

Ignoring the 1st word
Of an asset defintion
It is ?

TERMINOLOGY

- RECOGNIZED: Recorded to the ledger.. i.e incorporated into the financial statements
- REALIZED: Physical receipt/ giving. Not necessarily "recognized" at the same time as "realized"
- HISTORICAL COST: What we paid for something. It is GAAP in almost every instance.
- NET BOOK VALUE: What our initial historical cost was net of any depreciation or other adjustments since the date acquired.
- MEASUREMENT: Where do the amounts come from? Remember that assets and liabilities are "probable". Consequently we have to introduce "Estimation" to properly record an asset or liability at its properly measured amount. This is know as "Valuation" of assets and liabilities.

2

Revenue recorded only when cash is received.
Expense recorded only when cash is paid.

CASH VS. ACCRUAL ACCOUNTING

WHAT is the difference between cash basis and accrual basis accounting over time?

NO DIFFERENCE– THE QUESTION IS WHEN!

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Cash Basis versus Accrual Basis Example

Seminis, Inc. had the following transactions:

- **In September 2000, Seminis purchased seed inventory for $18,000 on credit. Seminis paid the suppliers invoice in** *September* **2000.**
- **In October 2000, Seminis sold the seed for $35,000 on credit.**
- **In November 2000, the customer paid the $35,000 due Seminis.**

Compute the net income for September, October, and November under cash basis accounting and accrual basis accounting.

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Cash Basis versus Accrual Basis Example

Seminis Inc.

Cash Basis Accounting

	Sept.	Oct.	Nov.	Total
Revenues			$ 35,000	$ 35,000
Expenses	(18,000)			(18,000)
Net income (loss)	$ (18,000)		$ 35,000	$ 17,000

Accrual Basis Accounting

	Sept.	Oct.	Nov.	Total
Revenues		$ 35,000		$ 35,000
Expenses		(18,000)		(18,000)
Net income (loss)		$ 17,000		$ 17,000

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Accrual Basis Accounting

Adheres to the:

- **Revenue Recognition Principle**
  Revenue recorded only when earned, not when cash is received
- **Matching Principle**
  Expense recorded only when incurred, not when cash paid

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Accrual Basis adheres to…

- **Generally**
- **Accepted**
- **Accounting**
- **Principles**

ADJUSTING ENTRIES

ADJUSTING ENTRIES:

When you create a balance sheet account, you are responsible for “truing it up”

If you do this:

Prepaid rent	$700	
Cash		$700

What “event” will take place to make that asset you just created go away?

YOU ARE THE EVENT, YOU HAVE TO “ADJUST” BEFORE YOU “CLOSE” THE BOOKS!

Adjusting Entries (Accrual Accounting)

In order for *revenues* to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred, *adjusting entries* are made at the end of the accounting period.

In short, adjustments are needed to ensure that the revenue recognition and matching principles are followed.

Prepayments	Accruals
1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets before they are used or consumed.	3. **Accrued Revenues.** Revenues earned but not yet received in cash.
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities before they are earned.	4. **Accrued Expenses.** Expenses incurred but not yet paid in cash.

Adjusting Entries (Prepaid Expenses)

Prepaids are payments of cash that are recorded as assets before they are used or consumed.

When a cost is incurred, an asset account is debited to show the service or benefit that will be received in the future.

Prepayments often occur in regard to:

- **insurance**
- **supplies**
- **advertising**
- **rent**
- **maintenance on equipment**
- **fixed assets**

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	June 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**6,000**
Liabi	
Equity:	

Income Statement

	June 2003
Revenues:	
Net income (loss)	

Journal Entry:	Debit	Credit
Prepaid Expense	6,000	
Cash		6,000

On June 1, 2003, Diamond Co. paid $6,000 for 12 months of insurance coverage. How is this transaction reflected in Diamonds' financial statements on June 1, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	June 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**6,000**
Liabilities:	
Equity:	

Income Statement

	June 2003
Revenues:	
Expenses:	
Net income (loss)	

How is this transaction reflected in Diamonds' financial statements for the month ending June 30, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	June 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**5,500**
Liabilities:	
Equity:	

Income Statement

	June 2003
Revenues:	
Expenses:	
Insurance expense	**500**
Net (income) loss	**500**

How is this transaction reflected in Diamonds' financial statements for the month ending June 30, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	June 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**5,500**
Liabi	
Equit	
Ret	

Income Statement

	June 2003
Revenues:	

Journal Entry:	Debit	Credit
Insurance expense	500	
Prepaid insurance		500
Closing Entry:		
Retained earnings	500	
Insurance expense		500

How is this transaction reflected in Diamonds' financial statements for the month ending June 30, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	July 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**5,500**
Liabilities:	
Equity:	
Retained earnings	**500**

Income Statement

	July 2003
Revenues:	
Expenses:	
Net (income) loss	

How is this transaction reflected in Diamonds' financial statements for the month ending July 31, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	July 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**5,000**
Liabilities:	
Equity:	
Retained earnings	**500**

Income Statement

	July 2003
Revenues:	
Expenses:	
Insurance expense	**500**
Net (income) loss	**500**

How is this transaction reflected in Diamonds' financial statements for the month ending July 31, 2003?

Adjusting Entries (Prepaid Expenses)

Balance Sheet

	July 2003
Assets:	
Cash	**$(6,000)**
Prepaid insurance	**5,000**
Liabilities:	
Equity:	
Retained earnings	**1,000**

Income Statement

	July 2003
Revenues:	
Expenses:	
Net (income) loss	

How is this transaction reflected in Diamonds' financial statements for the month ending July 31, 2003?

Adjusting Entries (Unearned Revenues)

Unearned revenues are the receipt of cash that is recorded as a liability because the revenue has not been earned.

When cash is received, a liability account is credited to show the obligation to provide goods or service in the future.

Unearned revenues often occur in regard to:

- **rent**
- **magazine subscriptions**
- **customer deposits**
- **airline tickets**
- **school tuition**

Adjusting Entries (Unearned Revenues)

Balance Sheet	October
Assets:	
Cash	12,000
Liabilities:	
Unearned revenue	(12,000)
Equity:	

Income Statement	October
Revenues:	
Expenses:	
Net (income) loss	

Pioneer Advertising Agency received $12,000 on October 2 from R. Knox for advertising services expected to be completed by December 31. Analysis reveals that $4,000 of those fees have been earned in October. How is this transaction reflected on Pioneers' financial statements for the month of October?

Adjusting Entries (Unearned Revenues)

Balance Sheet	October
Assets:	
Cash	12,000
Liabilities:	
Unearned revenue	(8,000)
Equity:	

Income Statement	October
Revenues:	
Advertising revenue	(4,000)
Expenses:	
Net (income) loss	(4,000)

Pioneer Advertising Agency received $12,000 on October 2 from R. Knox for advertising services expected to be completed by December 31. Analysis reveals that $4,000 of those fees have been earned in October. How is this transaction reflected on Pioneers' financial statements for the month of October?

Adjusting Entries (Unearned Revenues)

Balance Sheet	October
Assets:	
Cash	12,000
Liabilities:	
Unearned revenue	(8,000)
Equity:	
Retained earnings	(4,000)

Income Statement	October
Revenues:	
Expenses:	
Net (income) loss	

Pioneer Advertising Agency received $12,000 on October 2 from R. Knox for advertising services expected to be completed by December 31. Analysis reveals that $4,000 of those fees have been earned in October. How is this transaction reflected on Pioneers' financial statements for the month of October?

Adjusting Entries (Accrued Revenues)

Accrued revenues represent revenues earned for which the cash has not been received.

An adjusting entry is required to show the receivable that exists at the balance sheet date and to record the revenue that has been earned during the period.

Accrued revenues often occur in regard to:

- **rent**
- **interest**
- **services performed**

Adjusting Entries (Accrued Revenues)

Balance Sheet	October	Income Statement	October
Assets:		Revenues:	
Unbilled receivable	2,000	**Advertising revenue**	(2,000)
Liabilities:		Expenses:	
Equity:		Net (income) loss	(2,000)

In October Pioneer Advertising Agency earned $2,000 in fees for advertising services that were not billed to clients before October 31. How is this transaction reflected on Pioneers' financial statements for the month of October?

Adjusting Entries (Accrued Revenues)

Balance Sheet	October	Income Statement	October
Assets:		Revenues:	
Unbilled receivable	2,000		
Liabilities:		Expenses:	
Equity:			
Retained earnings	(2,000)	Net (income) loss	

In October Pioneer Advertising Agency earned $2,000 in fees for advertising services that were not billed to clients before October 31. How is this transaction reflected on Pioneers' financial statements for the month of October?

Adjusting Entries (Accrued Expenses)

Accrued expenses represent expenses incurred for which the cash has not been paid.

An adjusting entry is required to record the obligations that exist at the balance sheet date and to recognize the expenses that apply to the current period.

Accrued expenses often occur in regard to:

- **rent**
- **interest**
- **taxes**
- **salaries**
- **bad debts**

Adjusting Entries (Accrued Expenses)

Balance Sheet	October	Income Statement	October
Assets:		Revenues:	
Liabilities:		Expenses:	
Salaries payable	(7,500)	**Salaries expense**	7,500
Equity:			
Retained earnings	7,500	Net (income) loss	7,500

At Pioneer Advertising, salaries were last paid on October 26; the next payment of salaries will not occur until November 9. After October 26, only three working days remain in October. Employees receive salaries of $2,500 per day. How are the unpaid salaries reflected on Pioneers' financial statements for the month of October?

More Advanced Concepts

- The income statement "closes" out to what?
  - RETAINED EARNINGS
- Ignoring dividends, what difference is there between retained earnings and an income statement which is for the period from inception to the date of the balance sheet?

  NONE

More Bonus Materials

- The balance sheet approach. BECAUSE A=L+E, problems in one argument become apparent in another. You can run, but you can not hide!
- If a company had overstated revenue, how might management or the auditors detect this?
  - ACCOUNTS RECEIVABLE—
- Understated COS?
  - INVENTORY

You can start with the trial balance to find information to adjust prepayments.

Sierra Corporation
Trial Balance
October 31, 2007

	Debit	Credit
Cash	**$15,200**	
Advertising Supplies	**2,500**	
Prepaid Insurance	**600**	
Office Equipment	**5,000**	
Notes Payable		**$ 5,000**
Accounts Payable		**2,500**
Unearned Service Revenue		**1,200**
Common Stock		**10,000**
Dividends	**500**	
Service Revenue		**10,000**
Salaries Expense	**4,000**	
Rent Expense	**900**	
	$28,700	**$28,700**

Depreciation

How do you apply the Matching Principle to the cost of a long lived asset ?

Depreciation

Allocates the cost of an asset to expense over its useful life – MATCHING PRINCIPLE

Is an estimate

Depreciation is ALLOCATION of cost- not VALUATION(Current Replacement Cost)

We're not attempting to reflect the actual change in value of an asset!

Office Equipment

Oct $40	Nov $40	Dec $40	Jan $40
Feb $40	Mar $40	Apr $40	May $40
June $40	July $40	Aug $40	Sept $40

Depreciation= $480/year

Office Equipment		Accumulated Depreciation- Office Equipment		Depreciation Expense	
Oct 2 5,000			Oct 31 40	Oct 31 40	

GENERAL JOURNAL	Debit	Credit
Oct 31 Depreciation Expense	40	
Accumulated Depreciation-Office Equip		40
To record monthly depreciation		

Accumulated depreciation is a contra asset account - an offset against the fixed asset account.

Balance Sheet Presentation

Office equipment	**$ 5,000**
Less : accumulated depreciation	**40**
	$4,960

Net Book Value or Carrying Value

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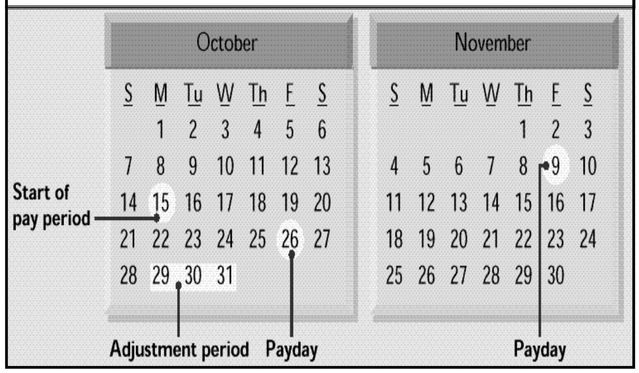
Accrued Salaries - Salaries Paid for after the Service Has Been Performed.



Accrued Salaries

Salaries Expense
Oct 31 1,200 |

Salaries Payable
| Oct 31 1,200

GENERAL JOURNAL	Debit	Credit
Oct 31 Salaries Expense	1,200	
Salaries Payable		1,200
Accrue salary expense for the month		

6

Adjusted Trial Balance

The adjusted trial balance is used to prove the equity of total debit balances and total credit balances after the adjusting entries have been made.

Financial statements (except Cash Flow Statement) can be easily prepared from the adjusted trial balance.

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SIERRA CORPORATION
Adjusted Trial Balance
October 31, 2007

	Dr.	Cr.
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Service Revenue		800
Salaries Payable		1,200
Common Stock		10,000
Retained Earnings		0
Dividends	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

SIERRA CORPORATION
Adjusted Trial Balance
October 31, 2007

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation— Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Service Revenue		800
Salaries Payable		1,200
Common Stock		10,000
Retained Earnings		0
Dividends	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

SIERRA CORPORATION
Income Statement
For the Month Ended October 31, 2007

Revenues		
Service revenue		$10,600
Expenses		
Salaries expense	$5,200	
Advertising supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		$ 2,860

SIERRA CORPORATION
Retained Earnings Statement
For the Month Ended October 31, 2007

Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$ 2,360

To balance sheet

SIERRA CORPORATION
Adjusted Trial Balance
October 31, 2007

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation— Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Service Revenue		800
Salaries Payable		1,200
Common Stock		10,000
Retained Earnings		0
Dividends	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

SIERRA CORPORATION
Balance Sheet
October 31, 2007

Assets		
Cash		$15,200
Accounts receivable		200
Advertising supplies		1,000
Prepaid insurance		550
Office equipment	$5,000	
Less: Accumulated depreciation	40	4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Interest payable	50	
Unearned service revenue	800	
Salaries payable	1,200	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

Balance at Oct. 31 from Retained Earnings Statement in Illustration 4-23

7

Closing the Books

Closing entries transfer the temporary account balances to the stockholders' equity account...

and reduce the balances in the temporary accounts to zero.

CLOSING ENTRIES:

Remember how the net income has to go into the retained earnings?

That is what is called “closing out”, or “closing”, but we just did it, ignoring the journal entry.

So how does the journal entry work?

See example next two slides

What I teach is more direct and simpler than what is in your book, but what is in your books is also correct (they achieve the exact same thing).

XYX
Abbreviated balance sheet
12/31/20xx

Total assets	**100,000**
Liabilities	75,000
Retained earnings	10,000
Total liabilities & equity	**85,000**

XYX
Abbreviated Income statement
12/31/20xx

Revenue	400,000
COGS	340,000
Operating expenses	45,000
Net income	**15,000**

Problem?

Balance sheet doesn’t balance because net income not in retained earnings.

We need the income statement to go back to zero, and for the net income to go to retained earnings. What to do?

Revenue	400,000	
COGS		340,000
Operating expenses		45,000
Retained earnings		**15,000**

COOL: Killed two birds with one stone: (1) zeroed out all the income statement accounts (2) moved net income to retained earnings.

Temporary	Permanent
All revenues accounts	All asset accounts
All expense accounts	All liability accounts
Dividends	Stockholders’ equity accounts

Close Temporary Accounts Only

Temporary

All revenue accounts
All expense accounts
Dividends

Zero balance after closing entries!

Permanent

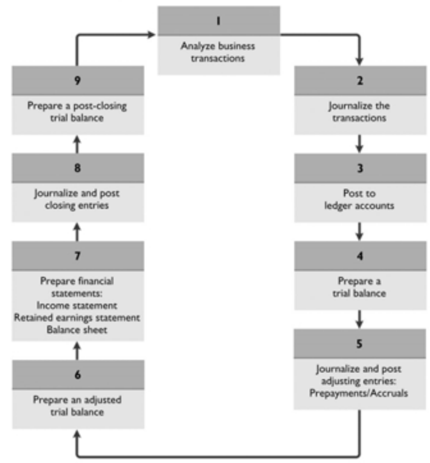
All asset accounts
All liability accounts
Stockholders’ equity accounts

Do not close!

8

The Accounting Cycle

Required Steps in the Accounting Cycle



Review

Which is ***not*** a temporary account?

a. Salaries expense

b. Service revenue

c. Accounts Receivable

d. Dividends

Review

Which is ***not*** a temporary account?

a. Salaries expense

b. Service revenue

c. Accounts Receivable

d. Dividends

Review

Which account will have a zero balance after closing entries?

a. Service Revenue

b. Advertising Supplies

c. Prepaid Insurance

d. Accumulated Depreciation

Review

Which account will have a zero balance after closing entries?

a. Service Revenue

b. Advertising Supplies

c. Prepaid Insurance

d. Accumulated Depreciation

Review

Which types of accounts will appear in the post-closing trial balance?

a. Temporary accounts

b. Accounts shown in the income statement

c. Permanent accounts

d. All of the above

Review

Which types of accounts will appear in the post-closing trial balance?

a. Temporary accounts

b. Accounts shown in the income statement

c. Permanent accounts

d. All of the above