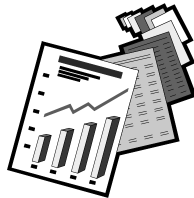
The Accounting Process

Chapter 3



GAAP LITERATURE

TRADITIONAL: Original pronouncements, issued by the FASB.

SEPT. 2009 CHANGE: Codification issued by the FASB.

DIFFERENCE: Codification is listed by topic which is much easier to perform research and capture all reules relating to a particular subject than the original pronouncements.

USGAAP… IFRS, WHATS UP WITH THAT?

We use USGAAP in the United States. In many foreign countries they use International Financial Reporting Standards (IFRS, aka iGAAP). Some important highlights:

- **UCSB teaching model based upon USGAAP.**
- **USGAAP & IFRS are both accrual based systems and are VERY SIMILAR:**
  - **Even as we speak, some of these items are being changed in both USGAAP and IFRS to make them even more similar!**
    - This is called "Convergence"
- **IFRS tends to be EASIER and LESS DETAILED (principle based)**
- **The SEC proposes that by 2011 "large" public companies will be required to adopt IFRS**
  - **Read between the lines… Small SEC companies and most private companies will continue to use USGAAP.**
- **We will reference key differences if applicable to concepts taught during this course and elaborate in an IFRS specific discussion at the end of the quarter.**

Cash Basis versus Accrual Basis Accounting

Measuring Income

The Income Statement report the revenues and expenses of a firm, for a particular period of time, stated according to the accrual basis ACCRUAL BASIS of accounting.

The objective of preparing an income statement is to obtain a measure of operating performance that matches a firm's outputs (revenues) with the associated inputs (expenses).

Cash Basis versus Accrual Basis of Accounting

Cash Basis (A COMPREHENSIVE BASIS OF ACCOUNTING THAT IS NOT GAAP):

Revenue is recorded only when the cash is received and,

expenses are recorded only when the cash is paid.

Accrual Basis: (GAAP)

Recognizing ***revenue*** when it is earned, without regard to when the cash is received, and

recognizing ***expenses*** when associated benefit (revenue) is recorded; also known as the matching principle.

Statement of cash flows fills in the gap!

FASB and SEC are currently making this very complex. Quote from the CFO at one of my SEC registrants: "Revenue MAYBE when cash is received and expenses immediately". SAB 101

NOTE: They are THE SAME in the long-term. Also the timing of recording revenues and expenses under GAAP is a primary objective of high-level accounting.

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.

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**

Cash Basis versus Accrual Basis of Accounting

Why use the Accrual Basis of Accounting?

The ***Matching Principle*** -- "let the expense follow the revenue."

Expenses are recognized on the income statement not when paid, or when the work is performed, or when a product is produced, but when the work or the product actually makes its contribution to revenue.

The matching principle dictates that efforts (expenses) be matched with accomplishment (revenues) whenever it is reasonable and practicable to do so.

- In our construction example, if materials were delivered to the job site and paid for, but not installed:
  - » **Has revenue from these costs been earned?**
  - » **So what do we debit?**

Cash Basis versus Accrual Basis Depreciation

Assume that in January of 1999, UC Company purchased equipment for $75,000. The equipment would be useful to UC for three years.

Question:

What impact would this equipment have on UC's future Income Statements, if:

a. UC used the cash basis of accounting

b. UC used the accrual basis of accounting?

Cash Basis versus Accrual Basis Example

UC Company - Income Statement

Cash Basis Accounting

	1999	2000	2001	Total
Revenues	$ 100,000	$ 100,000	$ 100,000	$ 300,000
Depreciation Expenses	(75,000)			(75,000)
Net income (loss)	$ 25,000	$ 100,000	$ 100,000	$ 225,000

Accrual Basis Accounting

	Sept.	Oct.	Nov.	Total
Revenues	$ 100,000	$ 100,000	$ 100,000	$ 300,000
Depreciation Expenses	(25,000)	(25,000)	(25,000)	(75,000)
Net income (loss)	$ 75,000	$ 75,000	$ 75,000	$ 225,000

The Accounting Equation

Assets= Liabilities + Equity

OR stated another way:

Equity= Assets – Liabilities

Simple Algebra

If you increase an asset and A=L+E is ALWAYS true, then:

- **L or E must *increase* too. (Or maybe another A decreases).**

This is why it is called a "dual entry" system, aka "self balancing set of accounts". For every debit, there is a "???"

CREDIT!!

EXAMPLES:

Cash paid to purchase equipment (credit cash), where is the debit?

FIXED ASSETS

Revenue is recorded when a sale is made (credit revenue). The amount has been billed to the customer but not yet received. Where is the debit?

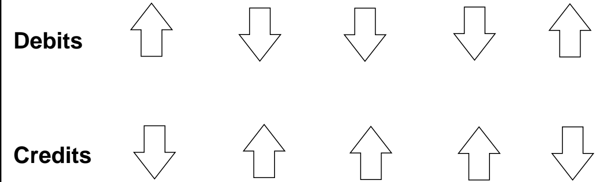
ACCOUNTS RECEIVABLE

Debits and Credits

	Balance Sheet			Income Stmt.	
	DR.	<CR>	<CR>**	<CR.>	DR.
	Assets =	**Liab.** +	**Equity**	**Rev.** -	**Exp.** =

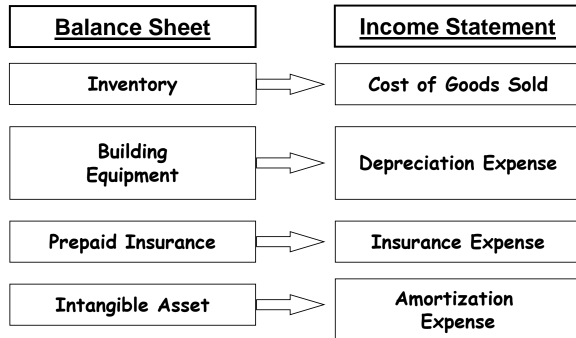
Debits

Credits



Not uncommon for negative equity (debit balance)

Flow of Asset Costs



Inventory / Cost of Goods Sold

Balance Sheet

	2004
Assets:	
Accounts receivable	75,000
Inventory	30,000
Liabilities:	
Accounts payable	(30,000)
Equity:	

Income Statement

	2004
Revenues:	
Sales	(75,000)
Expenses:	
Net (income) loss	

Purchase inventory for $30,000, Sell for $75,000

Inventory / Cost of Goods Sold

Balance Sheet

Assets:	2004
Accounts receivable	**75,000**
Inventory	**0**
Liabilities:	
Accounts payable	**(30,000)**
Equity:	
Retained earnings	**(45,000)**

Income Statement

	2004
Revenues:	
Sales	**(75,000)**
Expenses:	
Cost of goods sold	**30,000**
Net (income) loss	**(45,000)**

Purchase inventory for $30,000, Sell for $75,000

Inventory / Cost of Goods Sold

Balance Sheet

Assets:	2004
Accounts receivable	**75,000**
Inventory	**0**
Liabilities:	
Accounts payable	**(30,000)**
Equity:	
Retained earnings	**(45,000)**

Income Statement

	2004
Revenues:	
Sales	**(75,000)**
Expenses:	
Cost of goods sold	**30,000**
Net (income) loss	**(45,000)**

Pay supplier $30,000, Receive $75,000 from customer

Inventory / Cost of Goods Sold

Balance Sheet

Assets:	2004
Cash	**(30,000)**
Accounts receivable	**75,000**
Inventory	**0**
Liabilities:	
Accounts payable	**0**
Equity:	
Retained earnings	**(45,000)**

Income Statement

	2004
Revenues:	
Sales	**(75,000)**
Expenses:	
Cost of goods sold	**30,000**
Net (income) loss	**(45,000)**

Pay supplier $30,000, Receive $75,000 from customer

Inventory / Cost of Goods Sold

Balance Sheet

Assets:	2004
Cash	**45,000**
Accounts receivable	**0**
Inventory	**0**
Liabilities:	
Accounts payable	**0**
Equity:	
Retained earnings	**(45,000)**

Income Statement

	2004
Revenues:	
Sales	**(75,000)**
Expenses:	
Cost of goods sold	**30,000**
Net (income) loss	**(45,000)**

Pay supplier $30,000, Receive $75,000 from customer

Building / Depreciation Expense

Balance Sheet	2004
Assets:	
Building	**1,000,000**
Accum. deprec.	**(40,000)**
Liabilities:	
Notes payable	**(1,000,000)**
Equity:	
Retained earnings	**40,000**

Income Statement	2004
Revenues:	
Expenses:	
Depreciation exp.	**40,000**
Net (income) loss	**40,000**

Purchase building for $1,000,000, 25 year useful life

Adjusting Entries

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 provide benefit, ***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

1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities before they are earned.

Accruals

3. **Accrued Revenues.** Revenues earned but not yet received in cash.
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)

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

Income Statement (June 2003)

Income Statement	June 2003
Revenues:	
Expenses:	
Net income (loss)	

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:	
Retained earnings	**500**

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	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	Income Statement	July 2003
Assets:		Revenues:	
Cash	**$(6,000)**		
Prepaid insurance	**5,000**	Expenses:	
		Insurance expense	**500**
Liabilities:			
Equity:			
Retained earnings	**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	Income Statement	July 2003
Assets:		Revenues:	
Cash	**$(6,000)**		
Prepaid insurance	**5,000**	Expenses:	
		Insurance expense	**500**
Liabilities:			
Equity:			
Retained earnings	**1,000**	Net (income) loss	500

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	Income Statement	October
Assets:		Revenues:	
Cash	**12,000**		
		Expenses:	
Liabilities:			
Unearned revenue	**(12,000)**		
Equity:			
		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	Income Statement	October
Assets:		Revenues:	
Cash	**12,000**	**Advertising revenue**	**(4,000)**
Liabilities:		Expenses:	
Unearned revenue	**(8,000)**		
Equity:			
Retained earnings	**(4,000)**	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 (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:			
Retained earnings	**(2,000)**	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	**0**		
Account receivable	**2,000**		
Liabilities:		Expenses:	
Equity:			
Retained earnings	**(2,000)**	Net (income) loss	

In November it is billed

Adjusting Entries (Accrued Revenues)

Balance Sheet	October
Assets:	
Cash	**2,000**
Account receivable	**0**
Liabilities:	
Equity:	
Retained earnings	**(2,000)**

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

When it is collected

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
Assets:	
Liabilities:	
Salaries payable	**(7,500)**
Equity:	
Retained earnings	**7,500**

Income Statement	October
Revenues:	
Expenses:	
Salaries expense	**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?

January, 2003 Transactions for Ace Inc.

- Ace Inc., issue stock for $77,000 cash.
  Cash 77,000
  Common stock 77,000
- Ace purchased inventory for 52,000. Balance due in 45 days.
  Inventory 52,000
  Accounts payable 52,000
- Wages due employees for January amounted to $5,000. The wages were paid in February.
  SG&A expense 5,000
  Wages payable 5,000
- Sold inventory costing $10,000 for $25,000. Customer has 30 days to pay.
  Accounts rec. 25,000
  Sales 25,000
  COS 10,000
  Inventory 10,000
- On January 2, paid $3,000 for advertising to be done in January and February.
  Prepaid advertising 3,000
  Cash 3,000
- On January 2, purchased a copier for $6,000 cash. Copier is expected to be useful to Ace for two years.
  Equipment 6,000
  Cash 6,000
- Received $15,000 from customers for amounts owed to Ace.
  Cash 15,000
  Accounts receiv. 15,000

Ace, continued from prev. slide

From the previous slide, which items require an adjusting entry at the end of the month?

Advertising to be performed in January and February- one month consumed:

Advertising expense 1,500
Prepaid advertising 1,500

The photocopier good for two years- 1/24th consumed:

Depreciation expense 250
Accumulated depreciation 250

More Advanced Concepts

- The income statement "closes" out to what?
  - RETAINED EARNINGS
- If income is the only activity impacting retained earnings, 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

BONUS MATERIALS

- LOBSTER
- Revenue recognition:
  - Subscriptions
  - Your tuition
  - Point of sale
  - FOB shipping and receiving
- Cost recognition
  - » Materials delivered to a job but NOT used
  - » Advertising
  - » periodicals (newspaper)
  - » Billboard

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