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 rules 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
The Income Statement reports 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).

Measuring Income

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 of Accounting 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 Accounting

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$35,000</td>
<td>$35,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>(18,000)</td>
<td>(18,000)</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$17,000</td>
<td>$17,000</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

Accrual Basis Accounting

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$35,000</td>
<td>$35,000</td>
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</tr>
<tr>
<td>Expenses</td>
<td>(18,000)</td>
<td>(18,000)</td>
<td>(18,000)</td>
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<tr>
<td>Net income (loss)</td>
<td>$17,000</td>
<td>$17,000</td>
<td>$17,000</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>UC Company - Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Basis Accounting</strong></td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Depreciation Expenses</td>
</tr>
<tr>
<td>Net income (loss)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Accrual Basis Accounting</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues Sept. Oct. Nov.</td>
</tr>
<tr>
<td>Depreciation Expenses Sept. Oct. Nov.</td>
</tr>
<tr>
<td>Net income (loss) Sept. Oct. Nov.</td>
</tr>
</tbody>
</table>

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 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**

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Stmt.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DR.</strong></td>
<td><strong>CR.</strong></td>
</tr>
<tr>
<td>Assets = Liab. + Equity</td>
<td>Rev. - Exp. =</td>
</tr>
</tbody>
</table>

Debits

<table>
<thead>
<tr>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image1" alt="Debits" /></td>
<td></td>
</tr>
</tbody>
</table>

Credits

<table>
<thead>
<tr>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image2" alt="Credits" /></td>
<td></td>
</tr>
</tbody>
</table>

Not uncommon for negative equity (debit balance)

**Flow of Asset Costs**

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>Cost of Goods Sold</td>
</tr>
<tr>
<td>Building Equipment</td>
<td>Depreciation Expense</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>Insurance Expense</td>
</tr>
<tr>
<td>Intangible Asset</td>
<td>Amortization Expense</td>
</tr>
</tbody>
</table>

**Inventory / Cost of Goods Sold**

Balance Sheet

<table>
<thead>
<tr>
<th>Assets: 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (income) loss</td>
</tr>
</tbody>
</table>

Income Statement

2004

<table>
<thead>
<tr>
<th>Revenues:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net (income) loss</td>
</tr>
</tbody>
</table>

Purchase inventory for $30,000, Sell for $75,000
### Balance Sheet

<table>
<thead>
<tr>
<th>Assets:</th>
<th>2004</th>
<th>Liabilities:</th>
<th></th>
<th>Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>(30,000)</td>
<td>Accounts payable</td>
<td>0</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>75,000</td>
<td>Accounts payable</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>0</td>
<td>Inventory</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

### Income Statement

<table>
<thead>
<tr>
<th>Revenues:</th>
<th>2004</th>
<th>Expenses:</th>
<th></th>
<th>Net (income) loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>(75,000)</td>
<td>Cost of goods sold</td>
<td>30,000</td>
<td>(45,000)</td>
</tr>
</tbody>
</table>

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

**Pay supplier $30,000, Receive $75,000 from customer**
Building / Depreciation Expense

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td>Revenues:</td>
</tr>
<tr>
<td>Building</td>
<td>2004</td>
</tr>
<tr>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Accum. depreci.</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Liabilities:</td>
<td>Expenses:</td>
</tr>
<tr>
<td>Notes payable</td>
<td>Depreciation exp.</td>
</tr>
<tr>
<td>(1,000,000)</td>
<td>40,000</td>
</tr>
<tr>
<td>Equity:</td>
<td>Net (income) loss</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>40,000</td>
</tr>
</tbody>
</table>

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.

Adjusting Entries (Prepaid Expenses)

Prepays 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. Prepays often occur in regard to:
- insurance
- supplies
- advertising
- rent
- maintenance on equipment
- fixed assets
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?

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

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

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 Pioneer’s financial statements for the month of October?
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 these fees have been earned in October. How is this transaction reflected on Pioneers' financial statements for the month of October?

**Balance Sheet**
- **Assets:**
  - Cash 12,000

**Liabilities:**
- Unearned revenue (8,000)

**Equity:**
- Retained earnings (4,000)

**Income Statement**
- **Revenues:**
  - Advertising revenue (4,000)

- **Expenses:**
  - (4,000)

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?

**Balance Sheet**
- **Assets:**
  - Unbilled receivable 2,000

**Liabilities:**
- Retained earnings (2,000)

**Income Statement**
- **Revenues:**
  - Advertising revenue (2,000)

- **Expenses:**
  - (2,000)

In November it is billed

**Balance Sheet**
- **Assets:**
  - Unbilled receivable 0
  - Account receivable 2,000

**Liabilities:**
- Retained earnings (2,000)

**Income Statement**
- **Revenues:**
  - (2,000)

- **Expenses:**
  - Net (income) loss (2,000)

Accrued revenues often occur in regard to:
- rent
- interest
- services performed

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.
Adjusting Entries (Accrued Revenues)

Balance Sheet

Assets:  
- Cash 2,000
- Account receivable 0

Liabilities:

Equity:
- Retained earnings (2,000)

Income Statement

Revenues:  

Expenses:

Net (income) loss

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

January, 2003 Transactions for Ace Inc.

- Ace Inc. issue stock for $77,000 cash.
  
- Ace purchased inventory for $21,000. Balance due in 45 days.
- Inventory 21,000
- Accounts payable 21,000

- Wages due employees for January amounted to $7,500. The wages were paid in February.
  - Salaries expense 7,500
  - Wages payable 7,500

- Sold inventory costing $10,000 for $25,000. Customer has 30 days to pay.
  - Sales 25,000
  - Inventory 10,000
  - Cost of sales 10,000
  - Accounts receivable 25,000

- On January 2, paid $3,000 for advertising to be done in January and February.
  - Prepaid advertising 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
  
- Accepted $15,000 from customers for amounts owed to Ace.
  - Accounts receivable 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