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ACCOUNTING PRINCIPLES 11e

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3 Adjusting the Accounts

Learning Objectives

After studying this chapter, you should be able to:

[1] Explain the time period assumption.

[2] Explain the accrual basis of accounting.

[3] Explain the reasons for adjusting entries and Identify the major types of adjusting entries.

[4] Prepare adjusting entries for deferrals.

[5] Prepare adjusting entries for accruals.

[6] Describe the nature and purpose of an adjusted trial balance.

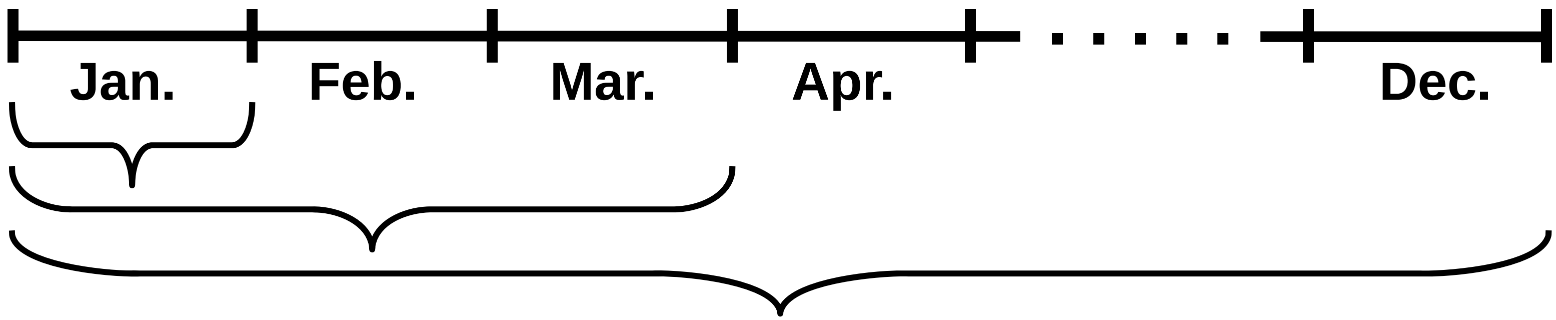
Preview of Chapter 3

ADJUSTING THE ACCOUNTS

Timing Issues	The Basics of Adjusting Entries	The Adjusted Trial Balance and Financial Statements
• Fiscal and calendar years • Accrual- vs. cash-basis accounting • Recognizing revenues and expenses	• Types of adjusting entries • Adjusting entries for deferrals • Adjusting entries for accruals • Summary of basic relationships	• Preparing the adjusted trial balance • Preparing financial statements

Timing Issues

Accountants divide the economic life of a business into artificial time periods (**Time Period Assumption**).



Generally a

- **month**,
- **quarter**, or
- **year**.

Alternative Terminology
The time period assumption is also called the *periodicity assumption*.

LO 1 Explain the time period assumption.

Timing Issues

Fiscal and Calendar Years

- Monthly and quarterly time periods are called **interim periods**.
- Public companies must prepare both **quarterly** and **annual** financial statements.
- **Fiscal Year** = Accounting time period that is **one year** in length.
- **Calendar Year** = January 1 to December 31.

LO 1 Explain the time period assumption.

Timing Issues

Review Question

The time period assumption states that:

a. revenue should be recognized in the accounting period in which it is earned.

b. expenses should be matched with revenues.

c. the economic life of a business can be divided into artificial time periods.

d. the fiscal year should correspond with the calendar year.

LO 1 Explain the time period assumption.

Timing Issues

Accrual- versus Cash-Basis Accounting

Accrual-Basis Accounting

- Transactions recorded in the **periods in which the events occur**.
- Companies **recognize revenues when they perform services** (rather than when cash is received).
- **Expenses** are recognized when **incurred** (rather than when paid).

LO 2 Explain the accrual basis of accounting.

Timing Issues

Accrual- vs. Cash-Basis Accounting

Cash-Basis Accounting

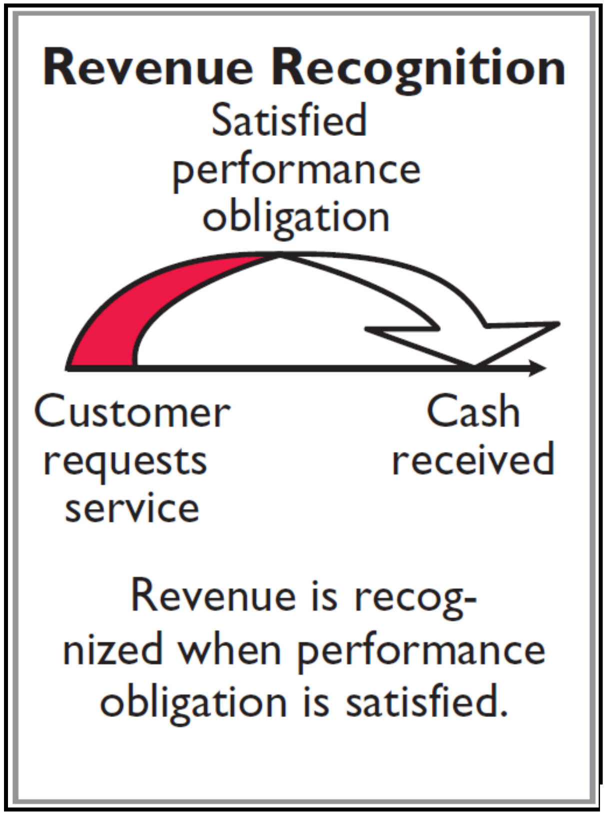
- **Revenues** recognized when **cash is received**.
- **Expenses** recognized when **cash is paid**.
- **Cash-basis accounting is not in accordance with generally accepted accounting principles (GAAP).**

Timing Issues

Recognizing Revenues and Expenses

REVENUE RECOGNITION PRINCIPLE

Recognize revenue in the accounting period in which the **performance obligation** is satisfied.



LO 2

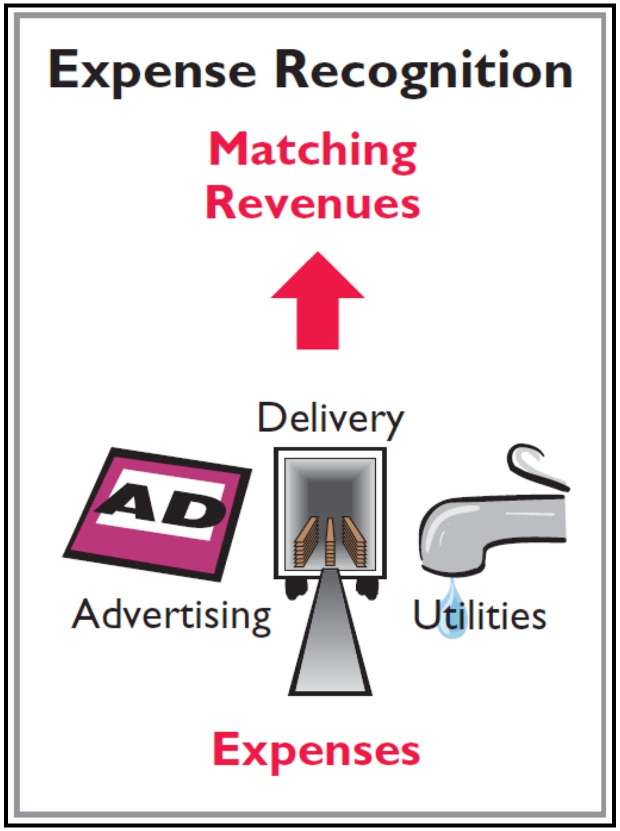
Timing Issues

Recognizing Revenues and Expenses

EXPENSE RECOGNITION PRINCIPLE

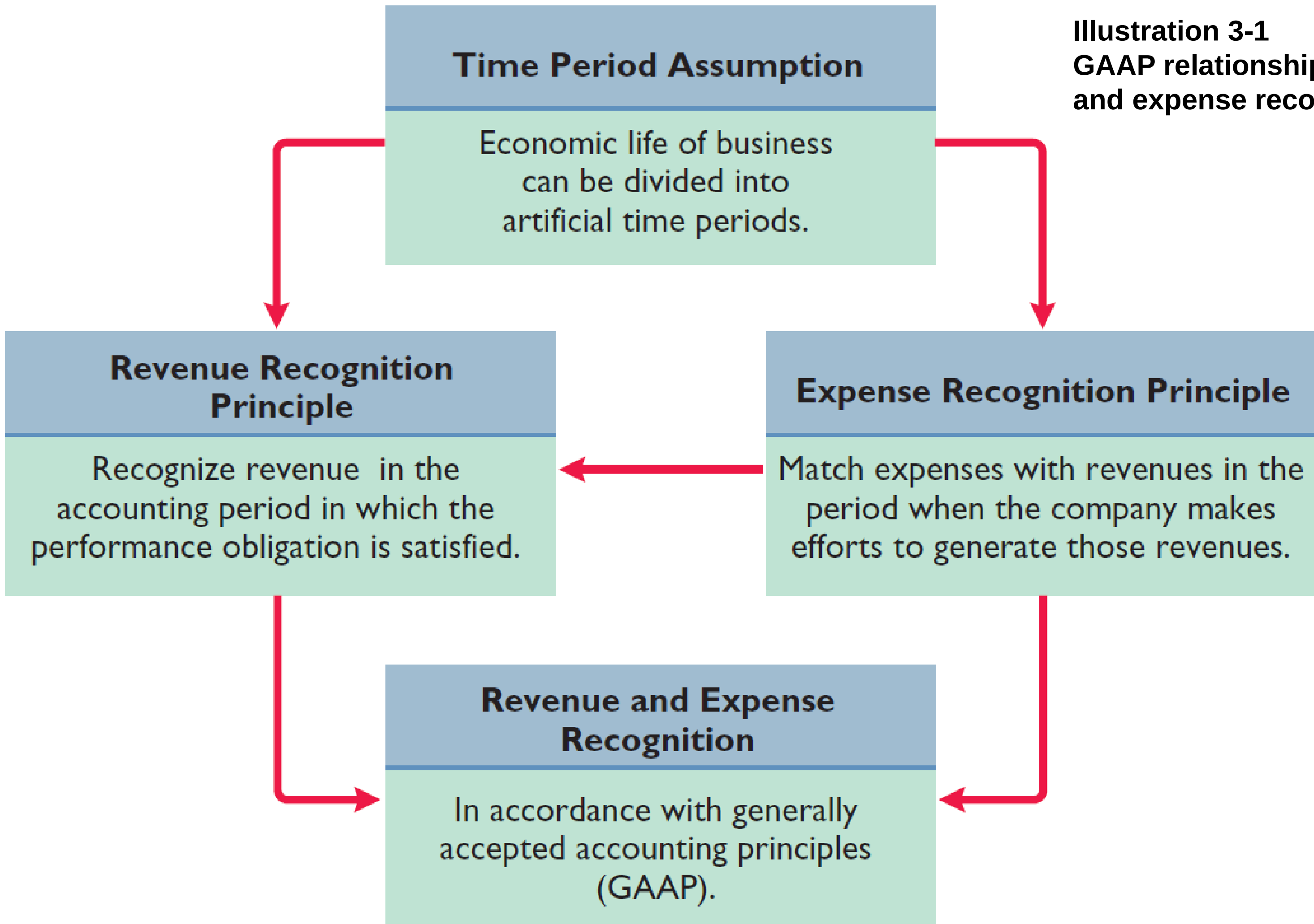
Match expenses with revenues in the period when the expense makes its contribution to revenue.

"Let the expenses follow the revenues."



Timing Issues

Illustration 3-1
GAAP relationships in revenue and expense recognition



Timing Issues

Review Question

One of the following statements about the accrual basis of accounting is *false?* That statement is:

a. Events that change a company's financial statements are recorded in the periods in which the events occur.

b. Revenue is recognized in the period in which the performance obligation is satisfied.

c. The accrual basis of accounting is in accord with generally accepted accounting principles.

d. Revenue is recorded only when cash is received, and expenses are recorded only when cash is paid.

LO 2 Explain the accrual basis of accounting.

ETHICS INSIGHT

Cooking the Books?

Allegations of abuse of the revenue recognition principle have become all too common in recent years. For example, it was alleged that Krispy Kreme sometimes doubled the number of doughnuts shipped to wholesale customers at the end of a quarter to boost quarterly results. The customers shipped the unsold doughnuts back after the beginning of the next quarter for a refund. Conversely, Computer Associates International was accused of backdating sales—that is, saying that a sale that occurred at the beginning of one quarter occurred at the end of the previous quarter in order to achieve the previous quarter's sales targets.

? What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues?

> DO IT!

A list of concepts is provided in the left column below, with a description of the concept in the right column below. There are more descriptions provided than concepts. Match the description of the concept to the concept.

1. __f__ Accrual-basis accounting.
2. __e__ Calendar year.
3. __c__ Time period assumption.
4. __b__ Expense recognition principle.

(a) Monthly and quarterly time periods.

(b) Efforts (expenses) should be matched with results (revenues).

(c) Accountants divide the economic life of a business into artificial time periods.

(d) Companies record revenues when they receive cash and record expenses when they pay out cash.

(e) An accounting time period that starts on January 1 and ends on December 31.

(f) Companies record transactions in the period in which the events occur.

The Basics of Adjusting Entries

Adjusting Entries

- Ensure that the **revenue recognition** and **expense recognition** principles are followed.
- Necessary because the **trial balance may not contain up-to-date** and complete data.
- **Required** every time a company prepares financial statements.
- Will include **one income statement account** and **one balance sheet account**.

LO 3 Explain the reasons for adjusting entries and Identify the major types of adjusting entries.

The Basics of Adjusting Entries

Review Question

Adjusting entries are made to ensure that:

a. expenses are recognized in the period in which they are incurred.

b. revenues are recorded in the period in which services are performed.

c. balance sheet and income statement accounts have correct balances at the end of an accounting period.

d. all of the above.

LO 3 Explain the reasons for adjusting entries and Identify the major types of adjusting entries.

The Basics of Adjusting Entries

Types of Adjusting Entries

Illustration 3-2
Categories of adjusting entries

Deferrals	Accruals
1. **Prepaid Expenses.** Expenses paid in cash before they are used or consumed.	1. **Accrued Revenues.** Revenues for services performed but not yet received in cash or recorded.
2. **Unearned Revenues.** Cash received before services are performed.	2. **Accrued Expenses.** Expenses incurred but not yet paid in cash or recorded.

LO 3 Explain the reasons for adjusting entries and Identify the major types of adjusting entries.

The Basics of Adjusting Entries

Types of Adjusting Entries

Trial Balance – Each account is analyzed to determine whether it is complete and up-to-date.

PIONEER ADVERTISING AGENCY Trial Balance October 31, 2014		
	Debit	**Credit**
Cash	$ 15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		$ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	$28,700	**$28,700**

Illustration 3-3

LO 3 Explain the reasons for adjusting entries and Identify the major types of adjusting entries.

The Basics of Adjusting Entries

Adjusting Entries for Deferrals

Deferrals are **expenses or revenues** that are recognized at a date later than the point when cash was originally exchanged. There are **two types**:

- Prepaid expenses and
- Unearned revenues.

LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

PREPAID EXPENSES

Payment of cash, that is recorded as an asset because service or benefit will be received in the future.

Cash Payment	**BEFORE**	Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- equipment
- buildings

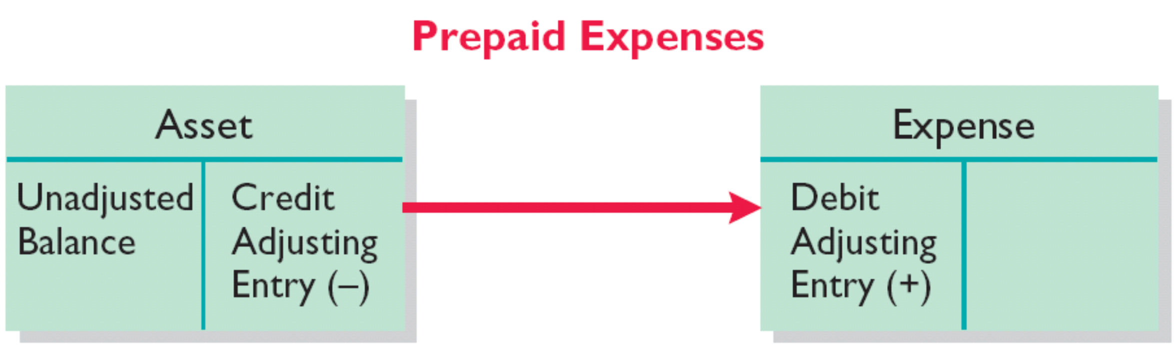
LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

PREPAID EXPENSES

- Expire either with the passage of time or through use.
- Adjusting entry:
  - **Increase** (debit) to an **expense account** and
  - **Decrease** (credit) to an **asset account**.

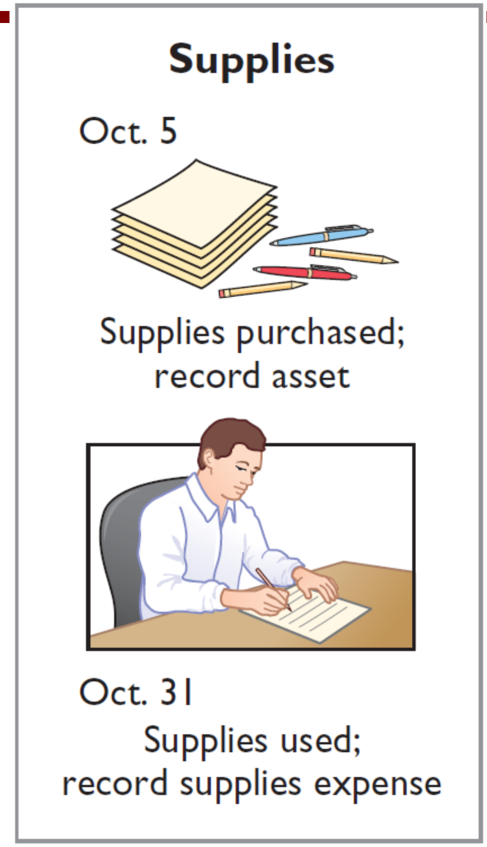
Illustration 3-4



LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

Illustration: Pioneer Advertising Agency purchased supplies costing $2,500 on October 5. Pioneer recorded the payment by increasing (debiting) the asset Supplies. This account shows a balance of $2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that $1,000 of supplies are still on hand.



Oct. 31	Supplies expense	1,500	
	Supplies		1,500

The Basics of Adjusting Entries

Illustration 3-5

Basic Analysis	The expense Supplies Expense is increased \$1,500, and the asset Supplies is decreased \$1,500.
Equation Analysis	(1) **Assets** = **Liabilities** + **Owner's Equity** Supplies = Supplies Expense –\$1,500 –\$1,500
Debit–Credit Analysis	Debits increase expenses: debit Supplies Expense \$1,500. Credits decrease assets: credit Supplies \$1,500.
Journal Entry	Oct. 31 Supplies Expense 1,500 Supplies 1,500 (To record supplies used)

Journal Entry

Oct. 31	Supplies Expense	1,500	
	Supplies		1,500
	(To record supplies used)		

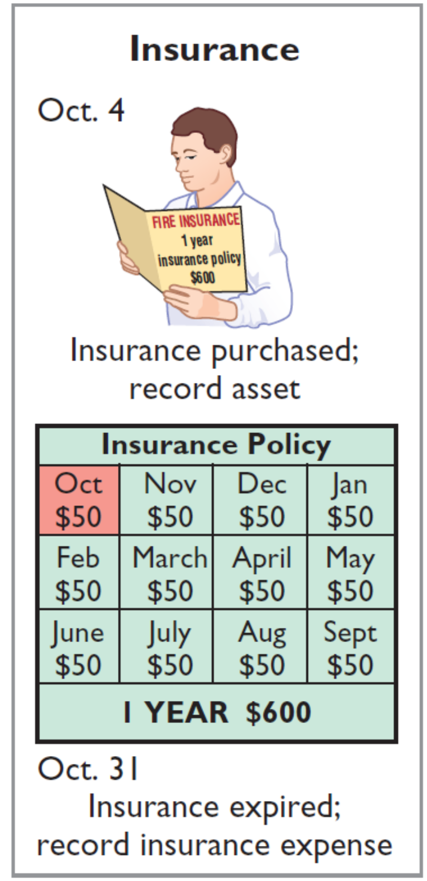
Posting

Supplies			126
Oct. 5	2,500	Oct. 31	**Adj. 1,500**
Oct. 31	Bal. 1,000		

Supplies Expense		631
Oct. 31	**Adj. 1,500**	
Oct. 31	Bal. 1,500	

The Basics of Adjusting Entries

Illustration: On October 4, Pioneer Advertising Agency paid $600 for a one-year fire insurance policy. Coverage began on October 1. Pioneer recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of $600 in the October 31 trial balance. Insurance of $50 ($600 ÷ 12) expires each month.



Oct. 31	Insurance expense	50	
	Prepaid insurance		50

LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

Illustration 3-6

Basic Analysis	The expense Insurance Expense is increased $50, and the asset Prepaid Insurance is decreased $50.
Equation Analysis	(2) **Assets** = **Liabilities** + **Owner's Equity**; Prepaid Insurance −$50 = Insurance Expense −$50
Debit–Credit Analysis	Debits increase expenses: debit Insurance Expense $50. Credits decrease assets: credit Prepaid Insurance $50.

Journal Entry

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50
	(To record insurance expired)		

Posting

Prepaid Insurance			130
Oct. 4	600	Oct. 31	**Adj. 50**
Oct. 31	Bal. 550		

Insurance Expense			722
Oct. 31	**Adj. 50**		
Oct. 31	Bal. 50		

The Basics of Adjusting Entries

Depreciation

- **Buildings**, **equipment**, and **motor vehicles** (assets that provide service for many years) are **recorded as assets**, rather than an expense, in the year acquired.
- **Depreciation** is the process of **allocating the cost of an asset to expense** over its **useful life**.
- Depreciation **does not attempt** to report the actual change in the **value of the asset**.

The Basics of Adjusting Entries

Illustration: For Pioneer Advertising, assume that depreciation on the equipment is \$480 a year, or \$40 per month.

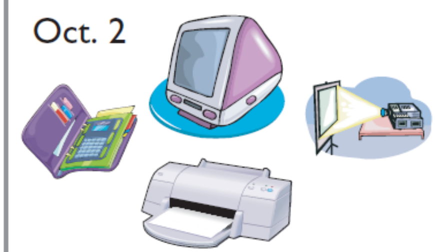
Oct. 31

Depreciation expense	40	
Accumulated depreciation		40

Accumulated Depreciation is called a **contra asset account**.

Depreciation

Oct. 2



Equipment purchased; record asset

Equipment			
Oct \$40	Nov \$40	Dec \$40	Jan \$40
Feb \$40	March \$40	April \$40	May \$40
June \$40	July \$40	Aug \$40	Sept \$40
Depreciation = \$480/year			

Oct. 31

Depreciation recognized; record depreciation expense

The Basics of Adjusting Entries

Illustration 3-7

Basic Analysis

The expense Depreciation Expense is increased $40, and the contra asset Accumulated Depreciation—Equipment is increased $40.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Accumulated Depreciation—Equipment	=			Depreciation Expense
−$40				−$40

Debit–Credit Analysis

Debits increase expenses: debit Depreciation Expense $40.
Credits increase contra assets: credit Accumulated Depreciation—Equipment $40.

Journal Entry

Oct. 31	Depreciation Expense	40	
	Accumulated Depreciation—Equipment		40
	(To record monthly depreciation)		

Posting

Equipment 157

Oct. 2 5,000	
Oct. 31 Bal. 5,000	

Accumulated Depreciation—Equipment 158

	Oct. 31 **Adj. 40**
	Oct. 31 Bal. 40

Depreciation Expense 711

Oct. 31 **Adj. 40**	
Oct. 31 Bal. 40	

The Basics of Adjusting Entries

Statement Presentation

- Accumulated Depreciation is a **contra asset account** (credit).
- **Appears just after** the account it offsets (Equipment) on the balance sheet.
- **Book value** is the difference between the cost of any depreciable asset and its accumulated depreciation.

Illustration 3-8

Equipment	$ 5,000
Less: Accumulated depreciation—equipment	40
	$4,960

LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

Illustration 3-9

ACCOUNTING FOR PREPAID EXPENSES

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Insurance, supplies, advertising, rent, depreciation	Prepaid expenses recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets or Contra Assets

LO 4 Prepare adjusting entries for deferrals.

The Basics of Adjusting Entries

UNEARNED REVENUES

Receipt of cash that is recorded as a liability because the service has not been performed.

Cash Receipt	BEFORE	Revenue Recorded

Unearned revenues often occur in regard to:

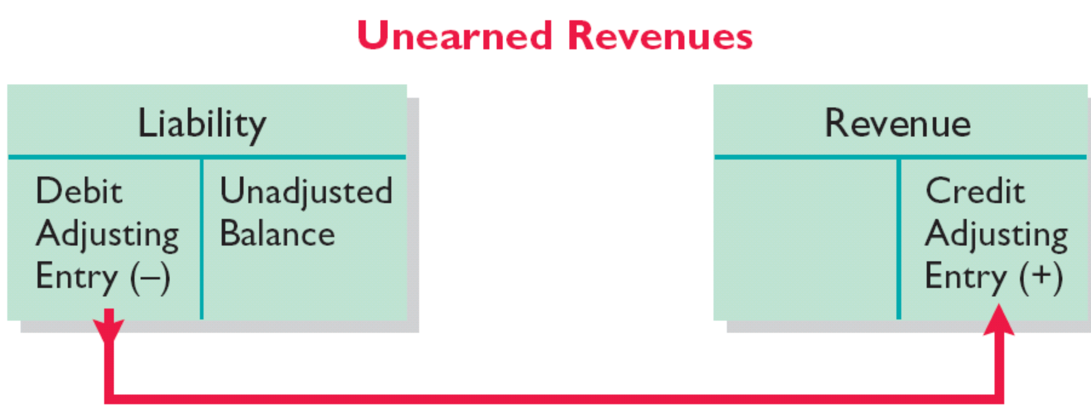
- Rent
- Airline tickets
- Magazine subscriptions
- Customer deposits

The Basics of Adjusting Entries

UNEARNED REVENUES

- Adjusting entry is made to **record the revenue** for services performed during the period and to show the liability that remains at the end of the period.
- Results in a **decrease** (debit) to a **liability account** and an **increase** (credit) to a **revenue account**.

Illustration 3-10



The Basics of Adjusting Entries

Illustration: Pioneer Advertising Agency received $1,200 on October 2 from R. Knox for advertising services expected to be completed by December 31. Unearned Service Revenue shows a balance of $1,200 in the October 31 trial balance. Analysis reveals that the company performed $400 of services in October.

Oct. 31	Unearned service revenue	400	
	Service revenue		400

The Basics of Adjusting Entries

Illustration 3-11

Basic Analysis
The liability Unearned Service Revenue is decreased $400, and the revenue Service Revenue is increased $400.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Unearned Service Revenue		Service Revenue
		−$400		+$400

Debit–Credit Analysis
Debits decrease liabilities: debit Unearned Service Revenue $400.
Credits increase revenues: credit Service Revenue $400.

Journal Entry

Oct. 31	Unearned Service Revenue	400	
	Service Revenue		400
	(To record revenue for services performed)		

Posting

Unearned Service Revenue 209			
Oct. 31	Adj. 400	Oct. 2	1,200
		Oct. 31 Bal.	800

Service Revenue 400			
		Oct. 3	10,000
		31 Adj.	400
		Oct. 31 Bal.	10,400

LO 4

The Basics of Adjusting Entries

Illustration 3-12

ACCOUNTING FOR UNEARNED REVENUES

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Rent, magazine subscriptions, customer deposits for future service	Unearned revenues recorded in liability accounts are now recognized as revenue for services performed.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues

LO 4 Prepare adjusting entries for deferrals.

ACCOUNTING ACROSS THE ORGANIZATION

Turning Gift Cards into Revenue

Those of you who are marketing majors (and even most of you who are not) know that gift cards are among the hottest marketing tools in merchandising today. Customers purchase gift cards and give them to someone for later use. In a recent year, gift-card sales topped $95 billion.

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is exercised? How should expired gift cards be accounted for? In a recent balance sheet, Best Buy reported unearned revenue related to gift cards of $479 million.

Source: Robert Berner, "Gift Cards: No Gift to Investors," *BusinessWeek* (March 14, 2005), p. 86.

? Suppose that Robert Jones purchases a $100 gift card at Best Buy on December 24, 2013, and gives it to his wife, Mary Jones, on December 25, 2013. On January 3, 2014, Mary uses the card to purchase $100 worth of CDs. When do you think Best Buy should recognize revenue and why? (See page 156.)

The Basics of Adjusting Entries

Adjusting Entries for Accruals

Accruals are made to record

- Revenues for services performed

OR

- Expenses incurred

in the current accounting period that have not been recognized through daily entries.

The Basics of Adjusting Entries

ACCRUED REVENUES

Revenues for services performed but not yet received in cash or recorded.

Revenue Recorded **BEFORE** Cash Receipt

Accrued revenues often occur in regard to:

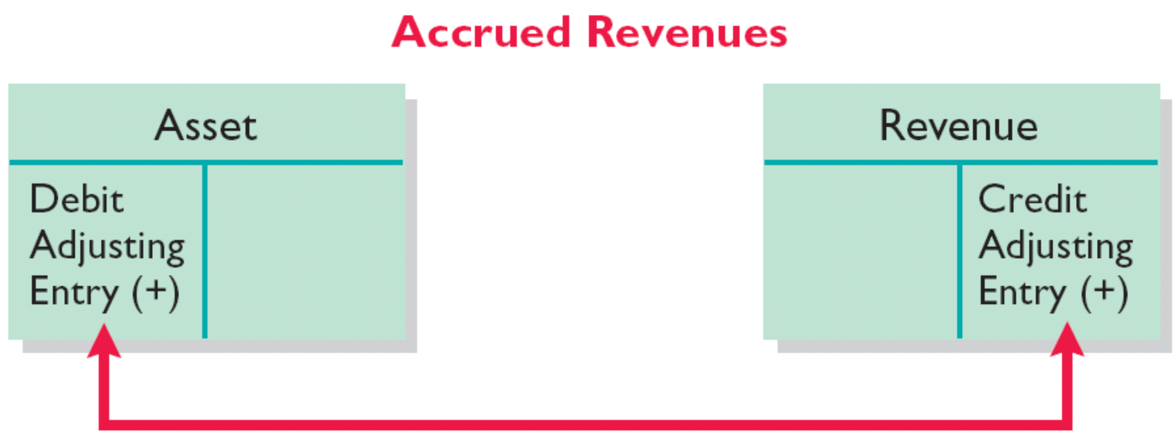
- Rent
- Interest
- Services performed

The Basics of Adjusting Entries

ACCRUED REVENUES

- Adjusting entry shows the **receivable** that exists and records the **revenues for services performed**.
- Adjusting entry:
  - **Increases** (debits) an **asset account** and
  - **Increases** (credits) a **revenue account**.

Illustration 3-13



The Basics of Adjusting Entries

Illustration: In October Pioneer Advertising Agency earned $200 for advertising services that had not been recorded.

Accrued Revenues

Revenue and receivable are recorded for unbilled services

Oct. 31

Accounts receivable	200	
Service revenue		200

On November 10, Pioneer receives cash of $200 for the services performed.

Nov. 10	Cash	200	
	Accounts receivable		200

LO 5 Prepare adjusting entries for accruals.

The Basics of Adjusting Entries

Illustration 3-14

Basic Analysis	The asset Accounts Receivable is increased $200, and the revenue Service Revenue is increased $200.
Equation Analysis	**Assets** = **Liabilities** + **Owner's Equity** Accounts Receivable +$200 = Service Revenue +$200
Debit–Credit Analysis	Debits increase assets: debit Accounts Receivable $200. Credits increase revenues: credit Service Revenue $200.

Journal Entry

Oct. 31	Accounts Receivable	200	
	Service Revenue		200
	(To record revenue for services performed)		

Posting

Accounts Receivable 112

Oct. 31	**Adj. 200**		
Oct. 31	Bal. 200		

Service Revenue 400

	Oct. 3	10,000
	31	400
	31 **Adj.**	**200**
	Oct. 31 Bal.	10,600

The Basics of Adjusting Entries

Illustration 3-15

ACCOUNTING FOR ACCRUED REVENUES

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, services	Services performed but not yet received in cash or recorded.	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues

Ethics Note

A report released by Fannie Mae's board of directors stated that improper adjusting entries at the mortgage-finance company resulted in delayed recognition of expenses caused by interest-rate changes. The motivation for such accounting apparently was the desire to hit earnings estimates.

LO 5 Prepare adjusting entries for accruals.

The Basics of Adjusting Entries

ACCRUED EXPENSES

Expenses incurred but not yet paid in cash or recorded.

Expense Recorded	BEFORE	Cash Payment

Accrued expenses often occur in regard to:

- Rent
- Interest
- Taxes
- Salaries

LO 5 Prepare adjusting entries for accruals.

The Basics of Adjusting Entries

ACCRUED EXPENSES

- Adjusting entry records the obligation and recognizes the expense.
- Adjusting entry:
  - **Increase** (debit) an **expense account** and
  - **Increase** (credit) a **liability account**.

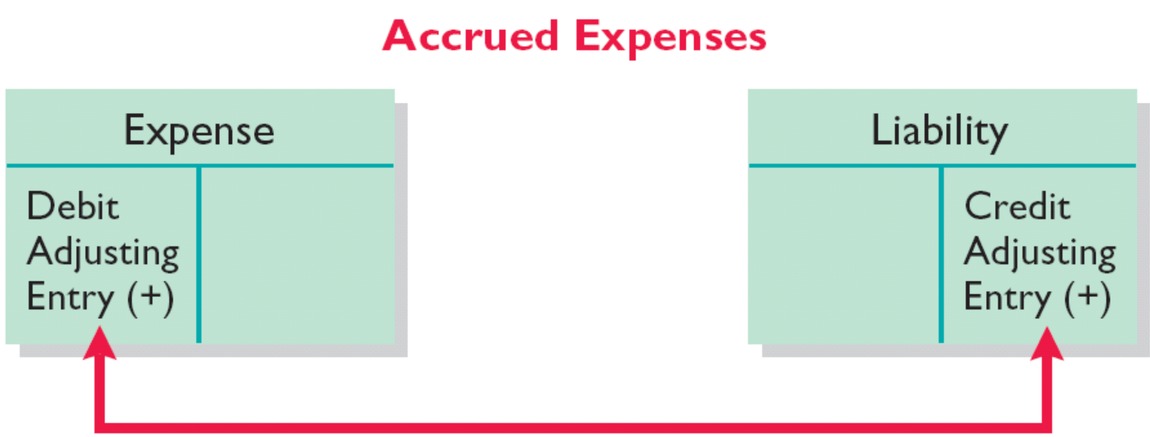


Illustration 3-16

LO 5

The Basics of Adjusting Entries

Illustration: Pioneer Advertising Agency signed a three-month note payable in the amount of $5,000 on October 1. The note requires Pioneer to pay interest at an annual rate of 12%.

Illustration 3-17

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
$5,000	×	12%	×	$\frac{1}{12}$	=	$50

Oct. 31	Interest expense	50	
	Interest payable		50

LO 5 Prepare adjusting entries for accruals.

The Basics of Adjusting Entries

Illustration 3-18

Basic Analysis

The expense Interest Expense is increased $50, and the liability Interest Payable is increased $50.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Interest Payable		Interest Expense
		+$50		−$50

Debit–Credit Analysis

Debits increase expenses: debit Interest Expense $50.
Credits increase liabilities: credit Interest Payable $50.

Journal Entry

Oct. 31	Interest Expense	50	
	Interest Payable		50
	(To record interest on notes payable)		

Posting

Interest Expense		905
Oct. 31	Adj. 50	
Oct. 31	Bal. 50	

Interest Payable		230
	Oct. 31	Adj. 50
	Oct. 31	Bal. 50

INTERNATIONAL INSIGHT

Cashing In on Accrual Accounting

The Chinese government, like most governments, uses cash accounting. A recent report, however, noted that it decided to use accrual accounting versus cash accounting for about $38 billion of expenditures in a recent budget projection. The Chinese government decided to expense the amount in the year in which it was originally allocated rather than when the payments would be made. Why did the Chinese government do this? It enabled the government to keep its projected budget deficit below a 3% threshold. While the Chinese government was able to keep its projected shortfall below 3%, it did suffer some criticism for its inconsistent accounting. Critics charge that this inconsistent treatment reduces the transparency of China's accounting information. That is, it is not easy for outsiders to accurately evaluate what is really going on.

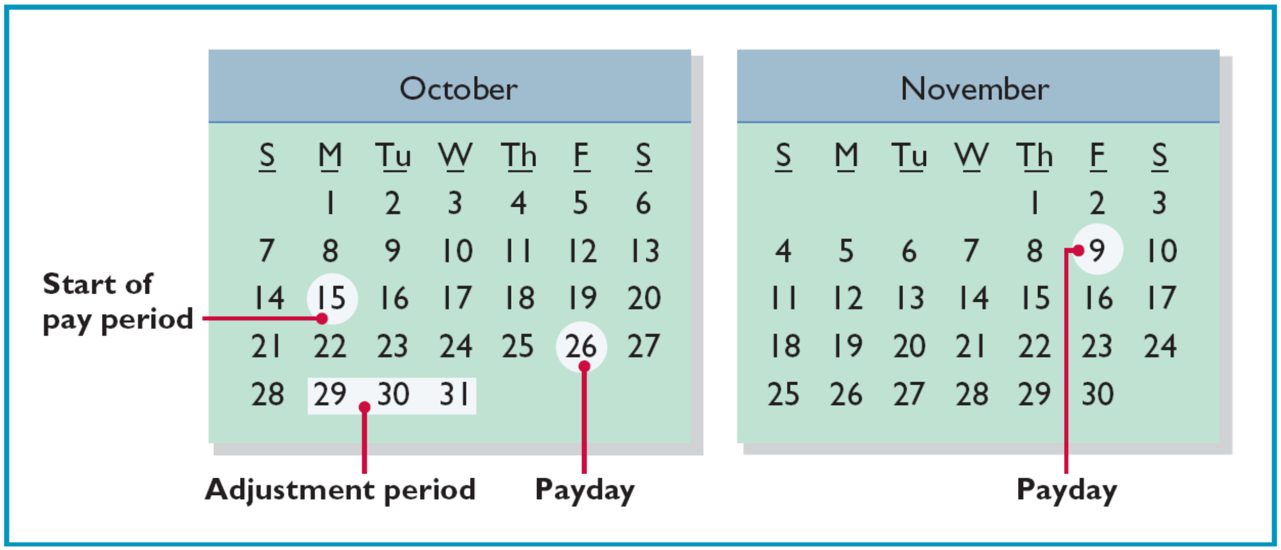
Source: Andrew Batson, "China Altered Budget Accounting to Reduce Deficit Figure," *Wall Street Journal Online* (March 15, 2010).

? Accrual accounting is often considered superior to cash accounting. Why, then, were some people critical of China's use of accrual accounting in this instance? (See page 157.)

The Basics of Adjusting Entries

Illustration: Pioneer Advertising Agency last paid salaries on October 26; the next payment of salaries will not occur until November 9. The employees receive total salaries of $2,000 for a five-day work week, or $400 per day. Thus, accrued salaries at October 31 are $1,200 ($400 x 3 days).

Illustration 3-19



LO 5 Prepare adjusting entries for accruals.

The Basics of Adjusting Entries

Illustration 3-20

Basic Analysis

The expense Salaries and Wages Expense is increased $1,200, and the liability account Salaries and Wages Payable is increased $1,200.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Salaries and Wages Payable		Salaries and Wages Expense
		+$1,200		−$1,200

Debit–Credit Analysis

Debits increase expenses: debit Salaries and Wages Expense $1,200.
Credits increase liabilities: credit Salaries and Wages Payable $1,200.

Journal Entry

Oct. 31	Salaries and Wages Expense	1,200	
	Salaries and Wages Payable		1,200
	(To record accrued salaries and wages)		

Posting

Salaries and Wages Expense 726

Oct. 26		4,000	
31	**Adj.**	**1,200**	
Oct. 31	Bal.	5,200	

Salaries and Wages Payable 212

	Oct. 31	**Adj.**	**1,200**
	Oct. 31	Bal.	1,200

The Basics of Adjusting Entries

Illustration 3-21

ACCOUNTING FOR ACCRUED EXPENSES

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, salaries	Expenses have been incurred but not yet paid in cash or recorded.	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities

LO 5 Prepare adjusting entries for accruals.

PEOPLE, PLANET, AND PROFIT INSIGHT

Got Junk?

Do you have an old computer or two that you no longer use? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete **each day**. Yet, in a recent year, only 11% of computers were recycled. It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.

What accounting issue might this cause for companies?

The Basics of Adjusting Entries

Summary of Basic Relationships

Illustration 3-22

Type of Adjustment	Accounts Before Adjustment	Adjusting Entry
Prepaid expenses	Assets overstated Expenses understated	Dr. Expenses Cr. Assets or Contra Assets
Unearned revenues	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated Revenues understated	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated Liabilities understated	Dr. Expenses Cr. Liabilities

LO 5 Prepare adjusting entries for accruals.

The Adjusted Trial Balance

Adjusted Trial Balance

- Prepared **after all adjusting entries** are journalized and posted.
- Purpose is to **prove the equality** of debit balances and credit balances in the ledger.
- Is the **primary basis for the preparation of financial statements**.

Illustration 3-25

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2014

	Dr.	Cr.
Cash	$ 15,200	
Accounts Receivable	**200**	
Supplies	**1,000**	
Prepaid Insurance	**550**	
Equipment	5,000	
Accumulated Depreciation—Equipment		**$ 40**
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		**50**
Unearned Service Revenue		**800**
Salaries and Wages Payable		**1,200**
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	**5,200**	
Supplies Expense	**1,500**	
Rent Expense	900	
Insurance Expense	**50**	
Interest Expense	**50**	
Depreciation Expense	**40**	
	$30,190	**$30,190**

LO 6

The Adjusted Trial Balance

Review Question

Which of the following statements is *incorrect* concerning the adjusted trial balance?

a. An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.

b. The adjusted trial balance provides the primary basis for the preparation of financial statements.

c. The adjusted trial balance lists the account balances segregated by assets and liabilities.

d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.

The Financial Statements

Financial Statements are prepared directly from the **Adjusted Trial Balance**.

Income Statement

Owner's Equity Statement

Balance Sheet

LO 6 Describe the nature and purpose of the adjusted trial balance.

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2014

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING AGENCY
Income Statement
For the Month Ended October 31, 2014

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

PIONEER ADVERTISING AGENCY
Owner's Equity Statement
For the Month Ended October 31, 2014

Owner's capital, October 1	$ -0-
Add: Investments	10,000
	10,000
Net income	2,860
	12,860
Owner's Drawings	500
Owner's capital, October 31	$12,360

To balance sheet

Illustration 3-26
Preparation of the income statement and owner's equity statement from the adjusted trial balance

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2014

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING AGENCY
Balance Sheet
October 31, 2014

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment	$5,000	
Less: Accumulated depreciation—equip.	40	4,960
Total assets		$21,910
Liabilities and Owner's Equity		
Liabilities		
Notes payable		$ 5,000
Accounts payable		2,500
Unearned service revenue		800
Salaries and wages payable		1,200
Interest payable		50
Total liabilities		9,550
Owner's equity		
Owner's capital		12,360
Total liabilities and owner's equity		$21,910

Capital balance at Oct. 31 from Owner's Equity Statement in Illustration 3-26

Illustration 3-27
Preparation of the balance sheet from the adjusted trial balance

Prepaid Expenses

- When a company prepays an expense, it debits that amount to **an expense account**.
- When it receives payment for future services, it credits the amount to **a revenue account**.

LO 7 Prepare adjusting entries for the alternative treatment of deferrals.

APPENDIX 3A Alternative Treatment of Prepaid Expenses and Unearned Revenues

Prepaid Expenses

Company may choose to **debit (increase) an expense account** rather than an asset account. This alternative treatment is simply more convenient.

Illustration 3A-2

Prepayment Initially Debited to Asset Account (per chapter)				Prepayment Initially Debited to Expense Account (per appendix)			
Oct. 5	Supplies	2,500		Oct. 5	Supplies Expense	2,500	
	Accounts Payable		2,500		Accounts Payable		2,500
Oct. 31	Supplies Expense	1,500		Oct. 31	Supplies	1,000	
	Supplies		1,500		Supplies Expense		1,000

LO 7 Prepare adjusting entries for the alternative treatment of deferrals.

APPENDIX 3A Alternative Treatment of Prepaid Expenses and Unearned Revenues

Unearned Revenues

Company may **credit (increase) a revenue account** when they receive cash for future services.

Illustration 3A-5

Unearned Service Revenue Initially Credited to Liability Account (per chapter)				Unearned Service Revenue Initially Credited to Revenue Account (per appendix)			
Oct. 2	Cash	1,200		Oct. 2	Cash	1,200	
	Unearned Service Revenue		1,200		Service Revenue		1,200
Oct. 31	Unearned Service Revenue	400		Oct. 31	Service Revenue	800	
	Service Revenue		400		Unearned Service Revenue		800

LO 7 Prepare adjusting entries for the alternative treatment of deferrals.

Summary of Additional Adjustment Relationships

Illustration 3A-7

Type of Adjustment	Reason for Adjustment	Account Balances before Adjustment	Adjusting Entry
1. Prepaid expenses	(a) Prepaid expenses initially recorded in asset accounts have been used.	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
	(b) **Prepaid expenses initially recorded in expense accounts have not been used.**	**Assets understated** **Expenses overstated**	**Dr. Assets** **Cr. Expenses**
2. Unearned revenues	(a) Unearned revenues initially recorded in liability accounts are now recognized as revenue.	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
	(b) **Unearned revenues initially recorded in revenue accounts are still unearned.**	**Liabilities understated** **Revenues overstated**	**Dr. Revenues** **Cr. Liabilities**

LO 7 Prepare adjusting entries for the alternative treatment of deferrals.

APPENDIX 3B Concepts in Action

Qualities of Useful Information

According to the FASB, useful information should possess two fundamental qualities, **relevance** and **faithful representation**.

- **Relevance** Accounting information has **relevance** if it would make a difference in a business decision. Information is considered relevant if it provides information that has **predictive value**, that is, helps provide accurate expectations about the future, and has **confirmatory value**, that is, confirms or corrects prior expectations. **Materiality** is a company-specific aspect of relevance. An item is material when its **size** makes it likely to influence the decision of an investor or creditor.

LO 8 Discuss financial reporting concepts.

APPENDIX 3B Concepts in Action

Qualities of Useful Information

According to the FASB, useful information should possess two fundamental qualities, **relevance** and **faithful representation**.

- **Faithful Representation** Faithful representation means that information accurately depicts what really happened. To provide a faithful representation, information must be **complete** (nothing important has been omitted), **neutral** (is not biased toward one position or another), and **free from error**.

APPENDIX 3B Concepts in Action

Qualities of Useful Information

ENHANCING QUALITIES

Comparability results when different companies use the same accounting principles.

Information is **verifiable** if independent observers, using the same methods, obtain similar results.

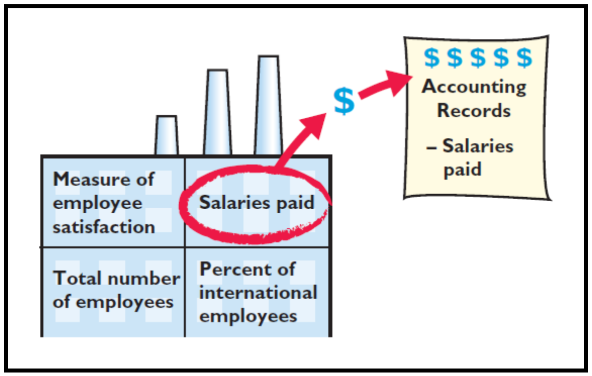
Information has the quality of **understandability** if it is presented in a clear and concise fashion.

Consistency means that a company uses the same accounting principles and methods from year to year.

For accounting information to have relevance, it must be **timely**.

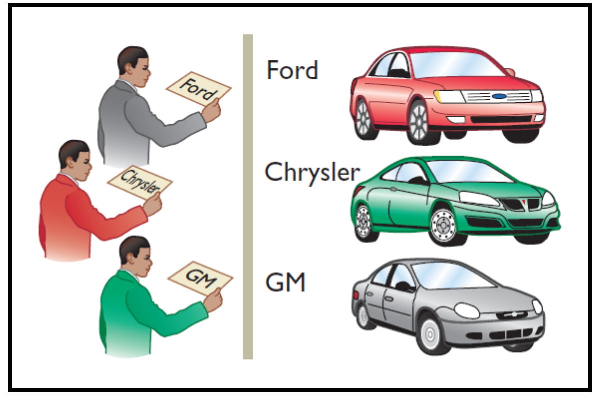
Assumptions in Financial Reporting

Illustration 3B-2



Monetary Unit

Requires that only those things that can be expressed in money are included in the accounting records.



Economic Entity

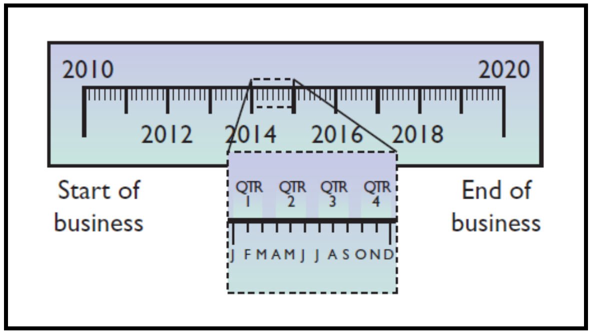
States that every economic entity can be separately identified and accounted for.

LO 8 Discuss financial reporting concepts.

APPENDIX 3B Concepts in Action

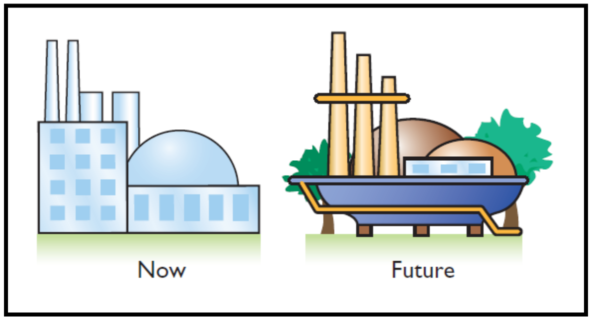
Assumptions in Financial Reporting

Illustration 3B-2



Time Period

States that the life of a business can be divided into artificial time periods.



Going Concern

The business will remain in operation for the foreseeable future.

LO 8 Discuss financial reporting concepts.

Principles in Financial Reporting

MEASUREMENT PRINCIPLES

HISTORICAL COST	FAIR VALUE
Or cost principle, dictates that companies record assets at their cost.	Indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

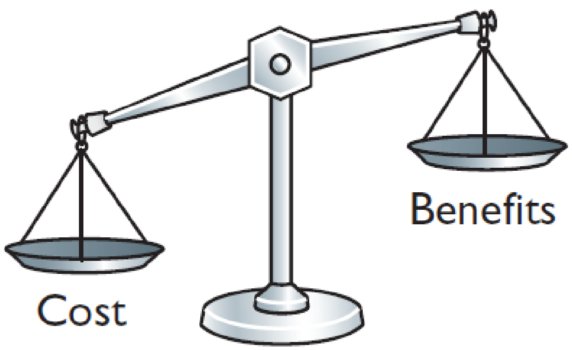
APPENDIX 3B Concepts in Action

Principles in Financial Reporting

REVENUE RECOGNITION PRINCIPLE	EXPENSE RECOGNITION PRINCIPLE	FULL DISCLOSURE PRINCIPLE
Requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.	Dictates that efforts (expenses) be matched with results (revenues). Thus, expenses follow revenues.	Requires that companies disclose all circumstances and events that would make a difference to financial statement users.

LO 8 Discuss financial reporting concepts.

Cost Constraint



Cost Constraint

Accounting standard-setters weigh the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.

LO 8 Discuss financial reporting concepts.

A Look at IFRS

Key Points

- Companies applying IFRS also use accrual-basis accounting to ensure that they record transactions that change a company's financial statements in the period in which events occur.
- Similar to GAAP, cash-basis accounting is not in accordance with IFRS.
- IFRS also divides the economic life of companies into artificial time periods. Under both GAAP and IFRS, this is referred to as the **time period assumption**.
- IFRS requires that companies present a complete set of financial statements, including comparative information annually.

LO 9 Compare the procedures for revenue recognition under GAAP and IFRS.

A Look at IFRS

Key Points

- The general revenue recognition principle required by GAAP that is used in this textbook is similar to that used under IFRS.
- Revenue recognition fraud is a major issue in U.S. financial reporting. The same situation occurs in other countries, as evidenced by revenue recognition breakdowns at Dutch software company Baan NV, Japanese electronics giant NEC, and Dutch grocer AHold NV.
- Under IFRS, revaluation of items such as land and buildings is permitted. IFRS allows depreciation based on revaluation of assets, which is not permitted under GAAP.

LO 9 Compare the procedures for revenue recognition under GAAP and IFRS.

A Look at IFRS

Key Points

- The terminology used for revenues and gains, and expenses and losses, differs somewhat between IFRS and GAAP. For example, income is defined as:

  Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from shareholders.

- Expenses are defined as:

  Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity other than those relating to distributions to shareholders.

A Look at IFRS

Looking into the Future

The IASB and FASB are completing a joint project on revenue recognition. The purpose of this project is to develop comprehensive guidance on when to recognize revenue. It is hoped that this approach will lead to more consistent accounting in this area. For more on this topic, see www.fasb.org/project/revenue_recognition.shtml.

LO 9 Compare the procedures for revenue recognition under GAAP and IFRS.

A Look at IFRS

IFRS Practice

IFRS:

a. uses accrual accounting.

b. uses cash-basis accounting.

c. allows revenue to be recognized when a customer makes an order.

d. requires that revenue not be recognized until cash is received.

A Look at IFRS

IFRS Practice

Which of the following statements is false?

a. IFRS employs the periodicity assumption.

b. IFRS employs accrual accounting.

c. IFRS requires that revenues and costs must be capable of being measured reliably.

d. IFRS uses the cash basis of accounting.

LO 9 Compare the procedures for revenue recognition under GAAP and IFRS.

A Look at IFRS

IFRS Practice

As a result of the revenue recognition project being undertaken by the FASB and IASB:

a. revenue recognition places more emphasis on when the performance obligation is satisfied.

b. revenue recognition places more emphasis on when revenue is realized.

c. revenue recognition places more emphasis on when expenses are incurred.

d. revenue is no longer recorded unless cash has been received.

LO 9

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