cHAPTER 3

adjusting accounts for FinAncial Statements

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| Chapter Outline |
| **I. Timing and Reporting** | |
| A. The Accounting Period To provide timely information, accounting systems prepare reports at regular intervals. | |
| 1. Time period principle assumes that an organization’s activities can be divided into specific time periods such as a month, a three-month quarter, a six-month interval, or a year for periodic reporting. Interim and annual financial statements can then be prepared.  2. Annual reporting period: | |
| a. Calendar year—January 1 to December 31.   1. Fiscal year—any twelve consecutive months on which to base the annual financial reports. 2. Natural business year—a fiscal year that ends when a company’s sales activities are at their lowest point. 3. Interim financial statements—statements prepared for any period less than a fiscal year. | |
| B. Accrual Basis versus Cash Basis | |
| 1. Accrual basis accounting—uses the adjusting process to recognize revenues when earned and expenses when incurred with revenues (match the expenses with the revenue). This means the revenues are recorded when services and products are delivered and expenses are recorded when incurred (matched with revenues). Accrual basis is consistent with GAAP. Improves comparability of statements.  2. Cash basis accounting—revenues are recognized when cash is received and expenses are recognized when cash is paid. Accrual accounting better reflects business performance than cash basis accounting. Accrual accounting increases the comparability of financial statements. | |
| C. Recognizing Revenues and Expenses | |
| 1. The *revenue recognition principle* requires that revenue be recorded when goods or services are provided to customers and at an amount expected to be received from customers.  2. The *expense recognition principle* (often called the matching principle) aims to record expenses in the same period as the revenues recognized as a result of these expenses. | |
| D. Framework for Adjustments—An adjusting entryis recorded to bring an asset or liability account balance to its proper amount. Adjustments exist for transactions that extend over more than one period. This entry also updates the related expense or revenue account. The three steps for making an adjustment are:   1. Determine the current account balance 2. Determine what the balance should equal 3. Record the adjusting entry to get from step 1 to step 2   **II. Deferral of Expense** | |
| 1. Adjusting Deferral of Expenses | |
| 1. Prepaid expenses (including depreciation) are items *paid for* in advance of receiving their benefits. Prepaid expenses, also called deferred expenses, are assets. As the assets are used, their costs become expenses. | |
| 1. Common prepaid items are supplies, prepaid insurance, prepaid rent, and depreciation.   3. Adjusting entries for prepaids involves increasing (debiting) expenses and decreasing (crediting) assets (with the exception of depreciation on plant and equipment). Depreciation is a special category of prepaid expenses. | |
| B. Adjusting for Depreciation | |
| 1. Depreciation is the process of allocating the cost of plant assets over their expected useful lives. 2. Adjusting entries for depreciation expense involve increasing (debiting) expenses and increasing (crediting) a special account called Accumulated Depreciation. This account is classified as a contra asset. It is linked to the asset as a subtraction and thus used to record the declining asset balance. 3. Book value is a term used to describe the asset less its contra asset (accumulated depreciation).   **III. Deferral of Revenue** | |
| A. Unearned revenues (also called deferred revenues) are liabilities created by cash received in advance of providing products or services. The obligation is to provide the service or product. As they are provided, unearned revenues (liabilities) become *earned* revenues (revenues).  B. Adjusting entries for unearned revenues involve increasing (crediting) revenues and decreasing (debiting) unearned revenues. | |
| **IV. Accrued Expense** | |
| 1. Accrued expenses are costs or expenses incurred in a period but are both unpaid and unrecorded. 2. Common accrued expenses are salaries, interest, rent, and taxes. 3. Adjusting entries for recording accrued expenses involve increasing (debiting) expenses and increasing (crediting) liabilities. (The liability is a “payable.”) | |
| **V. Accrued Revenue** | | |
| 1. Accrued revenues are revenues earned in a period that are both unrecorded and not yet received in cash. 2. Accrued revenues commonly result from partially completed jobs or interest earned. 3. Adjusting entries for recording accrued revenues involves increasing (debiting) assets and increasing (crediting) revenues. (The asset is a “receivable.”) | | |
| 1. Links to Financial Statements Each adjusting entry affects one or more income statement accounts *and* one or more balance sheet accounts. Failure to make a necessary adjustment will result in misstatements of amounts on each of these statements. (See textbook Exhibit 3.12 for a summary of adjustments and financial statement links.) | | |
| 1. **Trial Balance and Financial Statements**   A. Adjusted Trial Balance—A list of accounts and balances prepared *after* adjusting entries are recorded and posted to the ledger.  B. Preparing Financial Statements—Prepare financial statements directly from information in the *adjusted* trial balance. The following preparation order shows the flow of information from one statement to another: | | |
| 1. Income Statement  2. Statement of Retained Earnings Requires use of net income or loss from previous statement.   1. Balance Sheet Requires use of ending retained earnings balance from previous statement. | | |
| 1. **Closing Process --** The closing process occurs at the end of the accounting period *after* financial statements are completed. | | | |
| A Steps in closing process:   1. Identify accounts for closing. 2. Record and post-closing entries. 3. Prepare a post-closing trial balance.   B. Two purposes of closing process:   1. To reset revenues, expenses, and dividends account balances to zero at the end of every period to prepare these accounts for proper measurement in the next period. This is done so that these accounts can properly measure income and dividends for the next period. 2. To update the balance in the retained earnings account to match the amount reported on the statement of retained earnings and the balance sheet.   C. Temporary and Permanent Accounts | | | |
| 1. *Temporary* *accounts* relate to one accounting period. They include all income | | | |
| statement accounts, dividends accounts, and Income Summary. Closing process applies only to temporary accounts.   1. *Permanent accounts* report on activities related to one or more future accounting periods. They include asset, liability, common stock and retained earnings accounts -- all balance sheet accounts. Permanent accounts are not closed each period and carry their balance into future periods. | | | |
| D. Recording Closing Entries—the purpose is to transfer the end-of-period balances in revenue, expense, and dividends accounts to the permanent capital account. Closing entries necessary at the end of each period after financial statements are prepared so revenue, expense, and dividends accounts can begin each period with zero balances, and so that retained earnings will reflect prior periods’ revenues, expenses and dividends. | | | |
| 1. Use a new temporary account called *Income Summary*. The four steps in the closing process: | | | |
| a. Step 1. Close credit balances in revenue accounts to Income Summary by debiting the revenue accounts and crediting Income Summary. This transfers revenue balances to the credit side Income Summary.  b. Step 2. Close debit balances in expense accounts to Income Summary by crediting the expense accounts and debiting Income Summary. This transfers the expense balances to the debit side of Income Summary.  c. Step 3. Close the Income Summary account to Retained Earnings. After steps 1 and 2, the balance in the Income Summary account equals net income. The third closing entry transfers the balance of the Income Summary account to the Retained Earnings account. This entry closes the Income Summary account.  d. Step 4. Close Dividends to Retained Earnings by crediting the account and debiting  the Retained Earnings account. | | | |
| 1. After all closing entries are posted, all temporary accounts have a zero balance and Retained Eearnings is up to date. | | | |
| E. Post-Closing Trial Balance—list of permanent accounts and their balances after all closing entries. | | | |
| 1. Verifies that total debits equal total credits for permanent accounts.  2. Verifies that all temporary accounts have zero ending balances. | | | |
| 1. **Accounting Cycle--** steps in preparing financial statements (see Exhibit 3.19). The ten steps repeated each accounting cycle are as follows: | | | |
| 1. Analyze transactions 2. Journalize 3. Post 4. Prepare unadjusted trial balance 5. Adjust 6. Prepare adjusted trial balance 7. Prepare statements 8. Close accounts 9. Prepare post-closing trial balance. 10. Optional: Reverse. | | | |
| 1. **Classified Balance Sheet --** organizes assets and liabilities into important subgroups. | | | |
| A. Classification Structure | | | |
| 1. One of the classifications is the separation between current and noncurrent assets and liabilities. 2. Current items are expected to come due (either collected or owed) within the longer of one year or the company’s *operating cycle*. 3. An operating cycle is the time span from when *cash is used* to acquire goods and services until *cash is received* from the sale of those goods and services. | | | |
| B. Classification Categories | | | |
| 1. Current assets—cash or other assets that are expected to be sold, collected, or used within one year or the operating cycle, whichever is longer. Examples: cash, short‑term investments, accounts receivable, short-term notes receivable, merchandise inventory, and prepaid expenses. | | | |
| 1. Long-term investments—assets held for more than one year, that are not used in business operations. Examples: notes receivable and investments in stocks and bonds expected to be held for more than one year or operating cycle. | | | |
| 3. Plant assets—tangible, long‑lived assets that are used to produce or sell goods and services. Examples: equipment, buildings, land. Also called property, plant and equipment (PP&E). | | | |
| 1. Intangible assets—long-term resources that benefit business operation. They lack physical form. Their value comes from the privileges or rights that are granted to or held by the owner. Examples: goodwill, patents, trademarks, franchises, copyrights. | | | |
| 5. Current liabilities—liabilities due to be paid or settled within the longer of one year or the operating cycle. Examples: accounts payable, wages payable, taxes payable, interest payable, current portions of long‑term liabilities. | | | |
| 6. Long‑term liabilities—liabilities that are not due to be paid within one year or the operating cycle of the business. Examples: notes payable, mortgage payable, bonds payable. | | | |
| 7. Equity—owner’s claim on assets. For a corporation it is reported in the equity section as common stock and retained earnings. | | | |
| **X. Decision Analysis: Profit Margin and Current Ratio**   1. Profit margin is used to evaluate operating results by measuring the ratio of a company’s net income   to sales. Also called *return on sales*. 2. Calculated as net income divided by net sales revenues. 3. Current ratio assesses a company’s ability to pay its debts. 4. Calculated as total current assets divided by total current liabilities.   **XI. Alternative Accounting for Prepayments (Appendix 3A)** | | | |
| A. Prepaid expenses may originally be recorded with debits to expense accounts instead of assets. If so, then adjusting entries must transfer the cost of the unused portions from expense accounts to prepaid expense (asset) accounts. | | | |
| B. Prepaid revenues or revenues collected in advance may originally be recorded with credits to revenue accounts instead of liabilities. If so, then adjusting entries must transfer the unearned portions from revenue accounts to unearned revenue (liability) accounts.  C. Note that the financial statements are identical under either procedure, but the adjusting entries are different. | | | |
| **XII. Work Sheet as a Tool (Appendix 3B)** | | | |
| 1. The work sheet is an internal document that serves as a useful tool for organizing accounting information. It is *not* a required report. 2. Benefits of a Work Sheet: helps in preparing financial statements, reduces risk of errors, links accounts and adjustments to financial statements, and shows the effect of proposed or “what if” transactions. | | | |
| C. Use of a Work Sheet – constructed at the end of a period before the adjusting process. Steps to prepare a work sheet: | | | |
| 1. Enter Unadjusted Trial Balance in the first two columns.  2. Enter Adjustments in the third and fourth columns. Total columns to verify debit adjustments equal credit adjustments.  3. Prepare the Adjusted Trial Balance. This is done by combining the unadjusted trial balance and adjustment columns. Total Adjusted Trial Balance columns to verify debits equal credits.  4. Sort Adjusted Trial Balance Amounts to Financial Statements. Expenses and revenues go to the Income Statement. Dividends and Retained Earnings go to the Statement of Retained Earnings; and assets, liabilities, Common Stock and Retained Earnings go to the Balance Sheet.   1. Total Statement Columns, Compute Income or Loss and Balance Columns by adding net income or loss.   D. Preparing Financial Statements from a Work Sheet - it does not substitute for financial statements. The financial statement columns yield pro forma financial statements because they show the statements *as if* the proposed transactions occurred. | | | |
| **XIII. Reversing Entries -Appendix 3C** | | | |
| 1. Accounting without reversing entries   1. To construct proper entries when the cash receipt/payment occurs in the next accounting period. They reverse the adjusting entries involving accrued revenue or expense adjustments. The purpose is to simplify recordkeeping.  2. With or without reversing entries use, it will yield the same result.  B. Accounting with reversing entries (an optional step). | | | |
| 1. Linked to asset and liability account balances that arose from the accrual of revenues and expenses. 2. Purpose is to simplify recordkeeping. 3. They are prepared after closing entries and dated the first day of the new period. 4. Procedure is to transfer accrued asset and liability account balances to related revenue and expense accounts creating an abnormal balance in these accounts. 5. The full subsequent cash receipts (and payments) are recorded as increases in revenue (and expense) accounts creating a net balance equal to the amount earned or incurred in that period. | | | |