3 Adjusting The Accounts

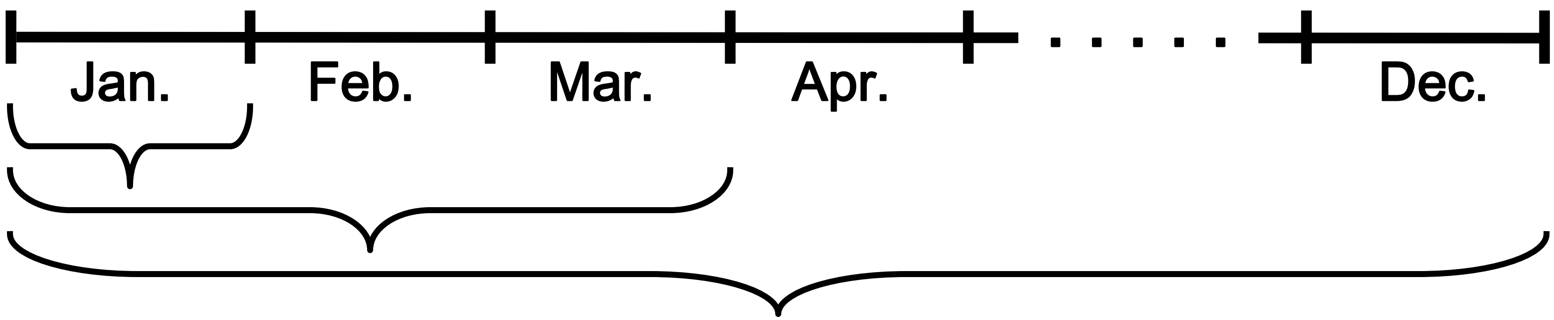
Learning Objectives

1. Explain the accrual basis of accounting and the reasons for adjusting entries.
2. Prepare adjusting entries for deferrals.
3. Prepare adjusting entries for accruals.
4. Describe the nature and purpose of an adjusted trial balance.

LEARNING OBJECTIVE 1

Explain the accrual basis of accounting and the reasons for adjusting entries.

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*.

Fisical and Calendar Years

- Monthly and quarterly time periods are called **interim periods**.
- Most large 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.

Fiscal and Calendar Years

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

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 they receive cash).
- **Expenses** are recognized when **incurred** (rather than when paid).
- In accordance with **generally accepted accounting principles (GAAP)**.

Accrual- versus Cash-Basis Accounting

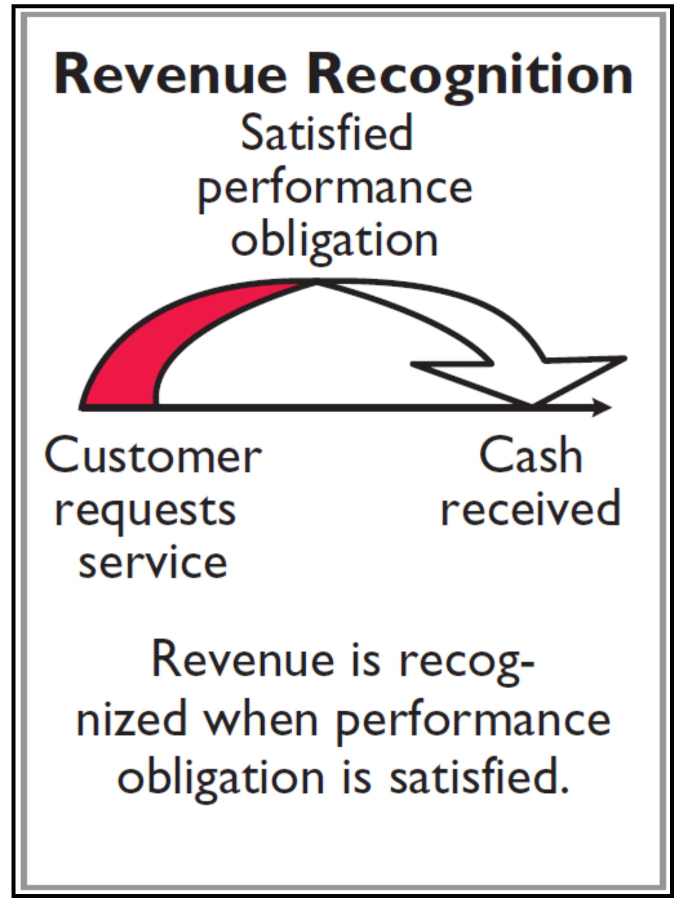
Cash-Basis Accounting

- **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)**.

Recognizing Revenues and Expenses

REVENUE RECOGNITION PRINCIPLE

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

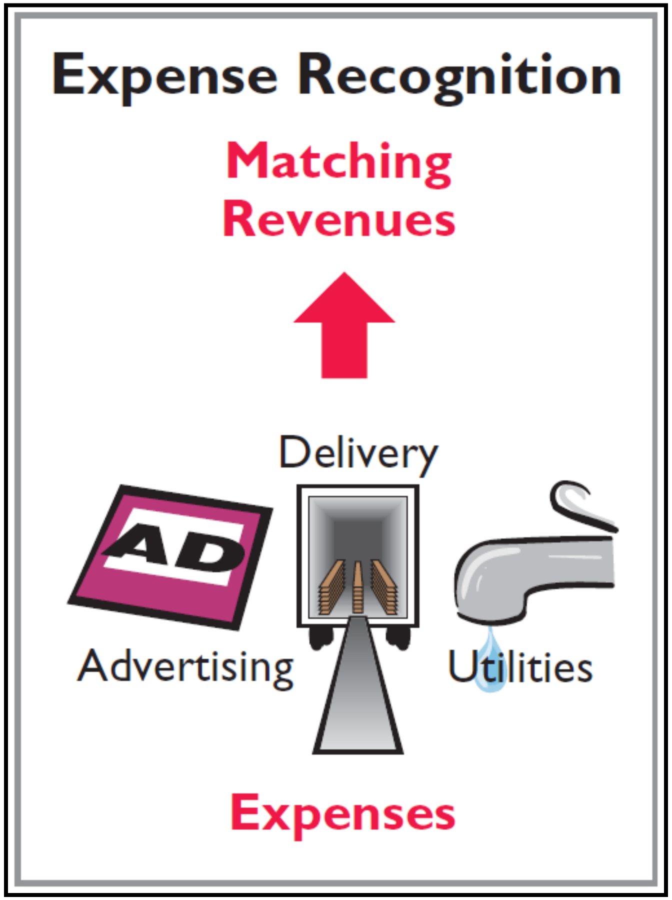


Recognizing Revenues and Expenses

EXPENSE RECOGNITION PRINCIPLE

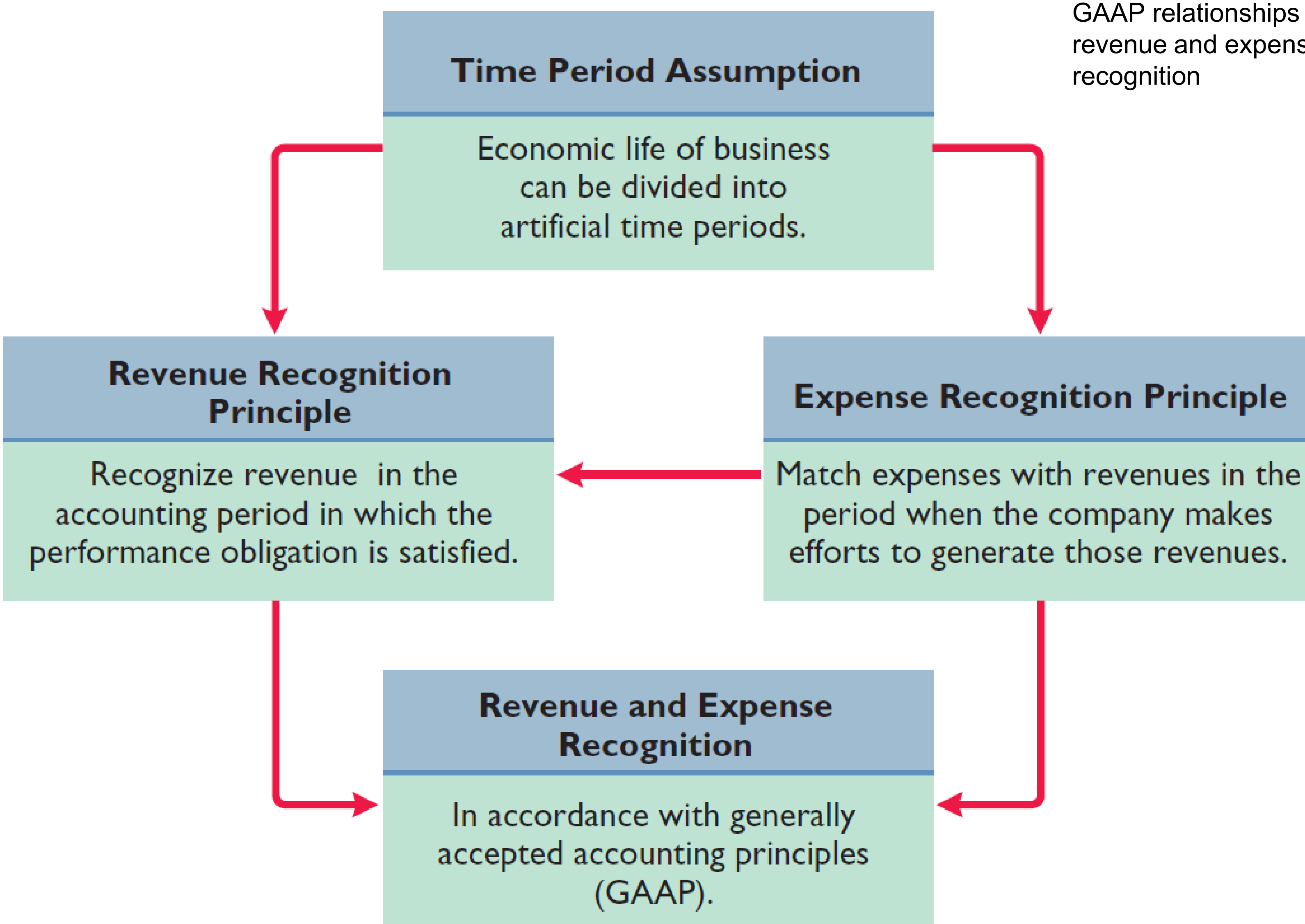
Match expenses with revenues in the period when the company makes efforts that generate those revenues.

"Let the expenses follow the revenues."



LO 1

Illustration 3-1
GAAP relationships in revenue and expense recognition



LO 1

Recognizing Revenues and Expenses

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.

Ethics Insight Krispy Kreme

© Dean Turner/iStockphoto

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, reporting a sale in one period that did not actually occur until the next period in order to achieve the earlier period's sales targets.

What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues? (Go to **WileyPLUS** for this answer and additional questions.)

The Need for 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**.

The Need for Adjusting Entries

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.

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.

Types of Adjusting Entries

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

Illustration 3-3

PIONEER ADVERTISING Trial Balance October 31, 2017	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

LO 1

DO IT! 1 Timing Concepts

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.

LO 1

LEARNING OBJECTIVE 2

Prepare 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**
- **Unearned revenues**

Prepaid Expenses

Payment of cash, that is recorded as an asset to show the service or benefit the company will receive in the future.

Cash Payment BEFORE **Expense Recorded**

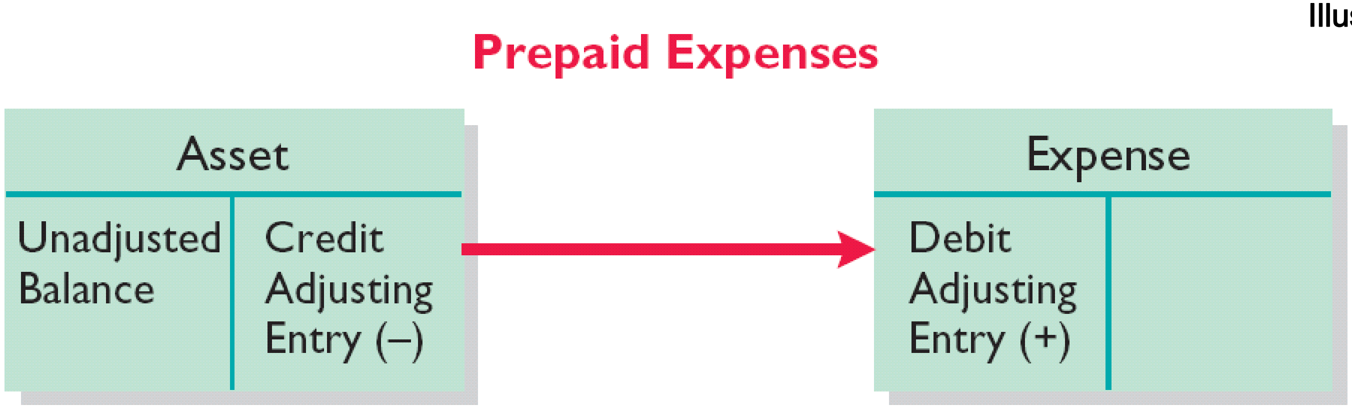
Prepayments often occur in regard to:

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

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 2

Supplies

Illustration: Pioneer Advertising 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

Supplies

Illustration 3-5

Basic Analysis

The expense Supplies Expense is increased $1,500, and the asset Supplies is decreased $1,500.

Equation Analysis

	Assets	=	Liabilities	+	Owner's Equity
(1)	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)		

Posting

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

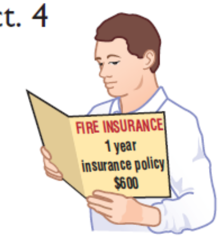
Supplies Expense		631
Oct. 31	Adj. 1,500	
Oct. 31	Bal. 1,500	

Insurance

Illustration: On October 4, Pioneer Advertising 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.

Insurance

Oct. 4



Insurance purchased; record asset

Insurance Policy			
Oct $50	Nov $50	Dec $50	Jan $50
Feb $50	March $50	April $50	May $50
June $50	July $50	Aug $50	Sept $50
I YEAR $600			

Oct. 31
Insurance expired; record insurance expense

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50

Insurance

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 = Insurance Expense −$50 −$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		

Depreciation

- **Buildings**, **equipment**, and **motor vehicles** (assets that provide service for many years) are **recorded as assets**, rather than an expense, on the date 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.**
  - **Allocation concept**, not a valuation concept.

Depreciation

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**.

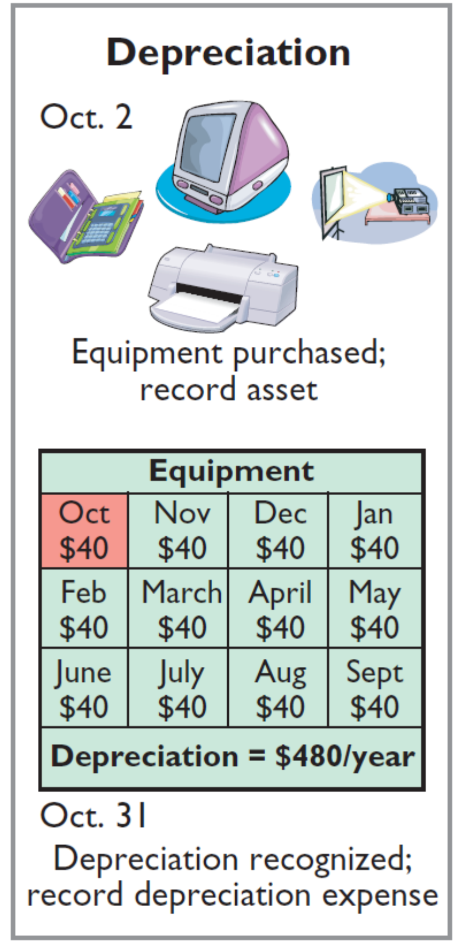


Illustration 3-7

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	

Depreciation

STATEMENT PRESENTATION

- Accumulated Depreciation is a **contra asset account** (credit).
- **Offsets related asset account** 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 2

Prepaid Expenses

Summary of the accounting for prepaid expenses.

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

Illustration 3-9
Accounting for prepaid expenses

Unearned Revenues

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

Cash Receipt BEFORE **Revenue Recorded**

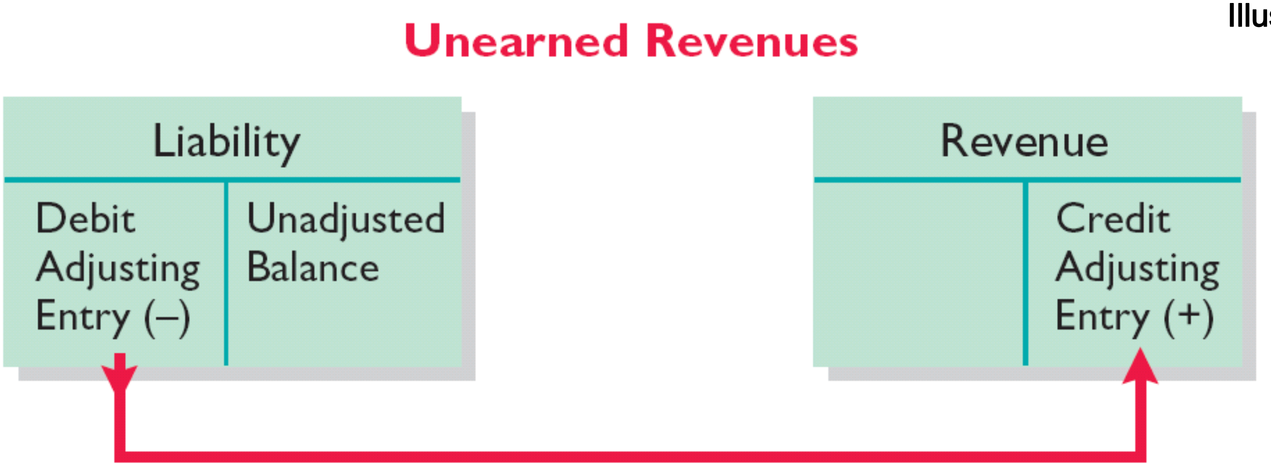
Unearned revenues often occur in regard to:

- Rent
- Airline tickets
- Magazine subscriptions
- Customer deposits

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.**

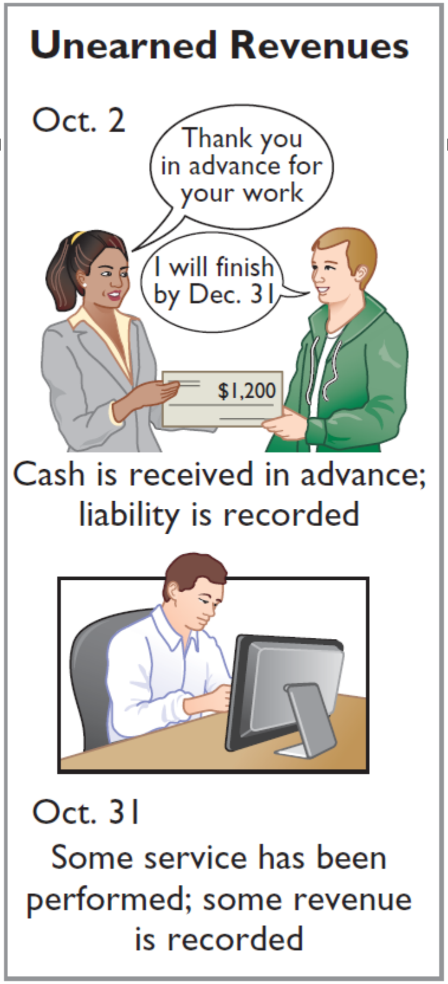
Illustration 3-10



LO 2

Unearned Revenues

Illustration: Pioneer Advertising 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

Unearned Revenues

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

Unearned Revenues

Summary of the accounting for unearned revenues.

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

Accounting Across the Organization — Best Buy

© Skip ODonnell/iStockphoto

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 $428 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, 2016, and gives it to his wife, Mary Jones, on December 25, 2016. On January 3, 2017, Mary uses the card to purchase $100 worth of CDs. When do you think Best Buy should recognize revenue and why? (Go to **WileyPLUS** for this answer and additional questions.)

LO 2

DO IT! 2 Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

An analysis of the accounts shows the following.

1. Insurance expires at the rate of $100 per month.
2. Supplies on hand total $800.
3. The equipment depreciates $200 a month.
4. During March, services were performed for one-half of the unearned service revenue.

Prepare the adjusting entries for the month of March.

DO IT! 2 Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

Prepare the adjusting entries for the month of March.

1. Insurance expires at the rate of $100 per month.

Insurance Expense	100	
Prepaid Insurance		100

DO IT! 2 Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

Prepare the adjusting entries for the month of March.

2. Supplies on hand total $800.

Supplies Expense	2,000	
Supplies		2,000

DO IT! 2 Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

Prepare the adjusting entries for the month of March.

3. The equipment depreciates $200 a month.

Depreciation Expense	200	
Accumulated Depreciation—Equipment		200

DO IT! 2 Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

Prepare the adjusting entries for the month of March.

4. During March, services were performed for one-half of the unearned service revenue.

Unearned Service Revenue	4,600	
Service Revenue		4,600

LO 2

LEARNING OBJECTIVE 3

Prepare adjusting entries for accruals.

Accruals are made to record

- **Revenues** for services performed but not yet recorded at the statement date.
- **Expenses** incurred but not yet paid or recorded at the statement date.

Accrued Revenues

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

Revenue Recorded	BEFORE	Cash Receipt

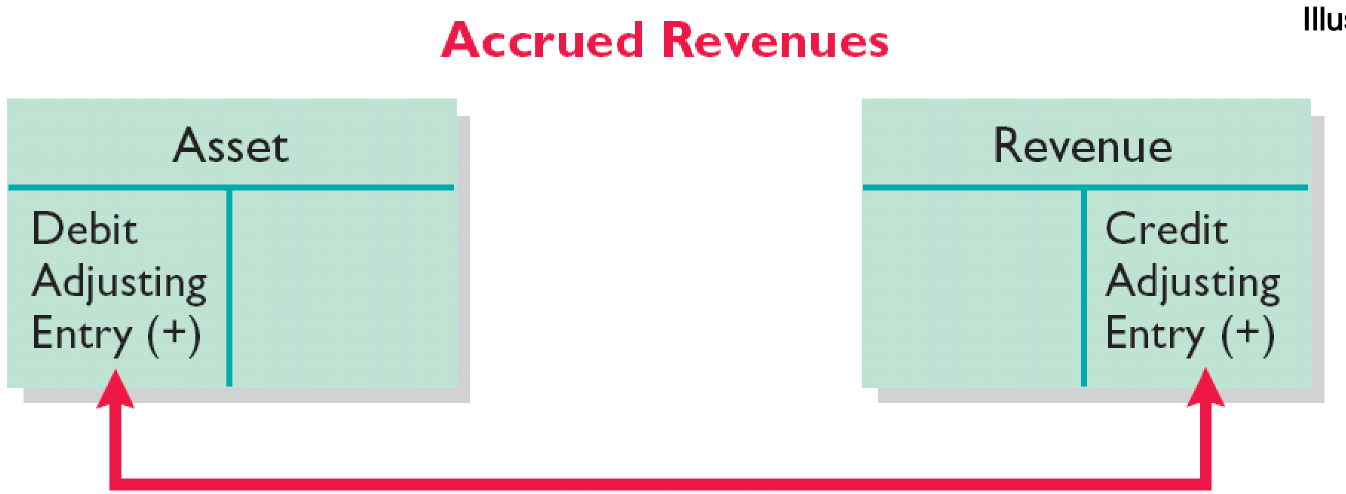
Accrued revenues often occur in regard to:

- Rent
- Interest
- Services

Accrued Revenues

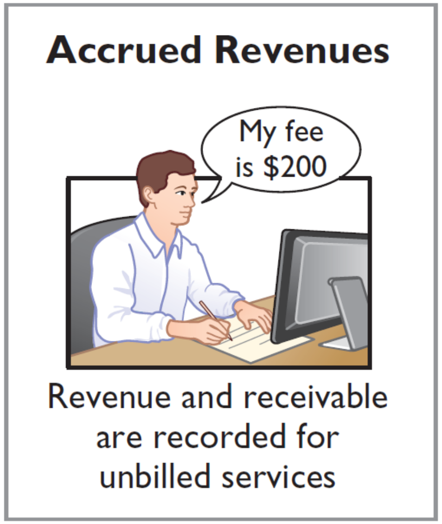
- Adjusting entry shows the **receivable** that exists and records the **revenues for services performed**.
- Adjusting entry:
  - **Increases** (debits) an **asset account** and
  - **Increases** (credits) a **revenue account**.

Illustration 3-13



Accrued Revenues

Illustration: In October Pioneer Advertising performed services worth $200 that were not billed to clients on or before October 31.



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 3

Accrued Revenues

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				Service Revenue
+$200				+$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

Accrued Revenues

Summary of the accounting for accrued revenues.

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

Accrued Expenses

Expenses incurred but not yet paid in cash or recorded.

Expense Recorded BEFORE **Cash Payment**

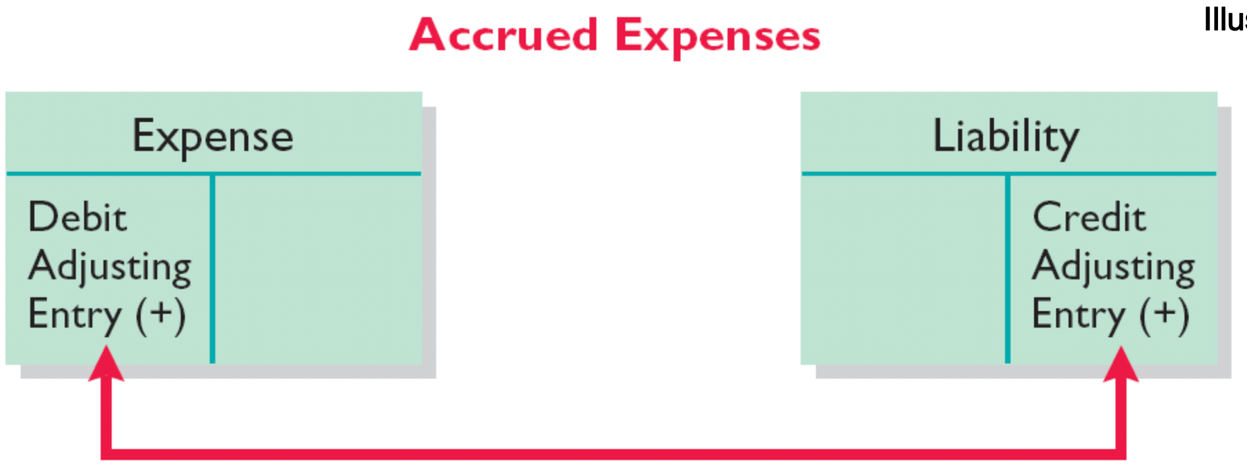
Accrued expenses often occur in regard to:

- Rent
- Interest
- Taxes
- Salaries

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 3

Accrued Expenses

ACCRUED INTEREST

Illustration: Pioneer Advertising 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 3

Accrued Expenses

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	

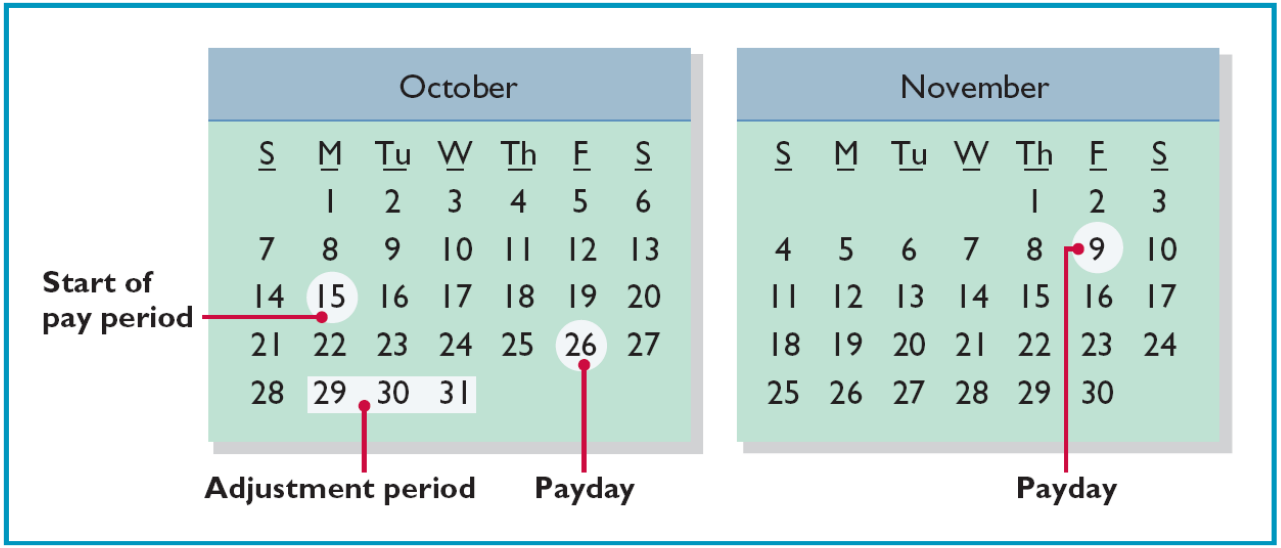
Interest Payable		230
	Oct. 31	**Adj. 50**
	Oct. 31	Bal. 50

Accrued Expenses

ACCRUED INTEREST

Illustration: Pioneer Advertising paid salaries and wages 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.

Illustration 3-19



LO 3

Accrued Expenses

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	

Accrued Expenses

Summary of the accounting for accrued expenses.

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

People, Planet, and Profit Insight

© Nathan Gleave/iStockphoto

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? (Go to **WileyPLUS** for this answer and additional questions.)

LO 3

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

DO IT! 3 Adjusting Entries for Accruals

Micro Computer Services began operations on August 1, 2017. At the end of August 2017, management prepares monthly financial statements. The following information relates to August.

1. At August 31, the company owed its employees $800 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed $30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
3. Revenue for services performed but unrecorded for August totaled $1,100.

Prepare the adjusting entries needed at August 31, 2017.

DO IT! 3 Adjusting Entries for Accruals

Prepare the adjusting entries needed at August 31, 2017.

1. At August 31, the company owed its employees $800 in salaries and wages that will be paid on September 1.

Salaries and Wages Expense	**800**	
Salaries and Wages Payable		**800**

2. On August 1, the company borrowed $30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.

Interest Expense	**250**	
Interest Payable		**250**

3. Revenue for services performed but unrecorded for August totaled $1,100.

Accounts Receivable	**1,100**	
Service Revenue		**1,100**

LO 3

LEARNING OBJECTIVE 4

Describe the nature and purpose of an 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**.

PIONEER ADVERTISING

Illustration 3-25

Adjusted Trial Balance

October 31, 2017

	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
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 4

Adjusted Trial Balance

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.

Preparing Financial Statements

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

↓ ↓ ↓

Income Statement | **Owner's Equity Statement** | **Balance Sheet**

PIONEER ADVERTISING
Adjusted Trial Balance
October 31, 2017

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
Income Statement
For the Month Ended October 31, 2017

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
Owner's Equity Statement
For the Month Ended October 31, 2017

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
Adjusted Trial Balance
October 31, 2017

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
Balance Sheet
October 31, 2017

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

DO IT! 4 Trial Balance

Skolnick Co. was organized on April 1, 2017. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below.

	Debit		Credit
Cash	$ 6,700	Accumulated Depreciation— Equipment	$ 850
Accounts Receivable	600	Notes Payable	5,000
Prepaid Rent	900	Accounts Payable	1,510
Supplies	1,000	Salaries and Wages Payable	400
Equipment	15,000	Interest Payable	50
Owner's Drawings	600	Unearned Rent Revenue	500
Salaries and Wages Expense	9,400	Owner's Capital	14,000
Rent Expense	1,500	Service Revenue	14,200
Depreciation Expense	850	Rent Revenue	800
Supplies Expense	200		
Utilities Expense	510		
Interest Expense	50		
	$37,310		$37,310

(a) Determine the net income for the quarter April 1 to June 30.

(b) Determine the total assets and total liabilities at June 30, 2017, for Skolnick Co.

(c) Determine the amount of owner's capital at June 30, 2017.

LO 4

DO IT! 4 Trial Balance

Solution

(a) The net income is determined by adding revenues and subtracting expenses. The net income is computed as follows.

Revenues		
Service revenue	$14,200	
Rent revenue	800	
Total revenues		$15,000
Expenses		
Salaries and wages expense	9,400	
Rent expense	1,500	
Depreciation expense	850	
Utilities expense	510	
Supplies expense	200	
Interest expense	50	
Total expenses		12,510
Net income		$ 2,490

DO IT! 4 Trial Balance

Solution

(b) Total assets and liabilities are computed as follows.

Assets			Liabilities	
Cash		$ 6,700	Notes payable	$5,000
Accounts receivable		600	Accounts payable	1,510
Supplies		1,000	Unearned rent revenue	500
Prepaid rent		900	Salaries and wages payable	400
Equipment	$15,000		Interest payable	50
Less: Accumulated depreciation—equipment	850	14,150		
Total assets		$23,350	Total liabilities	$7,460

DO IT! 4 Trial Balance

Solution

(c)	Owner's capital, April 1	$ 0
	Add: Investments	14,000
	Net income	2,490
	Less: Owner's drawings	600
	Owner's capital, June 30	$15,890

LEARNING OBJECTIVE 5

APPENDIX 3A: Prepare adjusting entries for the alternative treatment of deferrals.

Alternate Treatment for Adjusting Entries

1. When a company prepays an expense, it **debits** that amount to **an expense account**.

2. When it receives payment for future services, it **credits** the amount to **a revenue account**.

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

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

Summary of Additional Adjustments 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**

LEARNING OBJECTIVE 6

APPENDIX 3B: Discuss financial reporting concepts.

Qualities of Useful Information

Two fundamental qualities, **relevance** and **faithful representation**.

Relevance

- Make a difference in a business decision.
- Provides information that has **predictive value** and **confirmatory value**.
- 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.

Qualities of Useful Information

Two fundamental qualities, **relevance** and **faithful representation**.

Faithful Representation

- Information accurately depicts what really happened.
- Information must be
  - **complete** (nothing important has been omitted),
  - **neutral** (is not biased toward one position or another), and
  - **free from error**.

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.

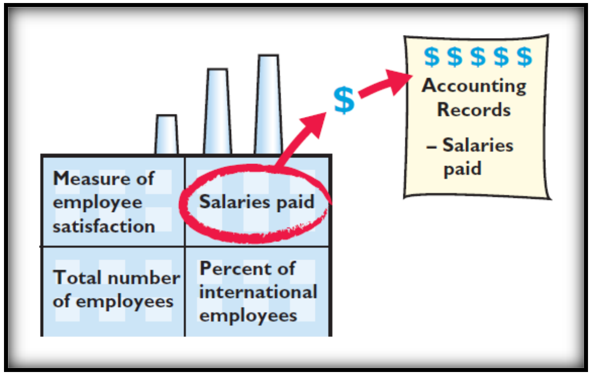
Information has the quality of **understandability** if it is presented in a clear and concise fashion.

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**.

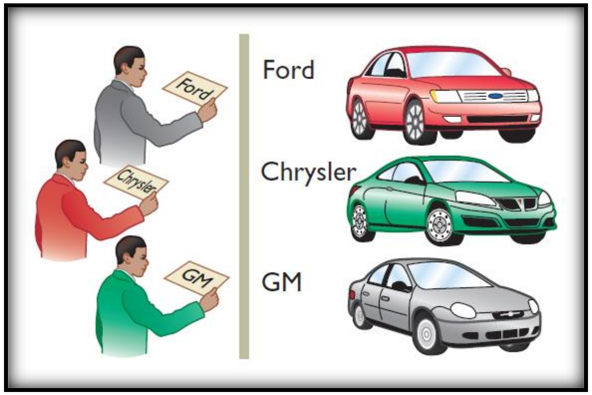
Assumptions in Financial Reporting

Illustration 3B-2



Monetary Unit

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

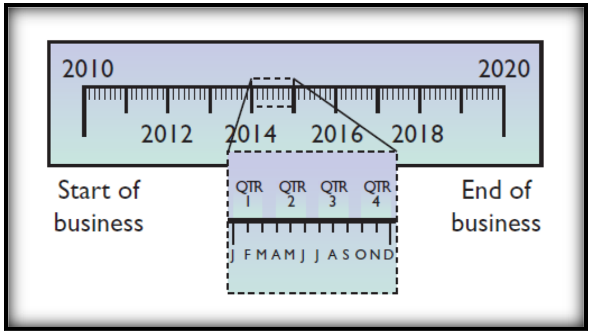


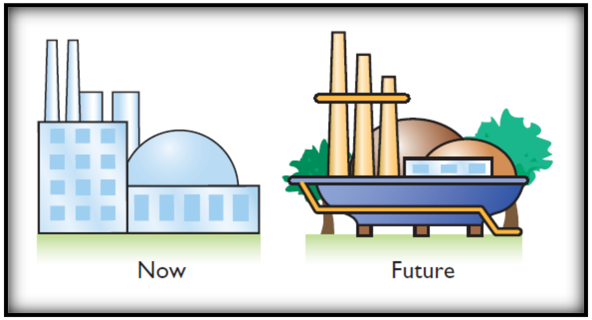
Economic Entity

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

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.

Principles of Financial Reporting

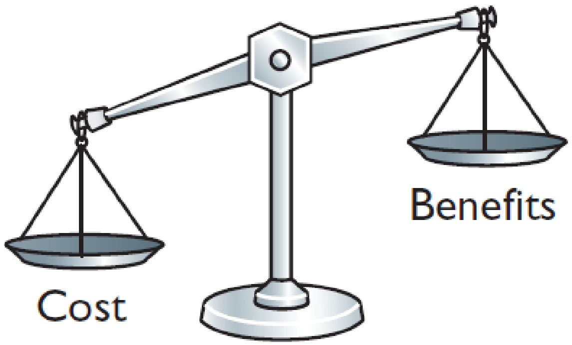
MEASUREMENT PRINCIPLES

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).

Principles of 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.

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.

A Look at IFRS

LEARNING OBJECTIVE 7

Compare the procedures for adjusting entries under GAAP and IFRS.

Key Points

Similarities

- 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**.

A Look at IFRS

Key Points

Similarities

- 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.

LO 7

A Look at IFRS

Key Points

Differences

- Under IFRS, revaluation (using fair value) of items such as land and buildings is permitted. IFRS allows depreciation based on revaluation of assets, which is not permitted under GAAP.
- The terminology used for revenues and gains, and expenses and losses, differs somewhat between IFRS and GAAP. For example, income includes both revenues, which arise during the normal course of operating activities, and gains, which arise from activities outside of the normal sales of goods and services. The term income is not used this way under GAAP. Instead, under GAAP income refers to the net difference between revenues and expenses.

A Look at IFRS

Key Points

Differences

- Under IFRS, expenses include both those costs incurred in the normal course of operations as well as losses that are not part of normal operations. This is in contrast to GAAP, which defines each separately.

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 7

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.

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.

Copyright