ACCRUAL ACCOUNTING CONCEPTS

LO 1: Explain the accrual basis of accounting and the reasons for adjusting entries.

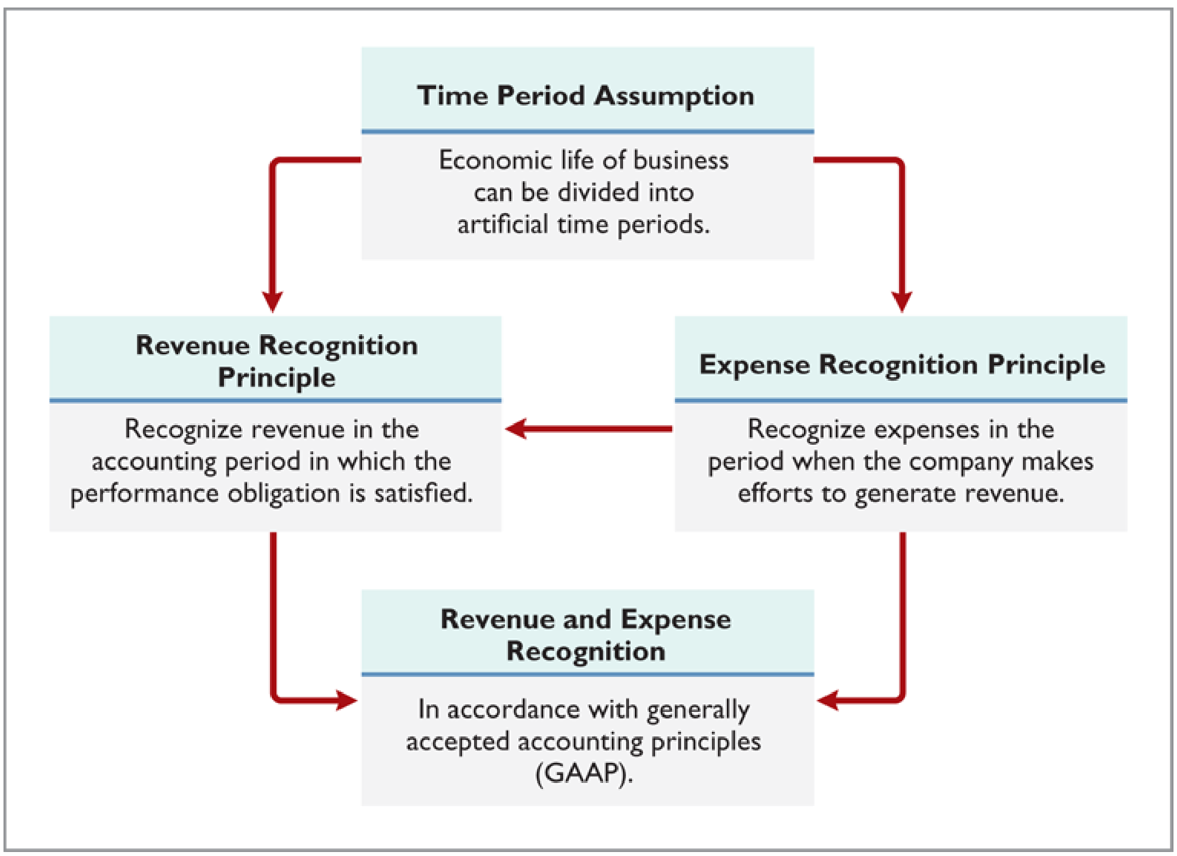
- **<u>Periodicity Assumption</u>:** Accounting divides the economic life of a business into artificial time periods (ex: month, quarter, or year)
  - **Fiscal Year**: an accounting time period that is one year long.
- **<u>Revenue Recognition Principle</u>:** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied **(when the money is EARNED, not collected.)**

Ex: John mowed Danny's lawn for $40 on May 15. Danny didn't have the money to pay John until May 26. What are the journal entries for George on May 15 and May 26?

Date	Account Title	Ref.	Debit	Credit
May 15	Accounts Receivable		40	
	Service Revenue			40

Date	Account Title	Ref.	Debit	Credit
May 26	Accounts Receivable		40	
	Service Revenue			40

- **<u>Expense Recognition (Matching) Principle</u>:** requires that companies match expenses with revenues in the period when the company makes efforts to generate those revenues. **(when the expense has been INCURRED, not paid.)**



ACCRUAL VERSUS CASH BASIS OF ACCOUNTING

Accrual-Basis Accounting

- Transactions recorded in the periods in which the events occur.
- Revenues are recognized when services performed, even if cash was not received.
- Expenses are recognized when incurred, even if cash was not paid.

Cash-Basis Accounting

- Revenues are recognized only when cash is received.
- Expenses are recognized only when cash is paid.
- **Not in accordance with generally accepted accounting principles (GAAP).**

Ex: Suppose that P Company paints a large office building in 20 YR 1. In 20 YR 1, it incurs and pays total expenses (salaries and paint costs) of $30,000. It bills the customer $50,000, but does not receive payment until 20 YR 2.

		Accrual Basis	
	Revenue	$	50,000
20 YR 1	Expenses	$	30,000
	Net Income	$	20,000
20 YR 2	Revenue	$	-
	Expenses	$	-
	Net Income	$	-

		Cash Basis	
	Revenue	$	-
20 YR 1	Expenses	$	30,000
	Net Income	$	(30,000)
20 YR 2	Revenue	$	50,000
	Expenses	$	-
	Net Income	$	50,000

ADJUSTING ENTRIES

- Ensure that the revenue recognition and expense recognition principles are followed.
- Required every time a company prepares financial statements.
- Includes one income statement account and one balance sheet account.

Types of Adjusting Entries

Deferrals:

1. **Prepaid expenses**: Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned revenues**: Cash received before service are performed.

Accruals:

1. **Accrued revenues**: Revenues for services performed but not yet received in cash or recorded.
2. **Accrued expenses**: Expenses incurred but not yet paid in cash or recorded.

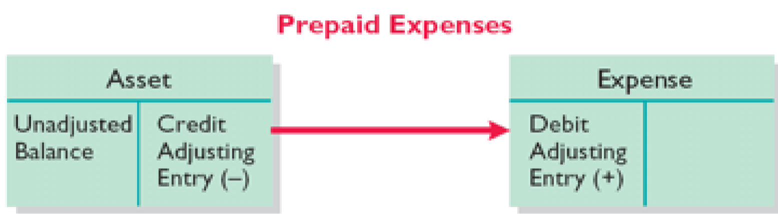
*ADJUSTING ENTRIES NEVER INVOLVE CASH

LO 2: Prepare adjusting entries for deferrals.

DEFERRALS

1. **PREPAID EXPENSES**: Cash payment **BEFORE** expense is recorded.
   - Costs that expire either with the passage of time or through use.
   - Adjusting entry results in an increase (a debit) to an expense account and a decrease (a credit) to an asset account.

Examples of Prepaid Expenses (Assets): Supplies, Prepaid insurance, Prepaid Advertising, Prepaid Rent, Equipment, and Buildings.
*Adjusted because they have been USED or CONSUMED in the business operations.



- Increases (debits) an expense account and
- Decreases (credits) an asset account.

Ex (Prepaid Insurance): Jones Co. pays $5,000 for Insurance for 24 months on January 1. What is the journal entry on January 1 and the adjusting entry at the END of the year when 12 months of the insurance is USED UP?

Date	Account Title	Ref.	Debit	Credit
Jan. 1	Prepaid Insurance		5,000	
	Cash			5,000

Date	Account Title	Ref.	Debit	Credit
Dec. 31	Insurance Expense		2,500	
	Prepaid Insurance			2,500

($5,000/24 months) * 12 months

INSURANCE EXPENSE

Dec. 31 $2,500	
Balance $2,500	

PREPAID INSURANCE

Jan. 1 $5,000	Dec. 31 $2,500
Balance $2,500	

Depreciation: the process of allocating the cost of an asset to expense (depreciation) over its useful life.

- Buildings, equipment, and motor vehicles (long-lived assets) are recorded as assets, rather than an expense, in the year acquired.
- Depreciation does not attempt to report the actual change in the value of an asset.
- **"Using Up"** of these long-lived fixed assets is debited to depreciation expense and the account that is credited is the **accumulated depreciation** account which is a **contra-asset** **(Normal Balance is a CREDIT….opposite of an asset.)**
- For journal entry think of the term **DEAD** to help you remember.

Ex: Bob's office equipment depreciated by $300 during the year. The journal entry to record depreciation on December 31 is

Date	Account Title	Ref.	Debit	Credit
Dec. 31	Depreciation Expense		300	
	Accumulated Depreciation			300

- The difference between the original cost of the office equipment and the balance in the accumulated depreciation—office equipment account is called the ***BOOK VALUE OF THE ASSET*** (or net book value).
- It is computed as follows:

Book Value of Asset = Cost of the Asset – Accumulated Depreciation of Asset

Ex: Cost of Equipment= $50,000 (on balance sheet)
Accumulated Depreciation-Equipment= $40,000
Book Value = $50,000 - $40,000
Book Value= $10,000

SUMMARY ACCOUNTING FOR PREPAID EXPENSES

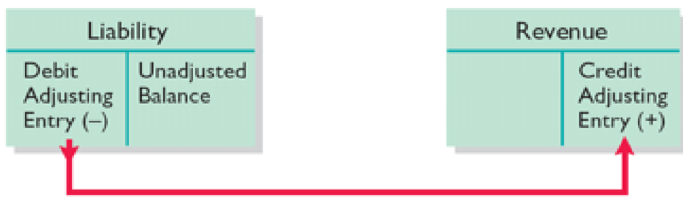
Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Insurance, supplies, advertising, rent, depreciation	Prepaid expenses recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets

2. **UNEARNED REVENUES**: Cash receipt **BEFORE** revenue is recorded.

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

Examples of Unearned Revenue (Liability): Unearned Rent, Unearned Ticket Revenue, Unearned Subscription Revenue, Unearned Service Revenue, and Customer Deposits.
*Adjusted because originally when cash is received services weren't provided so a liability was recorded. By the end of the accounting period some services were provided to the customer.

Unearned Revenues



- Decrease (a debit) to a liability account.
- Increase (a credit) to a revenue account.

Ex: Tom receives $50 from his neighbor Dave before mowing the lawn on August 25 because Dave is going on vacation. Tom mows Dave's lawn on September 5. Prepare the journal entries for Tom for both days.

Date	Account Title	Ref.	Debit	Credit
Aug. 25	Cash		50	
	Unearned Service Revenue			50

Service Revenue

	Sept. 5 $50
	Balance $50

Date	Account Title	Ref.	Debit	Credit
Sept. 5	Unearned Service Revenue		50	
	Service Revenue			50

Unearned Service Revenue

Sept. 5 $50	Aug. 25 $50
Balance $0	

SUMMARY 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

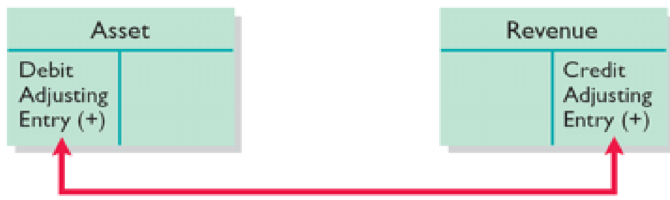
LO 3: Prepare adjusting entries for accruals.

ACCRUALS

3. **ACCRUED REVENUES**: Revenue recorded **BEFORE** cash receipt.
   - An adjusting entry serves 2 purposes:
     1. Shows the **receivable** that exists.
     2. Records the revenues for services performed.

Examples of Accrued Revenue: Rent Revenue, Interest Revenue, and Service Revenue.
*Adjusted because services have been provided to the customer, but have not been billed or recorded. Interest has been earned, but has not been received or recorded.

Accrued Revenues



- Increases (debits) an asset account.
- Increases (credits) a revenue account.

Ex: George shoveled Kim's driveway for $30 on December 20. Kim didn't have the money to pay George until December 28. What are the journal entries for George on December 20 and December 28?

Date	Account Title	Ref.	Debit	Credit
Dec. 20	Accounts Receivable		30	
	Service Revenue			30

Date	Account Title	Ref.	Debit	Credit
Dec. 28	Cash		30	
	Accounts Receivable			30

ACCOUNTS RECIEVABLE

Dec. 20 $30	Dec. 28 $30
Balance $0	

SERVICE REVENUE

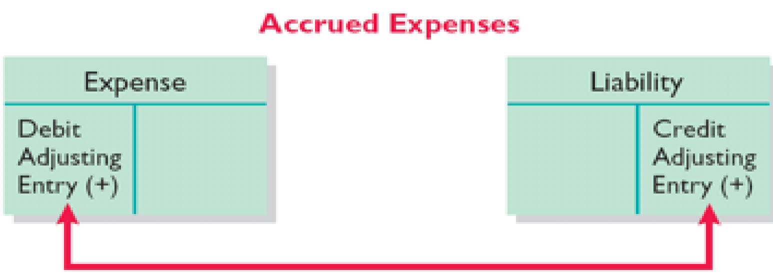
	Dec. 20 $30
	Balance $30

SUMMARY ACCOUNTING FOR ACCRUED REVENUES

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

4. **ACCRUED EXPENSES**: Expenses recorded **BEFORE** cash payment.
   - An adjusting entry serves 2 purposes:
     1. Records the obligations **(payable)**.
     2. Recognizes the expenses.

Examples of Accrued Expenses: Interest, Taxes, Utilities, and Salaries.
*Adjusted because expenses were incurred but have not been paid or recorded.



- Increases (debits) an expense account.
- Increases (credits) a liability account.

Ex (Salaries and Wages): Employees of Lincoln Co. are paid $5,000 every 2 weeks. If December 31 occurs at the end of the 1st week of the pay period what journal entry is made? When the payment for the 2 week pay period actually happens January 7 what is the journal entry?

Date	Account Title	Ref.	Debit	Credit
Dec. 31	Salaries and Wages Expense		2,500	
	Salaries and Wages Payable			2,500

($5,000/ 2 weeks)

Salaries and Wages Expense- Current Year

Dec. 31 $2,500	
Balance $2,500	

Salaries and Wages Payable- Current Year

	Dec. 31 $2,500
	Balance $2,500

Date	Account Title	Ref.	Debit	Credit
Jan. 7	Salaries and Wages Expense		2,500	
	Salaries and Wages Payable		2,500	
	Cash			5,000

Labor occurred in the current year (last week of December)

Labor occurred next year (first week of January)

Salaries and Wages Expense- Next Year

Jan. 7 $2,500	
Balance $2,500	

***Expenses are closed out at YEAR END**

Salaries and Wages Payable- Current Year

Jan. 7 $2,500	Dec. 31 $2,500
	Balance $0

Ex (Interest): M Corporation signed a three-month note payable in the amount of $8,000 on November 1. The note requires M Corporation to pay interest at an annual rate of 10%. What is the adjusting entry to record the accrual of interest in November?

Face Value of Note × Annual Interest Rate × Time in Terms of One Year = **Interest**

$8,000 x 10% x (1/12) = 66.67 ≈ **$67**

Date	Account Title	Ref.	Debit	Credit
Nov. 30	Interest Expense		67	
	Interest Payable			67

SUMMARY

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 4: Prepare an Adjusted Trial Balance

- **<u>Adjusted Trial Balance</u>:** Prepared after all adjusting entries are journalized and posted to the ledger accounts.
    - Purpose is to prove the **EQUALITY** of debit balances and credit balances in the ledger.
    - The primary basis for the preparation of the financial statements.

SIERRA CORPORATION
Adjusted Trial Balance
October 31, 2017

	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
Common Stock		10,000
Retained Earnings		0
Dividends	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

- Order the financial statements are prepared from the adjusted trial balance.
    1. **Income Statement**
    2. **Retained Earnings Statement**
    3. **Balance Sheet**

Companies can prepare financial statements directly from the adjusted trial balance. Illustrations below present the interrelationships of data in the adjusted trial balance and the financial statements.

1. **Preparation of the Income Statement and Retained Earnings statement from the adjusted trial balance**

Pioneer Advertising Inc.
Adjusted Trial Balance
October 31, 2022

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Office 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
Common Stock		**10,000**
Retained Earnings		**–0–**
Dividends	**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 Inc.
Income Statement
For the Month Ended October 31, 2022

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 Inc.
Retained Earnings Statement
For the Month Ended October 31, 2022

Retained earnings, October 1	$ –0–
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$2,360

To balance sheet

2. Preparation of the Balance Sheet from the adjusted trial balance

Pioneer Advertising Inc.
Adjusted Trial Balance
October 31, 2022

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**
Common Stock		**10,000**
Retained Earnings		–0–
Dividends	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 Inc.
Balance Sheet
October 31, 2022

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 Stockholders' 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
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

Balance at Oct. 31 from retained earnings statement in Illustration 3.27