Accounting: Tools for Business Decision Making

Seventh Edition

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Chapter 4

Accrual Accounting Concepts

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Chapter Outline:

Learning Objectives

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

LO 2 Prepare adjusting entries for deferrals.

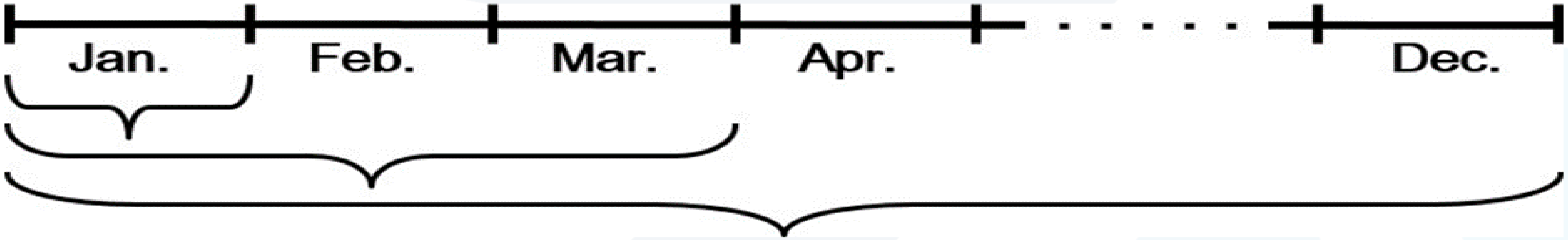
LO 3 Prepare adjusting entries for accruals.

LO 4 Prepare an adjusted trial balance and closing entries.

Learning Objective 1
Explain the Accrual Basis of Accounting and the Reasons for Adjusting Entries

Periodicity Assumption

Accountants divide the economic life of a business into artificial time periods generally a month, quarter, or year.



- Quarterly and annual financial statements
  - Prepared by most large companies
- Reporting periods can be
  - Calendar year from January 1 to December 31

Helpful Hint

An accounting time period that is one year long is called a fiscal year.

Accrual-Basis and Periodicity

Review Question

What is the periodicity assumption?

a. Companies should recognize revenue in the accounting period in which services are performed.

b. Companies should match expenses 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.

Accrual-Basis and Periodicity

Review Question Answer

What is the periodicity assumption?

a. Companies should recognize revenue in the accounting period in which services are performed.

b. Companies should match expenses with revenues.

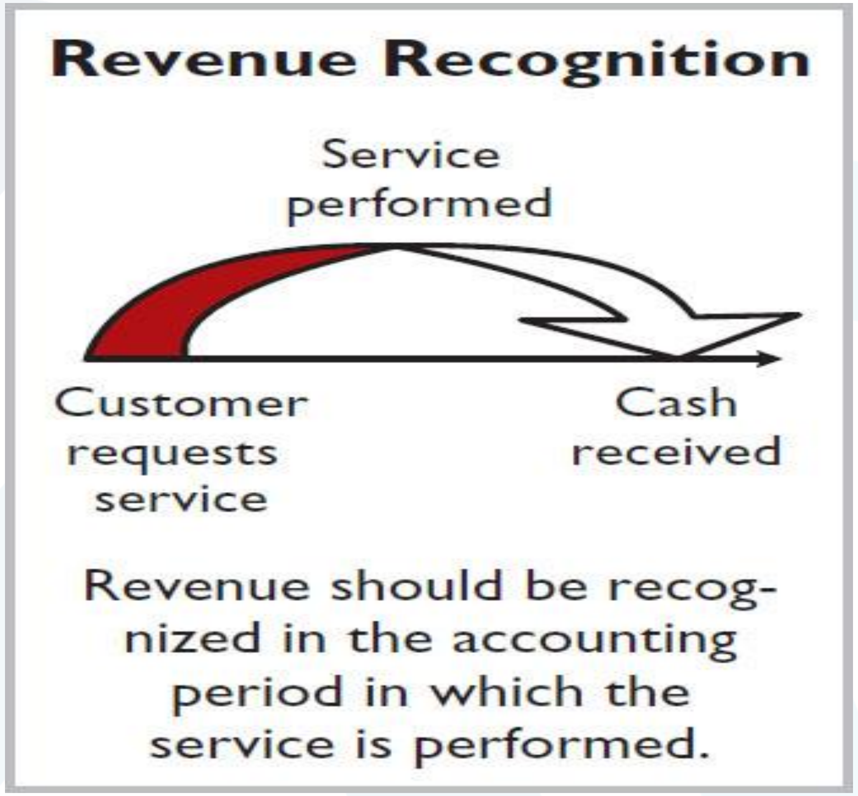
c. Answer: The economic life of a business can be divided into artificial time periods.

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

Accrual-Basis and Revenue Recognition

Revenue Recognition Principle

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



Revenue Recognition

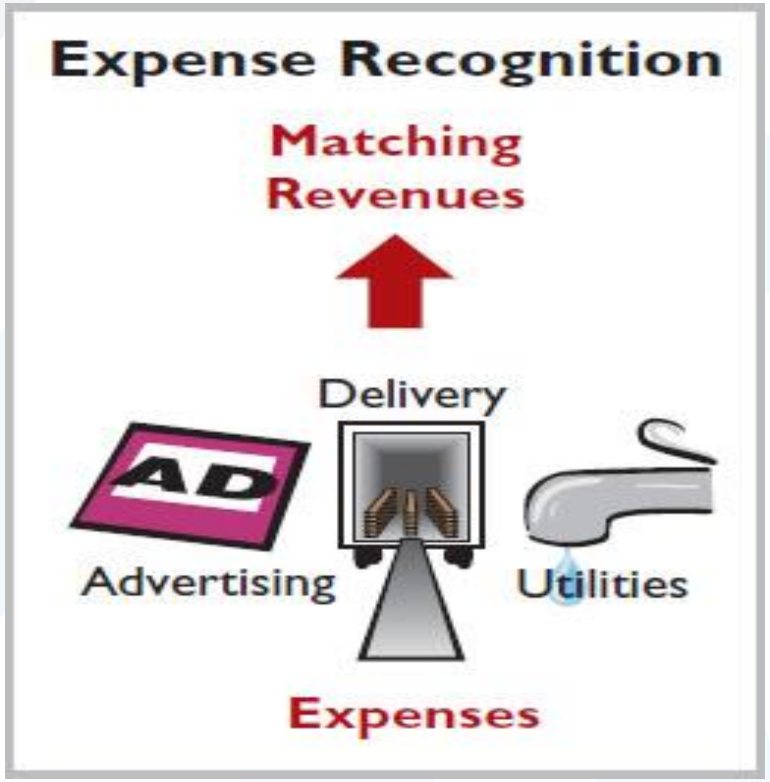
Step 1: Identify the contract with customers.	A contract is an agreement between two parties that creates enforceable rights or obligations. Sierra has a contract with the Lewis family to provide guide services.
Step 2: Identify the separate performance obligations in the contract.	Sierra has only one performance obligation—to provide guide services. If Sierra also agreed to sell the customer camping equipment, a separate performance obligation is recorded for this promise.
Step 3: Determine the transaction price.	The transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. The transaction price for Sierra is $1,500.
Step 4: Allocate the transaction price to the separate performance obligations.	Sierra has only one performance obligation—to provide guide services to the Lewis family.
Step 5: Recognize revenue when each performance obligation is satisfied.	Sierra recognizes revenue of $1,500 for providing guide services to the Lewis family when it satisfies its performance obligation—the completion of the guide trip.

Accrual-Basis and Expense Recognition

Expense Recognition Principle

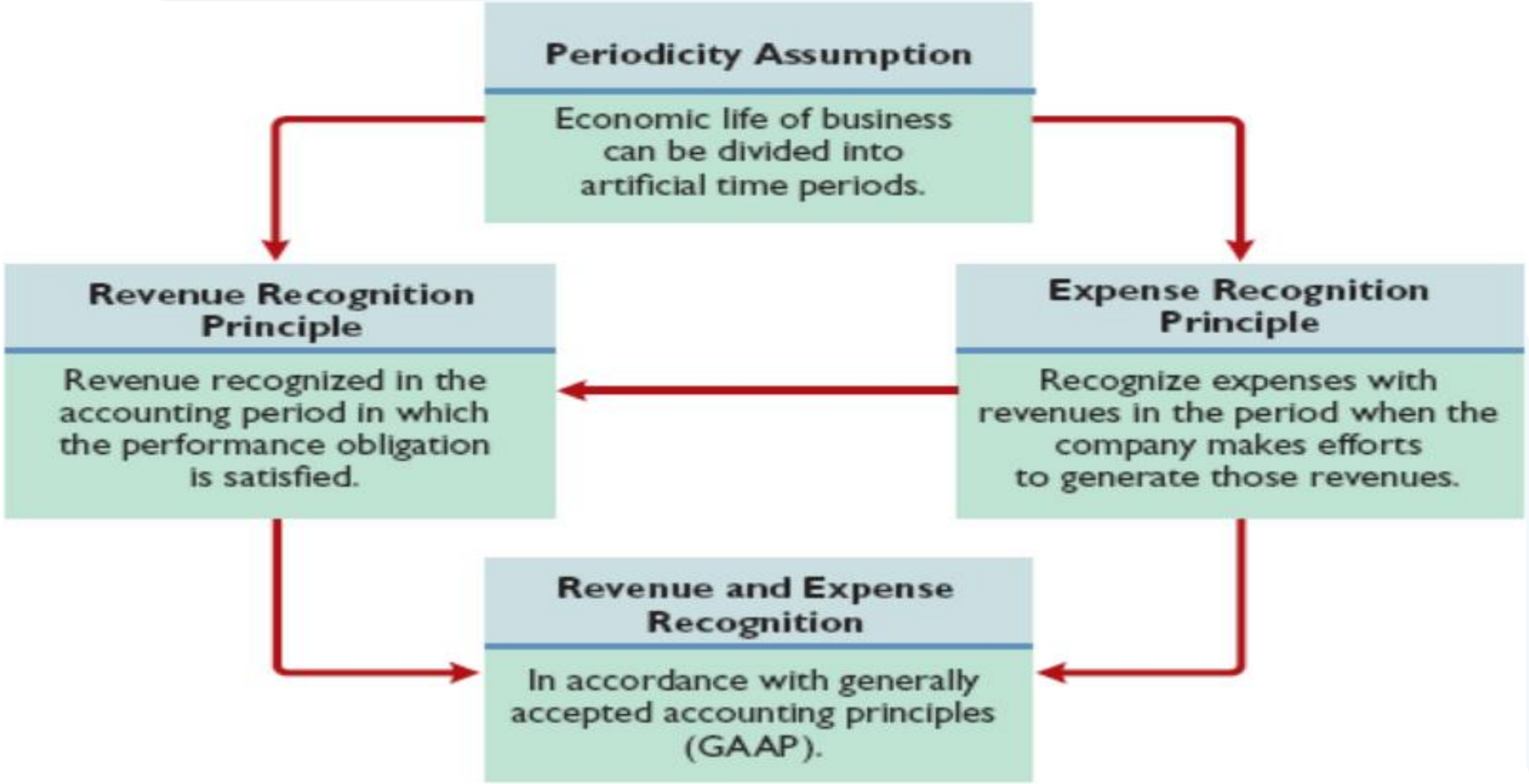
Companies recognize expenses in the period in which they make efforts (consume assets or incur liabilities) to generate revenue.

"Let the expenses follow the revenues."



Revenue and Expense Recognition

GAAP Relationships



Accrual-Basis of Accounting
Review Question

Which of the following statements about the accrual basis of accounting is **false**?

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 services are performed.

c. This basis is in accordance with generally accepted accounting principles.

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

Accrual-Basis of Accounting
Review Question Answer

Which of the following statements about the accrual basis of accounting is **false**?

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 services are performed.

c. This basis is in accordance with generally accepted accounting principles.

d. Answer: Revenue is recorded only when cash is received, and expense is recorded only when cash is paid.

Accrual versus Cash Basis Accounting (1 of 2)

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 (2 of 2)

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)

Comparing Accrual- versus Cash Basis

	2021	2022
Activity	 Purchased paint, painted building, paid employees	 Received payment for work done in 2021
Accrual basis	Revenue $80,000 Expense 50,000 Net income $30,000	Revenue $ 0 Expense 0 Net income $ 0
Cash basis	Revenue $ 0 Expense 50,000 Net loss $(50,000)	Revenue $80,000 Expense 0 Net income $80,000

Need for Adjusting Entries

- To 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

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 the responses above are correct.

The Need for Adjusting Entries

Review Question Answer

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. Answer: All the responses above are correct.

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.

Trial Balance

Subsequent examples are based on this trial balance from Chapter 3

Sierra Corporation
Trial Balance
October 31, 2022

	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
Common Stock		10,000
Retained Earnings		0
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	$28,700	$28,700

Do It! 1: Timing Concepts (1 of 2)

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

1. ________ Accrual-basis accounting.
2. ________ Calendar year.
3. ________ Periodicity assumption.
4. ________ 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.

Do It! 1: Timing Concepts (2 of 2)

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

1. _f_ Accrual-basis accounting.
2. _e_ Calendar year.
3. _c_ Periodicity 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.

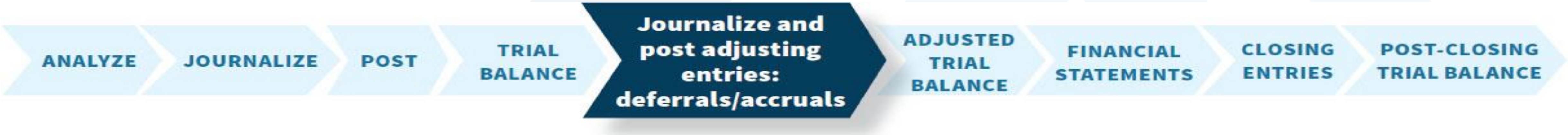
Learning Objective 2
Prepare Adjusting Entries for Deferrals

Adjusting Entries for Deferrals

Deferrals are costs or revenues that are recognized at a date later than the point when cash was originally exchanged

Types of deferrals:

- Prepaid expenses
- Unearned revenues



Prepaid Expenses (1 of 2)

Payments of expenses that are recorded as an asset to show the service or benefit the company will receive in the future.

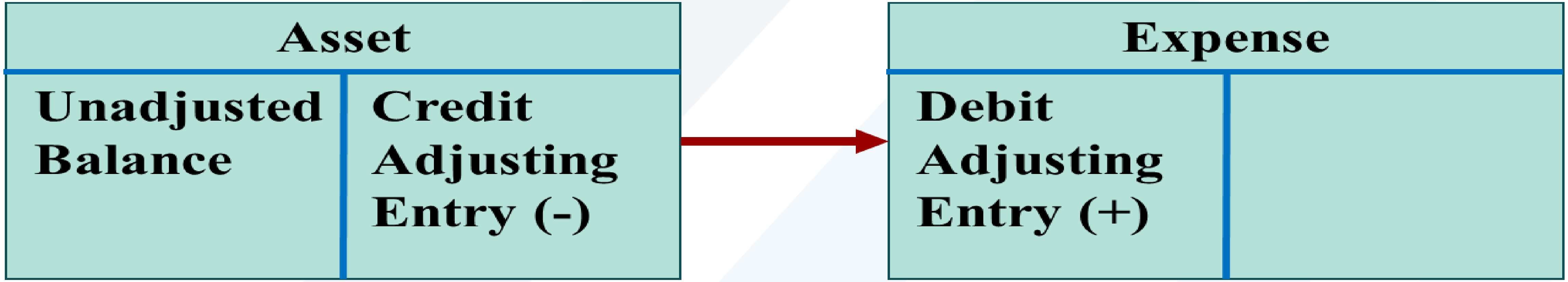
Cash Payment **BEFORE** **Expense Recorded**

Prepayments often occur in regard to

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

Prepaid Expenses (2 of 2)

- 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**



Supplies

Illustration: Sierra Corporation purchased supplies costing $2,500 on October 5. Sierra 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
	(To record supplies used)		

Adjustment for Supplies

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Basic Analysis	The expense Supplies Expense is increased \$1,500; the asset Supplies is decreased \$1,500.
Equation Analysis	(1) Assets = Liabilities + Stockholders' 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)		

Posting to Ledger

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

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

Insurance

Illustration: On October 4, Sierra Corporation paid $600 for a one-year fire insurance policy. Coverage began on October 1. Sierra 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
	(To record expired insurance)		

Adjustment for Insurance

Basic Analysis

The expense Insurance Expense is increased $50; the asset Prepaid Insurance is decreased $50.

Equation Analysis

(2)	Assets	=	Liabilities	+	Stockholders' 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 to Ledger

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

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

Depreciation (1 of 2)

- 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
  - An allocation concept, not a valuation concept

Depreciation (2 of 2)

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

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

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

Adjustment for Depreciation (1 of 2)

Basic Analysis	The expense Depreciation Expense is increased \$40; the contra asset Accumulated Depreciation—Equipment is increased \$40.

Equation Analysis

Assets	=	Liabilities	+	Stockholders' 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)		

Adjustment for Depreciation (2 of 2)

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Journal Entry

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

Posting to Ledger

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

Accumulated Depreciation—Equipment			
		Oct. 31	Adj. 40
		Oct. 31	Bal. 40

Depreciation Expense			
Oct. 31	Adj. 40		
Oct. 31	Bal. 40		

Reporting Depreciation

- Accumulated Depreciation
  - A **contra asset account** with a normal credit balance
  - Offsets the related asset account on the balance sheet
  - **Book value** is the difference between the cost of any depreciable asset and its accumulated depreciation

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

Prepaid Expenses

Accounting for Prepaid Expenses

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

Unearned Revenues (1 of 4)

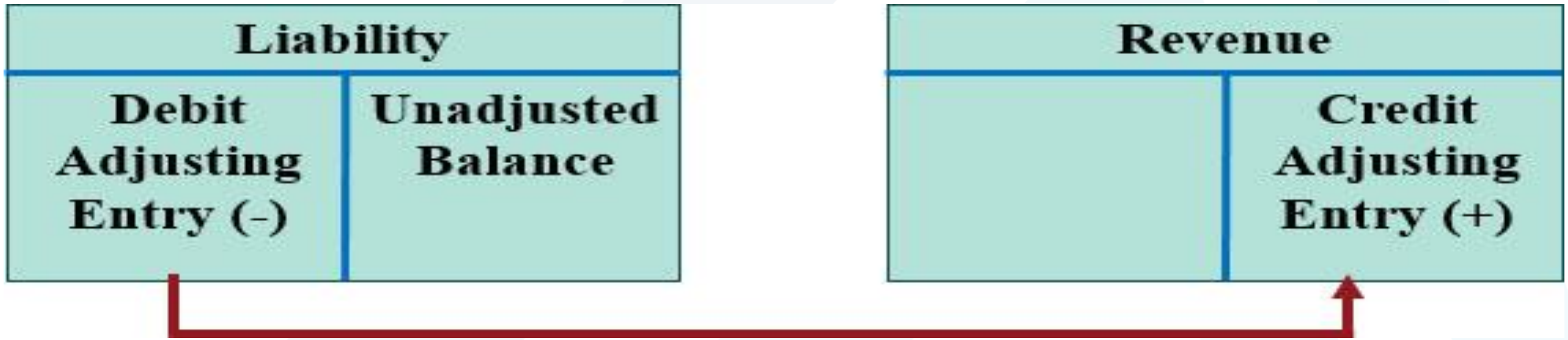
Receipt of cash before the service is performed is recorded as a liability — unearned revenue.

Unearned revenues often occurs in regard to:

- Rent
- Airline tickets
- Magazine subscriptions
- Customer deposits

Unearned Revenues (2 of 4)

- 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



Unearned Revenues (3 of 4)

Illustration: Sierra Corporation 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

Adjustment for Unearned Revenue

Basic Analysis

The liability Unearned Service Revenue is decreased \$400; the revenue Service Revenue is increased \$400.

Equation Analysis

Assets	=	Liabilities	+	Stockholders' 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

Date	Account	Debit	Credit
Oct. 31	Unearned Service Revenue	400	
	Service Revenue		400
	(To record revenue for services performed)		

Posting to Ledger

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

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

Unearned Revenues (4 of 4)

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

Do It! 2: Adjusting Entries Deferrals (1 of 5)

The ledger of Hammond Inc. on March 31, 2022, 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 $4,000 of the unearned service revenue reported.

Prepare the adjusting entries for the month of March.

Do It! 2: Adjusting Entries Deferrals (2 of 5)

The ledger of Hammond Inc. on March 31, 2022, 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

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

Oct. 31	Insurance Expense	100	
	Prepaid Insurance		100

Do It! 2: Adjusting Entries Deferrals (3 of 5)

The ledger of Hammond Inc. on March 31, 2022, 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

2. Supplies on hand totaled $800.

Oct. 31	Supplies Expense	2,000	
	Supplies		2,000

Do It! 2: Adjusting Entries Deferrals (4 of 5)

The ledger of Hammond Inc. on March 31, 2022, 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

3. The equipment depreciates $200 a month.

Oct. 31	Depreciation Expense	200	
	Accumulated Depreciation-Equipment		200

Do It! 2: Adjusting Entries Deferrals (5 of 5)

The ledger of Hammond, Inc. on March 31, 2022, 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

4. During March, services were performed for $4,000 of the unearned service revenue reported.

Oct. 31	Unearned Service Revenue	4,000	
	Service Revenue		4,000

Learning Objective 3

Prepare Adjusting Entries for Accruals

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 (1 of 4)

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

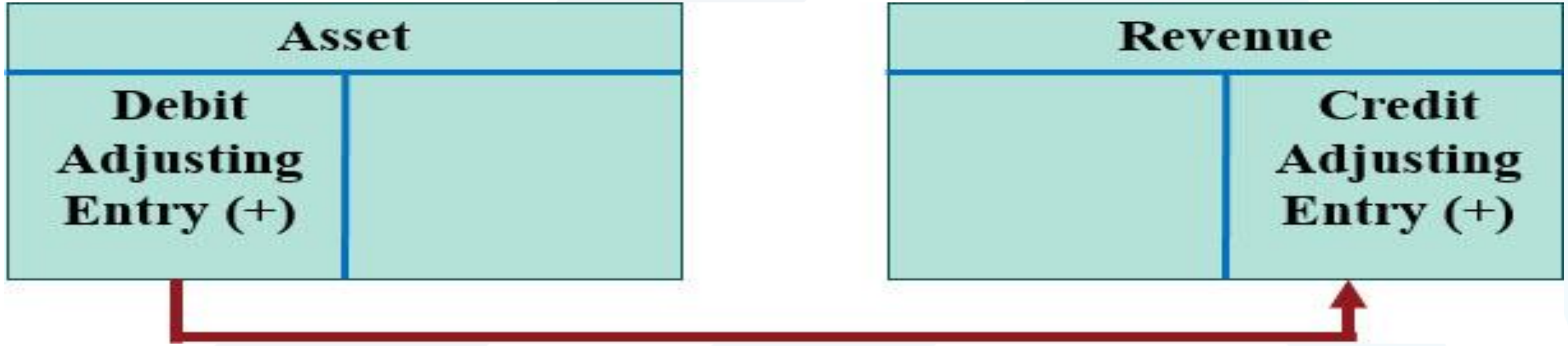
Revenue Recorded **BEFORE** **Cash Receipt**

Accrued revenues occur for

- Interest earned
- Services performed
- Rent rentals

Accrued Revenues (2 of 4)

- Adjusting entry records the receivable that exists and records the revenues for services performed
- Adjusting entry:
  - Increases an asset account with a debit
  - Increases a revenue account with a credit



Accrued Revenues (3 of 4)

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

Oct. 31	Account Receivable	200	
	Service Revenue		200

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

Nov. 10	Cash	200	
	Accounts Receivable		200

Adjustment for Accrued Revenue

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Basic Analysis

The asset Accounts Receivable is increased \$200; the revenue Service Revenue is increased \$200.

Equation Analysis

Assets	=	Liabilities	+	Stockholders' 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 to Ledger

Accounts Receivable

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

Service Revenue

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

Accrued Revenues (4 of 4)

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 (1 of 3)

Expenses incurred but not yet paid in cash or recorded.

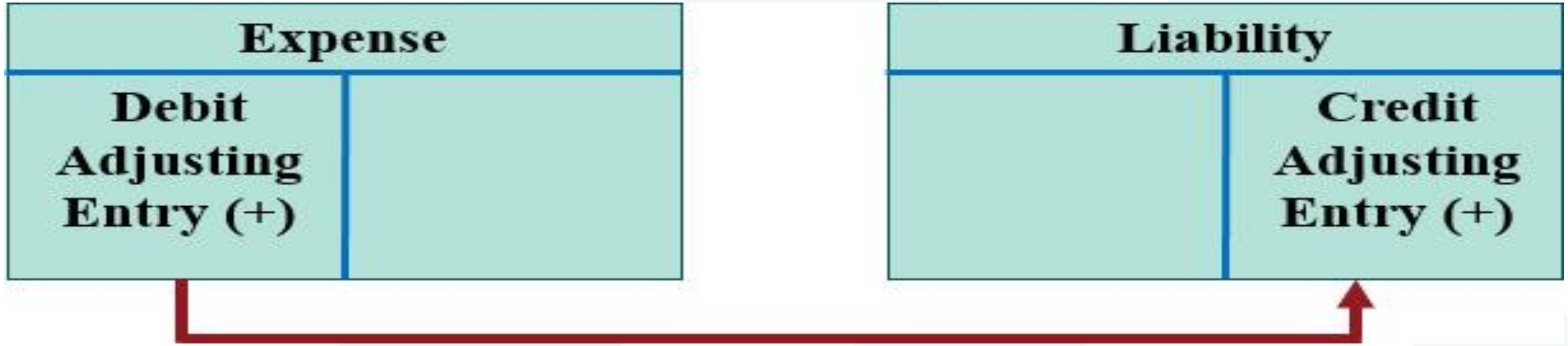
Expense Recorded **BEFORE** **Cash Payment**

Accrued expenses are often recognized for

- Rent
- Interest
- Taxes
- Salaries

Accrued Expenses (2 of 3)

- Adjusting entry records the obligation and recognizes the expense
  - Increase an expense account with a debit
  - Increase a liability account with a credit



Accrued Interest

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

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

Adjustment for Accrued Interest

Basic Analysis	The expense Interest Expense is increased $50; the liability Interest Payable is increased $50.
Equation Analysis	Assets = Liabilities (Interest Payable +$50) + Stockholders' Equity (Interest Expense −$50)
Debit–Credit Analysis	Debits increase expenses: debit Interest Expense $50. Credits increase liabilities: credit Interest Payable $50.

Journal Entry

Date	Account	Debit	Credit
Oct. 31	Interest Expense	50	
	Interest Payable		50
	(To record interest on notes payable)		

Posting to Ledger

Interest Expense

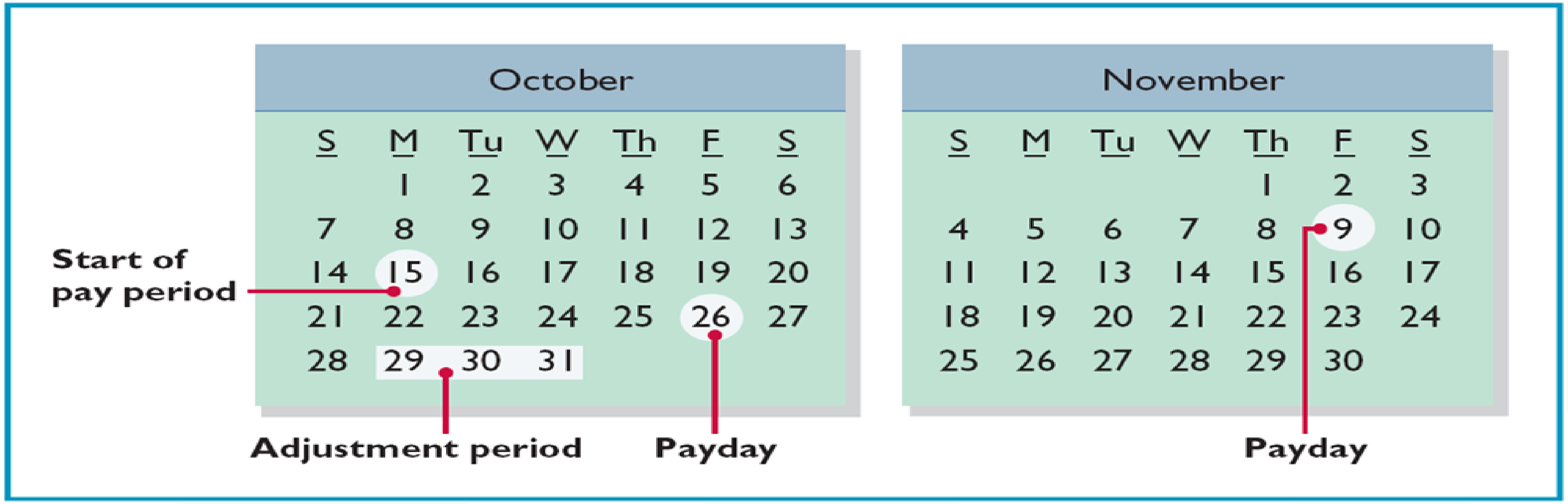
Debit		Credit
Oct. 31	Adj. 50	
Oct. 31	Bal. 50	

Interest Payable

Debit	Credit	
	Oct. 31	Adj. 50
	Oct. 31	Bal. 50

Accrued Salaries

Illustration: Sierra Corporation 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.



Adjustment for Accrued Salaries

Basic Analysis	The expense Salaries and Wages Expense is increased \$1,200; the liability Salaries and Wages Payable is increased \$1,200.
Equation Analysis	Assets = Liabilities + Stockholders' Equity Liabilities: Salaries and Wages Payable +\$1,200 Stockholders' Equity: Salaries and Wages Expense −\$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)		

Posting to Ledger

Salaries and Wages Expense

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

Salaries and Wages Payable

Debit	Credit		
	Oct. 31	Adj.	1,200
	Oct. 31	Bal.	1,200

Accrued Expenses (3 of 3)

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

Summary of Adjustments

Type of Adjustment	Accounts Before Adjustment	Adjusting Entry
Prepaid expenses	Assets overstated. Expenses understated	Dr. Expense 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 (1 of 3)

Micro Computer Services, Inc. began operations on August 1, 2022. At the end of August 2022, 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, 2022.

Do It! 3: Adjusting Entries for Accruals (2 of 3)

Prepare the adjusting entries needed at August 31, 2022.

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

Aug. 31	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%.

Aug. 31	Interest Expense	250	
	Interest Payable		250

Do It! 3: Adjusting Entries for Accruals (3 of 3)

Prepare the adjusting entries needed at August 31, 2022.

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

Aug. 31	Accounts Receivable	1,100	
	Service Revenue		1,100

Learning Objective 4

Prepare an Adjusted Trial Balance and Closing Entries

Nature of the Adjusted Trial Balance

- Prepared after adjusting entries are journalized and posted
- Proves equality of debit and credit balances
- Basis for the preparation of financial statements

Adjusted Trial Balance with Adjusted Accounts Highlighted

Sierra Corporation
Adjusted Trial Balance
October 31, 2022

	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
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

Adjusted Trial Balance Review

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.

Adjusted Trial Balance Review

Review Question Answer

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. Answer: 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
- Retained Earnings Statement
- Balance Sheet

Preparing Statement from the Trial Balance

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
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

Sierra Corporation
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

Sierra Corporation
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

Preparing the Balance Sheet

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المَنارة
MANARA UNIVERSITY

Sierra Corporation
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
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

Sierra Corporation
Balance Sheet
October 31, 2022

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment	$5,000	
Less: Accumulated depreciation—equipment	40	4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Salaries and wages payable	1,200	
Unearned service revenue	800	
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

Do It! 4a: Trial Balance (1 of 4)

Skolnick Co. was organized on April 1, 2022. The company prepares quarterly financial statements. The adjusted trail balance at June 30 are shown below.

	Debit		Credit
Cash	$ 6,700	Accumulated Depreciation	$ 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
Dividends	600	Unearned Rent Revenue	500
Salaries and Wages Expense	9,400	Common Stock	14,000
Rent Expense	1,500	Retained Earnings	0
Depreciation Expense	850	Service Revenue	14,200
Supplies Expense	200	Rent Revenue	800
Utilities Expense	510		
Interest Expense	50		
	$37,310		**$37,310**

Do It! 4a: Trial Balance (2 of 4)

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

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! 4a: Trial Balance (3 of 4)

b. Determine the total assets and total liabilities at June 30, 2022.

	Debit		Credit
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
Accumulated Depreciation	(850)		
Total assets	$23,350	Total liabilities	$7,460

Do It! 4a: Trial Balance (4 of 4)

c. Determine the amount of retained earnings at June 30, 2022.

Retained earnings, April 1	$ 0
Add: Net income	2,490
Less: Dividends	600
Retained earnings, June 30	**$1,890**

Closing the Books

At the end of the accounting period, the company makes the accounts ready for the next period.

Temporary and Permanent Accounts

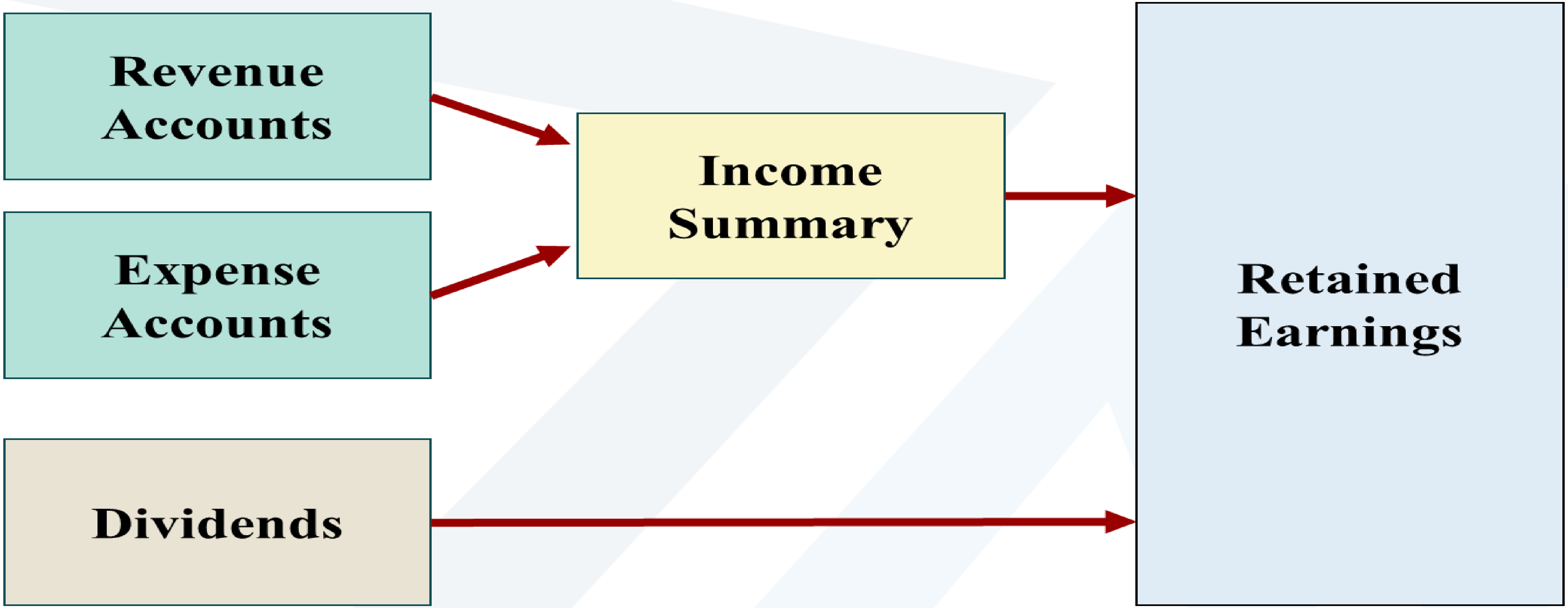
TEMPORARY These accounts are closed	PERMANENT These accounts are not closed
All revenue accounts	All asset accounts
All expense accounts	All liability accounts
Dividends	Stockholders’ equity accounts

Nature of Closing Entries

- **Closing entries** formally recognize in the ledger the transfer of
  - Net income (or net loss) to retained earnings
  - Dividends to retained earnings

- Produce a zero balance in each temporary account.
- Generally journalized and posted only at end of the annual accounting period

Preparing Closing Entries



Close Revenue and Expense Accounts

GENERAL JOURNAL

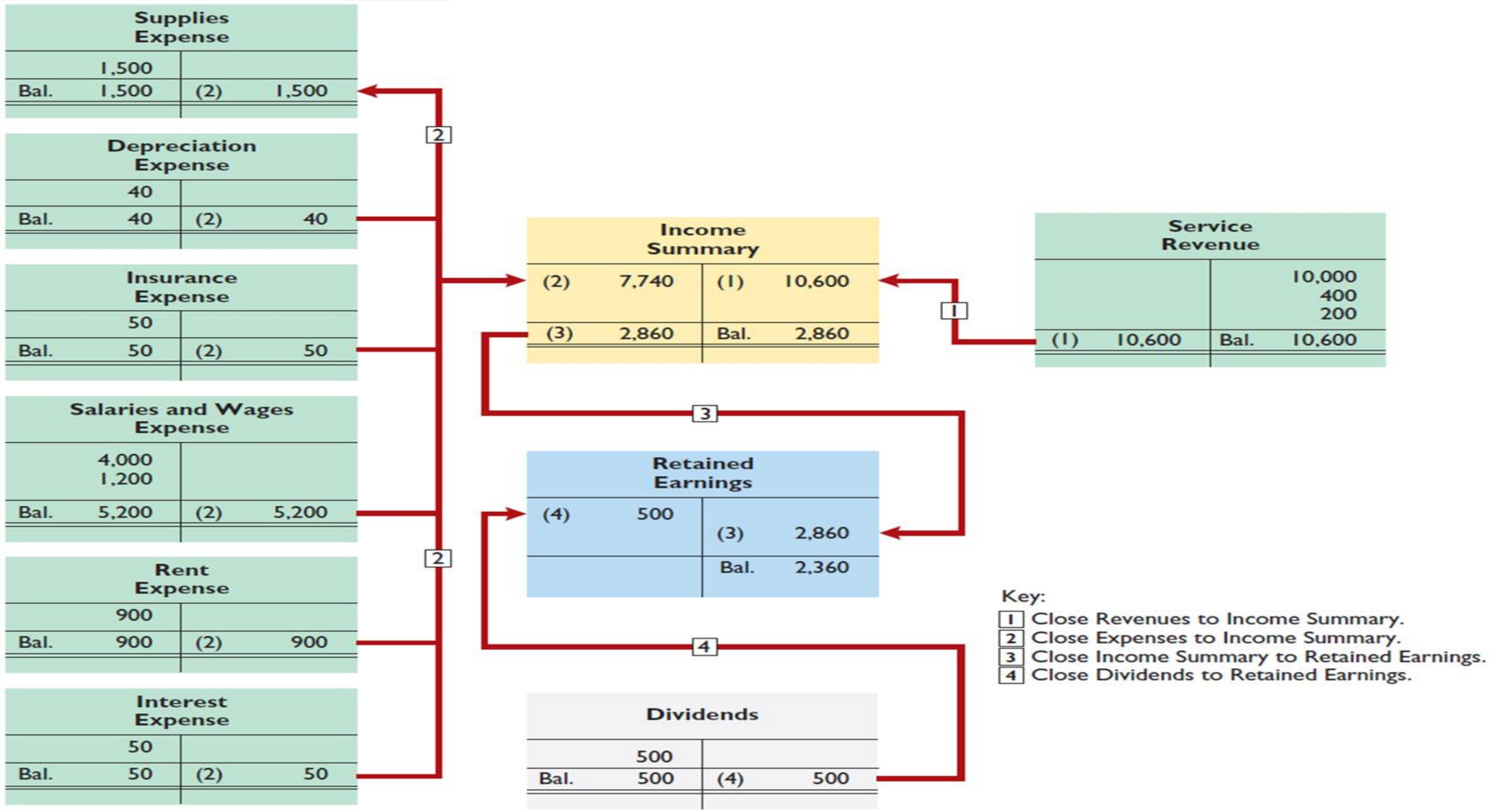
Date	Account Titles and Explanation	Debit	Credit
	Closing Entries		
2022	(1)		
Oct. 31	Service Revenue	10,600	
	Income Summary		10,600
	(To close revenue account)		
	(2)		
31	Income Summary	7,740	
	Salaries and Wages Expense		5,200
	Supplies Expense		1,500
	Rent Expense		900
	Insurance Expense		50
	Interest Expense		50
	Depreciation Expense		40
	(To close expense accounts)		

Close Income Summary and Dividends

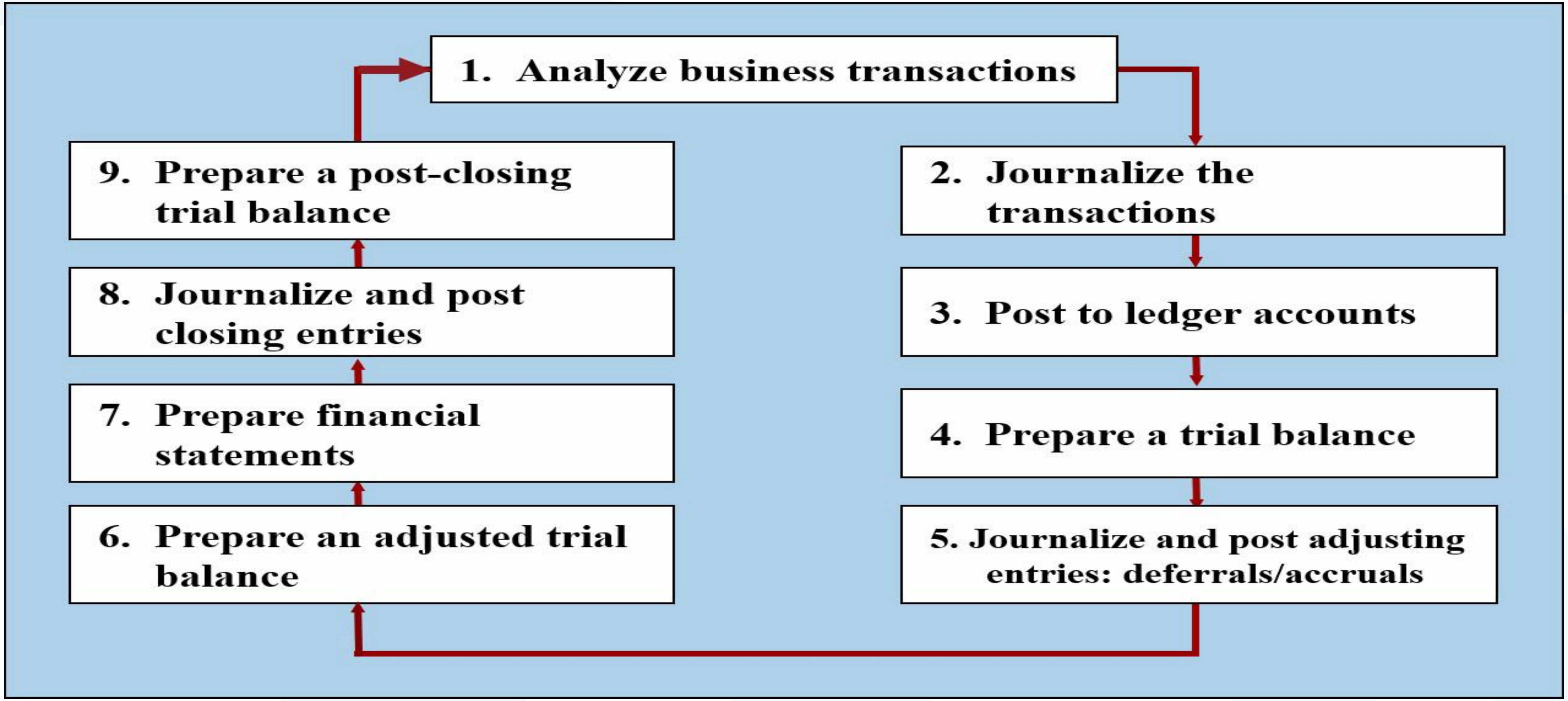
GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
	Closing Entries		
	(3)		
31	Income Summary	2,860	
	Retained Earnings		2,860
	(To close net income to retained earnings)		
	(4)		
31	Retained Earnings	500	
	Dividends		500
	(To close dividends to retained earnings)		

Posting of Closing Entries



Summary of the Accounting Cycle



Do It! 4b: Closing Entries (1 of 3)

Hancock Company has the following balances in selected accounts of its adjusted trial balance.

Accounts Payable	$27,000	Dividends	$15,000
Service Revenue	98,000	Retained Earnings	42,000
Rent Expense	22,000	Accounts Receivable	38,000
Salaries and Wages Expense	51,000	Supplies Expense	7,000

Prepare the closing entries at December 31.

Dec. 31	Service Revenue	98,000	
	Income Summary		98,000
	(To close revenue)		

Do It! 4b: Closing Entries (2 of 3)

Accounts Payable	$27,000	Dividends	$15,000
Service Revenue	98,000	Retained Earnings	42,000
Rent Expense	22,000	Accounts Receivable	38,000
Salaries and Wages Expense	51,000	Supplies Expense	7,000

Prepare the closing entries at December 31.

Dec. 31	Income Summary	80,000	
	Salaries and Wages Expense		51,000
	Rent Expense		22,000
	Supplies Expense		7,000
	(To close expense accounts)		

Do It! 4b: Closing Entries (3 of 3)

Accounts Payable	$27,000	Dividends	$15,000
Service Revenue	98,000	Retained Earnings	42,000
Rent Expense	22,000	Accounts Receivable	38,000
Salaries and Wages Expense	51,000	Supplies Expense	7,000

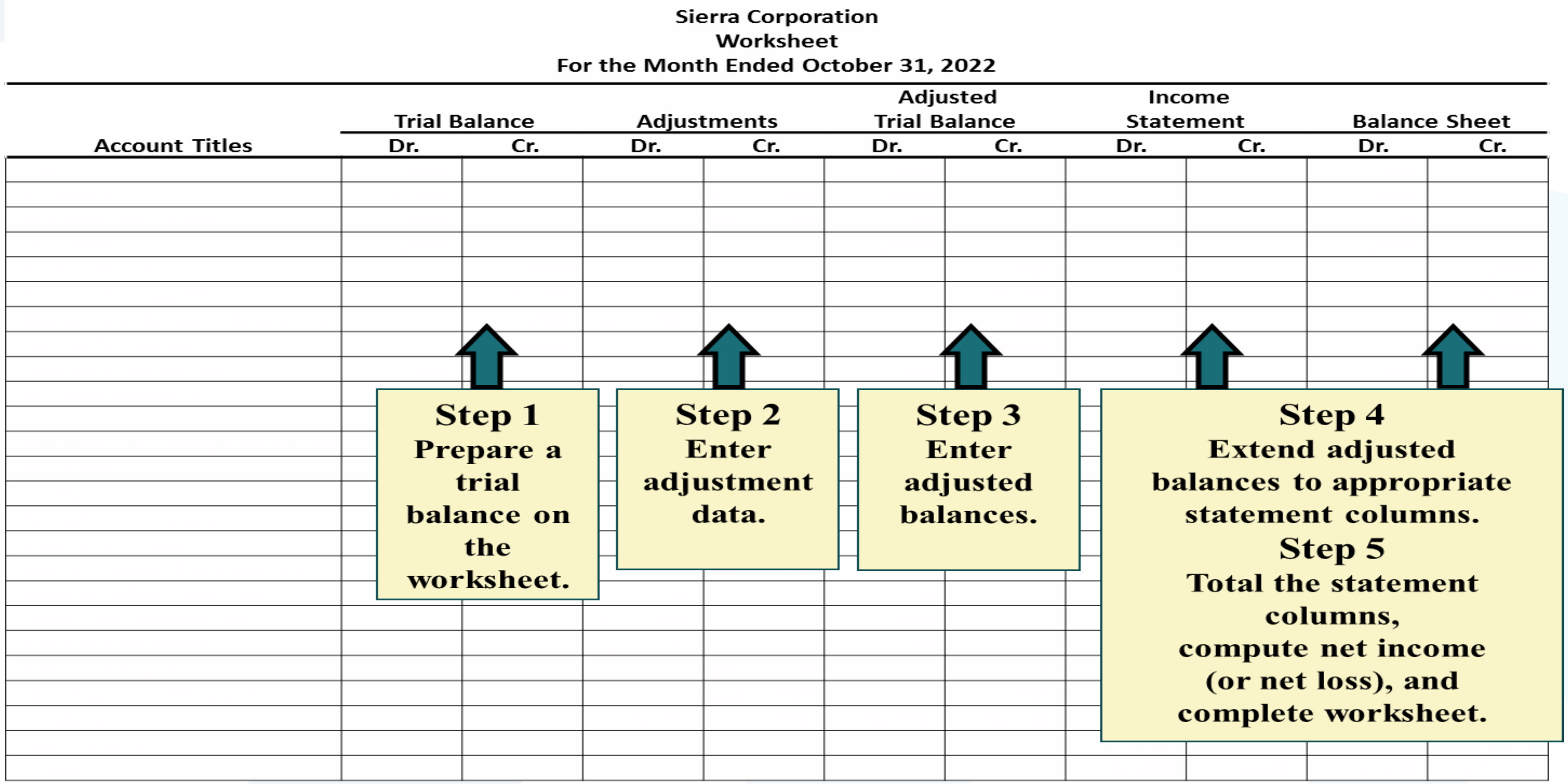
Dec. 31	Income Summary	18,000	
	Retained Earnings		18,000
	(To close income summary)		
	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends)		

Learning Objective 5
Describe the Purpose and the Basic Form of a Worksheet

Appendix 4A – Using a Worksheet

- Multiple-column form used in the adjustment process and in preparing financial statements
- Not a permanent accounting record
- May be a computerized worksheet
- Use of worksheet is optional
- Prepared using a five-step process

Steps in Preparing a Worksheet



Completed Worksheet

Sierra Corporation
Worksheet
For the Month Ended October 31, 2022

Account Titles	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Income Statement Dr.	Income Statement Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	15,200				15,200				15,200	
Supplies	2,500			(a) 1,500	1,000				1,000	
Prepaid Insurance	600			(b) 50	550				550	
Equipment	5,000				5,000				5,000	
Notes Payable		5,000				5,000				5,000
Accounts Payable		2,500				2,500				2,500
Unearned Service Revenue		1,200	(d) 400			800				800
Common Stock		10,000				10,000				10,000
Retained Earnings		0				0				0
Dividends	500				500				500	
Service Revenue		10,000		(d) 400		10,600		10,600		
				(e) 200						
Salaries and Wages Expense	4,000		(g) 1,200		5,200		5,200			
Rent Expense	900				900		900			
Totals	28,700	28,700								
Supplies Expense			(a) 1,500		1,500		1,500			
Insurance Expense			(b) 50		50		50			
Accumulated Depreciation				(c) 40		40				40
Depreciation Expense			(c) 40		40		40			
Accounts Receivable			(e) 200		200				200	
Interest Expense			(f) 50		50		50			
Interest Payable				(f) 50		50				50
Salaries and Wages Payable				(g) 1,200		1,200				1,200
Totals			3,440	3,440	30,190	30,190	7,740	10,600	22,450	19,590
Net Income							2,860			2,860
Totals							10,600	10,600	22,450	22,450

Learning Objective 6
Compare the Procedures for Adjusting Entries Under GAAP and IFRS

A Look at IFRS (1 of 3)

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 **periodicity assumption**.
- The **general** revenue recognition principle required by GAAP that is used in this text is the same as that used under IFRS.

A Look at IFRS (2 of 3)

Similarities

- Revenue recognition fraud is a major issue in U.S. financial reporting. The same situation occurs in countries using IFRS.
    - As evidenced by revenue recognition breakdowns at Dutch software company **Baan NV**, Japanese electronics giant **NEC**, and Dutch grocer **Ahold NV**

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.

A Look at IFRS (3 of 3)

Differences

- The terminology used for revenues and gains, and expenses and losses, differs somewhat between IFRS and GAAP.
  - Income under IFRS 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.
  - Under GAAP income refers to the net difference between revenues and expenses.
- 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.

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