Chapter Outline

I. Timing and Reporting
   A. The Accounting Period
      To provide timely information, accounting systems prepare periodic reports at regular intervals.
      1. The time-period principle assumes that an organization’s activities can be divided into specific time periods such as a month, a three-month quarter, a six-month interval, or a year. Reports covering a one-year period are known as annual financial statements. Interim financial statements cover one, three, or six months of activity.
      2. Annual reporting period:
         a. Calendar year—January 1 to December 31.
         b. Fiscal year—any twelve consecutive months used to base annual financial reports on.
         c. Natural business year—a fiscal year that ends when a company's sales activities are at their lowest level for the year.
   B. Accrual Basis versus Cash Basis
      1. Accounts are adjusted at the end of a period to record internal transactions and events that are not yet recorded.
      2. Accrual basis accounting—uses the adjusting process to recognize revenue when earned and to match expenses with revenues. This means the economic effects of revenues and expenses are recorded when earned or incurred, not when cash is received or paid. Accrual basis is consistent with GAAP.
      2. Cash basis accounting—revenues are recognized when cash is received and expenses are recognized when cash is paid. The cash basis is not consistent with GAAP or IFRS.
      3. Accrual accounting also increases the comparability of financial statements from one period to another.
   C. Recognizing Revenues and Expenses
      1. The revenue recognition principle requires revenue be recorded when earned, not before and not after.
      2. The expense recognition (matching principle) requires expenses be recorded in the same period as the revenues earned as a result of these expenses.
II. Adjusting Accounts

Adjusting accounts is a 3-step process: (1) Determine the current account balance, (2) Determine what the current account balance should be, and (3) Record adjusting entry to get from step 1 to step 2.

A. Framework for Adjustments

Adjustments are necessary for transactions and events that extend over more than one period. Adjusting entries are necessary so that revenues, expenses, assets and liabilities are correctly reported. Each adjusting entry affects one or more income statement accounts and one or more balance sheet accounts (but never the cash account).

B. Prepaid (Deferred) Expenses

1. Prepaid Expenses are items paid for in advance of receiving their benefits. Prepaid expenses are assets. When the assets are used, their costs become expenses.

2. Common prepaid items are prepaid insurance, supplies, and other prepaid expenses.

3. Adjusting entries for prepaids involve increasing (debiting) expenses and decreasing (crediting) assets (with the exception of depreciation on plant and equipment assets).

4. A special category of prepaid expenses is plant assets. Plant assets are long-term tangible assets used to produce and sell products and services; they are expected to provide benefits for more than one period.

5. Depreciation is the process of allocating the cost of plant and equipment assets over their expected useful lives. Straight-line depreciation allocates equal amounts of the assets’ net cost to depreciation during its useful life.

6. Adjusting entries for depreciation expense involve increasing (debiting) expenses and increasing (crediting) a special account called Accumulated Depreciation. Accumulated depreciation is a contra asset account. A contra account is an account linked with another account, and having an opposite normal balance.

7. Accumulated depreciation is reported as a subtraction from the related plant asset account balance in the balance sheet. This account includes total depreciation expense for all prior periods for which the asset was used.

8. Book value is a term used to describe the asset’s cost less its contra-asset (accumulated depreciation).

C. Unearned (Deferred) Revenues

1. Unearned Revenues are liabilities created by cash received in
advance of providing products or services. The company has an obligation to provide the service or product. As they are provided, unearned revenues (liabilities) become *earned* revenues (revenues).

2. Adjusting entries for unearned revenues involve increasing (crediting) revenues and decreasing (debiting) unearned revenues.

D. **Accrued Expenses**
   1. **Accrued expenses** refer to costs that are incurred in a period but are both unpaid and unrecorded.
   2. Common accrued expenses are salaries, interest, rent, and taxes.
   3. Adjusting entries for recording accrued expenses involve increasing (debiting) expenses and increasing (crediting) liabilities. (The liability is a payable.)
   4. Future payment of accrued expenses generally results in cash payments in the next period. Debit the payable for amount accrued and credit cash for the full amount paid. If the amount paid exceeds the amount accrued, the difference is an expense in the current period.

E. **Accrued Revenues**
   1. **Accrued revenues** refer to revenues earned in a period that are both unrecorded and not yet received in cash (or other assets).
   2. Accrued revenues commonly result from services, products, interest, and rent.
   3. Adjusting entries for recording accrued revenues involve increasing (debit) assets and increasing (credit) revenues. (The asset is a receivable.)
   4. Accrued revenues at the end of one accounting period result in cash receipts in a future period. Debit cash for the full amount received and credit the receivable for the amount accrued.
   5. If the amount received exceeds the amount accrued, the difference is an additional amount earned to be credited to revenue.

F. **Links to Financial Statements**
The process of adjusting accounts is intended to bring an asset or liability account balance to its correct amount. It also updates a related expense or revenue account. Each adjusting entry affects one or more income statement accounts and one or more balance sheet accounts, but never cash. Failure to make a necessary adjustment will result in misstatements of amounts on each of the financial statements. (See Exhibit 3-12 for a summary of adjustments.)
Chapter Outline

G. Adjusted Trial Balance
   An unadjusted trial balance is a list of accounts and balances prepared before adjustments are recorded. An adjusted trial balance is a list of accounts and balances prepared after adjusting entries have been recorded and posted to the ledger.

III. Preparing Financial Statements
   Financial statements are prepared directly from information in the adjusted trial balance. Each trial balance amount is used in only one financial statement.
   
   A. Revenue and expense balances are transferred from the adjusted trial balance to the income statement.
   B. The net income, retained earnings, and dividends are then used to prepare the statement of retained earnings.
   C. Asset, liability, and common stock balances on the adjusted trial balance are transferred to the balance sheet; the ending retained earnings is determined on the statement of retained earnings and transferred to the balance sheet.
   D. Financial statements are usually prepared in the following order: income statement, statement of retained earnings, balance sheet, and statement of cash flows.

IV. Closing Process
   The closing process is an important step at the end of the accounting period after financial statements have been completed. It prepares accounts for recording the transactions and the events of the next period.

   A. Steps in closing process:
      1. Identify accounts for closing.
      2. Record and post closing entries.
      3. Prepare a post-closing trial balance.
   
   B. Purpose of closing process:
      1. Resets revenue, expense, and dividend account balances to zero at the end of each period so that these accounts can properly measure income and dividends for the next period.
      2. Helps in summarizing a period's revenues and expenses.

   C. Temporary and Permanent Accounts
      1. Temporary (or nominal) accounts accumulate data related to one accounting period; they include all income statement accounts, the dividends account, and the Income Summary account. The closing process applies only to temporary accounts.
      2. Permanent (or real) accounts report on activities related to one or more future accounting periods. They carry their ending
## Chapter Outline

balances into the next period and consist of balance sheet accounts. Real accounts are not closed.

### D. Recording Closing Entries

1. To record and post closing entries is to transfer the end-of-period balances in revenue, expense, and dividends accounts to retained earnings.

2. To close these accounts, transfer their balances first to a temporary account (used only for the closing process) called **Income Summary**. Its balance equals net income or net loss and is transferred to Retained Earnings.

3. The four steps necessary to close temporary accounts are:
   a. Close credit balances in revenue (and gain) accounts to Income Summary; bring accounts with credit balances to zero by debiting them.
   b. Close debit balances in expense (and loss) accounts to Income Summary; bring accounts with debit balances to zero by crediting them.
   c. Close the Income Summary account to the Retained Earnings account; after the first two steps, the balance of the Income Summary account is equal to the period’s net income. If a net loss occurred, the third entry is reversed: debit Retained Earnings and credit Income Summary.
   d. Close the Dividends account to the Retained Earnings account; bring the Dividends account, which has a debit balance, to zero by crediting it.

### E. Post-Closing Trial Balance.

1. A **post-closing trial balance** is a list of permanent accounts and their balances from the ledger after all closing entries have been journalized and posted.

2. Verify that total debits equal total credits for permanent accounts, and all temporary accounts have zero balances.

### F. Accounting Cycle Summary

The term **accounting cycle** refers to the steps in preparing financial statements; it is a cycle because all steps are repeated each reporting period. Exhibit 3.19 shows the ten steps in the cycle:

1. Analyze transactions
2. Journalize
3. Post
4. Prepare unadjusted trial balance
5. Adjust
6. Prepare adjusted trial balance
7. Prepare statements
Chapter Outline

8. Close
9. Prepare post-closing trial balance
10. Reverse (optional; explained in Appendix 3C).

V. Classified Balance Sheet—organizes assets and liabilities into subgroups that provide more useful information to decision makers:
   A. Classification Structure
      1. One of the more important classifications is the separation between current and noncurrent assets and liabilities. Only assets and liabilities are classified as current or noncurrent.
      2. Current items are expected to come due (both collected and owed) within one year or the company’s operating cycle, whichever is longer.
      3. The operating cycle is the time span from when cash is used to acquire goods and services until cash is received from their sale. Most operating cycles are less than one year; a few companies have an operating cycle longer than one year.
   B. Classification Categories
      1. Current Assets—cash or other assets that are expected to be sold, collected, or used within one year or the company’s operating cycle, whichever is longer. Examples: cash, short-term investments, accounts receivable, short-term notes receivable, goods for sale (called merchandise or inventory), and prepaid expenses.
      2. Long-Term Investments—assets that are expected to be held for more than the longer of one year or the operating cycle. Examples: notes receivable, investments in stocks, and land held for future expansion.
      3. Plant Assets—tangible, long-lived assets that are both long-lived and used to produce or sell products and services. Examples: equipment, machinery, buildings, and land that are used to produce or sell products and services.
      4. Intangible Assets—long-term resources that benefit business operations. They usually lack physical form and have uncertain benefits. Examples: patents, trademarks, copyrights, franchises, and goodwill.
      5. Current Liabilities—obligations due to be paid or settled within one year or the operating cycle, whichever is longer. Examples: accounts payable, notes payable, wages payable, taxes payable, interest payable, and unearned revenues. Any portion of a long-term liability due to be paid within one year or the operating cycle, whichever is longer, is a current liability.
Chapter Outline

6. **Long-Term Liabilities**—obligations *not* due within one year or the operating cycle, whichever is longer. Examples: notes payable, mortgages payable, bonds payable, and lease obligations.

7. **Equity**—owners’ claim on assets; divided into two main subsections: common stock and retained earnings.

C. **Global View**

1. **Adjusting Accounts and the Closing Process** – Both GAAP and IFRS include broad and similar guidance for adjusting accounts. All of the adjustments in this chapter are accounted for identically under the two systems. The closing process is also identical under both systems.

2. **Preparing Financial Statements** – Both GAAP and IFRS prepare the same four financial statements following the same process discussed in this chapter. GAAP balance sheets report assets in order of liquidity and liabilities are listed from nearest maturity to furthest. IFRS balance sheets present noncurrent items first and equity before liabilities, but this is not a requirement.

3. **Reporting Assets and Liabilities**
   a. The definition of an asset is similar under both systems and involve three basic criteria: the company owns or controls the right to use the item; the right arises from a past transaction or event; and the item can be reliably measured. Both define the initial asset value as historical cost. After acquisition, one of two asset measurement systems are applied: historical cost or fair value. GAAP defines fair value as the amount to be received in an orderly sale. IFRS defines fair value as exchange value—either replacement cost or selling price.
   
   b. The definition of a liability is similar under GAAP and IFRS and involves three basic criteria: the item is a present obligation requiring a probably future resource outlay; the obligation arises from a past transaction or event, and the obligation can be reliably measured. Both systems apply one of two measurement systems to specific liabilities: historical cost or fair value.

VI. **Decision Analysis—Profit Margin and Current Ratio**

A. **Profit Margin**

1. **Profit margin** (also called *return on sales*) is a useful measure of a company’s operating results.

2. It is calculated as net income divided by net sales.
Chapter Outline

3. It is interpreted as reflecting the portion of profit in each dollar of sales.

B. Current Ratio
   1. The current ratio is an important measure of a company’s ability to pay its short-term obligations.
   2. It is calculated as total current assets divided by total current liabilities.

VII. Alternative Accounting for Prepayments (Appendix 3A)
   A. Recording Prepayment of Expenses in Expense Accounts
      Prepaid expenses may originally be recorded with debits to expense accounts (instead of to asset accounts). If so, then adjusting entries must transfer the cost of the unused portions from expense accounts to prepaid expense (asset) accounts.
   B. Recording Prepayment of Revenues in Revenue Accounts
      Unearned revenues may originally be recorded with credits to revenue accounts (instead of to liability accounts). If so, then adjusting entries must transfer the unearned portions from revenue accounts to unearned revenue (liability) accounts.
   C. Note that the financial statements are identical under either procedure, but the adjusting entries are different.

VIII. Work Sheet as a Tool (Appendix 3B)
   A. Working papers are internal documents. One widely used working paper is the work sheet, which is a useful tool for preparers in working with accounting information. It is usually not available to external decision makers.
   B. Use of a Work Sheet
      Preparing a work sheet has five important steps:
   1. Enter the unadjusted trial balance in the first two columns.
   2. Enter the adjustments in the third and fourth columns. Total columns to verify debit adjustments equal credit adjustments.
   3. Prepare the Adjusted Trial Balance. This is done by combining the unadjusted trial balance and adjustment columns. Total Adjusted Trial Balance columns to verify debits equal credits.
   4. Sort the adjusted trial balance amounts to the appropriate financial statement columns.
   5. Total statement columns, compute net income or loss, and balance the columns by adding net income or loss.
## Reversing Entries (Appendix 3C)

A. **Reversing entries** are optional; they are recorded in response to accrued assets and accrued liabilities that were created by adjusting entries at the end of a reporting period.

B. Accounting *without* Reversing Entries—the disadvantage of this approach is the slightly more complex entry required when the cash subsequently changes hands (i.e., when cash is received for the asset that was originally accrued or when cash is paid for the liability that was originally accrued).

C. Accounting *with* Reversing Entries
   1. A reversing entry is the exact opposite of an adjusting entry.
   2. Reversing entries are prepared after closing entries and dated the first day of the new period.
   5. Procedure is to transfer accrued asset and liability account balances to related revenue and expense accounts creating abnormal balances in these accounts.
   6. The full subsequent cash receipts (and payments) are recorded as increases in revenue (and expense) accounts creating a net balance equal to the amount earned or incurred in that period.
ACCRUAL BASIS ACCOUNTING

(Follows GAAP)

requires that the

Income Statement
(for a period)

reports

ALL REVENUES EARNED in period (Collected or Not)

Minus ALL EXPENSES INCURRED in period (Paid or Not)

Equals Net Income or Net Loss for the period

ACCOUNTS MUST BE ADJUSTED TO FOLLOW PRINCIPLES
DEFERRALS

The converse of statements in Visual #3-1 also applies.

Revenue not earned or expense not incurred results in Deferrals*

\[
\text{UNEARNED} = \text{LIABILITY}\ *
\]

A REVENUE not earned cannot be shown, even if collected.

An EXPENSE not incurred cannot be shown, even if paid.

\[
\text{PREPAID} = \text{ASSET} \ *
\]

*We defer or postpone the reporting of the collected revenues (as revenues) and prepaid expenses (as expenses) until the revenue is earned and the expense is incurred.
## VISUAL #3-3

### ADJUSTMENTS

<table>
<thead>
<tr>
<th>TYPE</th>
<th>GENERALIZED* ENTRY</th>
<th>AMOUNT</th>
</tr>
</thead>
</table>
| 1. Prepaid items or supplies  
   a) initially recorded as assets | Dr. _________ Expense  
   Cr. The Asset* acct. | Amount used, or consumed, or expired |
| b) initially recorded as expenses (alternate treatment) | Dr. the Asset** acct.  
   Cr. _________ Expense | Amount left, or not consumed, or unexpired |
| 2. Accrued expenses  
   (expenses incurred but not yet recorded) | Dr. _________ Expense  
   Cr. _________ Payable | Amount accrued |
| 3. Accrued revenues  
   (revenues earned but not yet recorded) | Dr. _________ Receivable  
   Cr. The Revenue** acct. | Amount accrued |
| 4. Long-term assets that are depreciable | Dr. Depreciation Expense  
   Cr. Accumulated Depreciation | Portion of cost allocated to this period as depreciation |
| 5. Unearned revenues  
   (received in advance)  
   a) record initially as liability  
   (unearned account) | Dr. Unearned _________  
   Cr. The Revenue** acct. | Amount earned to date |
| b) initially recorded as a revenue (alternate treatment) | Dr. the Revenue** acct.  
   Cr. Unearned_________ | Amount still not earned |

*  Note: (1) Each adjustment affects a Balance Sheet Account and an Income Statement Account (2) **CASH NEVER** appears in an adjustment.  
  ** Title or account name varies.
### THE ACCOUNTING CYCLE

<table>
<thead>
<tr>
<th>STEPS</th>
<th>PURPOSE</th>
<th>TIMING</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Analyze transactions</td>
<td>Analyze transactions to prepare for journalizing.</td>
<td>During the period</td>
</tr>
<tr>
<td>2. Journalize</td>
<td>Record accounts, including debits and credits, in a journal.</td>
<td>During the period</td>
</tr>
<tr>
<td>3. Post</td>
<td>Transfer debits and credits from the journal to the ledger.</td>
<td>During the period</td>
</tr>
<tr>
<td>4. Prepare unadjusted trial balance</td>
<td>Summarize unadjusted ledger accounts and amounts.</td>
<td>End of period</td>
</tr>
<tr>
<td>5. Adjust</td>
<td>Record adjustments to bring account balances up to date; journalize and post adjusting entries.</td>
<td>End of period</td>
</tr>
<tr>
<td>6. Prepared adjusted trial balance</td>
<td>Summarize adjusted ledger accounts and amounts.</td>
<td>End of period</td>
</tr>
<tr>
<td>7. Prepare statements</td>
<td>Use adjusted trial balance to prepare financial statements.</td>
<td>End of period</td>
</tr>
<tr>
<td>8. Close</td>
<td>Journalize and post entries to close temporary accounts.</td>
<td>End of year</td>
</tr>
<tr>
<td>10. Reverse (Optional)</td>
<td>Reverse certain adjustments in the next period</td>
<td>Beginning of next year</td>
</tr>
</tbody>
</table>
## Music World Balance Sheet
#### December 31, xxxx

### Assets

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$30,360</td>
</tr>
<tr>
<td>Short-Term Investments</td>
<td>2,000</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>8,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>35,300</td>
</tr>
<tr>
<td>Merchandise Inventory</td>
<td>60,400</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>6,600</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,696</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>$144,356</td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td></td>
</tr>
<tr>
<td>Land Held for Future Use</td>
<td>13,950</td>
</tr>
<tr>
<td><strong>Property, Plant, and Equipment</strong></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$4,500</td>
</tr>
<tr>
<td>Building</td>
<td>$20,650</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>8,640</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>$8,600</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total Property, Plant, and Equipment</strong></td>
<td>20,110</td>
</tr>
<tr>
<td><strong>Intangible Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Trademark</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$178,916</td>
</tr>
</tbody>
</table>

### Liabilities

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td>$15,000</td>
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<tr>
<td>Accounts Payable</td>
<td>25,683</td>
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<tr>
<td>Salaries Payable</td>
<td>2,000</td>
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<tr>
<td>Current Portion of Mortgage Payable</td>
<td>10,200</td>
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<tr>
<td><strong>Total Current Liabilities</strong></td>
<td>$52,883</td>
</tr>
<tr>
<td><strong>Long-Term Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Mortgage Payable</td>
<td>27,600</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$80,483</td>
</tr>
</tbody>
</table>

### Equity

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>40,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>58,433</td>
</tr>
<tr>
<td><strong>Total Liabilities and Equity</strong></td>
<td>$178,916</td>
</tr>
</tbody>
</table>