Course Title: Financial Accounting

Course Code: ACT 101

Course Instructor: Fairose Farin

Chapter3:Adjusting the Accounts

PREVIEW OF CHAPTER 3

ADJUSTING THE ACCOUNTS

Timing Issues

- Fiscal and calendar years
- Accrual- vs. cash-basis accounting
- Recognizing revenues and expenses

The Basics of Adjusting Entries

- Types of adjusting entries
- Adjusting entries for deferrals
- Adjusting entries for accruals
- Summary of basic relationships

The Adjusted Trial Balance and Financial Statements

- Preparing the adjusted trial balance
- Preparing financial statements

Financial Accounting

IFRS 3rd Edition

Weygandt ● Kimmel ● Kieso

CHAPTER

3 | Adjusting the Accounts

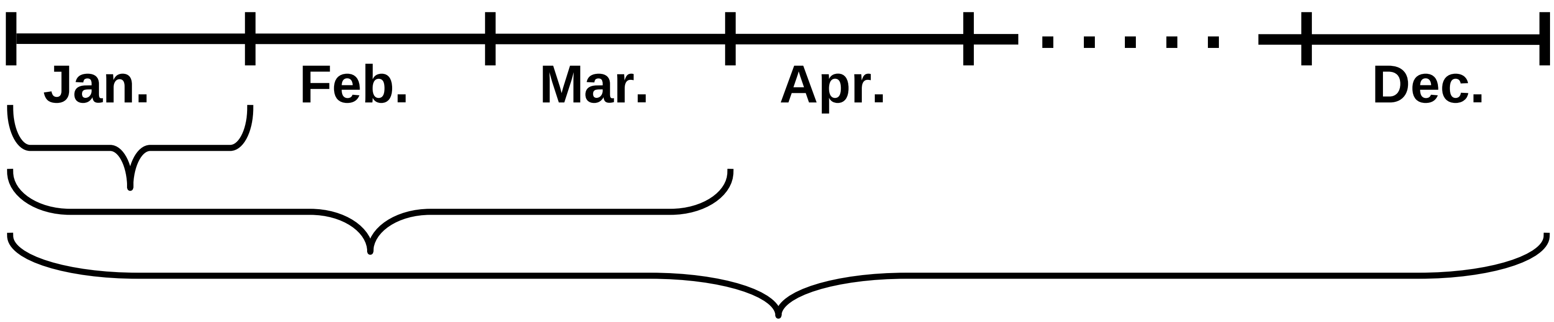
LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain the time period assumption.
2. Explain the accrual basis of accounting.
3. Explain the reasons for adjusting entries.
4. Identify the major types of adjusting entries.
5. Prepare adjusting entries for deferrals.
6. Prepare adjusting entries for accruals.
7. Describe the nature and purpose of an adjusted trial balance.

Timing Issues

✓ **Accountants divide the economic life of a business into artificial time periods (Time Period Assumption).**



- Generally, a month, a quarter, or a year.
- Time Period Assumption also known as the "***Periodicity Assumption***"

EXAMPLE

✓ **Coca-Cola has been in business for 138 years, with its origins dating back to May 8, 1886, when Dr. John Pemberton sold the first glass of Coca-Cola in Atlanta, Georgia.**

Coca-Cola reports its financial results on a **quarterly and annual basis**, in line with the time period assumption.

- **Quarterly Reports (10-Q):** Coca-Cola issues reports every 3 months, providing investors and regulators with timely insights into the company's performance.
- **Annual Reports (10-K):** At the end of each fiscal year, Coca-Cola compiles a full-year report with audited financial statements.
- Coca-Cola uses the time period assumption to **track sales, revenues, and expenses over each quarter.**
- Compare performance **period over period** (e.g., Q1 2025 vs Q1 2024). Identify seasonal trends (e.g., higher beverage sales in summer).

Fiscal 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.A fiscal year usually begins with the first day of a month and ends 12 months later on the last day of a month.such as **Vodafone Group's (GBR) fiscal year which ends March 31.**
- **Calendar Year** = **January 1 to December 31**.

Fiscal and Calendar Years

Question

The time period assumption states that:

a. companies must wait until the calendar year is completed to prepare financial statements.

b. companies use the fiscal year to report financial information.

c. the economic life of a business can be divided into artificial time periods.

d. companies record information in the time period in which the events occur.

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). You record income when it’s earned even if you haven't received the money yet.
- **Expenses** are recognized when **incurred** (rather than when paid).

Accrual Accounting Example

Imagine you run a small design business:

- **You finish a $1,000 project on June 30**, but your client doesn't pay you until July 15.
  - **Under accrual accounting**, you record the $1,000 as income on **June 30** (when the work was done).
  - Even though the money arrives later, the income is counted when **earned**.
- Similarly, say you **get a $300 bill for software** you used in June, but you'll **pay it in July**.
  - You record the $300 expense in **June**, not July, because that's when you **used** the service.

Accrual- versus Cash-Basis Accounting

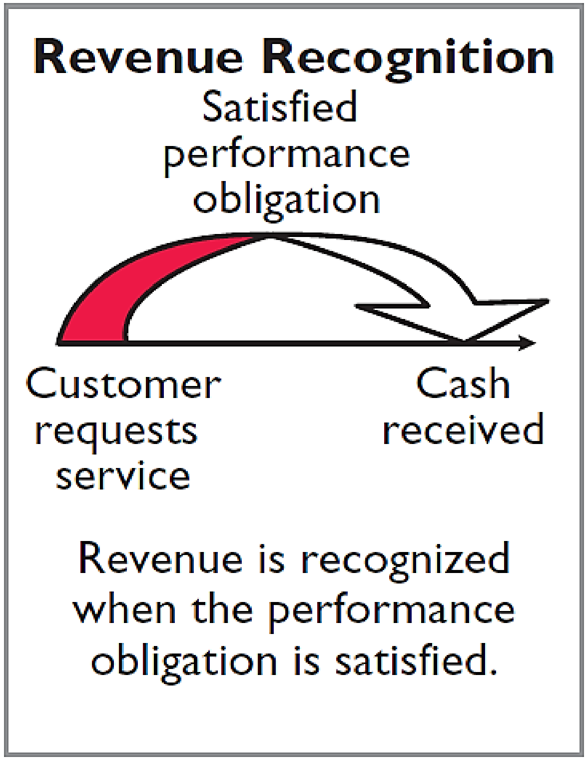
Cash-Basis Accounting

- **Revenues** are recorded when **cash is received**.
- **Expenses** are recorded when **cash is paid**.
- **Cash-basis accounting is not in accordance with International Financial Reporting Standards (IFRS).**

Recognizing Revenues and Expenses

❑ REVENUE RECOGNITION PRINCIPLE

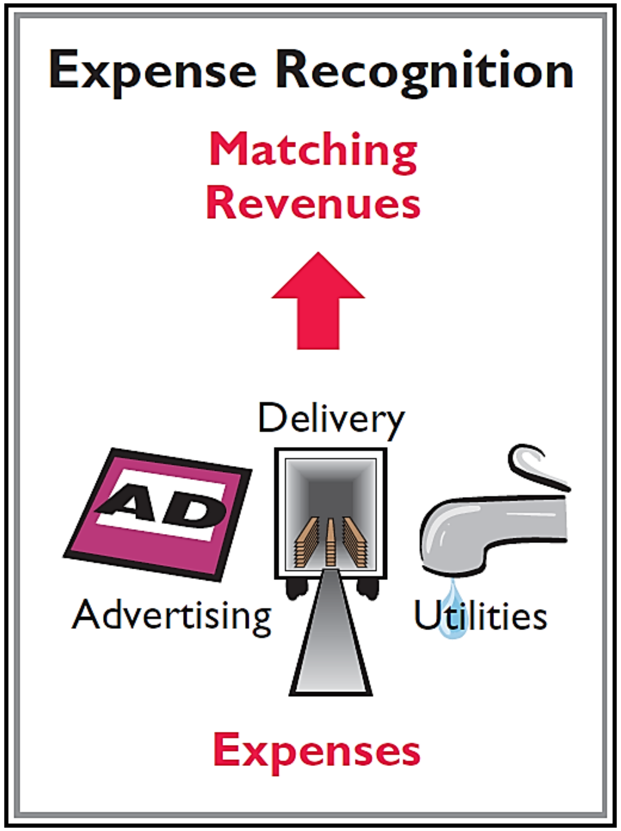
- ✓ **Recognize** revenue in the accounting period in which the **performance obligation is satisfied**. A business should recognize revenue only when it has done what it promised to do for the customer.
- ✓ Example: On **August 1**, a client hires you to build a website for **$5,000**.You finish and deliver the website on **August 20**.The client pays you on **September 5**.
  - ✓ You **record the $5,000 revenue on August 20** — the day you completed the service and earned the income.
  - ✓ **It doesn't matter** that you were paid in September — revenue is recognized **when the work is done**, not when the money arrives.



Recognizing Revenues and Expenses

EXPENSE RECOGNITION PRINCIPLE

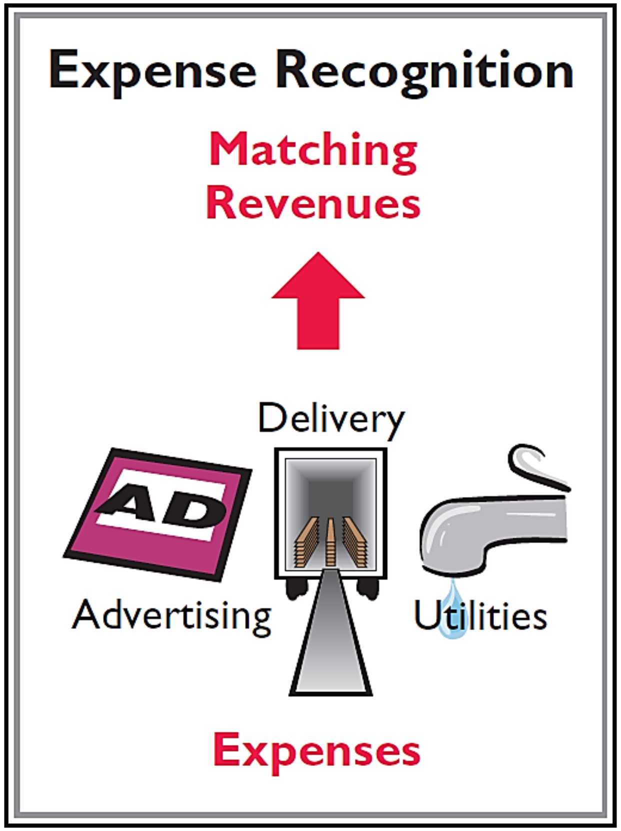
- ✓ Match expenses with revenues in the period when the company makes efforts to generate those revenues.
- ✓ **"Let the expenses follow the revenues." A company should record the costs (expenses) in the same time period as the revenues those costs helped to produce.**



Recognizing Revenues and Expenses

❑ EXPENSE RECOGNITION PRINCIPLE(CONT.)

- ✓ **Example:** A bakery sells 1,000 cakes in June and earns $50,000.To make those cakes, the bakery spent $20,000 on flour, eggs, sugar, etc.
- ✓ Even if the bakery bought the ingredients in May, the $20,000 expense should be recorded in June, because that's when the cakes were sold and revenue was earned.
- ✓ This principle helps match **expenses with related revenues**, giving a more accurate picture of profit for the period.



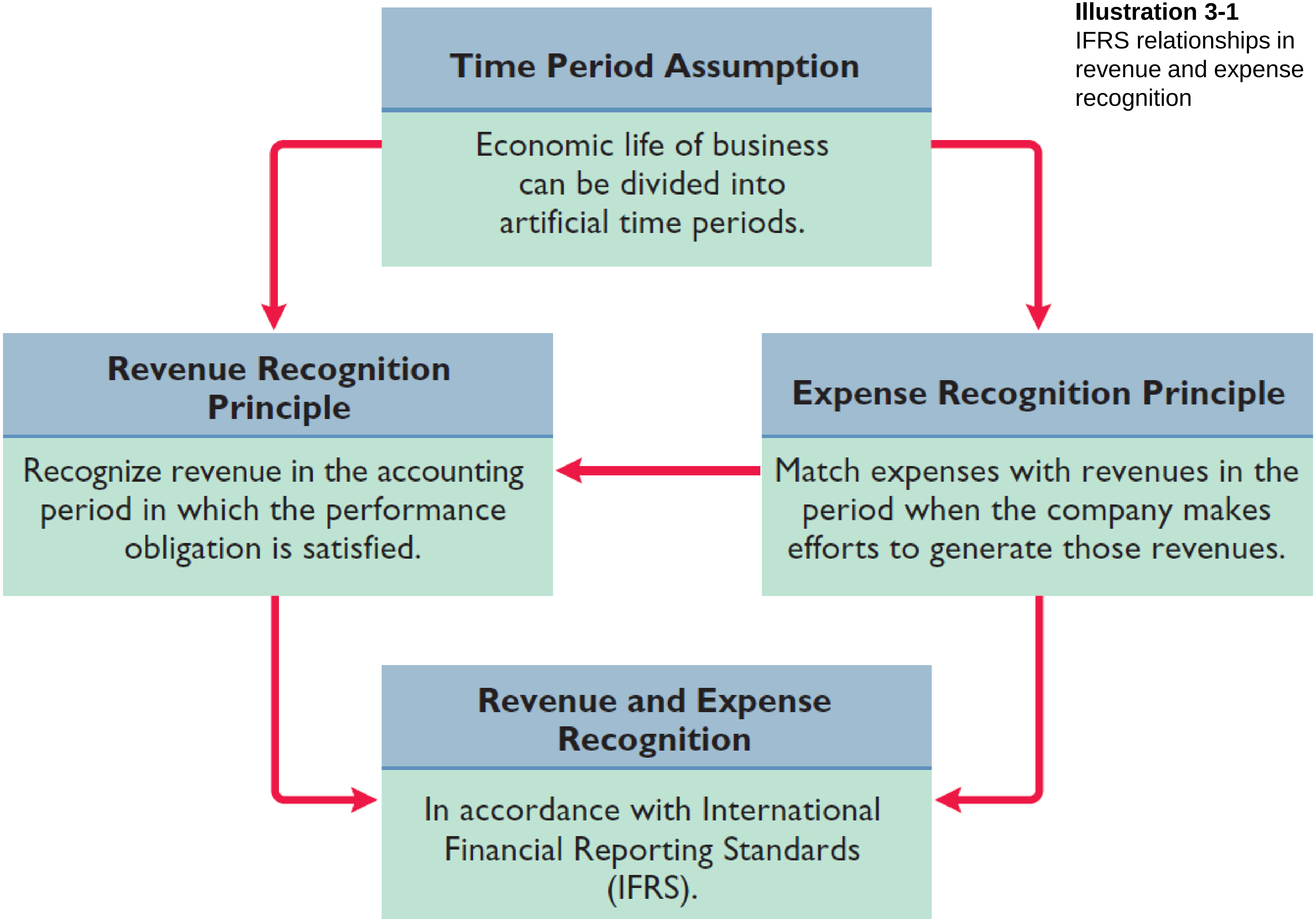


Illustration 3-1
IFRS relationships in revenue and expense recognition

LO 2

Recognizing Revenues and Expenses

Question

The revenue recognition principle states that:

a. revenue should be recognized in the accounting period in which a performance obligation is satisfied.

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.

> DO IT!

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 2

The Basics of Adjusting Entries

Adjusting Entries

- Ensure that the **revenue recognition** and **expense recognition** principles are followed.

- **They needed** because sometimes:

- You earned money but haven't recorded it yet.
- You used up something (like supplies or prepaid rent) but haven't recorded the expense.
- You recorded something too early or too late.

Simple example: Imagine you paid $1,200 for a 12-month magazine subscription on January 1.

- You paid upfront, but you **only use one month's worth of the subscription in January**.
  At the end of January, you make an **adjusting entry** to record the expense for just January ($100), not the whole $1,200.

The Basics of 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 statement of financial position account**.

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. statement of financial position and income statement accounts have correct balances at the end of an accounting period.

d. All the responses above are correct.

Types of Adjusting Entries

Deferrals

1. **Prepaid Expenses.** Expenses paid in cash before they are used or consumed such as **prepaid** **rent or insurance**

2. **Unearned Revenues.** Cash received before services are performed.

Accruals

1. **Accrued Revenues.** Revenues for services performed but not yet received in cash or recorded such as accounts receivable

2. **Accrued Expenses.** Expenses incurred but not yet paid in cash or recorded.

YAZICI ADVERTISING A.Ş.
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
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	₺28,700	**₺28,700**

Illustration 3-3
Trial balance

Each account is analyzed to determine whether it is complete and up-to-date for financial statement purposes.

Adjusting Entries for Deferrals

Deferrals happen when **cash is received or paid before the related revenue or expense is actually earned or used**.

Basically, you **delay recognizing the revenue or expense** until the right time.

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

In simple words, deferrals are accounting adjustments made when **cash has been exchanged before the related expense or revenue is recognized in the financial statements.**

There are **two types**:

- **Prepaid expenses and**
- **Unearned revenues.**

Adjusting Entries for Deferrals

Two main types of deferrals:

1. **Deferred Revenue (Unearned Revenue):**
   - You get paid **before** you deliver the product or service.
   - You don’t count it as revenue yet because you still owe the customer.
   - Later, when you deliver, you recognize the revenue.
2. **Deferred Expense (Prepaid Expense):**
   - You pay **before** you actually use or consume the service or item. You don’t count it as an expense yet.
   - Later, as you use it, you recognize the expense.

PREPAID EXPENSES

Payments of expenses that will benefit more than one accounting period.

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

Prepayments often occur in regard to:

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

Example: Paid $1,200 for one year of insurance. Each month, $100 is moved from Prepaid Insurance (asset) to Insurance Expense.

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**.

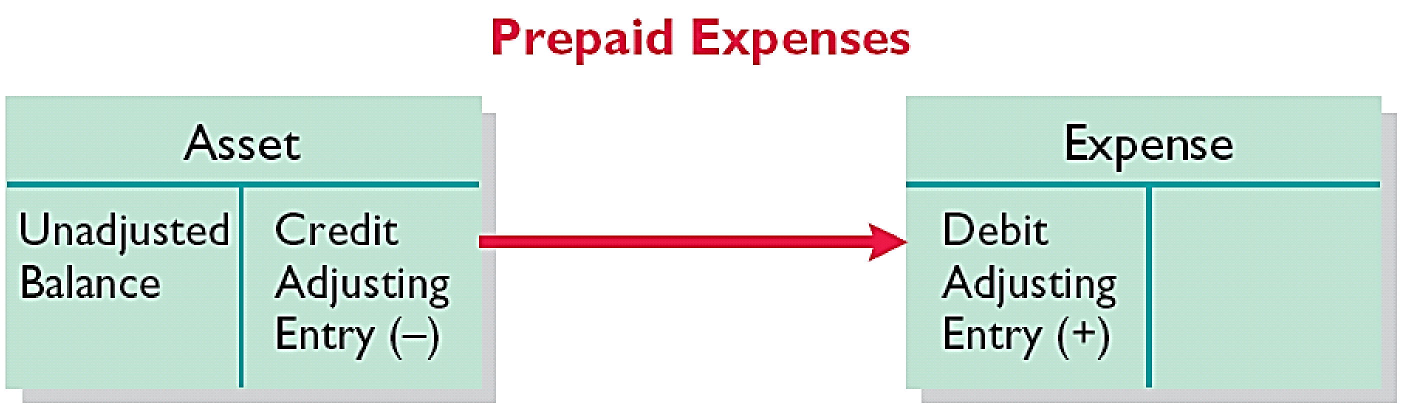
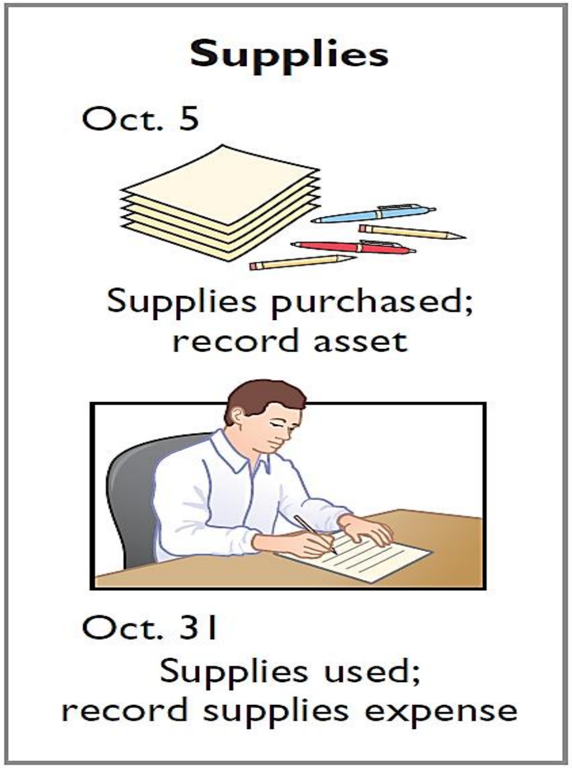


Illustration 3-4
Adjusting entries for prepaid expenses

LO 5

PREPAID EXPENSES

Illustration: Yazici Advertising Inc. **purchased supplies** costing **₺2,500** on **October 5**. Yazici recorded the purchase 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. This means ₺1,500 (₺2,500 - ₺1,000) were used.**



Oct. 5	Supplies	2,500	
	Cash or Accounts Payable		2,500

Adjusting Journal Entry (October 31)

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

Basic Analysis

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

Equation Analysis

Assets	=	Liabilities	+	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

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		

Illustration 3-5
Adjustment for supplies

PREPAID EXPENSES

Illustration: On October 4, Yazici Advertising Inc. paid ₺600 for a one-year fire insurance policy. Coverage began on October 1. Yazici 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. Prepaid Insurance still shows ₺600, meaning no adjustment has been made yet.

Oct. 31	Prepaid Insurance	600	
	Cash		600

Adjusting Journal Entry (October 31)

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50

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
Insurance = ₺600/year			

Oct. 31
Insurance expired; record insurance expense

Basic Analysis

The expense Insurance Expense is increased ₺50, and the asset Prepaid Insurance is decreased ₺50.

Equation Analysis

Assets	=	Liabilities	+	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		

Illustration 3-6
Adjustment for insurance

DEPRECIATION

- **When you buy something big such as buildings**, **equipment**, and **motor vehicles** (assets that provide service for many years) you **record it as assets**, rather than an expense, on the date acquired. You don't expense it all at once.

- **Instead, you spread the cost over the years you use it .**

- **Depreciation is a non-cash expense as actual cash does not go out .**

- **Depreciation expense is portrayed in the expense section of statement of net income which results in reduction in the net income .**

DEPRECIATION

- **Depreciation** is the process of **allocating the cost of an asset to expense** over its **useful life**. **Useful life** refers to the period of time an asset is expected to be used by a business before it becomes obsolete, inefficient, or no longer economically viable.

- Depreciation **does not attempt** to report the actual change in the **value of the asset**. It doesn't reflect how much the asset could be sold for today.

ACCUMULATED DEPRECIATION

- Accumulated Depreciation **is contra asset account .**
- **It reduces the value of the asset on the statement of financial position.**
- **Accumulated Depreciation tracks total depreciation recorded over the years.**
- **Example:** A company **buys equipment for $10,000** with a **5-year useful life**. **It depreciates $2,000 per year**.
- After 2 years, the book value **(accounting value)** is $6,000.But the equipment's actual market value might be **$7,000** or **$4,000 depending on demand, condition, etc**.

PREPAID EXPENSES

Illustration: For Yazici Advertising, assume that depreciation on the equipment is ₺480 a year, or ₺40 per month.

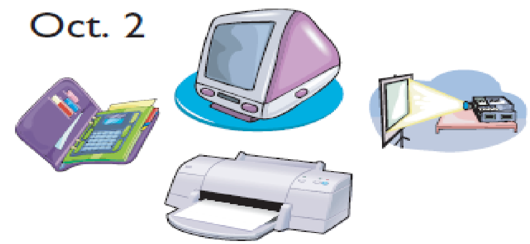
Oct. 31

Depreciation Expense	40	
Accumulated Depreciation		40

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

Depreciation

Oct. 2



Equipment purchased; record asset

Equipment			
Oct ₺40	Nov ₺40	Dec ₺40	Jan ₺40
Feb ₺40	March ₺40	April ₺40	May ₺40
June ₺40	July ₺40	Aug ₺40	Sept ₺40
Depreciation = ₺480/year			

Oct. 31

Depreciation recognized; record depreciation expense

• **HELPFUL HINT**
All contra accounts have increases, decreases, and normal balances opposite to the account to which they relate.

Basic Analysis

The expense Depreciation Expense is increased ₺40, and the contra asset Accumulated Depreciation—Equipment is increased ₺40.

Equation Analysis

Assets	=	Liabilities	+	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	

Illustration 3-7
Adjustment for depreciation

PREPAID EXPENSES

Statement Presentation

- **Accumulated Depreciation** is a **contra asset account** (credit).
- **Appears just after** the account it offsets (Equipment) 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

Illustration 3-8
Statement of financial position presentation of accumulated depreciation

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 Asset

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 accounting period.
- Results in a **decrease** (debit) to a **liability account** and an **increase** (credit) to a **revenue account**.

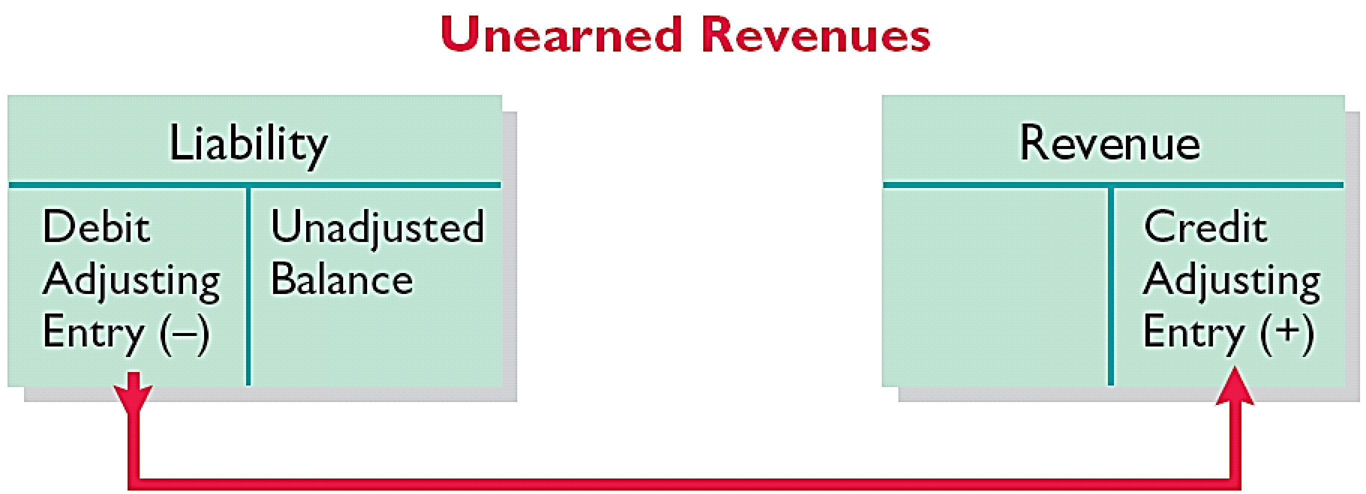


Illustration 3-10
Adjusting entries for unearned revenues

LO 5

UNEARNED REVENUES

Illustration: Yazici Advertising Inc. 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

Basic Analysis

The liability Unearned Service Revenue is decreased ₺400, and the revenue Service Revenue is increased ₺400.

Equation Analysis

Assets	=	Liabilities	+	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

Illustration 3-11
Service revenue accounts after adjustment

UNEARNED REVENUES

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

Illustration 3-12
Accounting for unearned revenues

> DO IT!

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

(amounts in thousands)	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. One-half of the unearned service revenue was performed in March.

Prepare the adjusting entries for the month of March.

> DO IT!

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

(amounts in thousands)	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!

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

(amounts in thousands)	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!

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

(amounts in thousands)	**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!

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

(amounts in thousands)	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. One-half of the unearned service revenue was performed in March.

Unearned Service Revenue	4,600	
Service Revenue		4,600

Adjusting Entries for Accruals

Learning Objective 6
Prepare adjusting entries for accruals.

Accruals are made to record

- Revenues for services performed but not yet recorded at the statement date (**accrued revenues**).

OR

- Expenses incurred but not yet paid or recorded at the statement date (**accrued expenses**).

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 performed

ACCRUED REVENUES

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

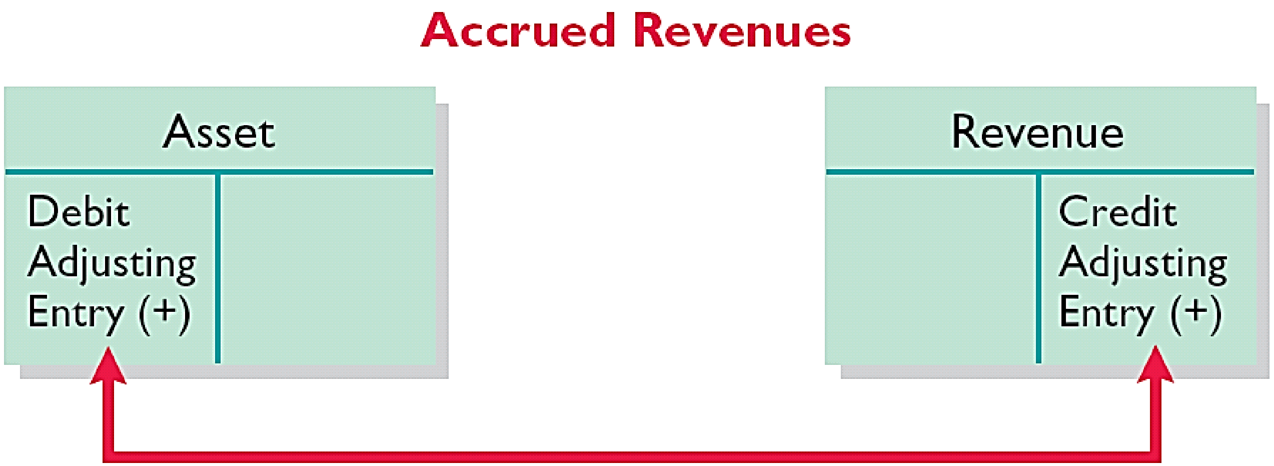
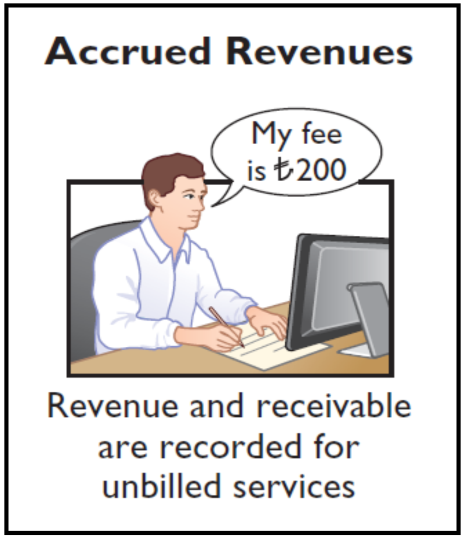


Illustration 3-13
Adjusting entries for accrued revenues

ACCRUED REVENUES

Illustration: In October, Yazici Advertising Inc. performed services worth ₺200 that were not billed to clients in October.



Oct. 31

Accounts Receivable	200	
Service Revenue		200

On November 10, Yazici receives cash of ₺200 for the services performed.

Nov. 10	Cash	200	
	Accounts Receivable		200

Basic Analysis	The asset Accounts Receivable is increased ₺200, and the revenue Service Revenue is increased ₺200.

Equation Analysis

Assets	=	Liabilities	+	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

Illustration 3-14
Adjustment for accrued revenue

ACCRUED REVENUES

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 recorded.	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues

Illustration 3-15
Accounting for accrued 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:

- 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**.

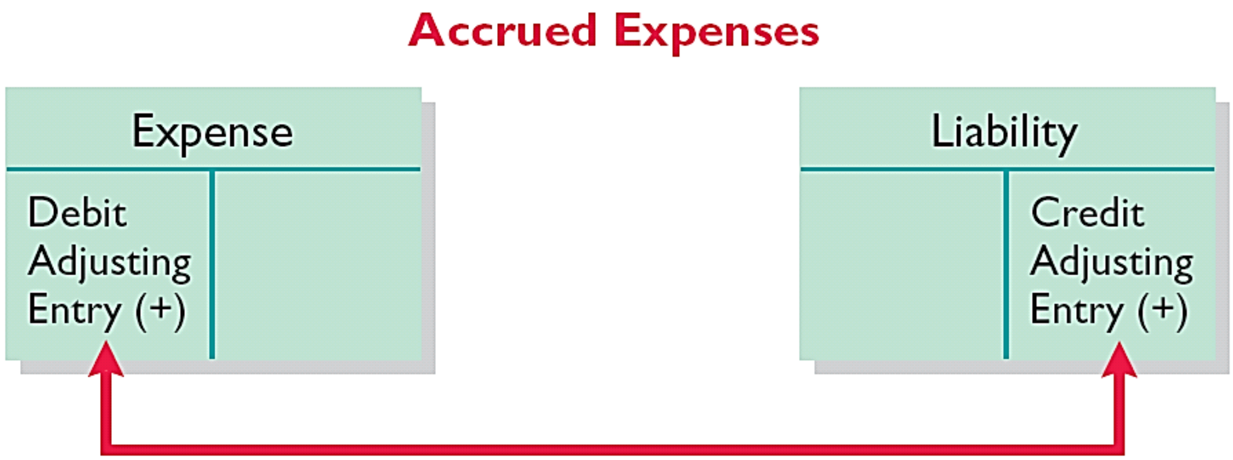


Illustration 3-16
Adjusting entries for accrued expenses

ACCRUED INTEREST

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

Illustration 3-17
Formula for computing interest

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

Basic Analysis

The expense Interest Expense is increased ₺50, and the liability Interest Payable is increased ₺50.

Equation Analysis

Assets	=	Liabilities	+	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	

Illustration 3-18
Adjustment for accrued interest

ACCRUED SALARIES AND WAGES

Illustration: Yazici 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. Thus, accrued salaries at October 31 are ₺1,200 (₺400 x 3 days).

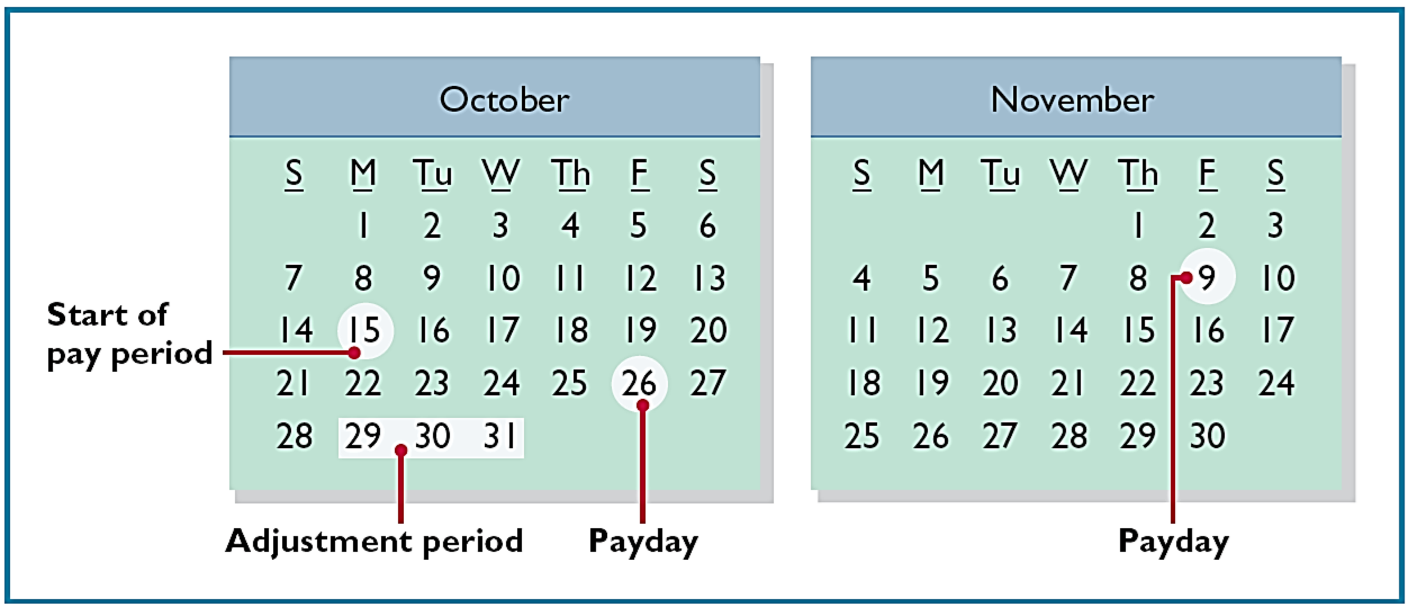


Illustration 3-19
Calendar showing Yazici's pay periods

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	+	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

Illustration 3-20
Adjustment for accrued salaries and wages

ACCRUED EXPENSES

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

Illustration 3-21
Accounting for accrued expenses

> DO IT!

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 ¥8,000 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed ¥300,000 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 ¥11,000.

Prepare the adjusting entries needed at August 31, 2017.

> DO IT!

Prepare the adjusting entries needed at August 31, 2017.

1. At August 31, the company owed its employees ¥8,000 in salaries and wages that will be paid on September 1.

Salaries and Wages Expense	**8,000**	
Salaries and Wages Payable		**8,000**

2. On August 1, the company borrowed ¥300,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.

Interest Expense	**2,500**	
Interest Payable		**2,500**

3. Revenue for services performed but unrecorded for August totaled ¥11,000.

Accounts Receivable	**11,000**	
Service Revenue		**11,000**

Summary of Basic Relationships

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

Illustration 3-22
Summary of adjusting entries

The Adjusted Trial Balance and Financial Statements

Learning Objective 7
Describe the nature and purpose of an adjusted trial balance.

Preparing the 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**.

YAZICI ADVERTISING A.Ş.
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**
Share Capital—Ordinary		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**

Illustration 3-25
Adjusted trial balance

Preparing the Adjusted Trail Balance

Question

Which of the following statements is incorrect concerning the adjusted trial balance?

a. (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

Retained Earnings Statement

Statement of Financial Position

YAZICI ADVERTISING A.Ş.
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
Share Capital—Ordinary		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

YAZICI ADVERTISING A.Ş.
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

YAZICI ADVERTISING A.Ş.
Retained Earnings Statement
For the Month Ended October 31, 2017

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

To statement of financial position

Illustration 3-26
Preparation of the income statement and retained earnings statement from the adjusted trial balance

LO 7

YAZICI ADVERTISING A.Ş.
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
Share Capital—Ordinary		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

YAZICI ADVERTISING A.Ş.
Statement of Financial Position
October 31, 2017

Assets		
Equipment	₺5,000	
Less: Accumulated depreciation—equip.	40	₺ 4,960
Prepaid insurance		550
Supplies		1,000
Accounts receivable		200
Cash		15,200
Total assets		₺21,910
Equity and Liabilities		
Equity		
Share capital—ordinary	₺10,000	
Retained earnings	2,360	₺12,360
Liabilities		
Notes payable	5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	9,550
Total equity and liabilities		₺21,910

Balance at Oct. 31 from retained earnings statement in Illustration 3-26

Illustration 3-27
Preparation of the statement of financial position from the adjusted trial balance

> DO IT!

Kang Company was organized on April 1, 2017. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below. (Amounts are in millions.)

	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
Dividends	600	Unearned Rent Revenue	500
Salaries and Wages Expense	9,400	Share Capital—Ordinary	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

> DO IT!

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

Revenues		
Total revenues		
Expenses		
Total expenses		
Net income		

> DO IT!

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

Assets		Liabilities	
Total assets		Total liabilities	

LO 7

> **DO IT!**

(c) Determine the amount that appears for retained earnings at June 30, 2017.

Retained earnings, April 1	
Retained earnings, June 30	

APPENDIX 3A

Alternative Treatment of Prepaid Expenses and Unearned Revenues

Learning Objective 8
Prepare adjusting entries for the alternative treatment of deferrals.

Alternate Treatment

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

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

Illustration 3A-2
Adjustment approaches—a comparison

Unearned Revenues

Company may **credit (increase) a revenue account** when they receive cash for future services.

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

Illustration 3A-5
Adjustment approaches—a comparison

Summary of Additional Adjustments Relationships

Type of Adjustment	Reason for Adjustment	Accounts before Adjustment	Adjusting Entry
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**
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**

Illustration 3A-7
Summary of basic relationships for deferrals

Learning Objective 9
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.

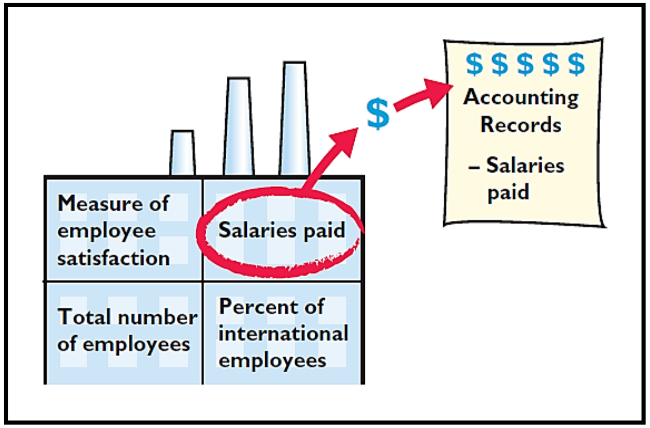
Information has the quality of **understandability** if it is presented in a clear and concise fashion.

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**.

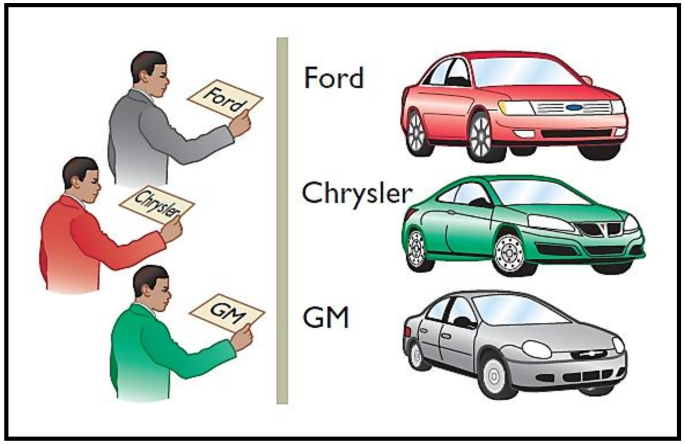
LO 9

Assumptions in Financial Reporting



Monetary Unit

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

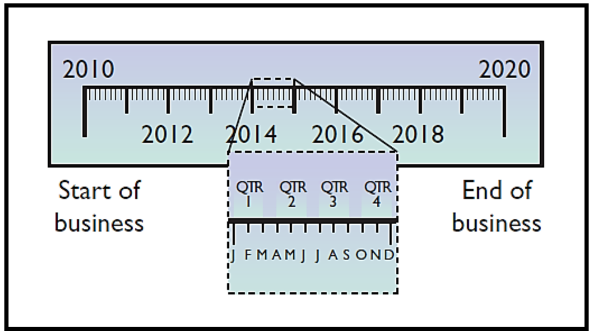


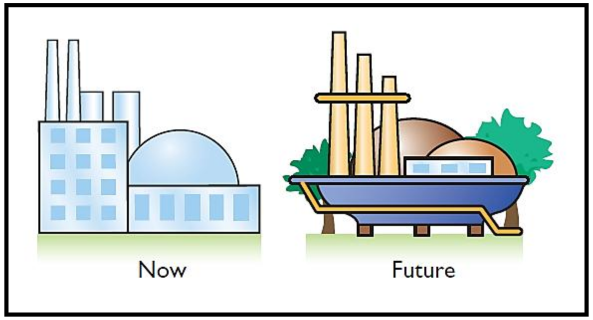
Economic Entity

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

Illustration 3B-2
Key assumptions in financial reporting

Assumptions in Financial Reporting





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.

Illustration 3B-2
Key assumptions in financial reporting

Principles of Financial Reporting

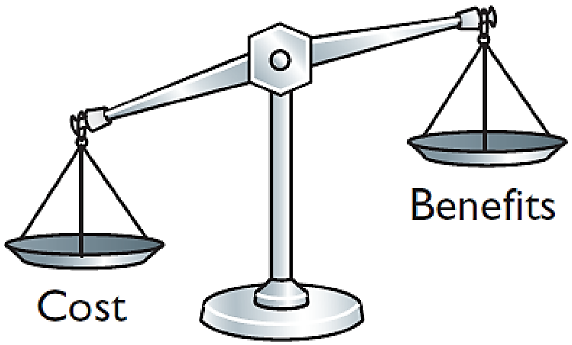
MEASUREMENT PRINCIPLES

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.

Assignment

E3-4, E3-6,E3-7,E3-9,E3-10
E3-13

THANK YOU