CHAPTER 3
ADJUSTING ACCOUNTS AND PREPARING FINANCIAL STATEMENT

Chapter Outline

Notes

I. Timing and Reporting

A. The Accounting Period
To provide timely information, accounting systems prepare reports at regular intervals.

1. 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 for periodic reporting. Interim and annual financial statements can then be prepared.
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 point.
   d. Interim financial statements—statements prepared for any period less than a fiscal year.

B. Accrual Basis versus Cash Basis

1. Accrual basis—uses the adjusting process to recognize revenues when earned and match expenses when incurred 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. Improves comparability of statements.
2. Cash basis—revenues are recognized when cash is received and expenses are recognized when cash is paid. Cash basis is not consistent with GAAP.

C. Recognizing Revenues and Expenses

1. The revenue recognition principle requires revenue be recorded when earned, not before and not after.
2. The matching principle aims to record expenses in the same period as the revenues earned as a result of these expenses.

II. Adjusting Accounts—An adjusting entry is recorded to bring an asset or liability account balance to its proper amount. This entry also updates the related expense or revenue account.

A. Framework for Adjustments
Adjustments are necessary for transactions that extend over more than one period.

Chapter Outline | **Notes**

B. Adjusting Prepaid (Deferred) Expenses
   1. Prepaid expenses (including depreciation) are items *paid for* in advance of receiving their benefits. Prepaid expenses, also called deferred expenses, are assets. As the assets are used, their costs become expenses.
   2. Common prepaid items are supplies, prepaid insurance, prepaid rent and depreciation.
   3. Adjusting entries for prepaids involve increasing (debiting) expenses and decreasing (crediting) assets (with the exception of depreciation on plant and equipment).

C. Adjusting for Depreciation
   1. Depreciation is the process of allocating the cost of plant assets over their expected useful lives.
   2. Adjusting entries for depreciation expense involve increasing (debiting) expenses and increasing (crediting) a special account called Accumulated Depreciation. This account is classified as a contra-asset. It is linked to the asset as a subtraction and thus used to record the declining asset balance.
   3. Book value is a term used to describe the asset less its contra-asset (accumulated-depreciation).

D. Adjusting Unearned (Deferred) Revenues
   1. Unearned revenues (also called deferred revenues) are liabilities created by cash received in advance of providing products or services. The obligation is 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.

E. Adjusting Accrued Expenses
   1. Accrued expenses are costs or expenses 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.")

G. Links to Financial Statements
   Each adjusting entry affects one or more income statement accounts *and* one or more balance sheet accounts. Failure to make a necessary adjustment will result in misstatements of amounts on each of these statements. (See textbook Exhibit 3-12, p.102 for a summary of adjustments and financial statement links.)

H. Adjusted Trial Balance
A list of accounts and balances prepared *after* adjusting entries are recorded and posted to the ledger.

III. Preparing Financial Statements—Prepare financial statements directly from information in the *adjusted* trial balance. The following preparation order shows the flow of information from one statement to another:

A. Income Statement

B. Statement of Owner's Equity
Requires use of net income or loss from previous statement.

C. Balance Sheet
Requires use of ending equity from previous statement.

IV. Decision Analysis—Profit Margin

A. Used to evaluate operating results by measuring the ratio of a company's net income to sales. Also called *return on sales*.

B. Calculated as net income divided by net sales revenues.

C. Interpreted as reflecting the portion of profit in each dollar of revenue.