Financial Accounting Sixth Edition

The Accounting Cycle: End of the Period

CHAPTER 3

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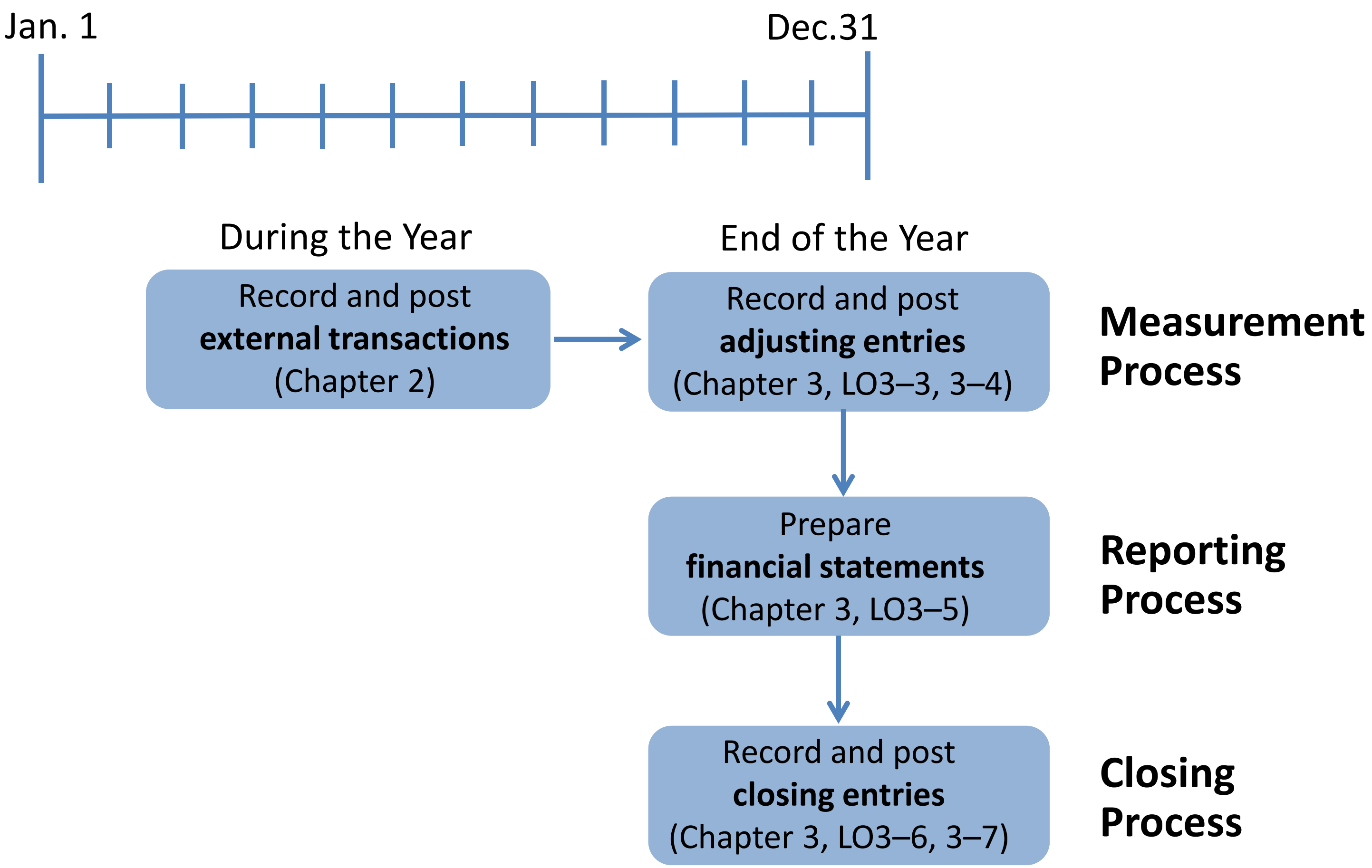
PART A

THE MEASUREMENT PROCESS

Illustration 3–1

The Accounting Cycle



Learning Objective 1

LO3–1 Understand when asset, liabilities, revenues, and expenses are recorded.

Cash-Basis Accounting

Under cash-basis accounting, we record transactions **only at the time *cash* is received or paid**.

Accrual-Basis Accounting

Under accrual-basis accounting, we record:

- Assets – at the time those resources are obtained.
- Liabilities – at the time those obligations occur.
- Revenues – at the time goods and services are provided to customers.
- Expenses – at the time costs are used in running the company.

Key Point

Under accrual-based accounting, economic events that affect assets, liabilities, revenues, and expenses are recorded as they occur.

Concept Check 3–1

Which statement best describes when expenses should be recorded when accrual-based accounting is used to record transactions?

a. Expenses are recorded when paid.

b. Expenses are recorded the day the company promises to pay its vendor or supplier.

c. Expenses are recorded when the cost is used in running the business.

d. None of the above statements are true.

Under accrual-basis accounting, economic events that affect assets, liabilities, revenues, and expenses are recorded *as they occur*.

Learning Objective 2

LO3–2 Distinguish between accrual-basis and cash-basis accounting.

Illustration 3–2

Accrual-Basis versus Cash-Basis for Revenue-Related Transactions

		Accrual-Basis		Cash-Basis	
Transaction	Description	Service Provided	Revenue Recorded	Cash Received	Revenue Recorded
(6) Dec. 12	Provide soccer training to customers for cash, $43,000.	✓	$43,000	✓	$43,000
(7) Dec. 17	Provide soccer training to customers on account, $20,000.	✓	$20,000	x	$0 Not recorded until cash received
(8) Dec. 23	Receive cash in advance for soccer training sessions to be given in the future, $6,000.	x	$0 Record as Deferred Revenue (liability) until service provided	✓	$6,000

Illustration 3–3

Accrual-Basis versus Cash-Basis for Expense-Related Transactions

Transaction	Description	Accrual-Basis: Cost Used	Accrual-Basis: Expense Recorded	Cash-Basis: Cash Paid	Cash-Basis: Expense Recorded
(4) Dec. 1	Pay one year of rent in advance, $60,000 ($5,000 per month).	x	$0 Record as Prepaid Rent (asset) until rent expires($5,000/month)	✓	$60,000
(5) Dec. 6	Purchase supplies on account, $23,000.	x	$0 Record as Supplies (asset) until supplies used	x	$0 Not recorded until cash paid
(9) Dec. 28	Pay salaries to employees, $28,000.	✓	$28,000	✓	$28,000

Timing Differences

- Under both accrual-basis and cash-basis accounting, all revenues and expenses are eventually **recorded for the same amount**.
- The **difference** between accrual-basis accounting and cash-basis accounting is in the **timing** of when we record those revenues and expenses.

Generally Accepted Accounting Principles

- Cash-basis accounting ***is not part*** of generally accepted accounting principles (GAAP).
- Accrual-basis accounting ***is part*** *of* GAAP.

Accrual-Basis Compared with Cash-Basis Accounting

Point of Difference	Accrual-Basis	Cash-Basis
Revenue Recognition	At the time goods and services are provided to customers	At the time we receive cash
Expense Recognition	At the time costs are used in business operations to help generate revenues	At the time we pay cash
GAAP	Part of GAAP	Not part of GAAP

Key Point

The difference between accrual-basis accounting and cash-basis accounting is *timing*.

Under accrual-basis accounting, we record revenues when we provide goods and services to customers, and we record expenses when costs are used in company operations.

Under cash-basis accounting, we record revenues when we receive cash, and we record expenses when we pay cash. Cash-basis accounting is not allowed for financial reporting purposes for most major companies.

Concept Check 3–2

Which of the following would be recorded as an expense under **cash-basis accounting**?

a. The company purchases office supplies with cash and does not use the supplies.

b. The company uses utilities in the current period but does not pay cash.

c. The company provides services to customers for cash.

d. The company purchases equipment by borrowing from the bank.

For cash-basis accounting, an expense is recorded when cash is paid for a cost of operating the business. The company paid cash for supplies and would therefore record Supplies Expense under cash-basis accounting.

Concept Check 3–3

Which of the following would be recorded as an expense under **accrual-basis accounting**?

a. The company purchases office supplies with cash and does not use the supplies.

b. The company uses utilities in the current period but does not pay cash.

c. The company provides services to customers for cash.

d. The company purchases equipment by borrowing from the bank.

For accrual-basis accounting, an expense is recorded when a cost is used to help generate revenues. A company that uses utilities has incurred a cost that helped to generate revenue in the current period and would therefore record Utilities Expense under accrual-basis accounting.

Learning Objective 3

LO3–3 Demonstrate the purposes and recording of adjusting entries.

Adjusting Entries

- Accrual-basis accounting creates timing differences between cash inflows and their related revenues, and between cash outflows and their related expenses.
- These timing differences are reported as assets and liabilities under accrual-basis accounting.
- We use adjusting entries to update balances of assets and liabilities (and their related revenues and expenses).

Illustration 3–4A

Prepayments and Related Adjusting Entries

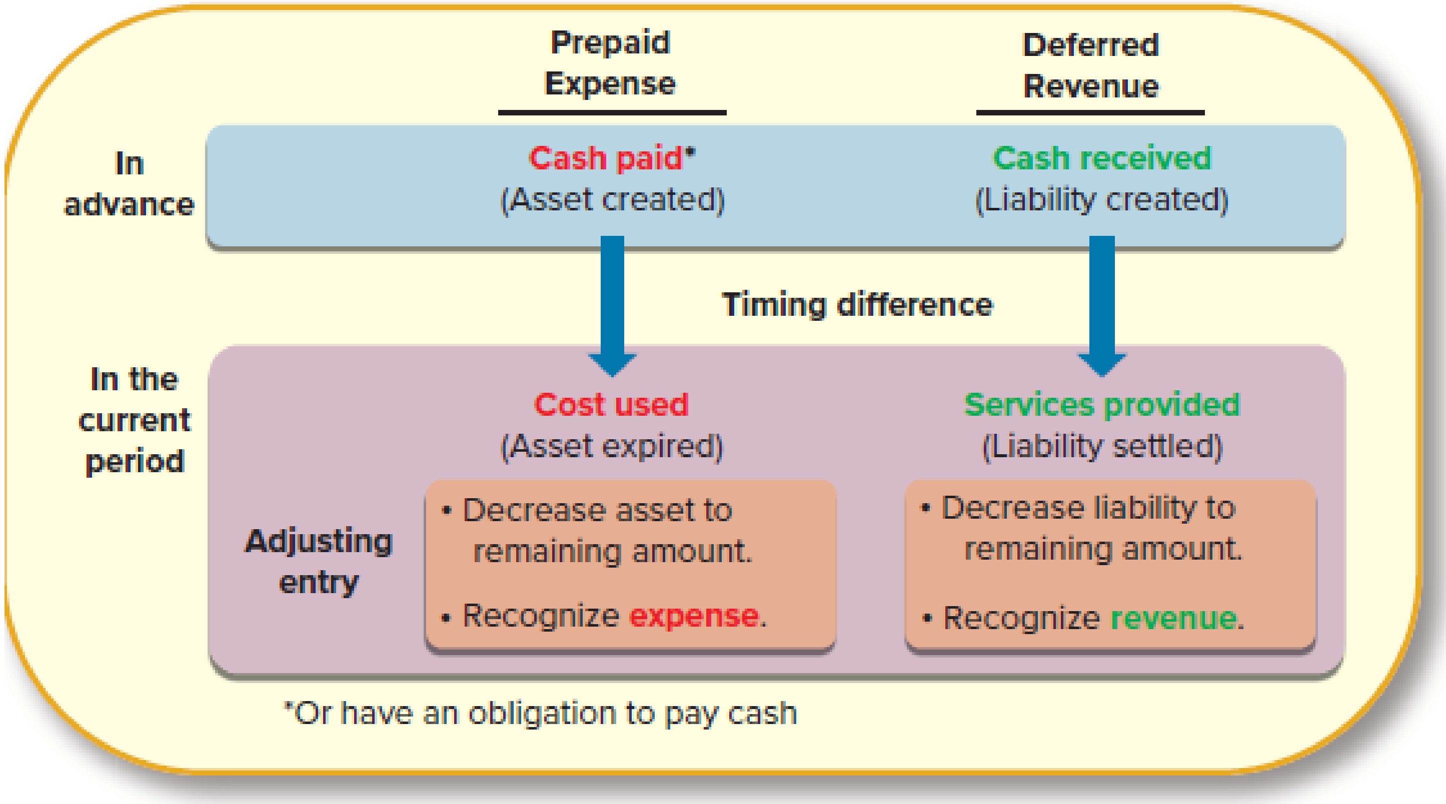


Illustration 3–4B
Accruals and Related Adjusting Entries

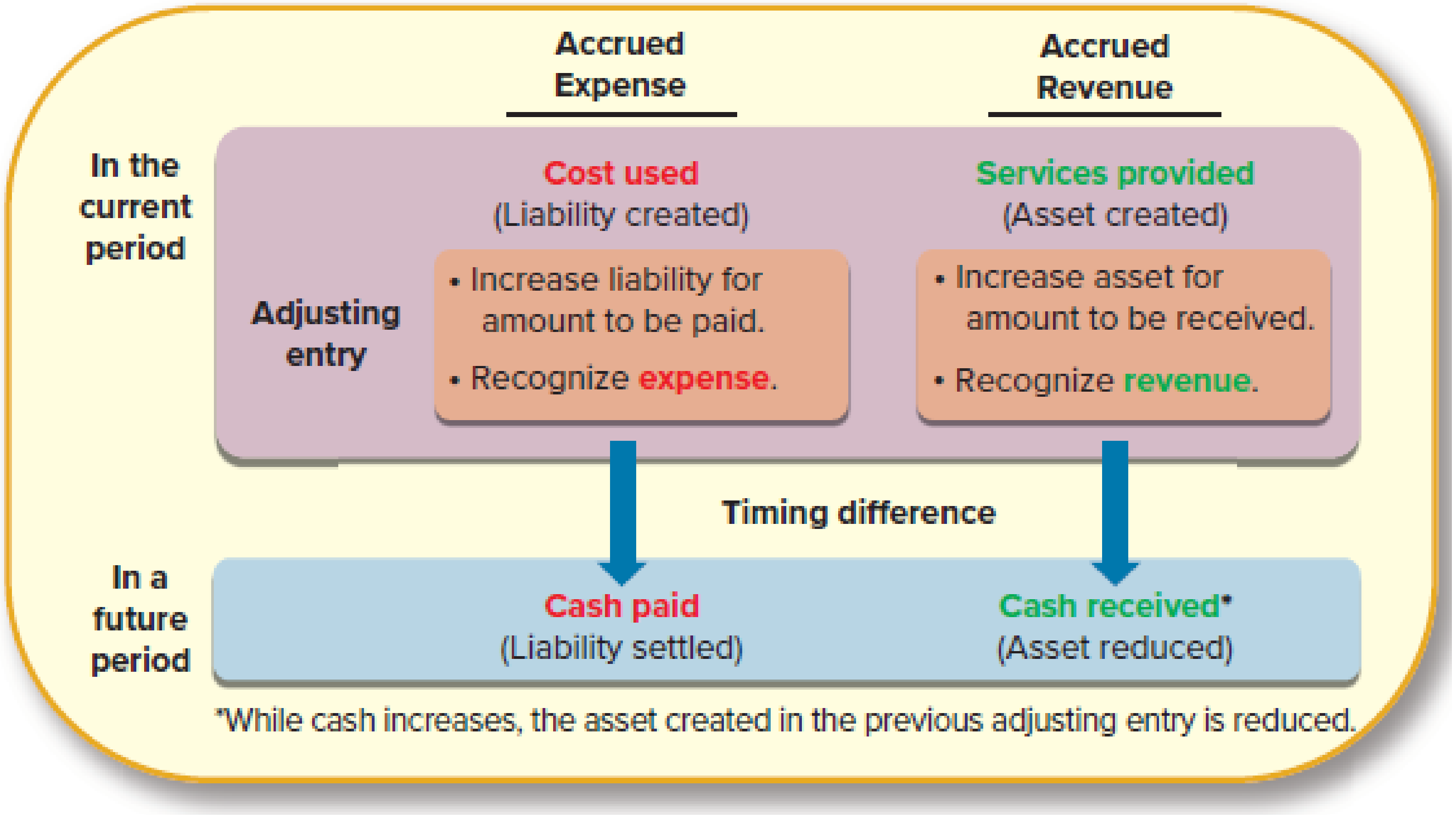


Illustration 3–5
External Transactions

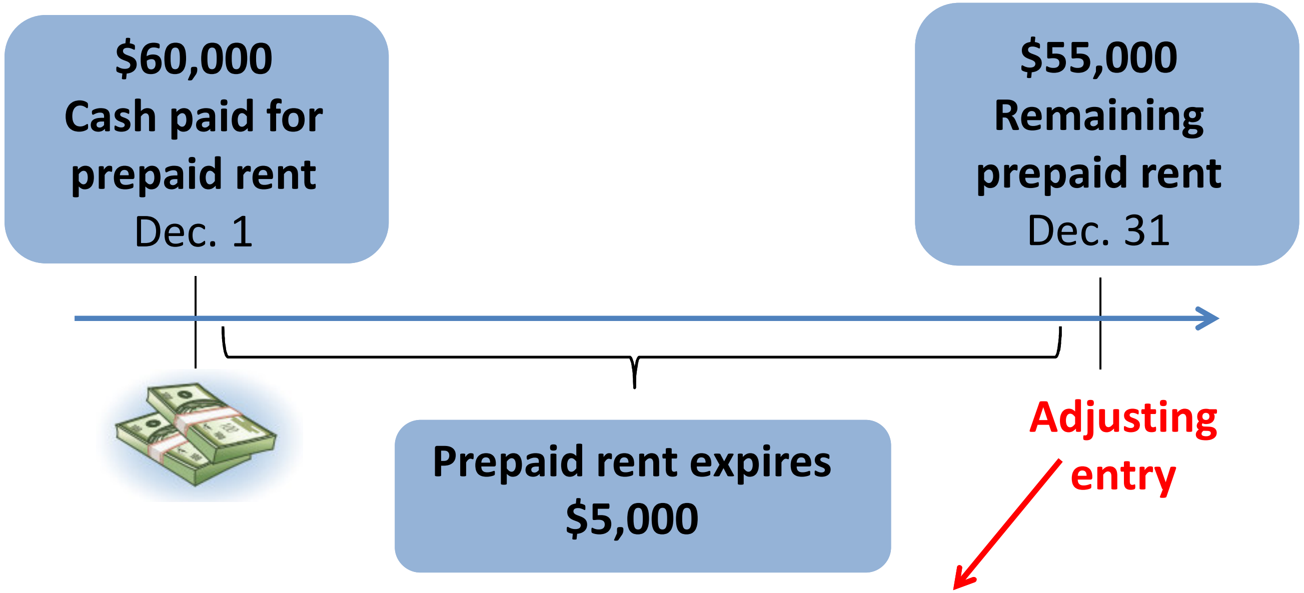
Transaction		Description
(1)	Dec. 1	Sell shares of common stock for $200,000 to obtain the funds necessary to start the business.
(2)	Dec. 1	Borrow $100,000 from the local bank and sign a note promising to repay the full amount of the debt in three years.
(3)	Dec. 1	Purchase equipment necessary for giving soccer training, $120,000 cash.
(4)	Dec. 1	Pay one year of rent in advance, $60,000 ($5,000 per month).
(5)	Dec. 6	Purchase supplies on account, $23,000.
(6)	Dec. 12	Provide soccer training to customers for cash, $43,000.
(7)	Dec. 17	Provide soccer training to customers on account, $20,000.
(8)	Dec. 23	Receive cash in advance for soccer training sessions to be given in the future, $6,000.
(9)	Dec. 28	Pay salaries to employees, $28,000.
(10)	Dec. 30	Pay cash dividends of $4,000 to shareholders.

Prepaid Expenses

- **Prepaid expenses** arise when a company pays cash (or has an obligation to pay cash) to acquire an asset that is not used until a later period.
- There is a **timing** difference—cash is paid now and then later the expense is recognized.
- These payments are recorded as **assets** at the time of purchase.
- In the period these assets are used, an adjusting entry is needed to (1) decrease the asset’s balance to its remaining (unused) amount and (2) recognize an **expense** for the cost of asset used.

Prepaid Expense—Rent

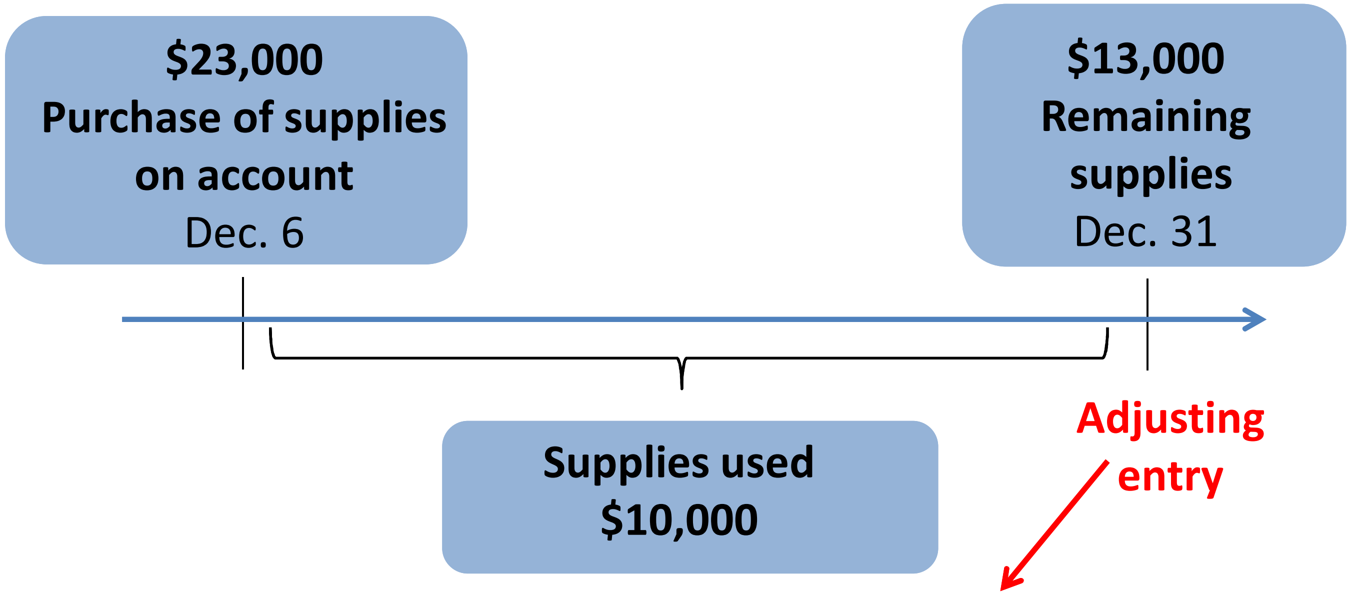
- On December 1, purchased one year of rent in advance for $60,000 ($5,000 per month).
- By December 31, one month of rent has expired.



December 31	Debit	Credit
Rent Expense *(+E, −SE)*	**5,000**	
Prepaid Rent *(−A)*		**5,000**
(Reduce prepaid rent due to the passage of time)		

Prepaid Expense—Supplies

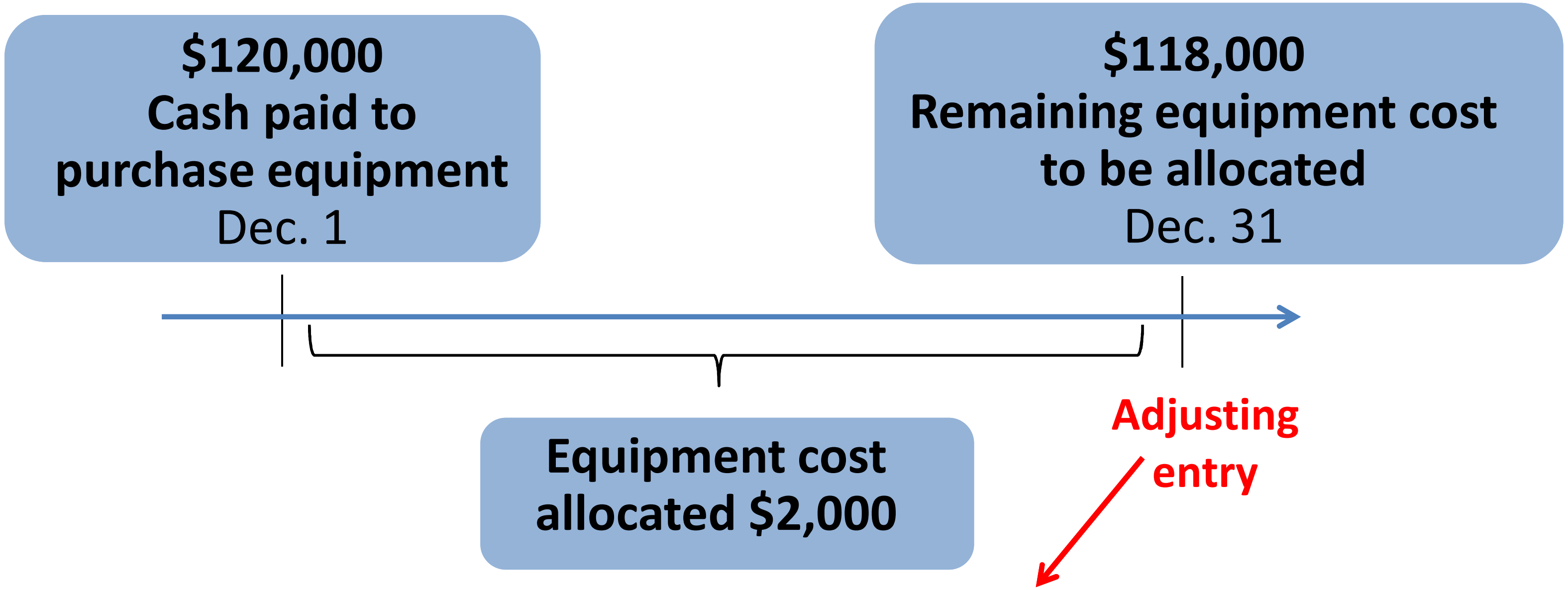
- On December 6, purchased supplies for $23,00 on account on December 6.
- At the end of December a count of supplies reveals that only $13,000 of supplies remains.



December 31	Debit	Credit
Supplies Expense *(+E, −SE)*	**10,000**	
Supplies *(−A)*		**10,000**
(Consume supplies during the current period)		

Prepaid Expense—Depreciable Assets

- On December 1, purchased equipment for $120,000 cash on December 1.
- By December 31, one month of the equipment's use has expired.



<u>December 31</u>	<u>Debit</u>	<u>Credit</u>
Depreciation Expense *(+E, −SE)*	**2,000**	
Accumulated Depreciation *(−A)*		**2,000**
(Depreciation expense = $120,000 ÷ 60 months = $2,000 per month)		

Concept Check 3–4

Which of the following is recorded with an adjusting entry associated with a prepaid expense?

a. Credit an asset
b. Debit a liability
c. Credit an expense
d. Debit an asset

The adjusting entry involving a prepaid expense always involves a debit to an expense and a credit to an asset or a contra account.

Illustration 3–6
Reporting Depreciation of Property and Equipment

FEDERAL EXPRESS
Balance Sheet (partial)
($ in millions)

Property and Equipment, at Cost	
Aircraft and related equipment	$24,518
Package handling and ground support equipment	11,382
Information technology	6,884
Vehicles	9,101
Facilities and other	13,139
	65,024
Less accumulated depreciation	(31,416)
Net property and equipment	**$33,608**

Concept Check 3–5

Which of the following is equivalent to the book value of an asset?

a. Cost of the asset plus the accumulated depreciation

b. Cost of the asset “net of” the accumulated depreciation

c. The estimate of time that the asset will last

d. Cost of the asset divided by its useful life

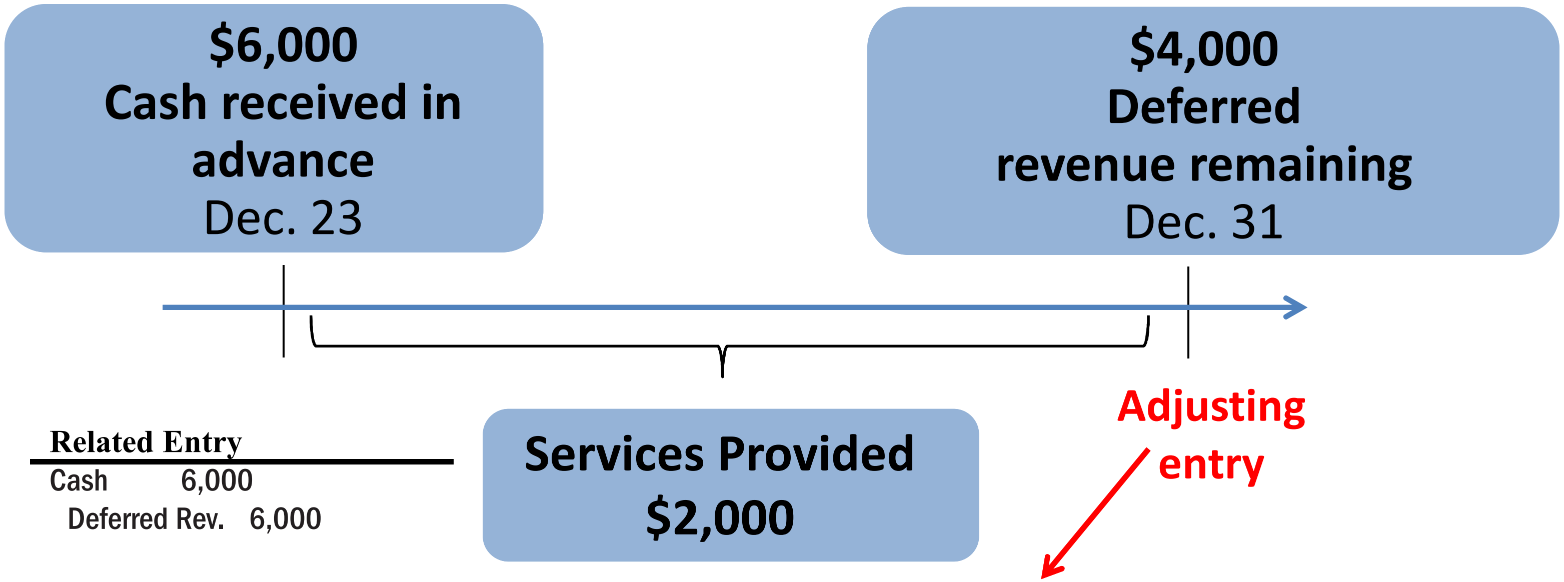
The book value of the asset is the asset’s original cost net of its accumulated depreciation. Another common word that is synonymous with book value is carrying value because this is the amount the asset is “carried” in the books.

Deferred Revenues (1 of 2)

- Deferred revenues arise when a company receives cash in advance from customers, but products and services won't be provided until a later period.
- When a company receives cash before providing services to customers, it *owes* the customer a service in return. This creates a **liability**.
- In the period those services are provided, the liability is settled, and an adjusting entry is needed to (1) decrease the liability to its remaining amount owed and (2) recognize **revenue**.

Deferred Revenues (2 of 2)

- On December 23, company received $6,000 cash in advance from customers.
- By December 31, $2,000 of services have been provided.



December 31	Debit	Credit
Deferred Revenue *(−L)*	**2,000**	
Service Revenue *(+R, +SE)*		**2,000**
(*Provide services to customers who paid in advance*)		

Illustration 3–7
Reporting Deferred Revenues and Other Current Liabilities

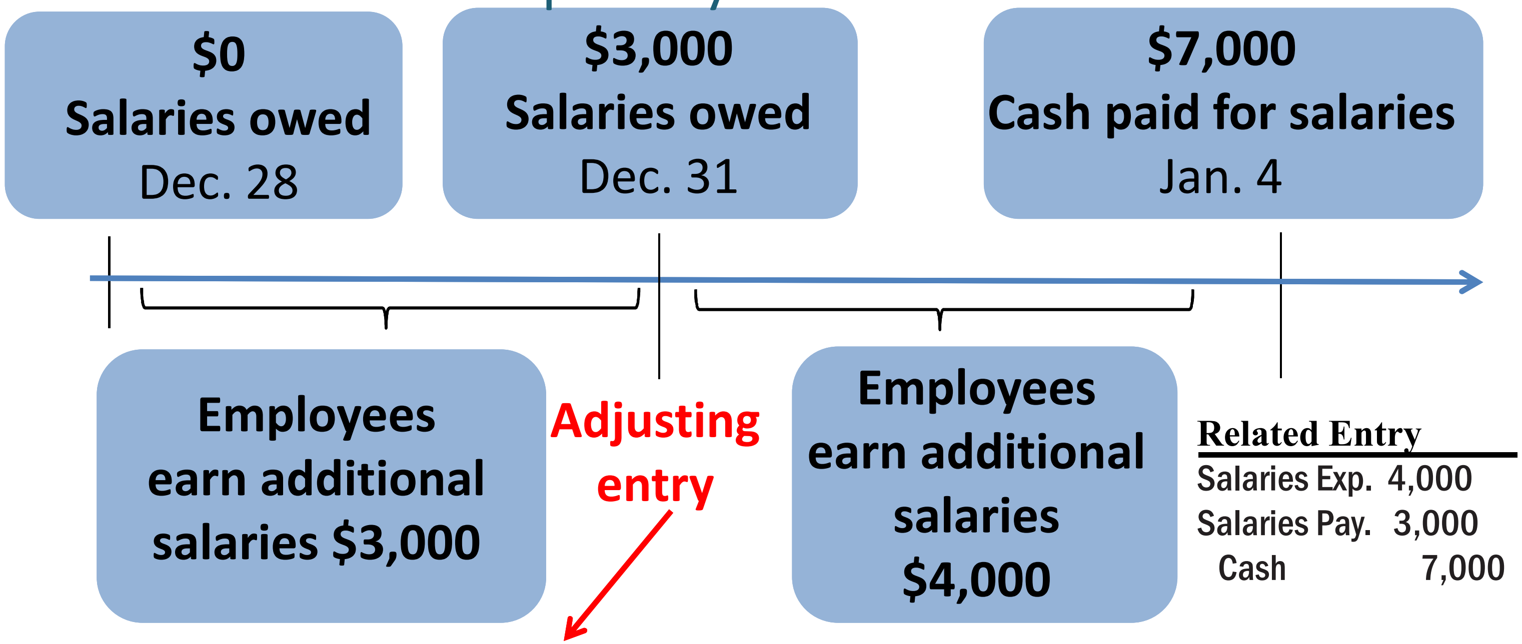
LOWE'S COMPANIES, INC. Balance Sheet (partial) ($ in millions)	
Current liabilities:	
Short-term borrowings	$ 1,941
Current maturities of long-term debt	597
Current operating lease liabilities	501
Accounts payable	7,659
Accrued compensation and employee benefits	684
Deferred revenue	**1,219**
Other current liabilities	2,581
Total current liabilities	$15,182

Accrued Expenses

- **Accrued expenses** occur when a company has used costs in the current period, but the company hasn't yet paid cash for those costs.
- The company has used these costs to operate the company in the current period and is obligated to pay them.
- An adjusting entry is needed to (1) record the **liability** to be paid and (2) recognize the cost as an **expense**.

Accrued Expenses—Salaries

- By December 31, \$3,000 in salaries have been earned by employees for the final three days of the month.
- These salaries are not paid by December 31.



December 31	Debit	Credit
Salaries Expense *(+E, −SE)*	**3,000**	
Salaries Payable *(+L)*		**3,000**
(Salaries incurred, but not paid, in the current period)		

Concept Check 3–6

If a company pays an employee $100 per day for a five-day work week that runs from Monday to Friday, and December 31 is a Tuesday, what is the amount of the salaries adjustment, assuming that Friday is payday?

a. $500

b. $400

c. $300

d. $200

Since the employee worked two days in the last week of December (Monday and Tuesday), the amount of the accrual should be for $200 (= $100 per day × 2 days). The adjusting entry on December 31 would be:

Salaries Expense	200	
Salaries Payable		200

Accrued Expenses—Utilities

- By December 31, utilities costs of $9,000 have been incurred but have not been paid

$0
Utilities owed
Dec. 1

$9,000
Utilities owed
Dec. 31

$9,000
Cash paid for utilities
Jan. 6

Utilities used
$9,000

Adjusting entry

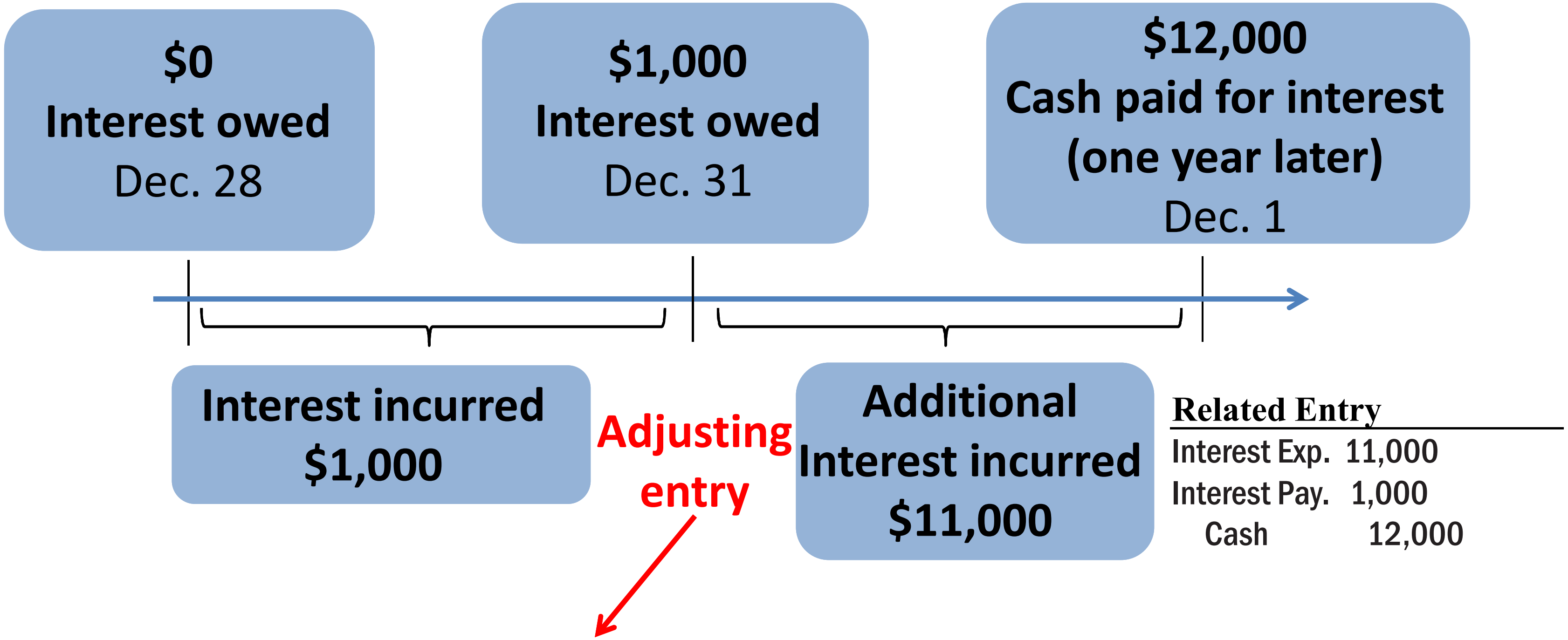
Related Entry

Utilities Payable	9,000	
Cash		9,000

December 31	Debit	Credit
Utilities Expense *(+E, −SE)*	**9,000**	
Utilities Payable *(+L)*		**9,000**
(Utilities used, but not paid, in the current period)		

Accrued Expenses—Interest

- By December 31, one month of interest has been charged for borrowing \$100,000 at 12% interest (= \$100,000 × 12% × 1/12)



December 31	Debit	Credit
Interest Expense *(+E, −SE)*	**1,000**	
Interest Payable *(+L)*		**1,000**
(Interest incurred, but not paid, in the current period)		

Common Mistake

When recording the interest payable on a borrowed amount, students sometimes mistakenly credit the liability associated with the principal amount (Notes Payable). We record interest payable in a ***separate account*** (Interest Payable) to keep the balance owed for principal separate from the balance owed for interest.

Concept Check 3–7

If a company borrowed $20,000 on November 1 at the rate of 6% annually, how much interest expense should be accrued at the year-end date of December 31, assuming no accrual has yet been made this year?

a. $1,200
b. $200
c. $600
d. $400

The formula to calculate interest for November and December (two months) is:

Note Payable × Annual Interest Rate × Fraction of the Year

$200 = $20,000 × 6% × 2/12

The adjusting entry on December 31 would be:

Interest Expense	200	
Interest Payable		200

Accrued Revenues

- **Accrued revenues** occur when a company provides products or services but hasn't yet received cash.
- Because the company has provided products and services in the current period and has the right to receive payment, an adjusting entry is needed to (1) record an **asset** for the amount expected to be received and (2) recognize **revenue**.

Accrued Revenues—Services

- By December 31, services of $7,000 have been provided to customers but have not yet been billed.

$20,000
Receivable from customers
Dec. 31

$27,000
Receivable from customers
Dec. 31

$27,000
Cash received from customers
Jan. 8–14

Services provided $7,000

Adjusting entry

Related Entry

Cash	27,000	
Accts. Rec.		27,000

<u>December 31</u>	<u>Debit</u>	<u>Credit</u>
Accounts Receivable *(+A)*	7,000	
Service Revenue *(+R, +SE)*		7,000
(Bill customers for services provided during the current period)		

Concept Check 3–8

An adjusting entry would be needed for which of the following transactions?

a. Accrued salaries

b. Services provided but unbilled

c. Interest accrued on a loan payable

d. All of the above

All of the transactions listed would necessitate an adjusting entry.

Key Point (Adjusting entries 1 of 2)

Adjusting entries are needed:

1. When cash flows or obligations occur *before* the revenue- or expense-related activity (prepayment), or
2. When cash flows occur *after* the revenue- or expense-related activity (accrual).

Key Point (Adjusting entries 2 of 2)

Adjusting entries are **unnecessary** in two cases:

1. For transactions that do not involve revenue or expense activities, and
2. For transactions that result in revenues or expenses being recorded at the same time as the cash flow.

Learning Objective 4

LO3–4 Post adjusting entries and prepare an adjusted trial balance.

Illustration 3–10
Adjusted Trial Balance

- Lists all account balances after updating them for adjusting entries
- Prepared after posting the adjusting entries to the general ledger

EAGLE SOCCER ACADEMY
Adjusted Trial Balance
December 31, 2024

Account	Debit	Credit
Cash	$137,000	
Accounts Receivable	27,000	
Supplies	13,000	
Prepaid Rent	55,000	
Equipment	120,000	
Accumulated Depreciation		$ 2,000
Accounts Payable		23,000
Deferred Revenue		4,000
Salaries Payable		3,000
Utilities Payable		9,000
Interest Payable		1,000
Notes Payable		100,000
Common Stock		200,000
Retained Earnings		0
Dividends	4,000	
Service Revenue		72,000
Rent Expense	5,000	
Supplies Expense	10,000	
Depreciation Expense	2,000	
Salaries Expense	31,000	
Utilities Expense	9,000	
Interest Expense	1,000	
Totals	$414,000	$414,000

Total Debits = Total Credits

Key Point

An adjusted trial balance is a list of all accounts and their balances at a particular date, after we have updated account balances for adjusting entries.

PART B

THE REPORTING PROCESS:

FINANCIAL STATEMENTS

Learning Objective 5

LO3–5 Prepare financial statements using the adjusted trial balance.

Illustration 3–11 (Partial)
Relationship between Adjusted Trial Balance and Financial Statements

EAGLE SOCCER ACADEMY
Adjusted Trial Balance
December 31, 2024

Accounts	Debit	Credit
Cash	$ 137,00	
Accounts Receivable	27,000	
Supplies	13,000	
Prepaid Rent	55,000	
Equipment	120,000	
Accumulated Depreciation		$ 2,000
Accounts Payable		23,000
Deferred Revenue		4,000
Salaries Payable		3,000
Utilities Payable		9,000
Interest Payable		1,000
Notes Payable		100,000
Common Stock		200,000
Retained Earnings		0
Dividends	4,000	
Service Revenue		72,000
Rent Expense	5,000	
Supplies Expense	10,000	
Depreciation Expense	2,000	
Salaries Expense	31,000	
Utilities Expense	9,000	
Interest Expense	1,000	
Totals	$414,000	$414,000

BALANCE SHEET

Assets
=
Liabilities
+
Stockholders' Equity

STATEMENT OF STOCKHOLDERS' EQUITY

Common Stock
+
Retained Earnings
(Beg. RE + NI – Div)
=
Stockholders' Equity

INCOME STATEMENT

Revenues
–
Expenses
=
Net Income

Illustration 3–12
Income Statement

EAGLE SOCCER ACADEMY Income Statement For the period ended December 31, 2024	
Revenues	
Service revenue	$72,000
Expenses	
Rent expense	5,000
Supplies expense	10,000
Depreciation expense	2,000
Salaries expense	31,000
Utilities expense	9,000
Interest expense	1,000
Total expenses	58,000
Net income	$14,000

Illustration 3–13
Statement of Stockholders’ Equity

EAGLE SOCCER ACADEMY Statement of Stockholders’ Equity For the period ended December 31, 2024			
	Common Stock	**Retained Earnings**	**Total Stockholders’ Equity**
Beginning balance (Dec. 1)	$ -0-	$ -0-	$ -0-
Issuance of common stock	200,000		200,000
Add: Net income for the period		14,000	14,000
Less: Dividends		(4,000)	(4,000)
Ending balance (Dec. 31)	$200,000	$ 10,000	$210,000

Illustration 3–14

Classified Balance Sheet

EAGLE SOCCER ACADEMY
Balance Sheet
December 31, 2024

Assets		**Liabilities**	
Current assets:		Current liabilities:	
Cash	$137,000	Accounts Payable	$ 23,000
Accounts Receivable	27,000	Deferred Revenue	4,000
Supplies	13,000	Salaries Payable	3,000
Prepaid Rent	55,000	Utilities Payable	9,000
Total current assets	232,000	Interest Payable	1,000
		Total current liabilities	40,000
Long-term assets:		Long-term liabilities:	
Equipment	120,000	Notes Payable	100,000
Less: Accum. Depr.	(2,000)	Total liabilities	140,000
		Stockholders' Equity	
		Common Stock	200,000
		Retained Earnings	10,000
		Total stockholders' equity	210,000
Total assets	$350,000	Total liabilities and stockholders' equity	$350,000

Statement of Cash Flows

- Measures activities involving cash receipts and cash payments
- Reflects a company’s operating, investing, and financing activities

Concept Check 3–9

Which financial statement would include a line for net income?

a. Income statement

b. Statement of stockholders’ equity

c. Balance sheet

d. Both a and b

Net income is the final result in the income statement. This amount is also transferred from the income statement to the statement of stockholders’ equity. So, the line item for net income would appear in both the income statement and the statement of stockholders’ equity.

PART C

THE CLOSING PROCESS

Learning Objective 6

LO3–6 Demonstrate the purposes and recording of closing entries.

Closing Entries

- Closing entries transfer the balances of all temporary accounts (revenues, expenses, and dividends) to the balance of the Retained Earnings account.
- Closing entries reduce the balances of these temporary accounts to zero to prepare them for the next period.

Illustration 3–15

Closing Entries

Retained Earnings	
	0
58,000	72,000
4,000	
	10,000

Before closing

After closing

December 31	Debit	Credit
(a) Service Revenue	**72,000**	
Retained Earnings		**72,000**
(Close revenues to retained earnings)		
(b) Retained Earnings	**58,000**	
Rent Expense		**5,000**
Supplies Expense		**10,000**
Depreciation Expense		**4,000**
Salaries Expense		**31,000**
Utilities Expense		**9,000**
Interest Expense		**1,000**
(Close expenses to retained earnings)		
(c) Retained Earnings	**4,000**	
Dividends		**4,000**
(Close dividends to retained earnings)		

Key Point

Closing entries serve two purposes:

(1) Transfer the balances of temporary accounts (revenues, expenses, and dividends) to the Retained Earnings account, and

(2) Reduce the balances of these temporary accounts to zero to prepare them for measuring activity in the next period.

Closing entries:

- Increase retained earnings by the amount of revenues for the period and
- Decrease retained earnings by the amount of expenses and dividends for the period.

Common Mistake

Students sometimes believe that closing entries are meant to reduce the balance of Retained Earnings to zero.

Retained Earnings is a permanent account, representing the accumulation of all revenues, expenses, and dividends over the life of the company.

Concept Check 3–10

Which account would NOT be closed during the closing process?

a. Retained Earnings
b. Dividends
c. Interest Expense
d. Interest Revenue

Only temporary accounts are closed. Temporary accounts include all revenues, expenses, and dividends. Balances of temporary accounts are transferred to the balance of Retained Earnings, which is a permanent account that is not closed.

Learning Objective 7

LO3–7 Post closing entries and prepare a post-closing trial balance.

Post-Closing Trial Balance

- The post-closing trial balance is a list of all accounts and their balances at a particular date *after we have updated account balances for closing entries.*
- The post-closing trial balance helps to verify that we prepared and posted closing entries correctly and that the accounts are now ready for the next period’s transactions.

Key Point

After we post the closing entries to the general ledger, the balance of Retained Earnings equals the amount shown in the balance sheet.

The balances of all revenue, expense, and dividend accounts are zero at that point.

Illustration 3–17

Post-Closing Trial Balance

EAGLE SOCCER ACADEMY
Post-Closing Trial Balance
December 31, 2024

Accounts	Debit	Credit
Cash	$137,000	
Accounts Receivable	27,000	
Supplies	13,000	
Prepaid Rent	55,000	
Equipment	120,000	
Accumulated Depreciation		$ 2,000
Accounts Payable		23,000
Deferred Revenue		4,000
Salaries Payable		3,000
Utilities Payable		9,000
Interest Payable		1,000
Notes Payable		100,000
Common Stock		200,000
Retained Earnings		10,000
Totals	$352,000	$352,000

Concept Check 3–11

Which of the following accounts would you find on a post-closing trial balance?

a. Dividends

b. Retained Earnings

c. Rent Expense

d. Service Revenue

The only one of these four accounts that would remain on a trial balance after all of the revenues, expenses, and dividends were closed would be Retained Earnings. Dividends, rent expense, and service revenue would have been closed during the closing process and therefore would not be on the post-closing trial balance.

End of Chapter 3