Accounting for Financial Decision
EMBA

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Accounting System

1. Understand basic accounting terminology.
2. Explain double-entry rules.
3. Identify steps in the accounting cycle.
4. Record transactions in **journals**, post to **ledger accounts**, and prepare a **trial balance**. Prepare **financial statement**.

   ....

5. Explain the reasons for preparing adjusting entries.
6. Prepare financial statement from the adjusted trial balance.
7. Prepare closing entries.

The Accounting Information System

Accounting Information	The Accounting Cycle	Financial Statements
• Basic terminology • Debits and credits • Accounting equation • Double Entry System	• Identifying and recording • Journalizing • Posting • Trial balance • Adjusting entries • Adjusted trial balance • Preparing financial statements • Closing • Post-closing trial balance • Reversing entries • Summary	• Income statement • Statement of retained earnings • Statement of financial position • Closing entries

Accounting Information System

Accounting Information System (AIS)

- Collects and processes transaction data.
- Disseminates the information to interested parties.

Basic Terminology

- Event
- Transaction
- Real Account
- Nominal Account
- Personal Account
- Journal
- Ledger
- Trial Balance
- Financial Statements
- Adjusting Entries
- Closing Entries

Debits and Credits

- An **Account** shows the effect of transactions on a given asset, liability, equity, revenue, or expense account.
- **Double-entry** accounting system (two-sided effect).
- Recording done by debiting at least one account and crediting another.
- **DEBITS must equal CREDITS**.

Debits and Credits

Account

- An arrangement that shows the effect of transactions on an account.
- Debit = Left
- Credit = Right

An Account can be illustrated in a T-Account form.

Account Name	
Debit / Dr.	**Credit / Cr.**

Debits and Credits

If Debit entries are greater than Credit entries, the account will have a debit balance.

Account Name

	Debit / Dr.	Credit / Cr.	
Transaction #1	$10,000	$3,000	Transaction #2
Transaction #3	8,000		
Balance	$15,000		

Debits and Credits

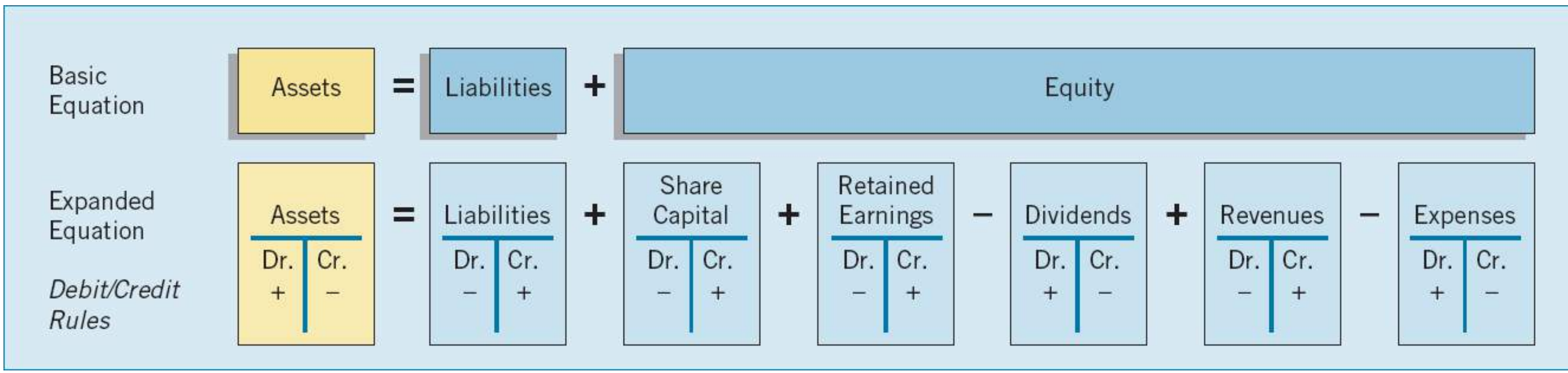
If Credit entries are greater than Debit entries, the account will have a credit balance.

	Account Name		
	Debit / Dr.	**Credit / Cr.**	
Transaction #1	$10,000	$3,000	Transaction #2
		8,000	Transaction #3
Balance		$1,000	

The Accounting Equation

Relationship among the assets, liabilities and equity of a business:

Illustration 3-3



The equation must be in balance after every transaction. For every **Debit** there must be a **Credit**.

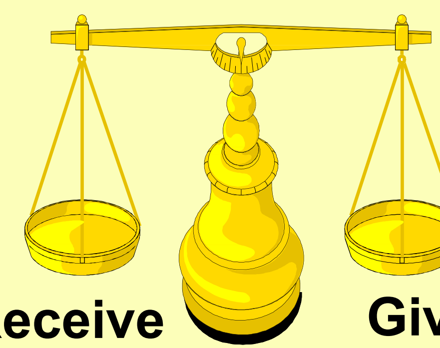
The Double Entry System

Double-Entry Accounting

“ Double-entry accounting is based on a simple concept: each party in a business transaction will receive something and give something in return. In bookkeeping terms, what is received is a debit and what is given is a credit. The T account is a representation of a scale or balance.”

Luca Pacioli Developer of Double-Entry Accounting

Scale or Balance



Receive DEBIT

Give CREDIT

T account

Left Side	Right Side
Receive	**Give**
DEBIT	**CREDIT**

The Double Entry System

Each transaction is recorded with at least:

One debit

One credit

Total debits must equal total credits.

The Double Entry System

- Some businesses enter into thousands of transactions daily or even hourly.

  Accountants must carefully keep track of and record these transactions in a systematic manner.

- Accountants use a double-entry accounting system in which at least two accounts are always affected by each transaction.

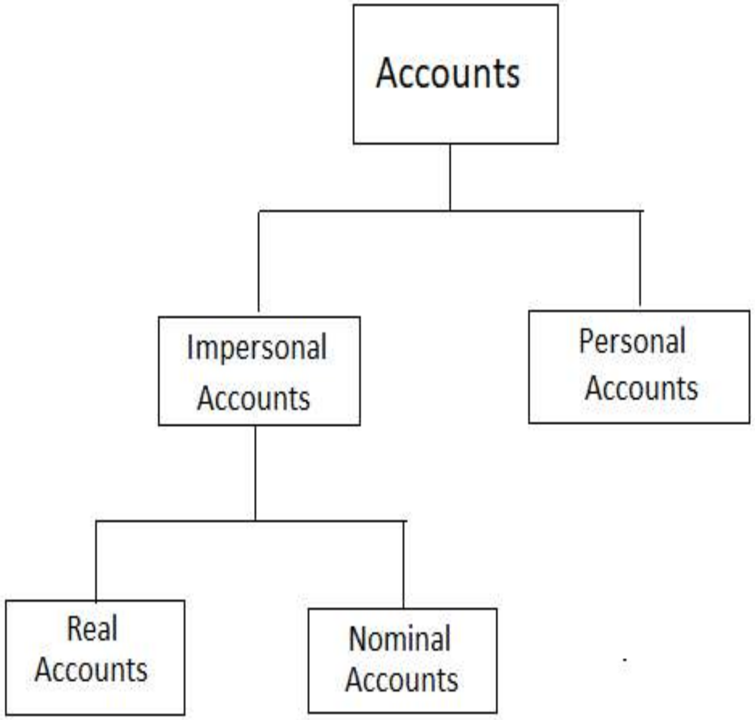
- Should understand the classification of accounts.

Classification of Accounts

- Accounts are classified using two approaches:

Traditional approach (also known as the British approach)
Modern approach (also known as the American approach)

Traditional



Modern

Asset accounts: Examples include land accounts, machinery accounts, accounts receivable accounts, prepaid rent accounts, and cash accounts.
Liability accounts: Examples include loan accounts, accounts payable accounts, wages payable accounts, salaries payable accounts, and rent payable accounts.
Revenue accounts: Examples include sales accounts, service revenue accounts, rent revenue accounts, and interest revenue accounts.
Expense accounts: Examples include wage expense accounts, commission expense accounts, salary expense accounts, and rent expense accounts.
Capital/ Owner's equity accounts: An example is an individual owner's account (e.g., Mr. X's account).

Classification of Accounts

- Real Account = Debit –What comes in
Credit- what goes out

Personal accounts are the accounts that are used to record transactions relating to individual persons, firms, companies, or other organizations. Examples of such accounts include an individual's accounts (e.g., Mr. X's account), the accounts held by modern enterprises, and city bank accounts.

- Personal Account = (Balance Sheet) Debit –Receiver
Credit - Giver

Real accounts exist even after the end of accounting period. For the next accounting period. these accounts start with a non-zero balance, which is carried forward from the previous accounting period. Examples of such accounts include machinery accounts, land accounts, furniture accounts, cash accounts, and accounts payable accounts.

- Nominal Account = (Income Statement) Debit –Expenses/Losses
Credit- Incomes/Gains

Nominal accounts are closed at the end of the accounting period. For the next account period, these accounts start with a zero balance. Nominal accounts typically cover issues such as revenue, expenses, gain, loss.

Classification of Accounts

There are some asset accounts:

- Cash
- Notes Receivable
- Accounts Receivable
- Prepaid Expenses
- Land
- Building
- Equipment

Classification of Accounts

There are some liability accounts:

- Notes Payable
- Accounts Payable
- Accrued Liabilities (for expenses incurred but not paid)
- Long-term Liabilities (bonds)

Classification of Accounts

There are some owner’s equity accounts:

- Capital or owner’s interest in the business
- Revenues
- Expenses

The Double Entry System

The system records the two-sided effect of transactions

Transaction	Two-sided effect
Bought furniture for cash	Decrease in *one* asset Increase in *another* asset
Took a loan in cash	Increase in an asset Increase in a liability

Double-Entry System Illustration

1. Owners invest $40,000 in exchange for share capital

Assets	=	Liabilities	+	Equity
+ 40,000				**+ 40,000**

Double-Entry System Illustration

2. Disburse $600 cash for secretarial wages.

Assets	=	Liabilities	+	Equity
- 600				**- 600** **(expense)**

Double-Entry System Illustration

3. Purchase office equipment priced at $5,200, giving a 10 percent promissory note in exchange.

Assets	=	Liabilities	+	Equity
+ 5,200		**+ 5,200**		

Double-Entry System Illustration

4. Received $4,000 cash for services rendered.

Assets	=	Liabilities	+	Equity
+ 4,000				**+ 4,000** **(revenue)**

Double-Entry System Illustration

5. Pay off a short-term liability of $7,000.

Assets	=	Liabilities	+	Equity
- 7,000		**- 7,000**		

Double-Entry System Illustration

6. Declared a cash dividend of $5,000.

Assets	=	Liabilities	+	Equity
		+ 5,000		**- 5,000**

Double-Entry System Illustration

7. Convert a long-term liability of $80,000 into ordinary shares.

Assets	=	Liabilities	+	Equity
		- 80,000		**+ 80,000**

Double-Entry System Illustration

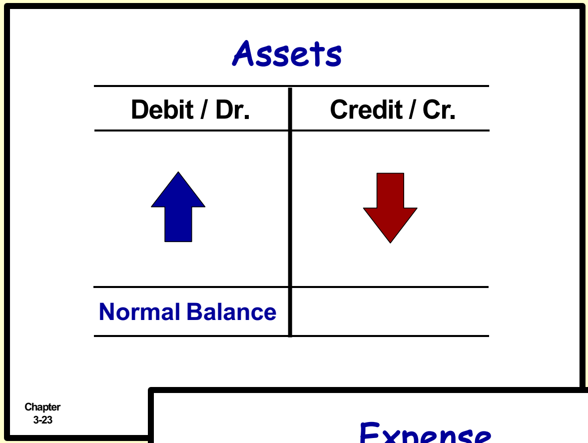
8. Pay cash of $16,000 for a delivery van.

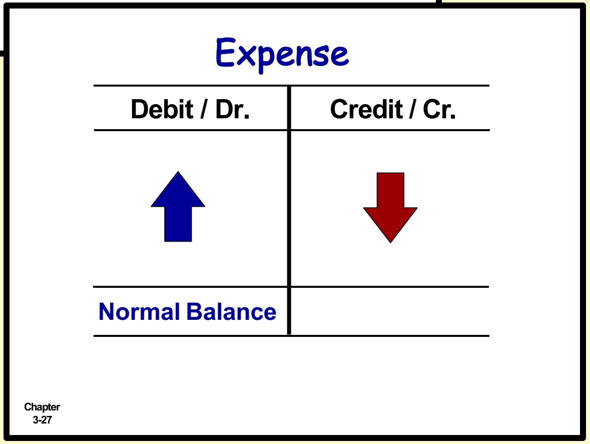
Assets	=	Liabilities	+	Equity
- 16,000				
+ 16,000				

Note that the accounting equation equality is maintained after recording each transaction.

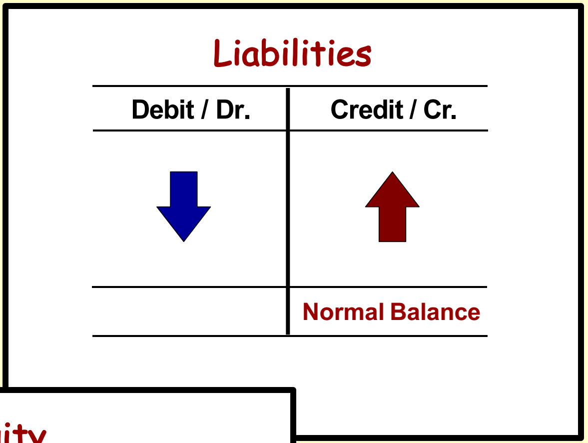
Debits and Credits Summary

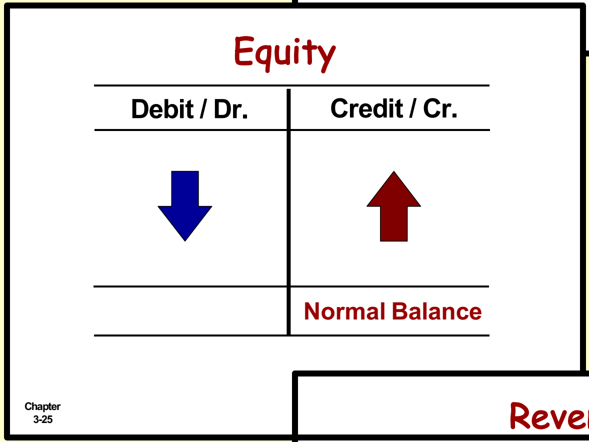
Normal Balance **Debit**

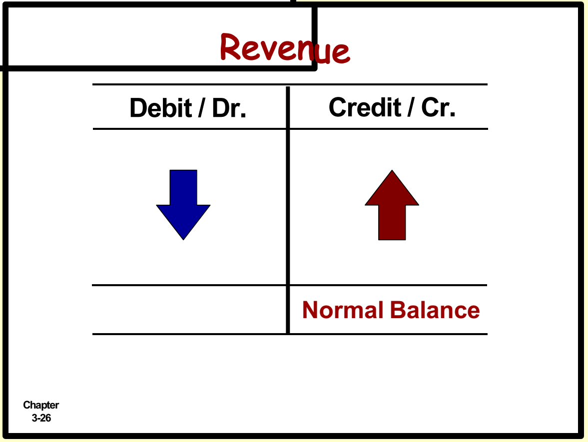




Normal Balance **Credit**



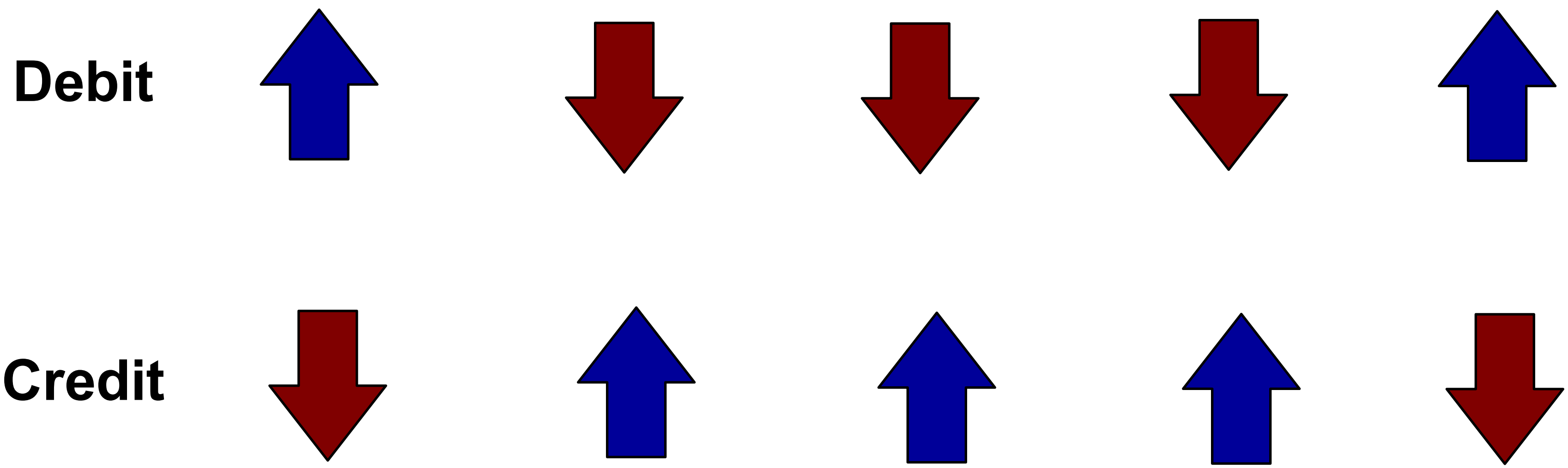




Debits and Credits Summary

<u>Statement of Financial Position</u> <u>Income Statement</u>

Asset = **Liability** + **Equity** **Revenue** - **Expense** =

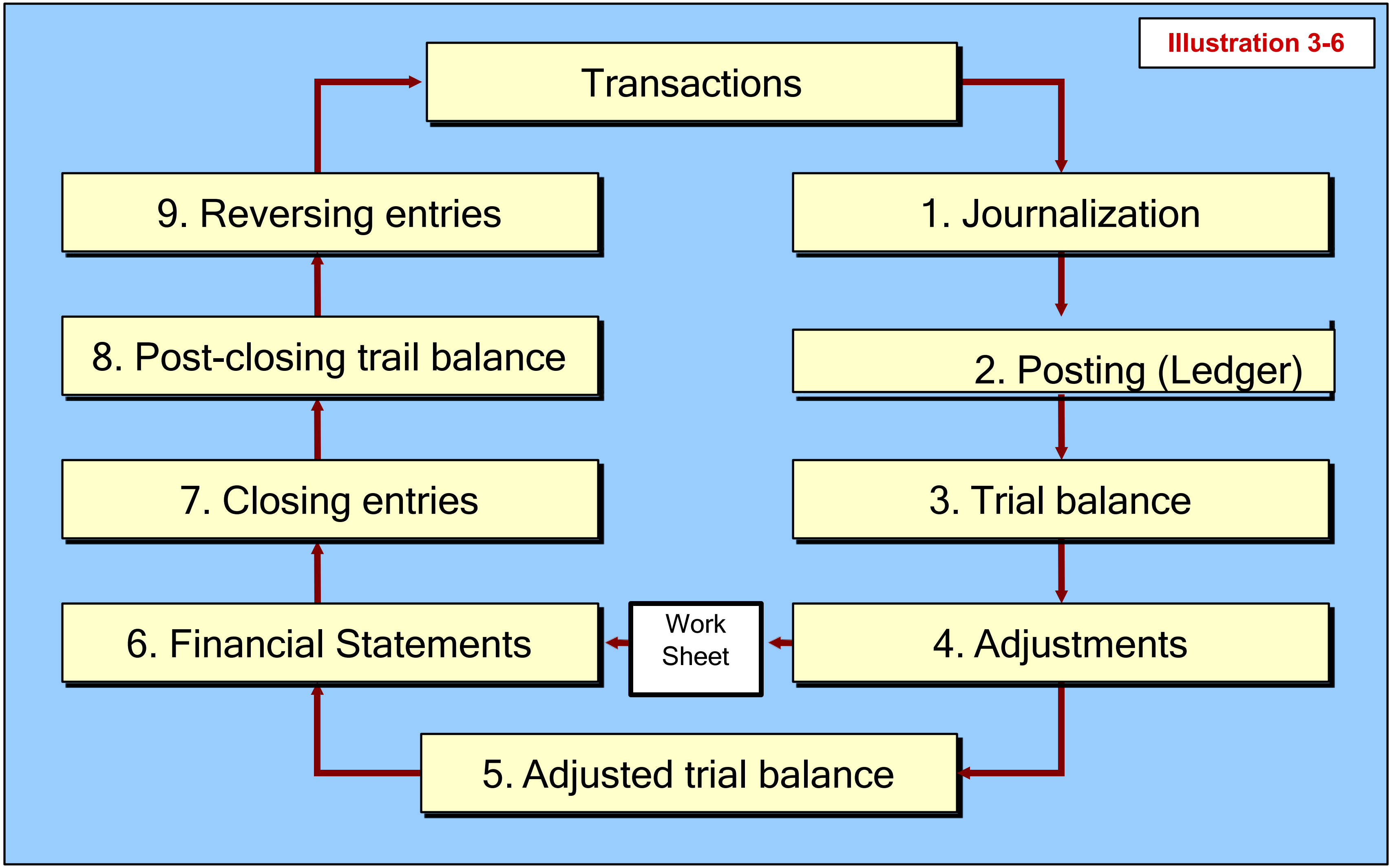


Double-Entry System Illustration

Note that the accounting equation equality is maintained

ONLY after recording each transaction.

The Accounting Cycle



The Accounting Cycle: Steps

1. Analyze the transaction
2. Journalize the transaction
3. Post the transaction to accounts in ledger
4. Prepare the trial balance
5. Prepare financial statements

The Recording Process

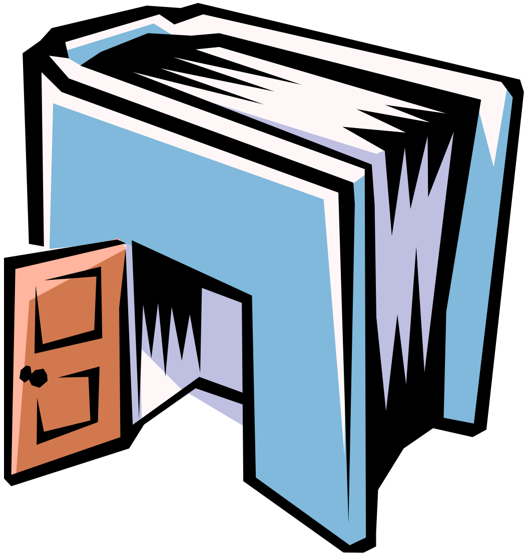
The process starts with source documents, which are the supporting original records of any transaction.

Examples are sales slips or invoices, check stubs, purchase orders, receiving reports, and cash receipt slips.

The Recording Process

In the second step, an analysis of the transaction is placed in the book of original entry, which is a chronological record of how the transactions affect the balances of applicable accounts.

The most common example is the general journal - a diary of all events (transactions) in an entity's life.



The Recording Process

In the third step, transactions are entered into the ledger.

Remember that a transaction is not entered in just one place; it must be entered in each account that it affects.

Depending on the nature of the organization, analysis of the transactions could occur continuously or periodically.

The Recording Process

The fourth step includes the preparation of the trial balance, which is a simple listing of all accounts from the ledger with their balances.

Aids in verifying accuracy and in preparing the financial statements

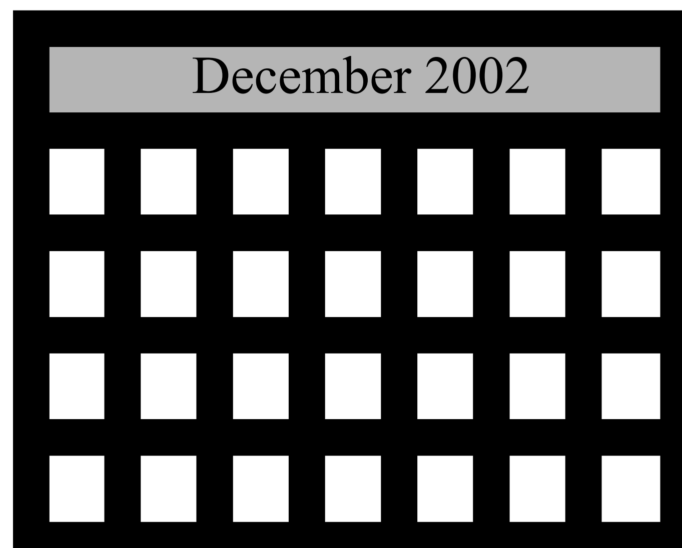
Prepared periodically as necessary

The Recording Process

In the final step, the financial statements are prepared.

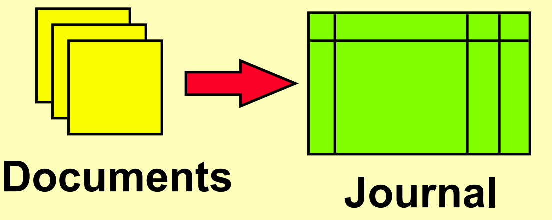
Financial statements may be prepared after each quarter of the year.

The companies may prepare financial statements at various other intervals to meet the needs of their users.



Accounting Cycle

1. Transactions are analyzed and recorded in journal.



Accounting Cycle

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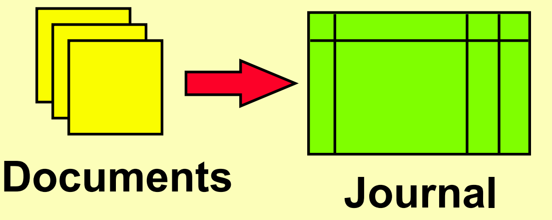
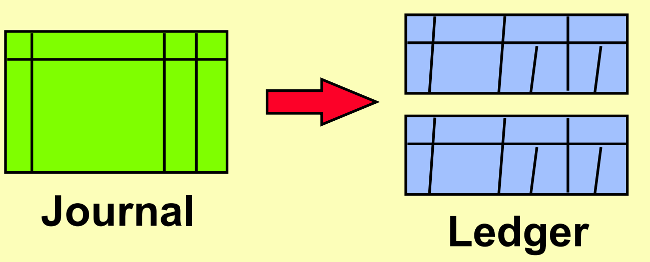


2. Transactions are posted from journal to ledger.



Accounting Cycle

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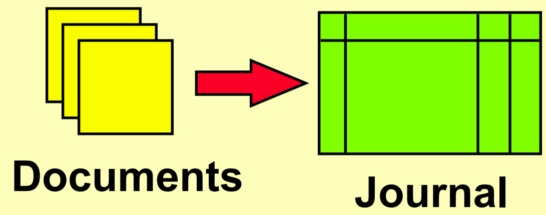
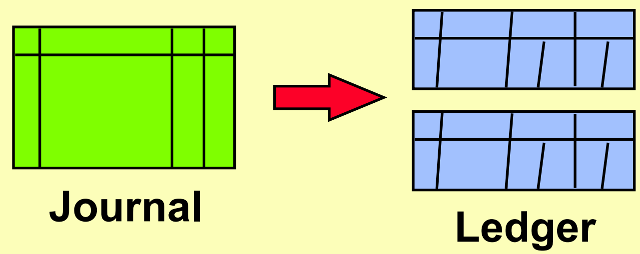
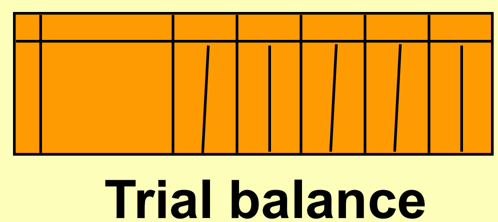


2. Transactions are posted from journal to ledger.



3. Trial balance is prepared,



Accounting Cycle

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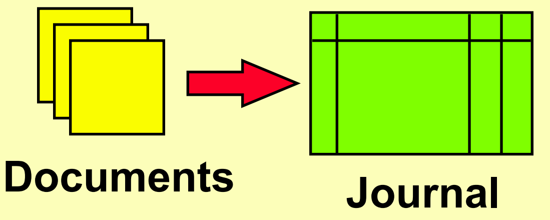
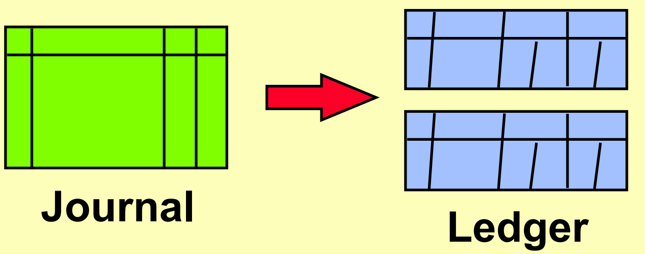


2. Transactions are posted from journal to ledger.



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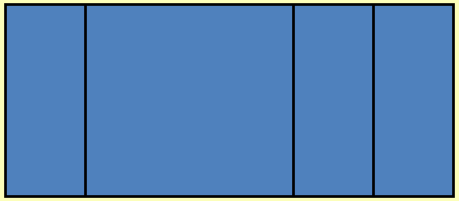
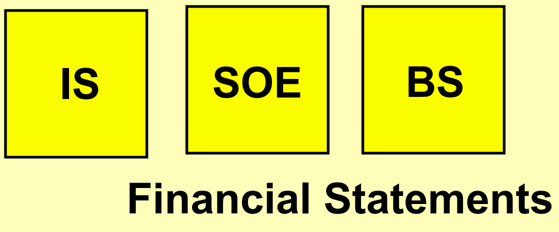


4. Financial statements are prepared and distributed.



1. Journalizing

General Journal - a chronological record of transactions.

Journal Entries are recorded in the journal.

September 1: Shareholders invested $15,000 cash in the corporation in exchange for ordinary shares.

Illustration 3-7

GENERAL JOURNAL **J1**

Date	Account Titles and Explanation	Ref.	Debit	Credit
2011				
Sept. 1	Cash		15,000	
	Share Capital—Ordinary			15,000
	(Issued ordinary shares for cash)			

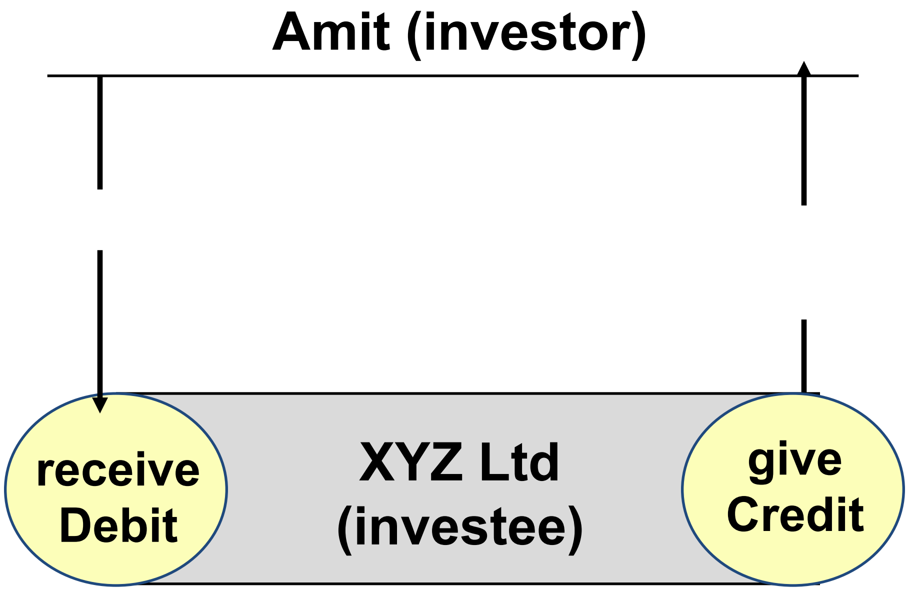
XYZ Ltd.
A Sole Proprietorship

“ On November 1, 2002, A started a sole proprietorship called XYZ Ltd. The following double-entry transactions show how amounts received (debits) always equal amounts given (credits).”

Business Transactions

Entry A.

Amit deposits Rs25,000 in a bank account for XYZ Ltd..



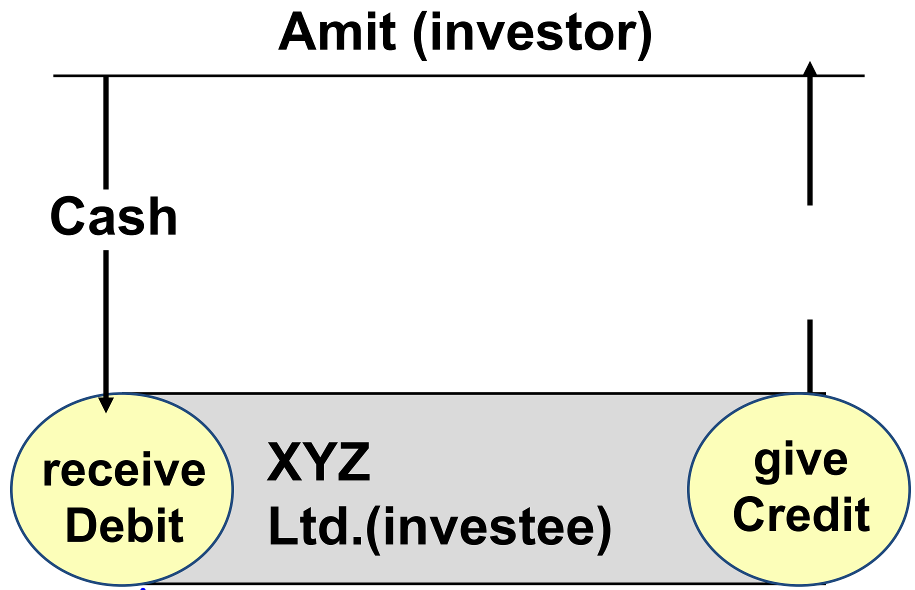
Journal

Date	Description	Debit	Credit
11/1			

Business Transactions

Entry A.

Amit deposits Rs25,000 in a bank account for XYZ Ltd..



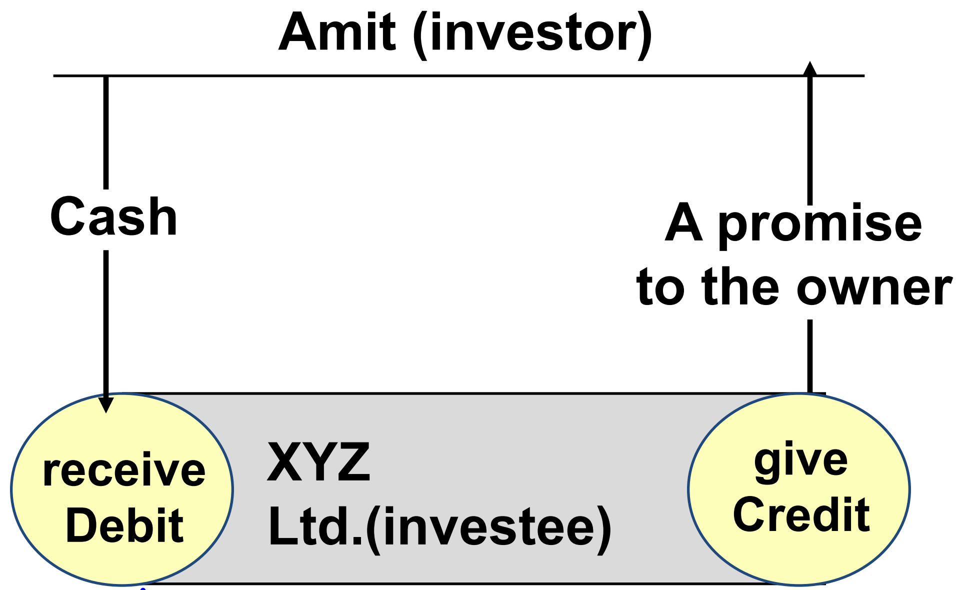
I Journal

Date	Description	Debit	Credit
11/1	Cash	25,000	

Business Transactions

Entry A.

Amit deposits Rs 25,000 in a bank account for XYZ Ltd..



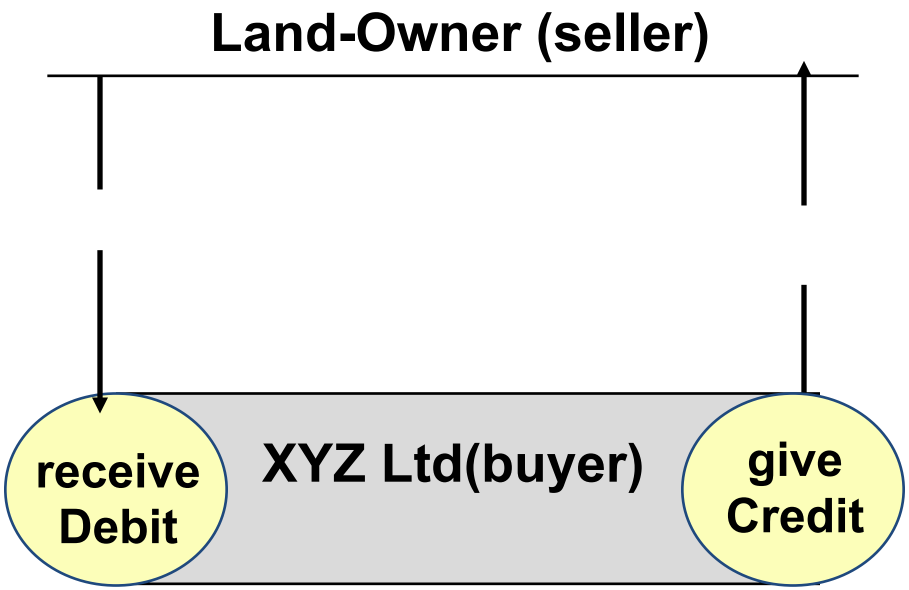
Journal

Date	Description	Debit	Credit
11/1	Cash	25,000	
	Amit, Capital		25,000

Business Transactions

Entry B.

XYZ Ltd. buys land for Rs20,000.



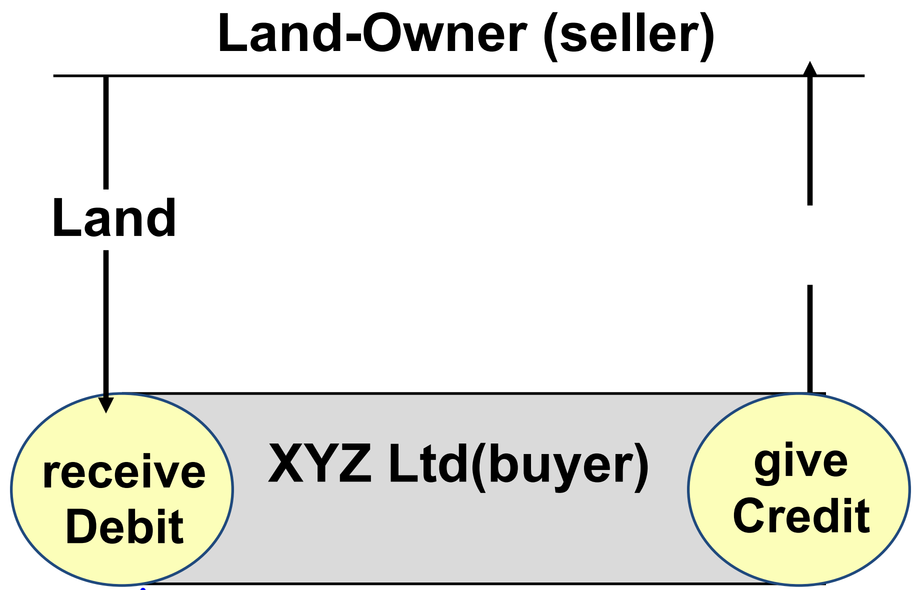
Journal

Date	Description	Debit	Credit
11/5			

Business Transactions

Entry B.

XYZ Ltd. buys land for Rs20,000.



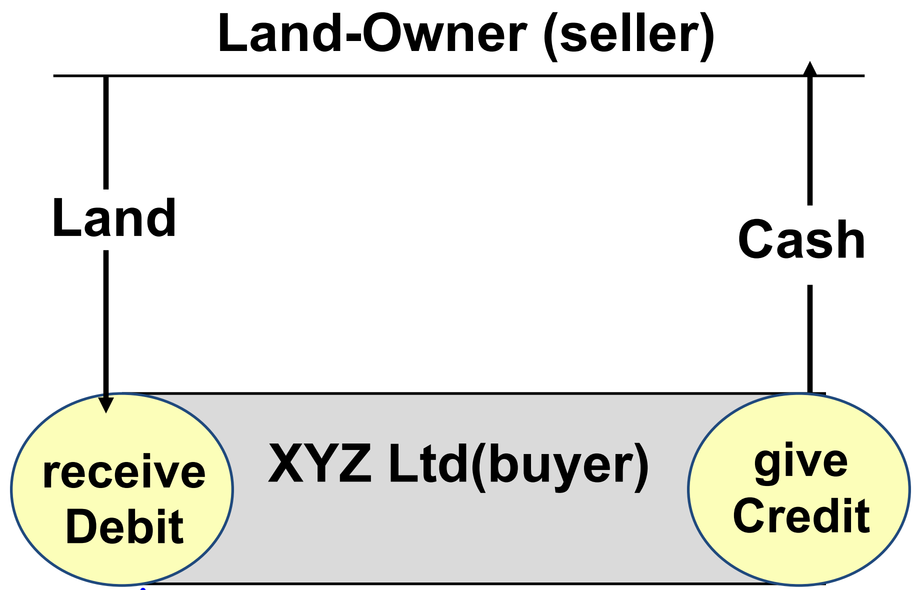
General Journal

Date	Description	Debit	Credit
11/5	Land	20,000	

Business Transactions

Entry B.

XYZ Ltd. buys land for Rs 20,000.



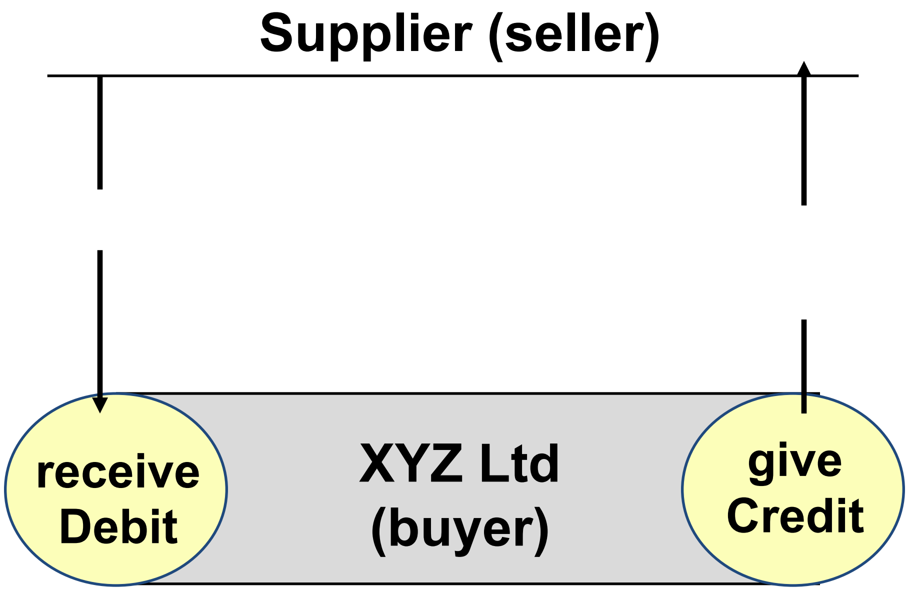
Journal

Date	Description	Debit	Credit
11/5	Land	20,000	
	Cash		20,000

Business Transactions

Entry C.

XYZ Ltd. buys supplies for Rs1,350, agreeing to pay in the near future.



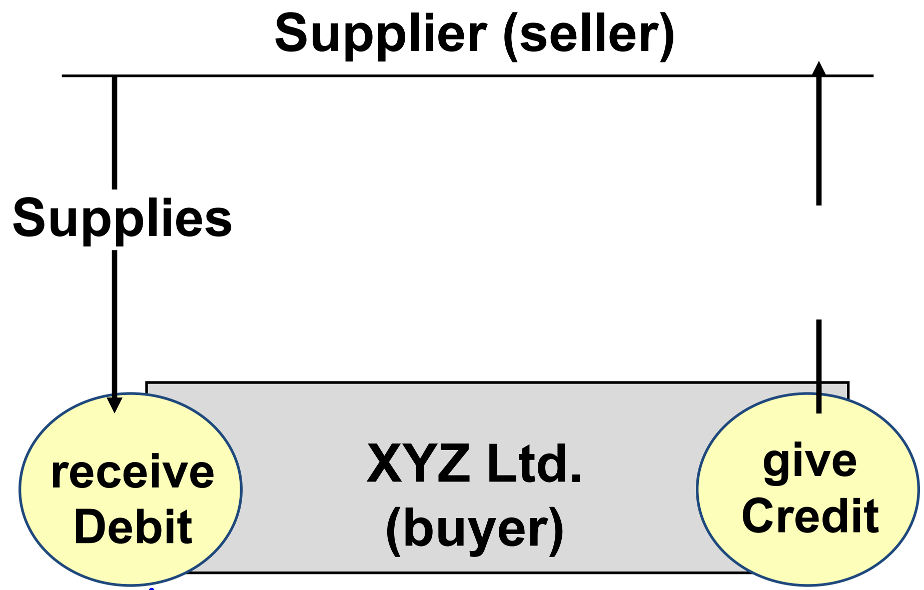
Journal

Date	Description	Debit	Credit
11/10			

Business Transactions

Entry C.

XYZ Ltd. buys goods for Rs1,350, agreeing to pay in the near future.



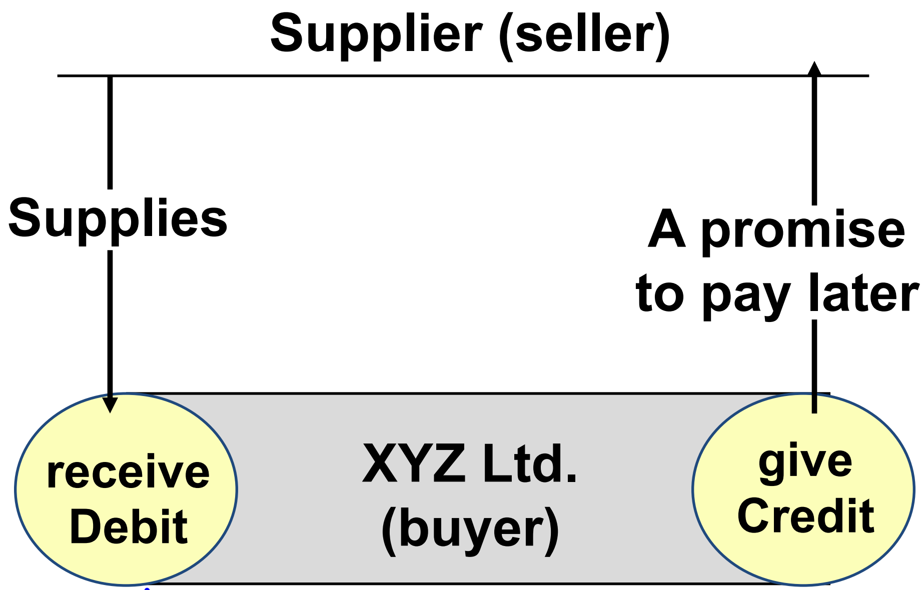
General Journal

Date	Description	Debit	Credit
11/10	Purchases	1,350	

Business Transactions

Entry C.

XYZ Ltd. buys goods for Rs1,350, agreeing to pay in the near future.



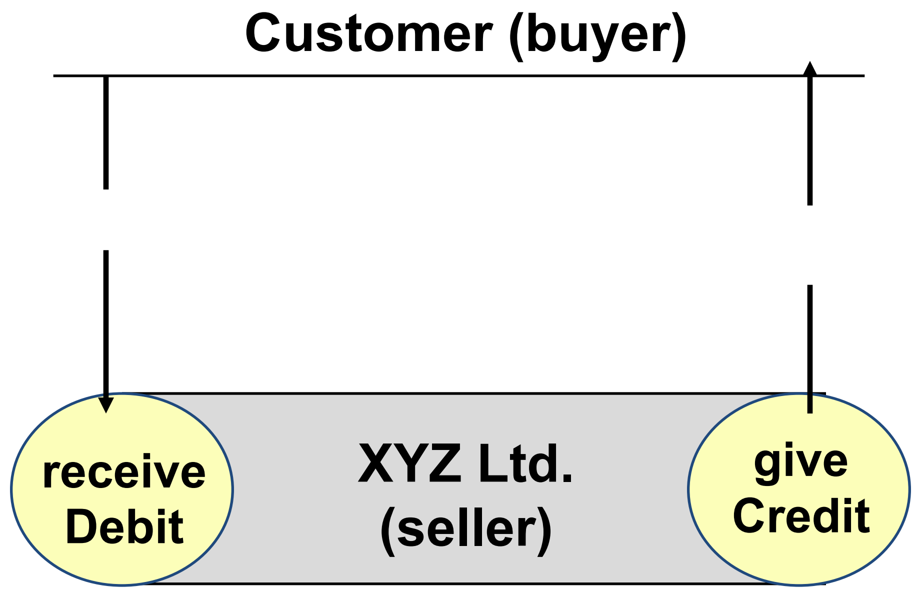
Journal

Date	Description	Debit	Credit
11/10	purchases	1,350	
	Accounts Payable		1,350

Business Transactions

Entry D.

XYZ Ltd. earns fees of Rs7,500, receiving cash.



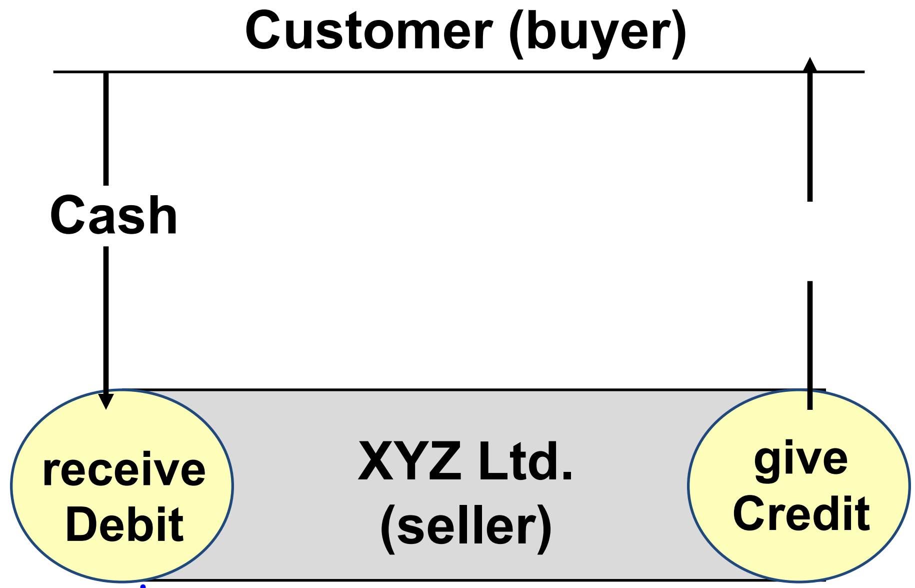
Journal

Date	Description	Debit	Credit
11/18			

Business Transactions

Entry D.

XYZ Ltd. earns fees of Rs7,500, receiving cash.



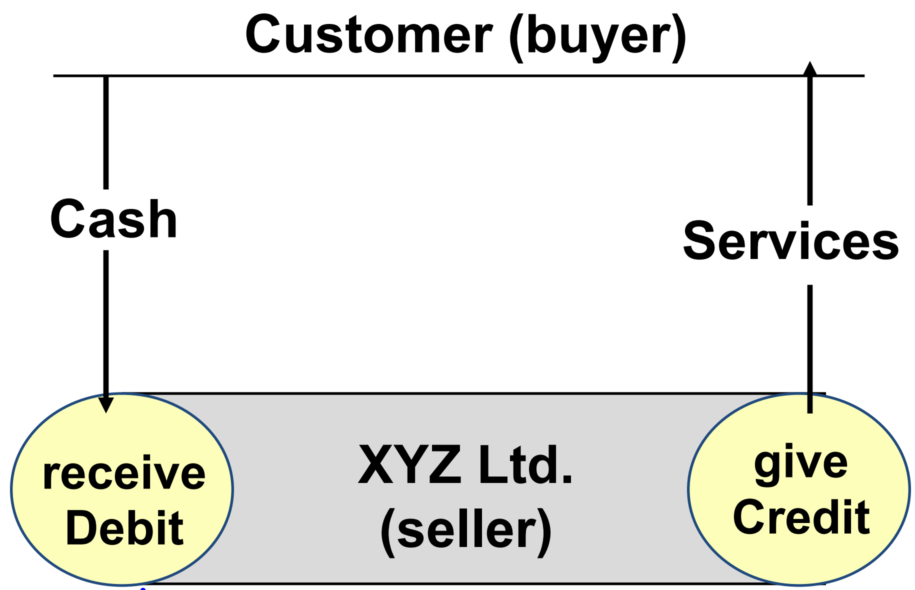
Journal

Date	Description	Debit	Credit
11/18	Cash	7,500	

Business Transactions

Entry D.

XYZ Ltd. earns fees of Rs7,500, receiving cash.



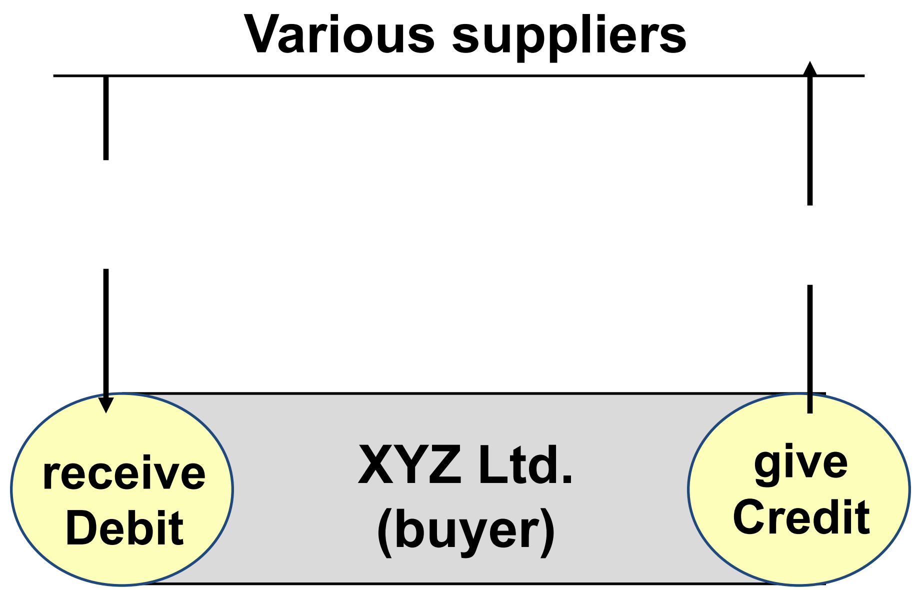
Journal

Date	Description	Debit	Credit
11/18	Cash	7,500	
	Fees Earned		7,500

Business Transactions

Entry E.

XYZ Ltd. paid: wages, Rs 2,125; rent, Rs 800; commissions, Rs450; and misc, Rs275.



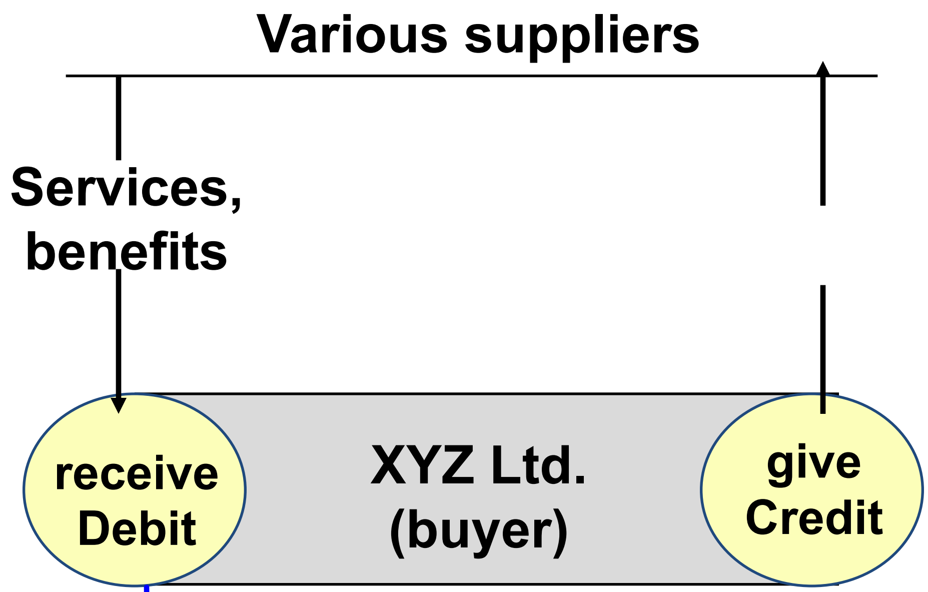
Journal

Date	Description	Debit	Credit

Business Transactions

Entry E.

XYZ Ltd. paid: wages, Rs 2,125; rent, Rs 800; commissions, Rs450; and miscellaneous, Rs275.



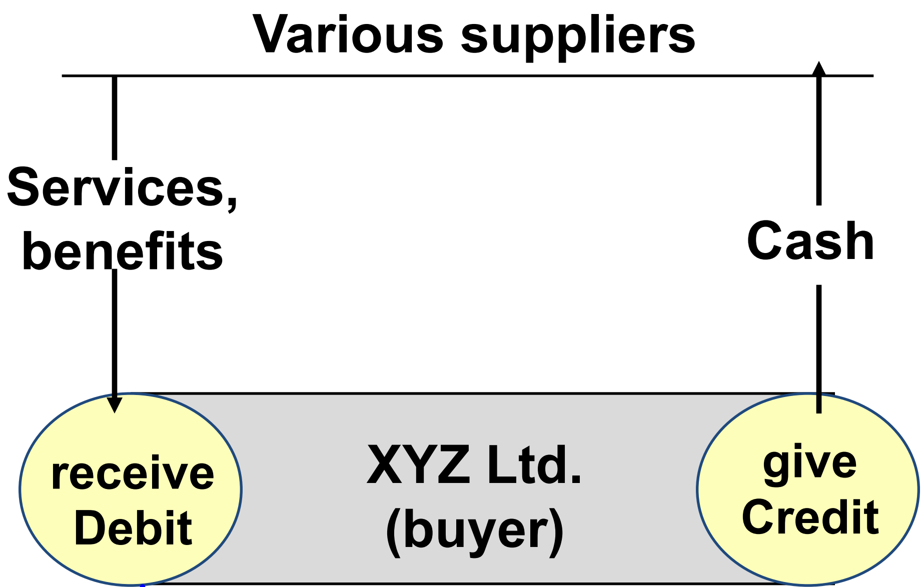
Journal

Date	Description	Debit	Credit
11/18	Wages Expense	2,125	
	Rent Expense	800	
	Commission	450	
	Misc. Expense	275	

Business Transactions

Entry E.

XYZ Ltd. paid: wages, Rs 2,125; rent, Rs 800; commissions, Rs 450; and misc Rs 275.



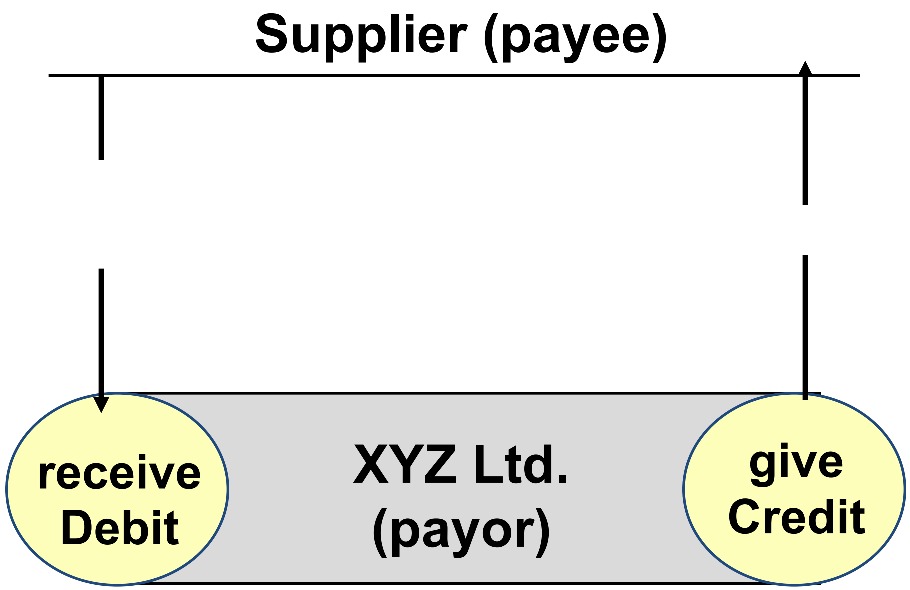
Journal

Date	Description	Debit	Credit
11/18	Wages Expense	2,125	
	Rent Expense	800	
	Commission	450	
	Misc. Expense	275	
	Cash		3,650

Business Transactions

Entry F.

XYZ Ltd. pays Rs950 to creditors on account.



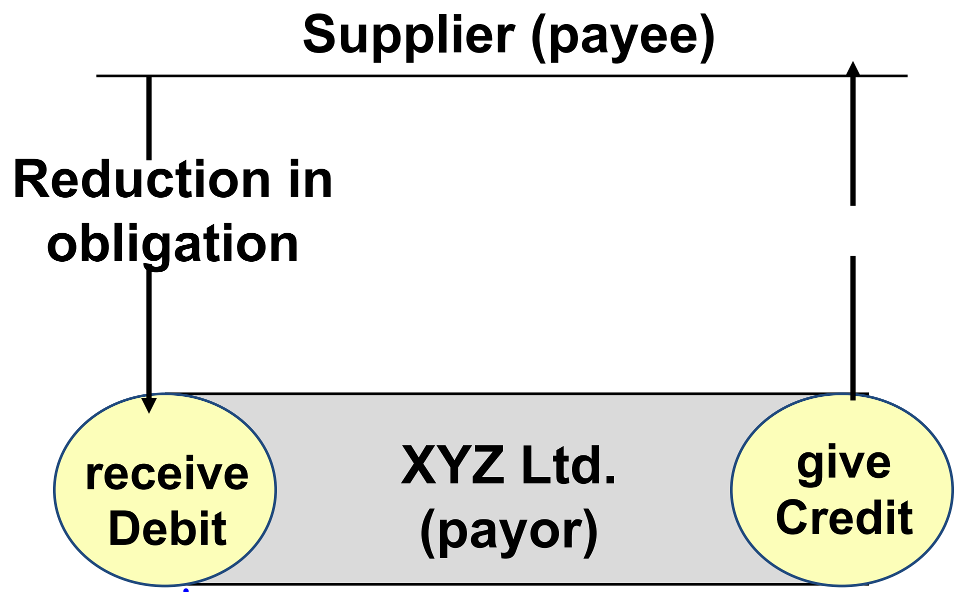
Journal

Date	Description	Debit	Credit
11/30			

Business Transactions

Entry F.

XYZ Ltd. pays Rs950 to creditors on account.



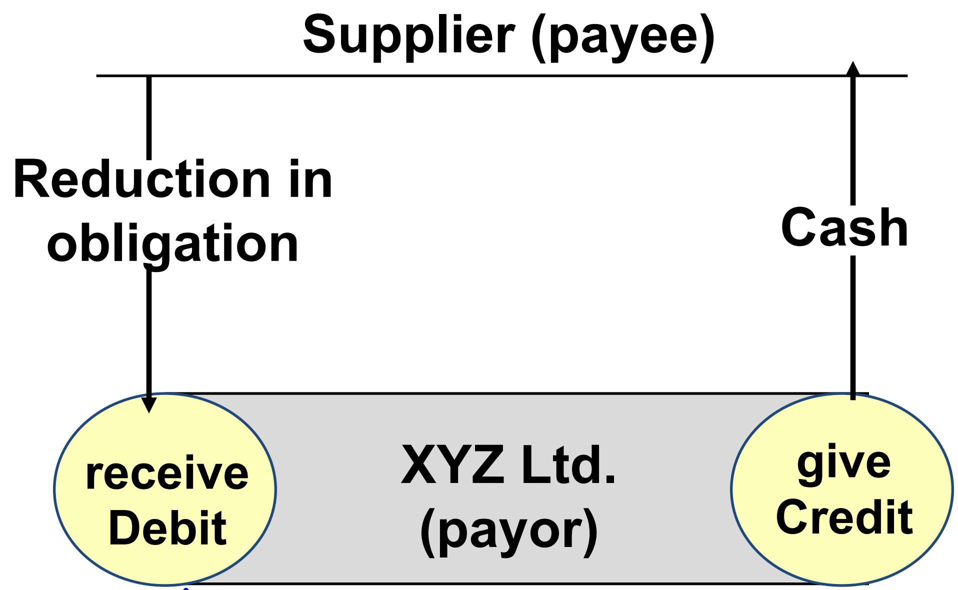
Journal

Date	Description	Debit	Credit
11/30	Accounts Payable	950	

Business Transactions

Entry F.

XYZ Ltd. pays Rs950 to creditors on account.



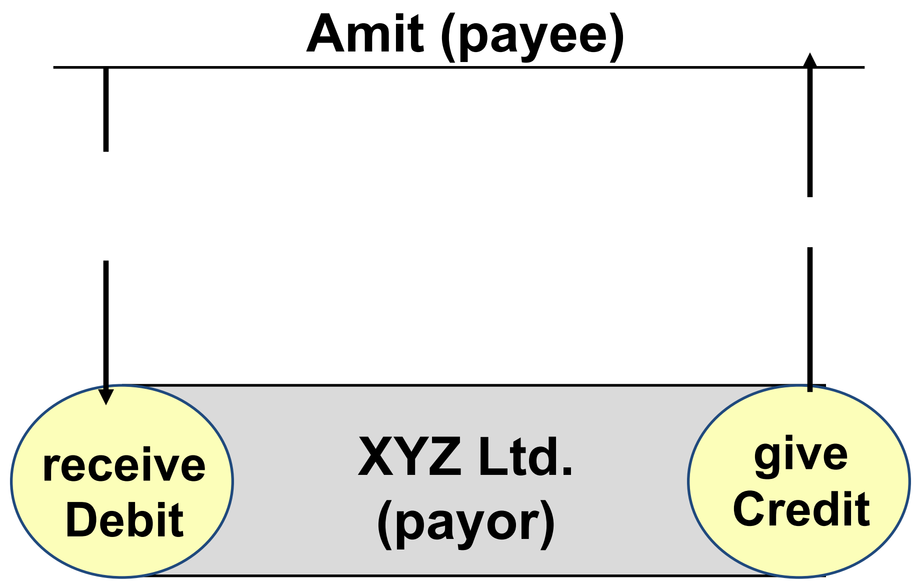
Journal

Date	Description	Debit	Credit
11/30	Accounts Payable	950	
	Cash		950

Business Transactions

Entry H.

Amit withdraws Rs 2,000 in cash.



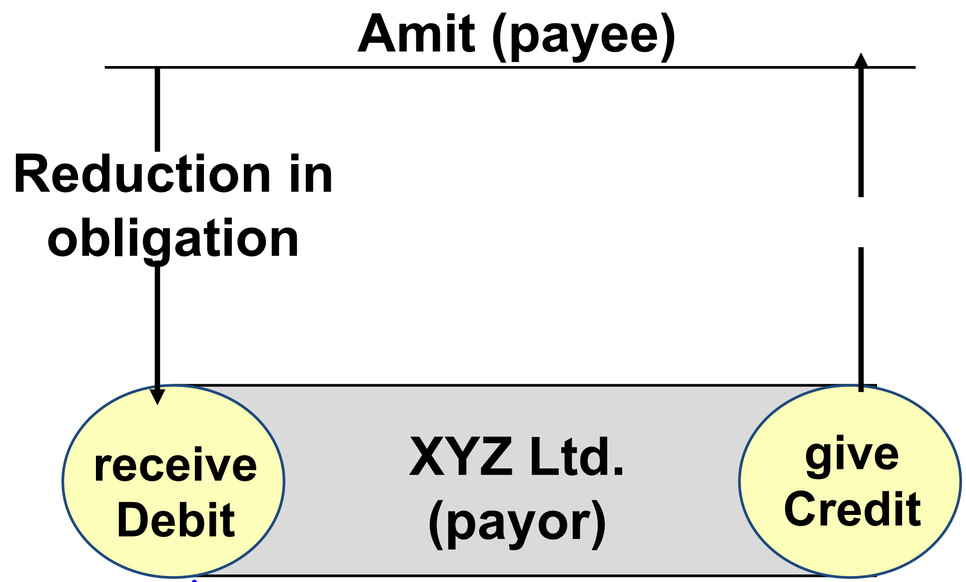
Journal

Date	Description	Debit	Credit
11/30			

Business Transactions

Entry H.

Amit withdraws Rs 2,000 in cash.



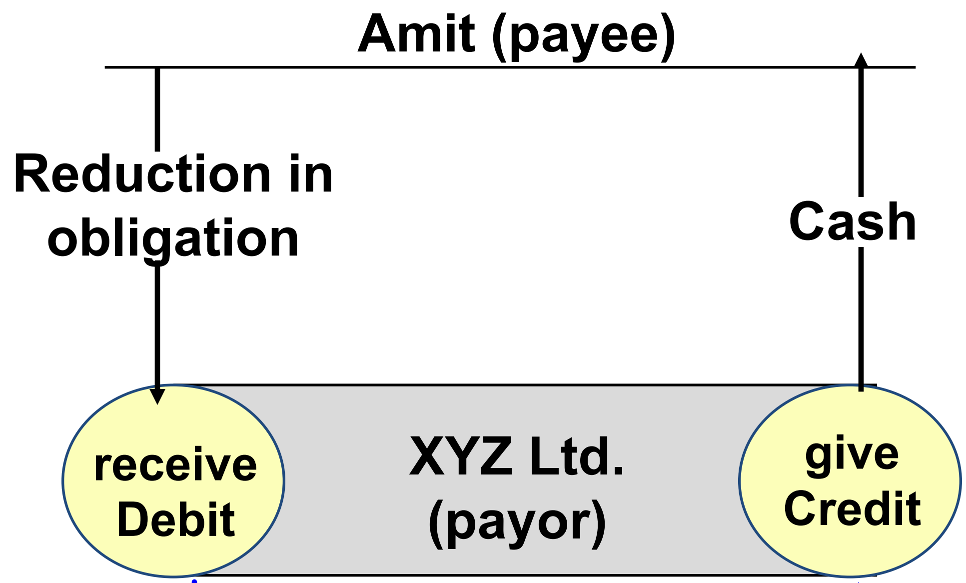
Journal

Date	Description	Debit	Credit
11/30	Amit, Drawing	2,000	

Business Transactions

Entry H.

Amit withdraws Rs 2,000 in cash.



Journal

Date	Description	Debit	Credit
11/30	Amit, Drawing	2,000	
	Cash		2,000

2. Posting/ Ledger

Posting - the process of transferring amounts from the journal to the ledger accounts.

Illustration 3-7

GENERAL JOURNAL				J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
2011				
Sept. 1	Cash		15,000	
	Share Capital—Ordinary			15,000
	(Issued ordinary shares for cash)			

GENERAL LEDGER

Illustration 3-8

Cash					No.101
Date	**Explanation**	**Ref.**	**Debit**	**Credit**	**Balance**

2. Posting/ Ledger

Posting - Transferring amounts from journal to ledger.

Illustration 3-8

GENERAL JOURNAL — **J1**

Date	Account Titles and Explanation	Ref.	Debit	Credit
2011 Sept. 1	Cash Share Capital—Ordinary (Issued ordinary shares for cash)	101 311	15,000	 15,000

GENERAL LEDGER

Cash — **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2011 Sept. 1		J1	15,000		15,000

Share Capital—Ordinary — **No. 311**

Date	Explanation	Ref.	Debit	Credit	Balance
2011 Sept. 1		J1		15,000	15,000

2. Posting/ Ledger

Expanded Example

The purpose of transaction analysis is

(1) to identify the type of account involved, and

(2) to determine whether a debit or a credit is required.

Keep in mind that every journal entry affects one or more of the following items: assets, liabilities, equity, revenues, or expense.

2. Posting

1. October 1: Shareholders invest $100,000 cash in an advertising venture to be known as Pioneer Advertising Agency Inc.

Illustration 3-9

2. Posting

1. October 1: Shareholders invest $100,000 cash in an advertising venture to be known as Pioneer Advertising Agency Inc.

Illustration 3-9

Oct. 1	Cash	100,000	
	Share capital - ordinary		100,000

Cash

Debit	Credit
100,000	

Share Capital - Ordinary

Debit	Credit
	100,000

2. Posting

2. October 1: Pioneer Advertising purchases office equipment costing $50,000 by signing a 3-month, note payable.

Illustration 3-10

2. Posting

2. October 1: Pioneer Advertising purchases office equipment costing $50,000 by signing a 3-month, note payable.

Illustration 3-10

Oct. 1	Office equipment	50,000	
	Notes payable		50,000

Office Equipment

Debit	Credit
50,000	

Notes Payable

Debit	Credit
	50,000

2. Posting

3. October 2: Pioneer Advertising receives a $12,000 cash advance from KC, a client, for advertising services that are expected to be completed by December 31.

Illustration 3-11

2. Posting

3. October 2: Pioneer Advertising receives a $12,000 cash advance from KC, a client, for advertising services that are expected to be completed by December 31.

Illustration 3-11

Oct. 2	Cash	12,000	
	Unearned service revenue		12,000

Cash

Debit	Credit
100,000	
12,000	

Unearned Service Revenue

Debit	Credit
	12,000

2. Posting

4. October 3: Pioneer Advertising pays $9,000 office rent, in cash, for October.

Illustration 3-12

2. Posting

4. October 3: Pioneer Advertising pays $9,000 office rent, in cash, for October.

Illustration 3-12

Oct. 3	Rent expense	9,000	
	Cash		9,000

Cash

Debit	Credit
100,000	9,000
12,000	

Rent Expense

Debit	Credit
9,000	

2. Posting

5. October 4: Pioneer Advertising pays $6,000 for a one-year insurance policy that will expire next year on September 30.

Illustration 3-13

2. Posting

5. October 4: Pioneer Advertising pays $6,000 for a one-year insurance policy that will expire next year on September 30.

Illustration 3-13

Oct. 4	Prepaid insurance	6,000	
	Cash		6,000

Cash

Debit	Credit
100,000	9,000
12,000	6,000

Prepaid Insurance

Debit	Credit
6,000	

2. Posting

6. October 5: Pioneer Advertising purchases, for $25,000 on account, an estimated 3-month supply of advertising materials from Aero Supply.

Illustration 3-14

2. Posting

6. October 5: Pioneer Advertising purchases, for $25,000 on account, an estimated 3-month supply of advertising materials from Aero Supply.

Illustration 3-14

Oct. 5	Advertising supplies	25,000	
	Accounts payable		25,000

Advertising Supplies

Debit	Credit
25,000	

Accounts Payable

Debit	Credit
	25,000

2. Posting

7. October 9: Pioneer Advertising signs a contract with a local newspaper for advertising inserts (flyers) to be distributed starting the last Sunday in November. Pioneer will start work on the content of the flyers in November. Payment of $7,000 is due following delivery of the Sunday papers containing the flyers.

Illustration 3-15

2. Posting

7. October 9: Pioneer Advertising signs a contract with a local newspaper for advertising inserts (flyers) to be distributed starting the last Sunday in November. Pioneer will start work on the content of the flyers in November. Payment of $7,000 is due following delivery of the Sunday papers containing the flyers.

Illustration 3-15

A business transaction has not occurred. There is only an agreement between Pioneer Advertising and the newspaper for the services to be provided in November. Therefore, no journal entry is necessary in October.

2. Posting

8. October 20: Pioneer Advertising's board of directors declares and pays a $5,000 cash dividend to shareholders.

Illustration 3-16

2. Posting

8. October 20: Pioneer Advertising's board of directors declares and pays a $5,000 cash dividend to shareholders.

Illustration 3-16

Oct. 20	Dividends	5,000	
	Cash		5,000

Cash Debit	Cash Credit	Dividends Debit	Dividends Credit
100,000	9,000	5,000	
12,000	6,000		
	5,000		

2. Posting

9. October 26: Employees are paid every four weeks. The total payroll is $2,000 per day. The pay period ended on Friday, October 26, with salaries of $40,000 being paid.

Illustration 3-17

2. Posting

9. October 26: Employees are paid every four weeks. The total payroll is $2,000 per day. The pay period ended on Friday, October 26, with salaries of $40,000 being paid.

Illustration 3-17

Oct. 26	Salaries expense	40,000	
	Cash		40,000

Cash

Debit	Credit
100,000	9,000
12,000	6,000
	5,000
	40,000

Salaries Expense

Debit	Credit
40,000	

2. Posting

10. October 31: Pioneer Advertising receives $28,000 in cash and bills Copa Company $72,000 for advertising services of $100,000 provided in October.

Illustration 3-18

2. Posting

10. October 31: Pioneer Advertising receives $28,000 in cash and bills Copa Company $72,000 for advertising services of $100,000 provided in October.

Illustration 3-18

Oct. 31	Cash	28,000	
	Accounts receivable	72,000	
	Service revenue		100,000

Cash

Debit	Credit
100,000	9,000
12,000	6,000
28,000	5,000
	40,000
80,000	

Accounts Receivable

Debit	Credit
72,000	

Service Revenue

Debit	Credit
	100,000

3. Trial Balance

Illustration 3-19

Trial Balance – A list of each account and its balance; used to prove equality of debit and credit balances.

3. Trial Balance

Illustration 3-19

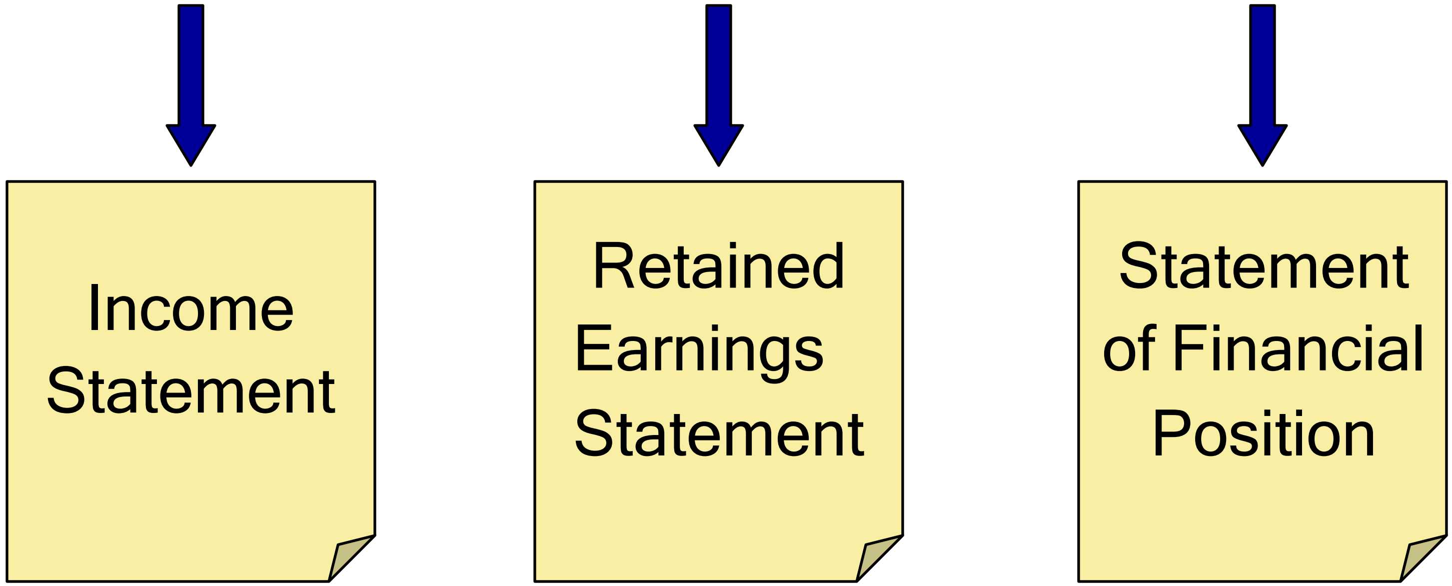
Trial Balance - A list of each account and its balance; used to prove equality of debit and credit balances.

PIONEER ADVERTISING AGENCY INC.
TRIAL BALANCE
OCTOBER 31, 2011

	Debit	Credit
Cash	$ 80,000	
Accounts Receivable	72,000	
Advertising Supplies	25,000	
Prepaid Insurance	6,000	
Office Equipment	50,000	
Notes Payable		$ 50,000
Accounts Payable		25,000
Unearned Service Revenue		12,000
Share Capital—Ordinary		100,000
Dividends	5,000	
Service Revenue		100,000
Salaries Expense	40,000	
Rent Expense	9,000	
	$287,000	$287,000

4. Preparing Financial Statements

Financial Statements are prepared directly from the Adjusted Trial Balance.



4. Preparing Financial Statements

Illustration 3-34

Profit and Loss Statement	
Revenue	100000
Sal. Expenses	40000
Rent. Expenses	9000
Net Income	51000

Dividend Payout	
Opn. reserve	0
Net Income	51000
Dividend	5000
Retain Earning	46000

Balance Sheet			
Assets		Liability	
Cash	80000	Note Payable	50000
Acc.Recievable	72000	Acc. Payable	25000
Adv. Supplies	25000	Unearned Rev	12000
Prepaid Insurance	6000	Share Capital	100000
Off. Equipment	50000	Ret. Earning	46000
	233000		233000

5. Closing Entries

- To reduce the balance of the income statement (**revenue** and **expense**) accounts to zero.
- To transfer net income or net loss to equity.
- Statement of financial position (**asset**, **liability**, and **equity**) accounts are not closed.
- Dividends are closed directly to the Retained Earnings account.

Practice

4. Adjusting Entries

Makes it possible to:

- Report on the statement of financial position the appropriate assets, liabilities, and equity at the statement date.
- Report on the income statement the proper revenues and expenses for the period.
    - **Revenues** are recorded in the period in which they are earned.
    - **Expenses** are recognized in the period in which they are incurred.

Types of Adjusting Entries

Illustration 3-20

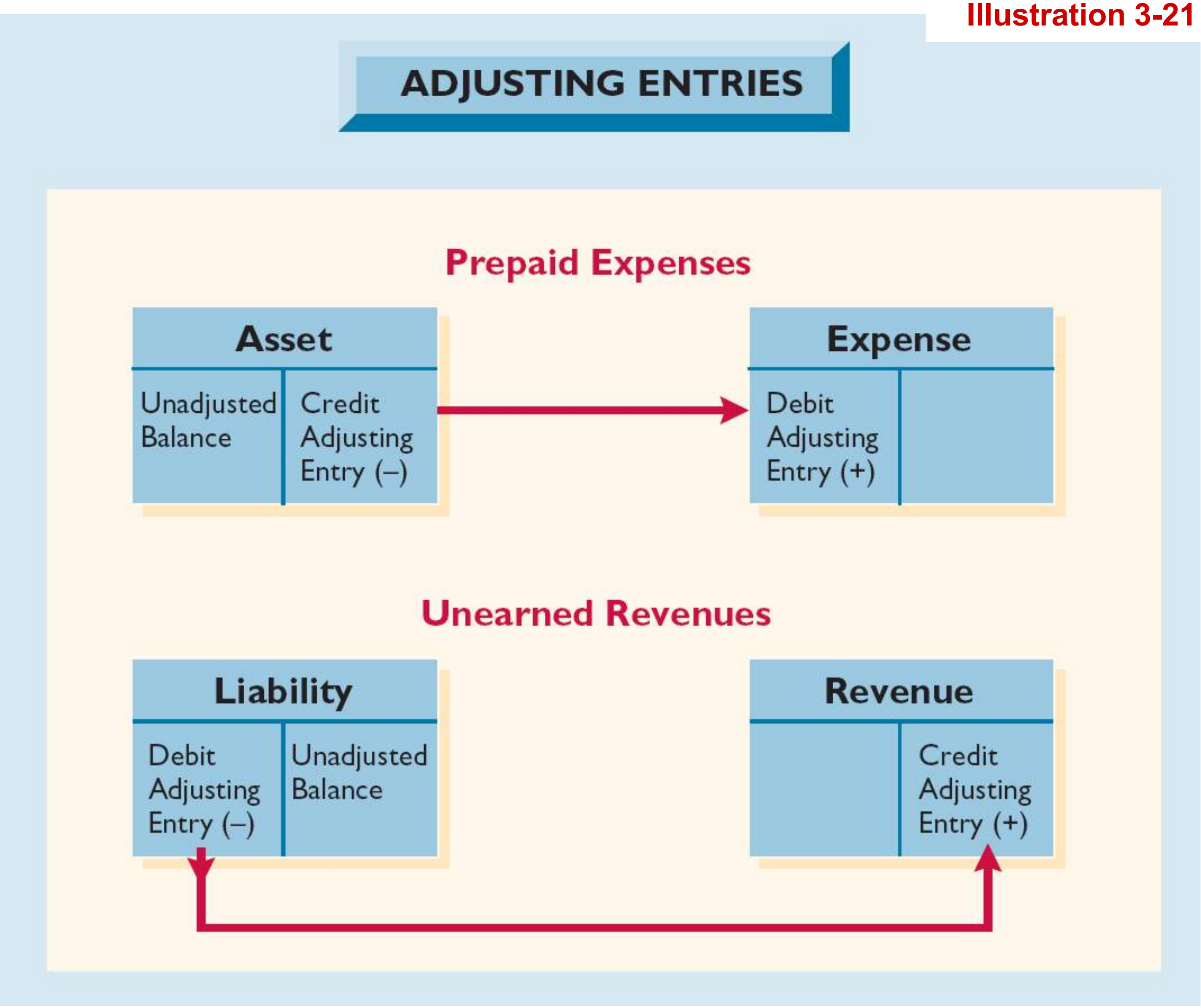
Deferrals	Accruals
1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets **before** they are used or consumed.	3. **Accrued Revenues.** Revenues earned but **not yet received** in cash or recorded.
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities **before** they are earned.	4. **Accrued Expenses.** Expenses incurred but **not yet paid** in cash or recorded.

Adjusting Entries for Deferrals

Deferrals are either

- **prepaid expenses** or
- **unearned revenues**.

Illustration 3-21



Adjusting Entries for "Prepaid Expenses"

Payment of cash that is recorded as an asset because service or benefit will be received in the future.

Cash Payment BEFORE **Expense Recorded**

Prepayments often occur in regard to:

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

Adjusting Entries for "Prepaid Expenses"

Supplies. Pioneer purchased advertising supplies costing $25,000 on October 5. Prepare the journal entry to record the purchase of the supplies.

Oct. 5	Advertising supplies	25,000	
	Cash		25,000

Advertising Supplies

Debit	Credit
25,000	

Cash

Debit	Credit
	25,000

Adjusting Entries for "Prepaid Expenses"

Supplies. An inventory count at the close of business on October 31 reveals that $10,000 of the advertising supplies are still on hand.

Oct. 31	Advertising supplies expense	15,000	
	Advertising supplies		15,000

Advertising Supplies

Debit	Credit
25,000	15,000
10,000	

Advertising Supplies Expense

Debit	Credit
15,000	

Adjusting Entries for "Prepaid Expenses"

Illustration 3-35

Statement Presentation:

Advertising supplies identifies that portion of the asset's cost that will provide future economic benefit.

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500

Adjusting Entries for "Prepaid Expenses"

Illustration 3-34

Statement Presentation:

Advertising expense identifies that portion of the asset's cost that expired in October.

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Adjusting Entries for "Prepaid Expenses"

Insurance. On Oct. 4th, Pioneer paid $6,000 for a one-year fire insurance policy, beginning October 1. Show the entry to record the purchase of the insurance.

Oct. 4	Prepaid insurance	6,000	
	Cash		6,000

Prepaid Insurance

Debit	Credit
6,000	

Cash

Debit	Credit
	6,000

Adjusting Entries for "Prepaid Expenses"

Insurance. An analysis of the policy reveals that $500 ($6,000 / 12) of insurance expires each month. Thus, Pioneer makes the following adjusting entry.

Oct. 31	Insurance expense	500	
	Prepaid insurance		500

Prepaid Insurance

Debit	Credit
6,000	500
5,500	

Insurance Expense

Debit	Credit
500	

Adjusting Entries for "Prepaid Expenses"

Illustration 3-35

Statement Presentation:

Prepaid Insurance identifies that portion of the asset's cost that will provide future economic benefit.

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets

Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500

Adjusting Entries for "Prepaid Expenses"

Illustration 3-34

Statement Presentation:

Insurance expense identifies that portion of the asset's cost that expired in October.

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Adjusting Entries for "Prepaid Expenses"

Depreciation. Pioneer Advertising estimates depreciation on its office equipment to be $400 per month. Accordingly, Pioneer recognizes depreciation for October by the following adjusting entry.

Oct. 31	Depreciation expense	400	
	Accumulated depreciation		400

Depreciation Expense

Debit	Credit
400	

Accumulated Depreciation

Debit	Credit
	400

Adjusting Entries for "Prepaid Expenses"

Illustration 3-35

Statement Presentation:

Accumulated Depreciation–is a contra asset account.

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500

Adjusting Entries for "Prepaid Expenses"

Illustration 3-34

Statement Presentation:

Depreciation expense identifies that portion of the asset's cost that expired in October.

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Adjusting Entries for "Unearned Revenues"

Receipt of cash that is recorded as a liability because the revenue has not been earned.

Cash Receipt	**BEFORE**	Revenue Recorded

Unearned revenues often occur in regard to:

- rent
- airline tickets
- school tuition
- magazine subscriptions
- customer deposits

Adjusting Entries for "Unearned Revenues"

Unearned Revenue. Pioneer Advertising received $12,000 on October 2 from KC for advertising services expected to be completed by December 31. Show the journal entry to record the receipt on Oct. 2nd.

Oct. 2	Cash	12,000	
	Unearned service revenue		12,000

Cash

Debit	Credit
12,000	

Unearned Service Revenue

Debit	Credit
	12,000

Adjusting Entries for "Unearned Revenues"

Unearned Revenues. Analysis reveals that Pioneer earned $4,000 of the advertising services in October. Thus, Pioneer makes the following adjusting entry.

Oct. 31	Unearned service revenue	4,000	
	Service revenue		4,000

Service Revenue

Debit	Credit
	100,000
	4,000

Unearned Service Revenue

Debit	Credit
4,000	12,000
	8,000

Adjusting Entries for "Unearned Revenues"

Illustration 3-35

Statement Presentation:

Unearned service revenue identifies that portion of the liability that has not been earned.

Equity and Liabilities

Equity		
Share capital—ordinary	$100,000	
Retained earnings	28,000	
Total equity		$128,000
Liabilities		
Notes payable	50,000	
Accounts payable	25,000	
Unearned service revenue	8,000	
Salaries payable	6,000	
Interest payable	500	
Total liabilities		89,500
Total equity and liabilities		$217,500

Adjusting Entries for "Unearned Revenues"

Illustration 3-34

Statement Presentation:

Service revenue represents that portion of the liability that was earned in October.

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

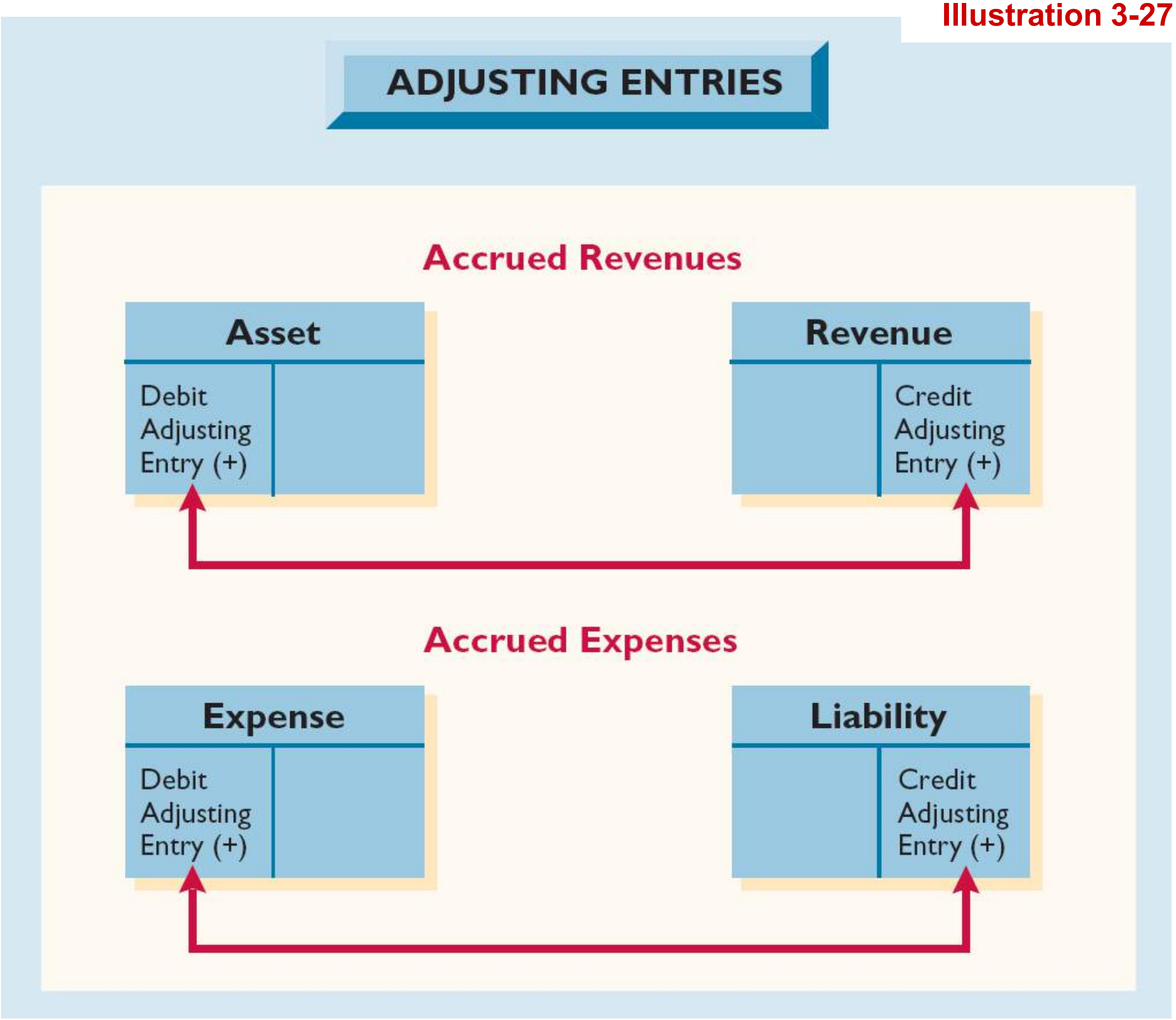
Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Adjusting Entries for Accruals

Accruals are either

- **accrued revenues** or
- **accrued expenses**.

Illustration 3-27



Adjusting Entries for "Accrued Revenues"

Revenues earned but not yet received in cash or recorded.

Adjusting entry results in:

Revenue Recorded **BEFORE** Cash Receipt

Accrued revenues often occur in regard to:

- rent
- interest
- services performed

Adjusting Entries for “Accrued Revenues”

Accrued Revenues. In October Pioneer earned $2,000 for advertising services that it did not bill to clients before October 31. Thus, Pioneer makes the following adjusting entry.

Oct. 31	Accounts receivable	2,000	
	Service revenue		2,000

Accounts Receivable		Service Revenue	
Debit	Credit	Debit	Credit
72,000			100,000
2,000			4,000
			2,000
74,000			106,000

Adjusting Entries for "Accrued Revenues"

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500
Equity and Liabilities		
Equity		
Share capital—ordinary	$100,000	
Retained earnings	28,000	
Total equity		$128,000
Liabilities		
Notes payable	50,000	
Accounts payable	25,000	
Unearned service revenue	8,000	
Salaries payable	6,000	
Interest payable	500	
Total liabilities		89,500
Total equity and liabilities		$217,500

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Illustration 3-34

Statement Presentation

Illustration 3-35

Adjusting Entries for "Accrued Expenses"

Expenses incurred but not yet paid in cash or recorded.

Adjusting entry results in:

Expense Recorded	**BEFORE**	Cash Payment

Accrued expenses often occur in regard to:

- rent
- interest
- salaries
- taxes

Adjusting Entries for "Accrued Expenses"

Accrued Interest. Pioneer signed a three-month, 12%, note payable in the amount of $50,000 on October 1. The note requires interest at an annual rate of 12 percent. Three factors determine the amount of the interest accumulation:

Illustration 3-29

1		2		3		
Face Value of Note	x	Annual Interest Rate	x	Time in Terms of One Year	=	Interest
$50,000	x	12%	x	1/12	=	**$500**

Adjusting Entries for "Accrued Expenses"

Accrued Interest. Pioneer signed a three-month, 12%, note payable in the amount of $50,000 on October 1. Prepare the adjusting entry on Oct. 31 to record the accrual of interest.

Oct. 31	Interest expense	500	
	Interest payable		500

Interest Expense

Debit	Credit
500	

Interest Payable

Debit	Credit
	500

Adjusting Entries for "Accrued Expenses"

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500
Equity and Liabilities		
Equity		
Share capital—ordinary	$100,000	
Retained earnings	28,000	
Total equity		$128,000
Liabilities		
Notes payable	50,000	
Accounts payable	25,000	
Unearned service revenue	8,000	
Salaries payable	6,000	
Interest payable	500	
Total liabilities		89,500
Total equity and liabilities		$217,500

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Illustration 3-34

Statement Presentation

Illustration 3-35

Adjusting Entries for "Accrued Expenses"

Accrued Salaries. At October 31, the salaries for these days represent an accrued expense and a related liability to Pioneer. The employees receive total salaries of $10,000 for a five-day work week, or $2,000 per day.

Adjusting Entries for "Accrued Expenses"

Accrued Salaries. Employees receive total salaries of $10,000 for a five-day work week, or $2,000 per day. Prepare the adjusting entry on Oct. 31 to record accrual for salaries.

Oct. 31	Salaries expense	6,000	
	Salaries payable		6,000

Salaries Expense

Debit	Credit
40,000	
6,000	
46,000	

Salaries Payable

Debit	Credit
	6,000

Adjusting Entries for "Accrued Expenses"

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500
Equity and Liabilities		
Equity		
Share capital—ordinary	$100,000	
Retained earnings	28,000	
Total equity		$128,000
Liabilities		
Notes payable	50,000	
Accounts payable	25,000	
Unearned service revenue	8,000	
Salaries payable	6,000	
Interest payable	500	
Total liabilities		89,500
Total equity and liabilities		$217,500

Illustration 3-35

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

Illustration 3-34

Statement Presentation

Adjusting Entries for "Accrued Expenses"

Accrued Salaries. On November 23, Pioneer will again pay total salaries of $40,000. Prepare the entry to record the payment of salaries on November 23.

Nov. 23	Salaries payable	6,000	
	Salaries expense	34,000	
	Cash		40,000

Salaries Expense

Debit	Credit
34,000	

Salaries Payable

Debit	Credit
6,000	6,000

Adjusting Entries for "Accrued Expenses"

Bad Debts. Assume Pioneer reasonably estimates a bad debt expense for the month of $1,600. It makes the adjusting entry for bad debts as follows.

	Oct. 31		
	Bad Debt Expense	1,600	
	Allowance for Doubtful Accounts		1,600
	(To record monthly bad debt expense)		

After Pioneer posts the adjusting entry, the accounts show the following.

Illustration 3-32

Accounts Receivable

10/ 1		72,000	
31	Adj.	2,000	

Allowance for Doubtful Accounts

	10/31	Adj.	1,600

Bad Debt Expense

10/31	Adj.	1,600	

5. Adjusted Trial Balance

Shows the balance of all accounts, after adjusting entries, at the end of the accounting period.

Illustration 3-33

PIONEER ADVERTISING AGENCY INC.
ADJUSTED TRIAL BALANCE
OCTOBER 31, 2011

	Debit	Credit
Cash	$ 80,000	
Accounts Receivable	74,000	
Allowance for Doubtful Accounts		$ 1,600
Advertising Supplies	10,000	
Prepaid Insurance	5,500	
Office Equipment	50,000	
Accumulated Depreciation— Office Equipment		400
Notes Payable		50,000
Accounts Payable		25,000
Interest Payable		500
Unearned Service Revenue		8,000
Salaries Payable		6,000
Share Capital—Ordinary		100,000
Dividends	5,000	
Service Revenue		106,000
Salaries Expense	46,000	
Advertising Supplies Expense	15,000	
Rent Expense	9,000	
Insurance Expense	500	
Interest Expense	500	
Depreciation Expense	400	
Bad Debt Expense	1,600	
	$297,500	$297,500

6. Preparing Financial Statements

Financial Statements are prepared directly from the Adjusted Trial Balance.

Income Statement

Retained Earnings Statement

Statement of Financial Position

6. Preparing Financial Statements

Illustration 3-34

PIONEER ADVERTISING AGENCY INC.
Adjusted Trial Balance
October 31, 2011

Account	Debit	Credit
Cash	$80,000	
Accounts Receivable	74,000	
Allowance for Doubtful Accounts		$ 1,600
Advertising Supplies	10,000	
Prepaid Insurance	5,500	
Office Equipment	50,000	
Accumulated Depreciation—Office Equipment		400
Notes Payable		50,000
Accounts Payable		25,000
Unearned Service Revenue		8,000
Salaries Payable		6,000
Interest Payable		500
Share Capital—Ordinary		100,000
Retained Earnings		–0–
Dividends	5,000	
Service Revenue		106,000
Salaries Expense	46,000	
Advertising Supplies Expense	15,000	
Rent Expense	9,000	
Insurance Expense	500	
Interest Expense	500	
Depreciation Expense	400	
Bad Debt Expense	1,600	
	$297,500	$297,500

PIONEER ADVERTISING AGENCY INC.
Income Statement
For the Month Ended October 31, 2011

Revenues		
Service Revenue		$106,000
Expenses		
Salaries expense	$46,000	
Advertising supplies expense	15,000	
Rent expense	9,000	
Insurance expense	500	
Interest expense	500	
Depreciation expense	400	
Bad debt expense	1,600	
Total expenses		73,000
Net income		$ 33,000

PIONEER ADVERTISING AGENCY INC.
Retained Earnings Statement
For the Month Ended October 31, 2011

Retained earnings, October 1	$ –0–
Add: Net income	33,000
	33,000
Less: Dividends	5,000
Retained earnings, October 31	$28,000

To the statement of financial position

6. Preparing Financial Statements

Illustration 3-35

PIONEER ADVERTISING AGENCY INC.
Adjusted Trial Balance
October 31, 2011

Account	Debit	Credit
Cash	$80,000	
Accounts Receivable	74,000	
Allowance for Doubtful Accounts		$ 1,600
Advertising Supplies	10,000	
Prepaid Insurance	5,500	
Office Equipment	50,000	
Accumulated Depreciation— Office Equipment		400
Notes Payable		50,000
Accounts Payable		25,000
Unearned Service Revenue		8,000
Salaries Payable		6,000
Interest Payable		500
Share Capital—Ordinary		100,000
Retained Earnings		–0–
Dividends	5,000	
Service Revenue		106,000
Salaries Expense	46,000	
Advertising Supplies Expense	15,000	
Rent Expense	9,000	
Insurance Expense	500	
Interest Expense	500	
Depreciation Expense	400	
Bad Debt Expense	1,600	
	$297,500	$297,500

PIONEER ADVERTISING AGENCY INC.
Statement of Financial Position
October 31, 2011

Assets		
Office equipment	$50,000	
Less: Accumulated depreciation	400	$49,600
Advertising supplies		10,000
Prepaid insurance		5,500
Accounts receivable	74,000	
Less: Allowance	1,600	72,400
Cash		80,000
Total assets		$217,500
Equity and Liabilities		
Equity		
Share capital—ordinary	$100,000	
Retained earnings	28,000	
Total equity		$128,000
Liabilities		
Notes payable	50,000	
Accounts payable	25,000	
Unearned service revenue	8,000	
Salaries payable	6,000	
Interest payable	500	
Total liabilities		89,500
Total equity and liabilities		$217,500

Balance at Oct. 31 from retained earnings statement in Illustration 3-34

7. Closing Entries

- To reduce the balance of the income statement (**revenue** and **expense**) accounts to zero.
- To transfer net income or net loss to equity.
- Statement of financial position (**asset**, **liability**, and **equity**) accounts are not closed.
- Dividends are closed directly to the Retained Earnings account.

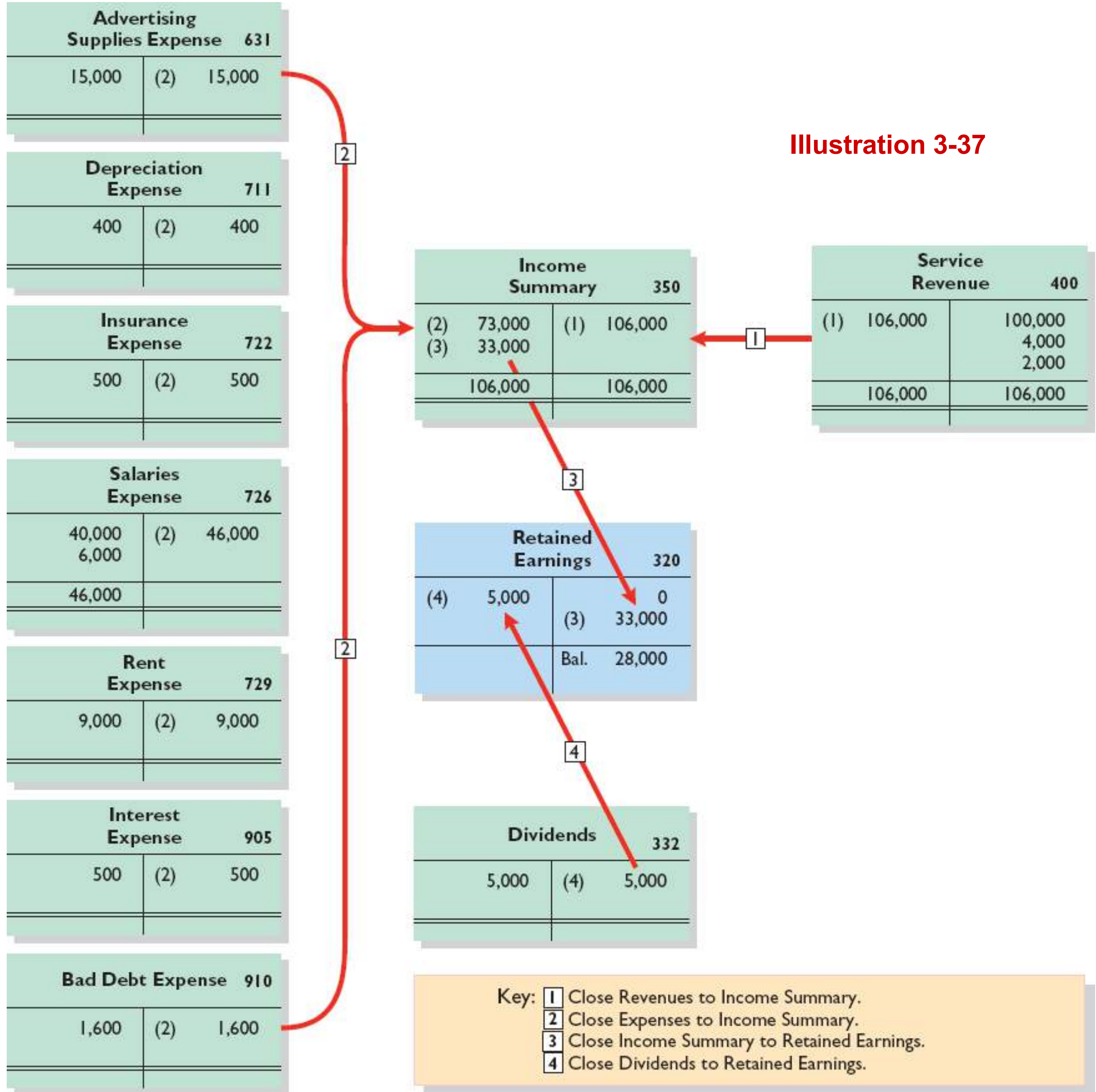
7. Closing Entries

Illustration 3-36

GENERAL JOURNAL			J3
Date	**Account Titles and Explanation**	**Debit**	**Credit**
	Closing Entries		
	(1)		
Oct. 31	Service Revenue	106,000	
	Income Summary		106,000
	(To close revenue account)		
	(2)		
31	Income Summary	73,000	
	Advertising Supplies Expense		15,000
	Depreciation Expense		400
	Insurance Expense		500
	Salaries Expense		46,000
	Rent Expense		9,000
	Interest Expense		500
	Bad Debt Expense		1,600
	(To close expense accounts)		
	(3)		
31	Income Summary	33,000	
	Retained Earnings		33,000
	(To close net income to retained earnings)		
	(4)		
31	Retained Earnings	5,000	
	Dividends		5,000
	(To close dividends to retained earnings)		

7. Closing Entries

Illustration 3-37



8. Post-Closing Trial Balance

Illustration 3-38

PIONEER ADVERTISING AGENCY INC.
POST-CLOSING TRIAL BALANCE
OCTOBER 31, 2011

Account	Debit	Credit
Cash	$ 80,000	
Accounts Receivable	74,000	
Allowance for Doubtful Accounts		$ 1,600
Advertising Supplies	10,000	
Prepaid Insurance	5,500	
Office Equipment	50,000	
Accumulated Depreciation—Office Equipment		400
Notes Payable		50,000
Accounts Payable		25,000
Unearned Service Revenue		8,000
Salaries Payable		6,000
Interest Payable		500
Share Capital—Ordinary		100,000
Retained Earnings		28,000
	$219,500	$219,500

9. Reversing Entries

After preparing the financial statements and closing the books, a company may reverse some of the adjusting entries before recording the regular transactions of the next period.

Accounting Cycle Summarized

1. Enter the transactions of the period in appropriate journals.
2. Post from the journals to the ledger (or ledgers).
3. Take an unadjusted trial balance (trial balance).
4. Prepare adjusting journal entries and post to the ledger(s).
5. Take a trial balance after adjusting (adjusted trial balance).
6. Prepare the financial statements from the second trial balance.
7. Prepare closing journal entries and post to the ledger(s).
8. Take a trial balance after closing (post-closing trial balance).
9. Prepare reversing entries **(optional)** and post to the ledger(s).

Financial Statements for a Merchandising Company

Illustration 3-39

UPTOWN CABINET CORP.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Net sales		$400,000
Cost of goods sold		316,000
Gross profit on sales		84,000
Selling expenses		
Sales salaries expense	$20,000	
Traveling expense	8,000	
Advertising expense	2,200	30,200
Administrative expenses		
Salaries, office and general	19,000	
Depreciation expense—furniture and equipment	6,700	
Property tax expense	5,300	
Rent expense	4,300	
Bad debt expense	1,000	
Telephone and Internet expense	600	
Insurance expense	360	37,260
Other income and expense		
Interest revenue		800
Income from operations		17,340
Interest expense		1,700
Income before income tax		15,640
Income tax		3,440
Net income		$ 12,200

Financial Statements of a Merchandising Company

Illustration 3-40

UPTOWN CABINET CORP.
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Retained earnings, January 1	$16,200
Add: Net income	12,200
	28,400
Less: Dividends	2,000
Retained earnings, December 31	$26,400

Financial Statements of a Merchandising Company

Illustration 3-41

UPTOWN CABINET CORP.
STATEMENT OF FINANCIAL POSITION
AS OF DECEMBER 31, 2011

Assets			
Non-current assets			
Property, plant, and equipment			
Furniture and equipment		$67,000	
Less: Accumulated depreciation		18,700	
Total property, plant, and equipment			$ 48,300
Current assets			
Merchandise inventory		40,000	
Prepaid insurance		540	
Prepaid rent expense		500	
Notes receivable	$16,000		
Accounts receivable	41,000		
Interest receivable	800		
Less: Allowance for doubtful accounts	3,000	54,800	
Cash		1,200	
Total current assets			97,040
Total assets			$145,340
Equity and Liabilities			
Equity			
Share capital—ordinary, $5.00 par value, issued and outstanding, 10,000 shares		$50,000	
Retained earnings		26,400	
Total equity			$ 76,400
Non-current liabilities			
Bonds payable, due June 30, 2018		30,000	
Current liabilities			
Notes payable	$20,000		
Accounts payable	13,500		
Property tax payable	2,000		
Income tax payable	3,440		
Total current liabilities		38,940	
Total liabilities			68,940
Total equity and liabilities			$145,340

CONVERGENCE CORNER

ACCOUNTING INFORMATION SYSTEMS

RELEVANT FACTS

- Internal controls are a system of checks and balances designed to prevent and detect fraud and errors. Both of these actions are required under SOX.
- Companies find that internal control review is a costly process. One study estimates the cost for U.S. companies at over $35 billion, with audit fees doubling in the first year of compliance.
- The enhanced internal control standards apply only to large public companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply.

APPENDIX 3A CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

Most companies use **accrual-basis accounting**

- recognize revenue when it is earned and
- expenses in the period incurred,

without regard to the time of receipt or payment of cash.

Under the strict cash basis, companies

- record revenue only when they receive cash, and
- record expenses only when they disperse cash.

Cash basis financial statements are not in conformity with IFRS.

APPENDIX 3A CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

Illustration: Quality Contractor signs an agreement to construct a garage for $22,000. In January, Quality begins construction, incurs costs of $18,000 on credit, and by the end of January delivers a finished garage to the buyer. In February, Quality collects $22,000 cash from the customer. In March, Quality pays the $18,000 due the creditors.

Illustration 3A-1

QUALITY CONTRACTOR
INCOME STATEMENT—CASH BASIS
For the Month of

	January	February	March	Total
Cash receipts				
Cash payments				
Net income (loss)				

APPENDIX 3A CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

Illustration: Quality Contractor signs an agreement to construct a garage for $22,000. In January, Quality begins construction, incurs costs of $18,000 on credit, and by the end of January delivers a finished garage to the buyer. In February, Quality collects $22,000 cash from the customer. In March, Quality pays the $18,000 due the creditors.

Illustration 3A-2

QUALITY CONTRACTOR
INCOME STATEMENT—ACCRUAL BASIS
For the Month of

	January	February	March	Total
Revenues				
Expenses				
Net income (loss)				

Conversion From Cash Basis To Accrual Basis

Illustration: Dr. Diane Windsor, like many small business owners, keeps her accounting records on a cash basis. In the year 2010, Dr. Windsor received $300,000 from her patients and paid $170,000 for operating expenses, resulting in an excess of cash receipts over disbursements of $130,000 ($300,000 - $170,000). At January 1 and December 31, 2010, she has accounts receivable, unearned service revenue, accrued liabilities, and prepaid expenses as shown in Illustration 3A-5.

Illustration 3A-5

	January 1, 2011	December 31, 2011
Accounts receivable	$12,000	$9,000
Unearned service revenue	–0–	4,000
Accrued liabilities	2,000	5,500
Prepaid expenses	1,800	2,700

APPENDIX 3A CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

Conversion From Cash Basis To Accrual Basis

Illustration: Calculate service revenue on an accrual basis.

Illustration 3A-8

Cash receipts from customers	$300,000
Service revenue (accrual)	

Illustration 3A-5

	January 1, 2011	December 31, 2011
Accounts receivable	$12,000	$9,000
Unearned service revenue	–0–	4,000
Accrued liabilities	2,000	5,500
Prepaid expenses	1,800	2,700

Conversion From Cash Basis To Accrual Basis

Illustration: Calculate operating expenses on an accrual basis.

Illustration 3A-11

Cash paid for operating expenses	$170,000
Operating expenses (accrual)	

Illustration 3A-5

	January 1, 2011	December 31, 2011
Accounts receivable	$12,000	$9,000
Unearned service revenue	–0–	4,000
Accrued liabilities	2,000	5,500
Prepaid expenses	1,800	2,700

Conversion From Cash Basis To Accrual Basis

Illustration 3A-12

DIANE WINDSOR, D.D.S.
Conversion of Income Statement Data from Cash Basis to Accrual Basis
For the Year 2011

	A	B	C	D	E
1		Cash Basis	Adjustments Add	Adjustments Deduct	Accrual Basis
2	Collections from customers	$300,000			
3	− Accounts receivable, Jan. 1			$12,000	
4	+ Accounts receivable, Dec. 31		$9,000		
5	+ Unearned service revenue, Jan. 1		—	—	
6	− Unearned service revenue, Dec. 31			4,000	
7	Service revenue				$293,000
8	Disbursement for expenses	170,000			
9	+ Prepaid expenses, Jan. 1		1,800		
10	− Prepaid expenses, Dec. 31			2,700	
11	− Accrued liabilities, Jan. 1			2,000	
12	+ Accrued liabilities, Dec. 31		5,500		
13	Operating expenses				172,600
14	Excess of cash collections over disbursements—cash basis	$130,000			
15	Net income—accrual basis				$120,400

Sheet1 Sheet2 Sheet3

Theoretical Weaknesses of the Cash Basis

Today’s economy is considerably more lubricated by credit than by cash.

The accrual basis, not the cash basis, recognizes all aspects of the credit phenomenon.

Investors, creditors, and other decision makers seek timely information about an enterprise’s *future* cash flows.

Illustration of Reversing Entries—Accruals

Illustration 3B-1

Reversing Entries Not Used				Reversing Entries Used			
Initial Salary Entry							
Oct. 24	Salaries Expense	4,000		Oct. 24	Salaries Expense	4,000	
	Cash		4,000		Cash		4,000
Adjusting Entry							
Oct. 31	Salaries Expense	1,200		Oct. 31	Salaries Expense	1,200	
	Salaries Payable		1,200		Salaries Payable		1,200
Closing Entry							
Oct. 31	Income Summary	5,200		Oct. 31	Income Summary	5,200	
	Salaries Expense		5,200		Salaries Expense		5,200
Reversing Entry							
Nov. 1	No entry is made.			Nov. 1	Salaries Payable	1,200	
					Salaries Expense		1,200
Subsequent Salary Entry							
Nov. 8	Salaries Payable	1,200		Nov. 8	Salaries Expense	2,500	
	Salaries Expense	1,300			Cash		2,500
	Cash		2,500				

Illustration of Reversing Entries—Deferrals

Illustration 3B-2

Reversing Entries Not Used				Reversing Entries Used			
Initial Purchase of Supplies Entry							
Dec. 10	Office Supplies	20,000		Dec. 10	Office Supplies Expense	20,000	
	Cash		20,000		Cash		20,000
Adjusting Entry							
Dec. 31	Office Supplies Expense	15,000		Dec. 31	Office Supplies	5,000	
	Office Supplies		15,000		Office Supplies Expense		5,000
Closing Entry							
Dec. 31	Income Summary	15,000		Dec. 31	Income Summary	15,000	
	Office Supplies Expense		15,000		Office Supplies Expense		15,000
Reversing Entry							
Jan. 1	No entry			Jan. 1	Office Supplies Expense	5,000	
					Office Supplies		5,000

Summary of Reversing Entries

1. All accruals should be reversed.
2. All deferrals for which a company debited or credited the original cash transaction to an expense or revenue account should be reversed.
3. Adjusting entries for depreciation and bad debts are not reversed.

Recognize that reversing entries do not have to be used. Therefore, some accountants avoid them entirely.

A company prepares a worksheet either on

- columnar paper or
- within an electronic spreadsheet.

A company uses the worksheet to adjust

- account balances and
- to prepare financial statements.

Worksheet Columns

A company prepares a worksheet either on

- columnar paper or
- within an electronic spreadsheet.

APPENDIX 3C

USING A WORKSHEET: THE ACCOUNTING CYCLE REVISITED

Adjusted Trial Balance

UPTOWN CABINET CORP.
Ten-Column Worksheet for The Year Ended December 31, 2011

	A	B	C	D	E	F	G	H	I	J	K
1	Accounts	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Income Statement Dr.	Income Statement Cr.	Statement of Financial Position Dr.	Statement of Financial Position Cr.
2	Cash	1,200				1,200				1,200	
3	Notes receivable	16,000				16,000				16,000	
4	Accounts receivable	41,000				41,000				41,000	
5	Allowance for doubtful accounts		2,000		(b) 1,000		3,000				3,000
6	Merchandise inventory	40,000				40,000				40,000	
7	Prepaid insurance	900			(c) 360	540				540	
8	Furniture and equipment	67,000				67,000				67,000	
9	Accumulated depreciation–furniture and equipment		12,000		(a) 6,700		18,700				18,700
10	Notes payable		20,000				20,000				20,000
11	Accounts payable		13,500				13,500				13,500
12	Bonds payable		30,000				30,000				30,000
13	Share capital—ordinary		50,000				50,000				50,000
14	Retained earnings, Jan. 1, 2010		16,200				16,200				16,200
15	Dividends	2,000				2,000				2,000	
16	Sales		400,000				400,000		400,000		
17	Cost of goods sold	316,000				316,000		316,000			
18	Sales salaries expense	20,000				20,000		20,000			
19	Advertising expense	2,200				2,200		2,200			
20	Traveling expense	8,000				8,000		8,000			
21	Salaries, office and general	19,000				19,000		19,000			
22	Telephone and Internet expense	600				600		600			
23	Rent expense	4,800			(e) 500	4,300		4,300			
24	Property tax expense	3,300		(f) 2,000		5,300		5,300			
25	Interest expense	1,700				1,700		1,700			
26	Totals	543,700	543,700								
27	Depreciation expense–furniture and equipment			(a) 6,700		6,700		6,700			
28	Bad debt expense			(b) 1,000		1,000		1,000			
29	Insurance expense			(c) 360		360		360			
30	Interest receivable			(d) 800		800				800	
31	Interest revenue				(d) 800		800		800		
32	Prepaid rent expense			(e) 500		500				500	
33	Property tax payable				(f) 2,000		2,000				2,000
34	Income tax expense			(g) 3,440		3,440		3,440			
35	Income tax payable				(g) 3,440		3,440				3,440
36	Totals			14,800	14,800	557,640	557,640	388,600	400,800		
37	Net income							12,200			12,200
38	Totals							400,800	400,800	169,040	169,040

Illustration 3C-1

Preparing Financial Statements from a Worksheet

The Worksheet:

- Provides information needed for preparation of the financial statements.
- Sorts data into appropriate columns, which facilitates the preparation of the statements.

Illustration 3-39

UPTOWN CABINET CORP.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Net sales		$400,000
Cost of goods sold		316,000
Gross profit on sales		84,000
Selling expenses		
Sales salaries expense	$20,000	
Traveling expense	8,000	
Advertising expense	2,200	30,200
Administrative expenses		
Salaries, office and general	19,000	
Depreciation expense—furniture and equipment	6,700	
Property tax expense	5,300	
Rent expense	4,300	
Bad debt expense	1,000	
Telephone and Internet expense	600	
Insurance expense	360	37,260
Other income and expense		
Interest revenue		800
Income from operations		17,340
Interest expense		1,700
Income before income tax		15,640
Income tax		3,440
Net income		$ 12,200

Illustration 3-40

UPTOWN CABINET CORP.
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Retained earnings, January 1	$16,200
Add: Net income	12,200
	28,400
Less: Dividends	2,000
Retained earnings, December 31	$26,400

Illustration 3-41

UPTOWN CABINET CORP.
STATEMENT OF FINANCIAL POSITION
AS OF DECEMBER 31, 2011

Assets			
Non-current assets			
Property, plant, and equipment			
Furniture and equipment		$67,000	
Less: Accumulated depreciation		18,700	
Total property, plant, and equipment			$ 48,300
Current assets			
Merchandise inventory		40,000	
Prepaid insurance		540	
Prepaid rent expense		500	
Notes receivable	$16,000		
Accounts receivable	41,000		
Interest receivable	800		
Less: Allowance for doubtful accounts	3,000	54,800	
Cash		1,200	
Total current assets			97,040
Total assets			$145,340
Equity and Liabilities			
Equity			
Share capital—ordinary, $5.00 par value, issued and outstanding, 10,000 shares		$50,000	
Retained earnings		26,400	
Total equity			$ 76,400
Non-current liabilities			
Bonds payable, due June 30, 2018		30,000	
Current liabilities			
Notes payable	$20,000		
Accounts payable	13,500		
Property tax payable	2,000		
Income tax payable	3,440		
Total current liabilities		38,940	
Total liabilities			68,940
Total equity and liabilities			$145,340