

## Timing Issues

- accounting divides the economic life of a business into artificial time periods
- time periods are usually one month, one quarter or one year

## Revenue Recognition

- revenue is recognized when
  - due to ordinary activities
    - sales
    - rent
    - interest
  - increase in future economic benefits arising from an increase in an asset or decrease in a liability
- **revenue recognition** occurs when the sales or performance effort is substantially complete
  - amount is determinable -> measurable
  - collection is reasonably assured
- merchandising company - > revenue is considered to be earned when the merchandise is sold (point of sale)
- service company -> revenue is considered earned at the time the service is performed
- The International Accounting Standards Board -> companies would recognize revenue upon the transfer of goods or services to customers
  - a contract based approach

## Expense Recognition



- expenses are recognized on the income statement when
  - due to an ordinary activity
  - decrease in future economic benefits related to a decrease in an asset or increase in a liability -> can be measured reliably
- **expense recognition** tied to changes in assets and liabilities
  - often coincides with revenue recognition
  - however, revenue is not always recognized when expenses are

## Accrual vs. Cash Basis of Accounting

- **accrual basis accounting** - the combined application of revenue recognition and expense recognition
  - means that transactions affecting a company's financial statements are recorded in the periods in which the events

occur -> rather than when the company actually receives or pays cash

- recognizing revenues when they are earned rather than when cash is received
  - expenses are recognized in the period which goods and services are used/consumed - > rather than when cash is paid
- **Cash basis accounting** - revenue is recorded only when cash is received and an expense is recorded only when cash is paid
  - using this type of accounting can lead to misleading financial statements
    - management can change the revenue and expenses that are reported
      - through timing the receipt and payment of cash
- profits can be increased
  - by paying expenses in the following year
- Profits can be lowered
  - and income tax reduced by asking customers to pay in the following year
- cash basis income statements
  - do not record revenues and expenses when related assets and liabilities arise

	Year 1	Year 2												
Activity	 <p>Purchased paint, painted building complex, paid employees</p>	 <p>Received payment for work done in year 1</p>												
Accrual basis	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Revenue</td> <td style="text-align: right;">\$ 80,000</td> </tr> <tr> <td>Expense</td> <td style="text-align: right;"><u>50,000</u></td> </tr> <tr> <td>Profit</td> <td style="text-align: right;"><u>\$ 30,000</u></td> </tr> </table>	Revenue	\$ 80,000	Expense	<u>50,000</u>	Profit	<u>\$ 30,000</u>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Revenue</td> <td style="text-align: right;">\$ 0</td> </tr> <tr> <td>Expense</td> <td style="text-align: right;"><u>0</u></td> </tr> <tr> <td>Profit</td> <td style="text-align: right;"><u>\$ 0</u></td> </tr> </table>	Revenue	\$ 0	Expense	<u>0</u>	Profit	<u>\$ 0</u>
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### The Basics of Adjusting Entries

- **adjusting entries** updates accounts at the end of the accounting period

- they make it possible to produce relevant financial information at the end of the accounting period
- it is necessary to make adjusting entries because the trial balance may not contain up to date information or data
- reasons
  - events are not always recorded daily -> may not be useful or efficient to do so
  - some costs are not recorded during the accounting period —> costs expire with the passage of time rather than as a result of recurring daily transactions
  - some items may be unrecorded
- are required every time financial statements are prepared
- data for adjusting entries is usually not provided until after the end of the period

#### Types of Adjusting Entries

- classified as either prepayments or accruals
- **prepayments**
  - **prepaid expenses** - expenses paid in cash and recorded as assets before they are used/consumed
  - **unearned revenue** - cash received and recorded as liabilities before revenue is earned
- **accruals**
  - **accrued revenues** - revenues earned but not yet received in cash or recorded
  - **accrued expenses** - expenses incurred but not yet paid in cash or recorded

SIERRA CORPORATION		
Trial Balance		
October 31, 2012		
	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Supplies	2,500	
Prepaid insurance	600	
Equipment	5,000	
Accounts payable		\$ 2,500
Unearned revenue		1,200
Notes payable		5,000
Common shares		10,000
Dividends	500	
Service revenue		10,000
Salaries expense	4,000	
Rent expense	900	
	<u>\$28,700</u>	<u>\$28,700</u>

### Adjusting Entries for Prepayments

- **prepayments** increase current assets (prepaid expenses and certain non current assets - buildings, equipment etc.)
- prepayments can be received and paid
- prepayments received can increase current liabilities
- adjusting entries for prepayments - allocates a cost from an asset or liability account to an expense or revenue account
- for prepayments made (prepaid expenses), adjusting entry records the expense that applies to the current period and reduces the asset account originally recorded
  - prepayment does not have future benefit
  - not an asset anymore
- for prepayments received (unearned revenue) - adjusting entry records the revenue earned in the period and reduces the liability account where unearned revenue was originally recorded
  - unearned revenue is no longer owed
  - is no longer a liability
  - revenue is earned

### Prepaid Expenses

- are costs paid for in cash before they are used
  - recorded as **prepaid expenses**
- asset (prepaid) account is debited - increases
  - shows the service or benefit will be received in the future
- cash is credited - decreases
- prepaid expenses are costs that expire with the passing of time or through use
  - insurance
  - rent
  - depreciable assets
- record expired costs when financial statements are prepared
- adjustment entries are made for two purposes
  - to record expenses -> expired costs -> to the current accounting period
  - to show the remaining amounts -> unexpired costs -> in the asset accounts
- assets are **overstated** and expenses are **understated** until prepaid expenses are adjusted for

- when expenses are understated -> shareholders' equity will be overstated
- adjusting entry for prepaid expenses
  - debit to an expense account - increase
  - credit to asset account - decrease
- TYPES OF PREPAID EXPENSES
  - **Supplies** - purchase of supplies -> increase to asset accounts
    - supplies expense is recognized at the end of the accounting period when they are used
    - difference between the balance in supplies as an asset and actual cost of supplies on hand = supplies expense

Adjustment	October 31: \$1,500 (\$2,500 - \$1,000) of supplies were used during the month.			
Basic Analysis	The use of supplies decreases the asset account Supplies by \$1,500 and increases an expense account, Supplies Expense, which in turn decreases shareholders' equity by \$1,500.			
Equation Analysis	Assets	=	Liabilities	+ Shareholders' Equity
				Common Shares + Retained Earnings
				Revenue - Expense
	-1,500			-1,500
Debit-Credit Analysis	Debits increase expenses: debit Supplies Expense \$1,500. Credits decrease assets: credit Supplies \$1,500.			
Adjusting Journal Entry	Oct. 31	Supplies Expense Supplies (To record supplies used)	1,500	1,500
Posting	Supplies		Supplies Expense	
	Oct. 9	2,500	Oct. 31 Adj.	1,500
	Oct. 31 Bal.	1,000	Oct. 31 Bal.	1,500

- **Insurance** is purchased to protect companies from losses caused by fires, thefts or unforeseen accidents
  - must be paid in advance - for one year
  - insurance payments (premiums) made in advance are recorded in the asset account - Prepaid insurance
  - adjustments are necessary at the financial statement date
    - increase Insurance Expense
    - decrease Prepaid Insurance
- **Depreciation** - the process of allocating the cost of a long lived, non current asset (property, plant or equipment) to expense its useful life

- **useful life** is the period of service an asset has
- acquisition of certain types of long lived assets is essentially a long term prepayment for services
- there is a need to recognize the cost that has been used -> the expense -> during the period
  - report the unused cost -> asset -> at the end of the period
- assets with specified useful lives are depreciated
  - **depreciable assets**
- **amortization** is used in relation to intangible assets
- depreciation is used in relation to property, plant and equipment (natural resources)
  - amortization and depreciation essentially mean the same thing
- depreciation - an allocation concept not a valuation concept
- **Calculation of Depreciation**
  - **straight line method of depreciation** - dividing the cost of an asset by it's useful life
  - depreciation is an estimate
  - Accumulated depreciation represents the cumulative total of the depreciation expense

Adjustment	October 31: \$83 ( $\$5,000 \div 5 \times 1/12$ ) of depreciation on the equipment must be recorded for the month.		
Basic Analysis	The allocation of depreciation increases a contra asset account Accumulated Depreciation, which in turn decreases assets by \$83. It also increases an expense account, Depreciation Expense, which in turn decreases shareholders' equity by \$83.		
Equation Analysis	Assets	= Liabilities +	Shareholders' Equity
			Common Shares + Retained Earnings
			Revenue - Expense
	-83		-83
Debit-Credit Analysis	Debits increase expenses: debit Depreciation Expense \$83. Credits increase contra assets: credit Accumulated Depreciation—Equipment \$83.		
Adjusting Journal Entry	Oct. 31	Depreciation Expense Accumulated Depreciation—Equipment (To record monthly depreciation)	83 83
Posting	Accumulated Depreciation—Equipment		Depreciation Expense
		Oct. 31 Adj.	83
		Oct. 31 Bal.	83

Cost	÷	Useful Life (in years)	=	Annual Depreciation Expense
\$5,000	÷	5	=	\$1,000

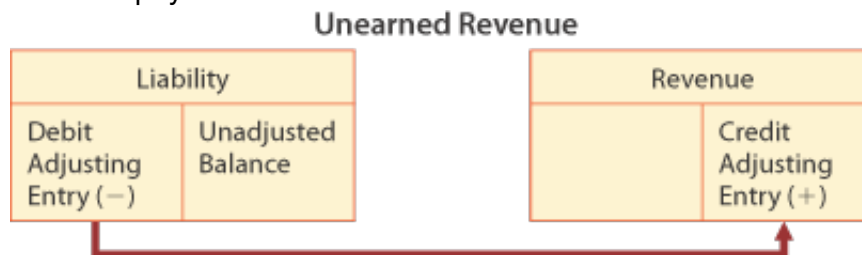
- **Statement Presentation**
  - contra accounts are accounts that offset against a related

- account on the income statement or balance sheet
- example of a contra asset account - Accumulated Depreciation - Equipment
  - normal balance is a credit
  - is offset against an asset account, Equipment
- Using the original asset account discloses the original cost of the equipment and total estimated cost that's expired to date
- helps separate actual amounts from estimated amounts
- **carrying amount** the difference between the cost of a depreciable asset and its related accumulated depreciation
  - also referred to as the net book value or book value

Equipment	\$5,000
Less: Accumulated depreciation—equipment	83
Carrying amount	4,917

#### Unearned Revenue

- **unearned revenues** cash received before revenue is earned and is recorded by increasing a liability account unearned revenues
  - rent, magazine subscriptions, customer deposits may all result in unearned revenues
- May also be called deferred revenues
- are the opposite of prepaid expenses
- unearned revenue in the books of one company may be recorded as a prepaid expense in another companies books who has made the advance payment



- payment received for services that will be provided in the future
  - CASH debited
  - UNEARNED REV. credited
- until adjustments are made, liabilities are overstated and revenues are

understated

- having revenues understated will result in shareholders' equity being understated as well

#### Adjusting Entries for Accruals

- are required in order to record revenues earned or expenses incurred in the accounting period
- accruals haven't been recognized through daily entries - not yet reflected in accounts
- up until an adjustment has been made, revenues and expenses are understated
- adjusting entries for accruals increases the statement of financial position and income statement account
- two types of adjusting entries for accruals
  - accrued revenues
  - accrued expenses

#### Accrued Revenues

- are revenues that have been earned but not yet received in cash or recorded on the statement that need to be recorded
- **accrued revenues** accumulates with the passing of time
  - may result from services that have been performed but not yet billed or collected
  - interest revenue
- adjusting revenue is required for two reasons
  - to show the receivable that exists at the statement of financial position date
  - to record the revenue that has been earned during the period
- up until the adjustment has been made, assets and revenues are understated
  - profit and shareholders' equity is understated
- Adjusting entry for accrued revenues -> increase to asset accounts (debit) and increase in revenue accounts (credit)

#### Accrued Expenses

- are expenses incurred but yet paid/recorded at the statement date which need to be recorded
- expenses are adjusted for the amount of the accrued expense
  - interest
  - rent
  - salaries

- property
- tax
- income tax
- result from the same factors as accrued revenues
- accrued expenses in the books of one company is an accrued revenue in the books of another company
- adjustments are necessary for 2 reasons
  - record obligations that exist at the statement of financial position date
  - recognize the expenses that apply to the current accounting period
- up until the adjustment has been made, liabilities and expenses are understated
  - profit and shareholders' equity are then understated as well
- ADJUSTING ENTRY FOR ACCRUED EXPENSES
  - debit to expense accounts - increase
  - credit to liability accounts - increase
- TYPES OF ACCRUED EXPENSES
  - **Interest** - interest rates are always expressed in annual terms
    - amount of interest accumulation is determined by 3 factors
      - face value or principal amount of note
      - interest rate, expressed as an annual rate
      - length of time the note is outstanding - or unpaid
    - time period expressed as a fraction of a year

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
\$5,000	×	6%	×	½	=	\$25

Adjustment	October 31: \$25 ( $\$5,000 \times 6\% \times 1/12$ ) of interest is owed for the month on the note payable (due January 1).		
Basic Analysis	The liability account Interest Payable is increased by \$25 for the amount owed. The expense account Interest Expense is increased by the same amount, which in turn decreases shareholders' equity.		
Equation Analysis	Assets	= Liabilities +	Shareholders' Equity
			Common Shares + Retained Earnings
			Revenue - Expense
		+25	-25
Debit-Credit Analysis	Debits increase expenses: debit Interest Expense \$25. Credits increase liabilities: credit Interest Payable \$25.		
Adjusting Journal Entry	Oct. 31	Interest Expense Interest Payable (To accrue interest on note payable)	25      25
Posting	Interest Expense		Interest Payable
	Oct. 31 Adj.	25	Oct. 31 Adj. 25
	Oct. 31 Bal.	25	Oct. 31 Bal. 25

Jan. 1	Interest Payable	75	
	Note Payable	5,000	
	Cash		5,075
	(To record payment of note and interest)		

- **Salaries** expenses such as employee salaries are paid for after the services have been performed
  - they require accrual adjustment for the preparation of financial statements

Adjustment	October 31: \$3,200 (8 × \$100 × 4) of salaries have been earned by employees but not yet paid (due November 2).		
Basic Analysis	The liability account Salaries Payable is increased by \$3,200 for the amount owed. The expense account Salaries Expense is increased by the same amount, which in turn decreases shareholders' equity.		
Equation Analysis	Assets	= Liabilities +	Shareholders' Equity
			Common Shares + Retained Earnings
			Revenue - Expense
		+3,200	-3,200
Debit-Credit Analysis	Debits increase expenses: debit Salaries Expense \$3,200. Credits increase liabilities: credit Salaries Payable \$3,200.		
Adjusting Journal Entry	Oct. 31	Salaries Expense Salaries Payable (To record accrued salaries)	3,200      3,200
Posting	Salaries Expense		Salaries Payable
	Oct. 19	4,000	
	31 Adj.	3,200	Oct. 31 Adj. 3,200
	Oct. 31 Bal.	7,200	Oct. 31 Bal. 3,200

Nov. 2	Salaries Payable (Oct. 22-31)	3,200	
	Salaries Expense (Nov. 1-2)	800	
	Cash		4,000
	(Paid salaries for Oct. 22-Nov. 2)		

- **Income Tax**

- corporate income tax must be accrued based on the current year's estimated profit
- if company operations occurred in the current year or there were no tax payables in the prior year
  - no income tax payments are required
- liability must still be accrued based on the current years estimated profit

- Adjusting entries affect on statement of financial position account and one income statement account

### The Adjusted Trial Balance & Financial Statements

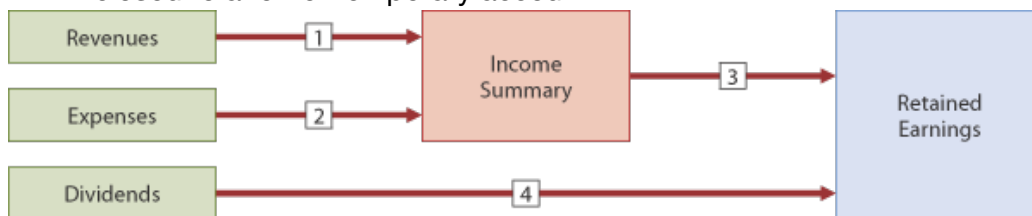
- **adjusted trial balance** is the trial balance prepared after all adjusting entries have been journalized and posted
- shows balances of all accounts at the end of the accounting period
- it proves the equality of the total debit balances and total credit balances in the ledger after all adjustments

## Closing the Books

- **temporary accounts** are revenues, expenses and dividends which relate to activities over a particular accounting period
- **permanent accounts** all statement of financial position accounts
  - their balances are carried forward into future accounting periods

### Preparing Closing Entries

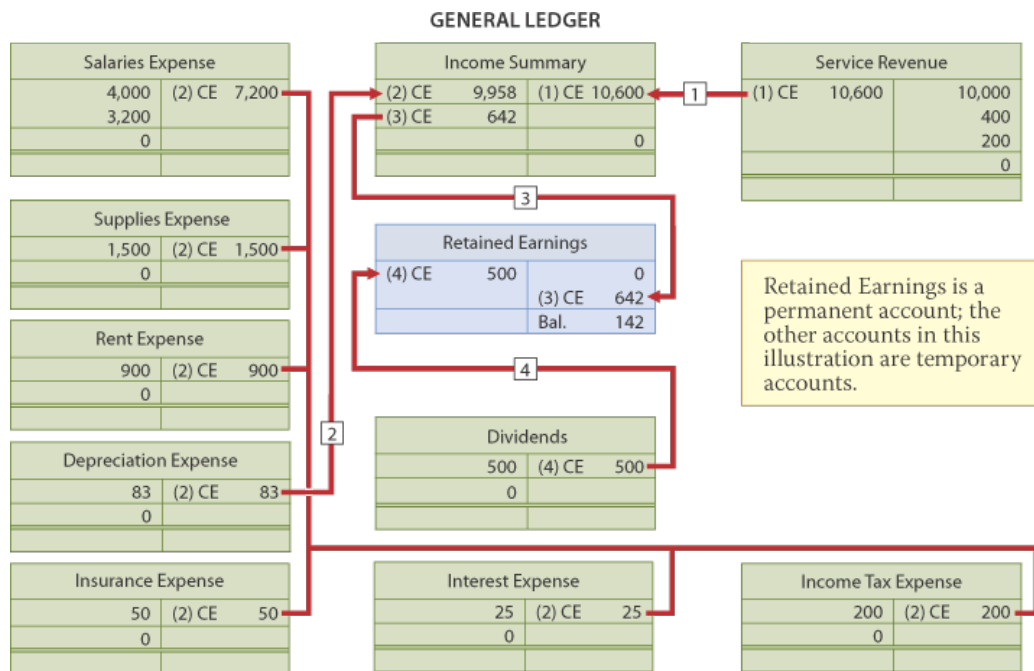
- at the end of the accounting period, temporary account balances are transferred to the permanent shareholders' equity account
  - account name - Retained earnings
- **Closing Entries** formally record in the general journal and the ledger the transfer of balances in the revenue, expense and dividends accounts to the retained earnings account
  - updating the account to its end of period balance
- until the time of closing entries, retained earnings balance will be its balance at the beginning of period
- after closing entries are recorded and posted, retained earnings balance will be the end of period balance
- ending account balance will be the same as the balance reported at the bottom of the statement of changes in equity in the retained earnings column
  - and the statement of financial position in the shareholders' equity section
- closing entries produce zero balances in each temporary account
  - for the purpose that they can collect information for the foregoing period
  - permanent accounts are not closed because of the future benefits attached to assets and obligations with liabilities
- **Income Summary** when revenues and expense accounts are first closed to another temporary account



- 4 Steps for preparing closing entries
  - **Closing Revenue Accounts** - debit each individual revenue account for its balance, credit Income Summary for total

revenues. Revenue accounts should have all zero balances

- **Closing Expense Accounts** - Debit income summary for total expenses, credit each individual expense account for their balance. Expense accounts should have all zero balances
- **Closing Income Summary Accounts** - Debit Income Summary for balances in the account -> credit if there is a loss, credit (or debit) retained earnings. Income Summary should have a balance of zero
- **Closing the Dividends Account** - Debit Retained Earnings for balance in the dividends account, credit dividends. Account balance should be zero
- dividends and expenses should never be closed together
  - they are a distribution of retained earnings
- Must journalize and post closing entries
  - is done after financial statements have been prepared
  - are usually recorded and posted at the end of a company's accounting period
- closing entries can be prepared directly from the general ledger or adjusted trial balance
- checking your work
  - make sure the balance in the income summary account equals the profit ( or loss ) reported on the income statement
  - all temporary accounts (dividends, revenues, expenses, income summary) should have zero balances
  - balance in retained earnings should equal the ending balance reported on the statement of changes in equity and statement of financial position



### Other Comprehensive Income and Accumulated Other Comprehensive Income

- companies reporting under IFRS, complex items not used to determine profit
- **OCI other comprehensive income**
  - companies reporting aspe do not recognize OCI
  - complex items determining other comprehensive incomes
  - items included in OCI - gains/losses relating to certain foreign currency transactions and certain adjustments made to reflect some assets and liabilities at fair value
  - balance appears on financial statements of public companies
- resulting amount is added to profit to determine **comprehensive income** or **total comprehensive income**
- can be reported in a combined statement of comprehensive income
  - includes both profit and other income
  - or two separate statements - income statement and statement of comprehensive income
- OCI is always closed out to various equity accounts relating to each type of item shown in OCI
- accounts are usually combined to form **accumulated other**

### comprehensive income

- reported in the statement of changes in equity and shareholders' equity

### Preparing a Post Closing Trial Balance

- Trial balance which is prepared after the closing entries are posted and journalized
- lists all permanent accounts and their balances after closing entries are journalized and posted
- proves the equality of the permanent account balances that are carried forward into the next annual accounting period

SIERRA CORPORATION Post-Closing Trial Balance October 31, 2012		
	<u>Debit</u>	<u>Credit</u>
Cash	\$15,200	
Accounts receivable	200	
Supplies	1,000	
Prepaid insurance	550	
Equipment	5,000	
Accumulated depreciation—equipment		\$ 83
Accounts payable		2,500
Salaries payable		3,200
Income tax payable		200
Interest payable		25
Unearned revenue		800
Notes payable		5,000
Common shares		10,000
Retained earnings		142
	<u>\$21,950</u>	<u>\$21,950</u>

### Accounting Cycle

