

Chapter 4- Accrual Accounting Concepts

Cash versus accrual basis accounting

Cash basis accounting:

- events are recognized in the period that cash is paid or received.
 - Revenue is recorded only when cash is received.
 - Expenses are recorded only when cash is paid.

Accruals basis accounting:

- transactions are recorded in the periods in which the events occur.
 - Revenue is recorded when **earned**, rather than when cash is received
 - Expenses are recorded when goods or services are **consumed** or **used**, rather than when cash is paid
- Cash basis accounting can lead to misleading information for decision-making:
 - Revenues and expenses can be manipulated by timing the receipt and payment of cash.
- Accrual basis of accounting is central to all accounting standards.
 - Revenue is recorded when earned
 - Expenses are matched to revenues, but not always.
 - Need some standards that define when we should recognize revenues and expenses.

Timing Issues

Revenue recognition

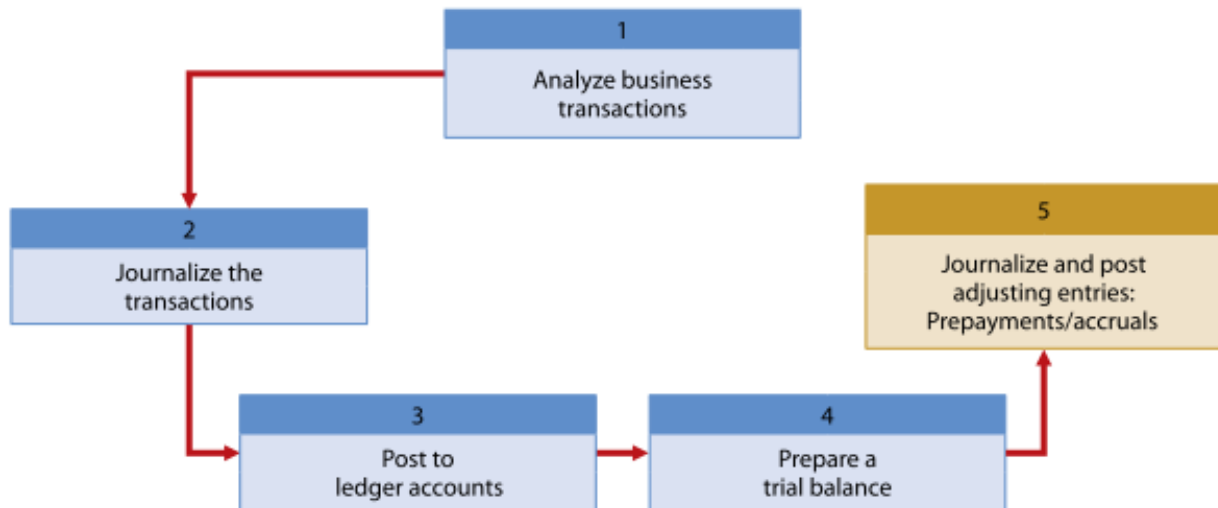
- Revenue is recognized (recorded) when there is an increase in future economic benefits arising from an increase in an asset or a decrease in a liability, due to ordinary activities.
- Criteria for recognition:
 - 1.the sales or performance effort is substantially complete,
 - 2.the amount is determinable (measurable),
 - 3.collection is reasonably assured.

Expense recognition

- Expenses are recognized when:
 - there is a decrease in future economic benefits due to an ordinary activity:
 - a decrease in an asset or
 - an increase in a liability
 - this change can be measured reliably.
- often coincide with revenue recognition (matching), but not always.
 - when there is a direct association between the expenses incurred and the generation of revenue, expenses are matched to revenues.
 - otherwise, expenses are recognized in the period the related liability arises.

Adjusting Entries

- To allocate revenues and expenses to the period in which they actually are applicable, we need to make some adjusting entries.



- Some events are not recorded daily.
- Some costs don't result from recurring daily transactions.
- Some items may be unrecorded.
- Record adjusting entries to update accounts at the end of the accounting period.
- Adjusting entries ensure that revenue recognition and expense recognition are properly applied.

Types of adjusting entries:

1. prepayments

- prepaid expenses (prepayments paid)
- unearned revenue (prepayments received)

2. accruals

- accrued expenses (incurred but not yet paid in cash or recorded)
- accrued revenues (earned but not yet received in cash or recorded)

1. Prepaid expenses

- are paid for in cash before they are used
- expire with the passage of time (insurance, depreciation) or through use (supplies).
 - It is not practical to record this expiration on a daily basis.

Original entry

Dr. Asset account
Cr. Cash

Adjusting entry

Dr. Expense account
Cr. Asset account

Until the adjustment is made:

- Assets are overstated
- Expenses are understated

Example:

A company adjusts its accounts annually. The following information is available for the year ended December 31, 2012:

- Purchased a one-year insurance policy on June 1, for \$1,800 cash.
- Paid \$6,500 on August 31 for five months' rent in advance.

1. For each of the above transactions, prepare the journal entry to record the initial transaction
2. For each of the above transactions, prepare the adjusting journal entry that is required on December 31, 2012.

Depreciation

- Depreciation is the process of allocating the acquisition cost of a long-lived or non current asset to expense over its useful life.
- It is not a valuation concept.
- Adjusting entry for depreciation:
 Dr. Depreciation expense
 Cr. Accumulated depreciation
- Straight line method of depreciation: $\text{Depreciation} = (\text{cost} - \text{residual value}) / \text{estimated useful life}$.

Example

A company purchased a truck for 58,000. The truck has a useful life of 5 years and a residual value of 8,000.

1. Calculate depreciation expense per year.
2. Prepare the adjusting journal entry

2. Unearned revenue

- Cash has been received before revenue is earned.
- Unearned revenues are later earned when the service is provided to the customer.
 - Not practical to make daily journal entries as the revenue is earned.

Original entry

Dr. Cash
 Cr. Liability account

Adjusting entry

Dr. liability account
 Cr. revenue account

Until the adjustment is made:

- Liabilities are overstated
- Revenues are understated

Example:

A company adjusts its accounts annually. The following information is available for the year ended December 31, 2012:

On September 14, received \$3,600 cash from a corporation to sponsor a game each month for the most improved students. The amount is to be distributed evenly over nine times of playing the game, once on the first Friday of each month starting in October.

1. prepare the journal entry to record the initial transaction.
2. prepare the adjusting journal entry that is required on December 31, 2012.

3. Accrued revenues

- revenues that have been earned but not yet received on cash or recorded.
- May accumulate with the passing of time (e.g., interest revenue).
- May result from services that have not yet billed or collected (e.g, fees).

No original entry

Adjusting entry:

Dr. asset account
 Cr. revenue account.

Until the adjustment is made:

- Assets and revenues are understated
- Profit and shareholders equity are understated.

Example:

A company has earned \$500 in interest revenue, which has not been collected in cash or recorded at the financial statement date.

Prepare the adjustment entry

Adjusting entry:

Interest receivable 500
 Interest revenue 500

4. Accrued expenses

- expenses incurred but not yet paid or recorded at the statement date.
- Examples: interest, rent, salaries, property tax, income taxes.
- An accrued expense on the books of one company is an accrued revenue to another company.

No original entry

Adjusting entry:

Dr. expense account
 Cr. liability account.

Until the adjustment is made:

- Liabilities and expenses are understated
- Profit and shareholders' equity are overstated.

Example:

On November 1, a company borrows \$24,000 at 3% interest for six months. The principal and all interest are due on May 1. The company prepares its financial statements at December 31. Prepare the adjusting entry.

Adjusting entry

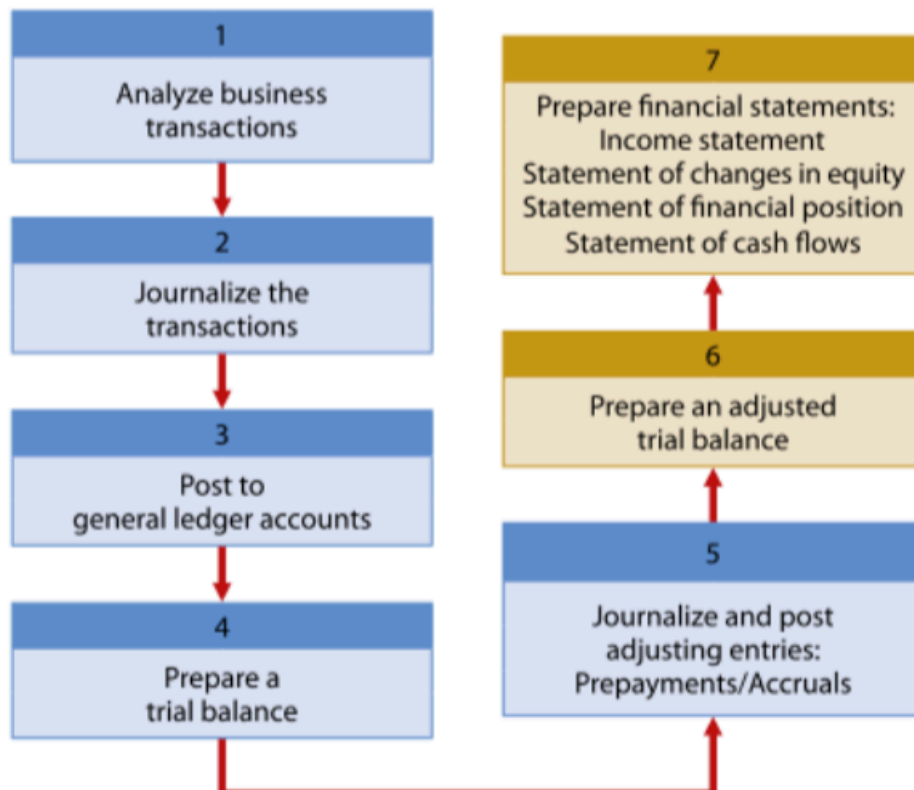
Interest expense 120
 Interest payable 120

	<u>Type of Adjustment</u>	<u>Reason for Adjustment</u>	<u>Accounts before Adjustment</u>	<u>Adjusting Entry</u>
Prepayments	Prepaid expenses	Prepaid expenses, originally recorded in asset accounts, have been used.	Assets overstated; expenses understated	Dr. Expense Cr. Asset
	Unearned revenues	Unearned revenues, initially recorded in liability accounts, have been earned.	Liabilities overstated; revenues understated	Dr. Liability Cr. Revenue
Accruals	Accrued revenues	Revenues have been earned but not yet received in cash or recorded.	Assets understated; revenues understated	Dr. Asset Cr. Revenue
	Accrued expenses	Expenses have been incurred but not yet paid or recorded.	Expenses understated; liabilities understated	Dr. Expense Cr. Liability

The Adjusted Trial Balance

- After all adjusting entries have been journalized and posted, another trial balance is prepared from the general ledger accounts. This trial balance is called an adjusted trial balance
- It shows the balances of all accounts at the end of the accounting period, including those that have been adjusted.
- The adjusted trial balance is the main source for the preparation of financial statements.

SIERRA CORPORATION		
Adjusted Trial Balance		
October 31, 2015		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 7,400	
Accounts receivable	15,200	
Supplies	1,000	
Prepaid insurance	550	
Equipment	5,000	
Accumulated depreciation—equipment		\$ 83
Accounts payable		1,500
Salaries payable		2,000
Interest payable		25
Unearned revenue		800
Bank loan payable		5,000
Common shares		10,000
Retained earnings		0
Dividends	500	
Service revenue		20,600
Salaries expense	6,000	
Supplies expense	1,500	
Rent expense	900	
Depreciation expense	83	
Insurance expense	50	
Interest expense	25	
Income tax expense	1,800	
	<u>\$40,008</u>	<u>\$40,008</u>



Preparing Financial Statements

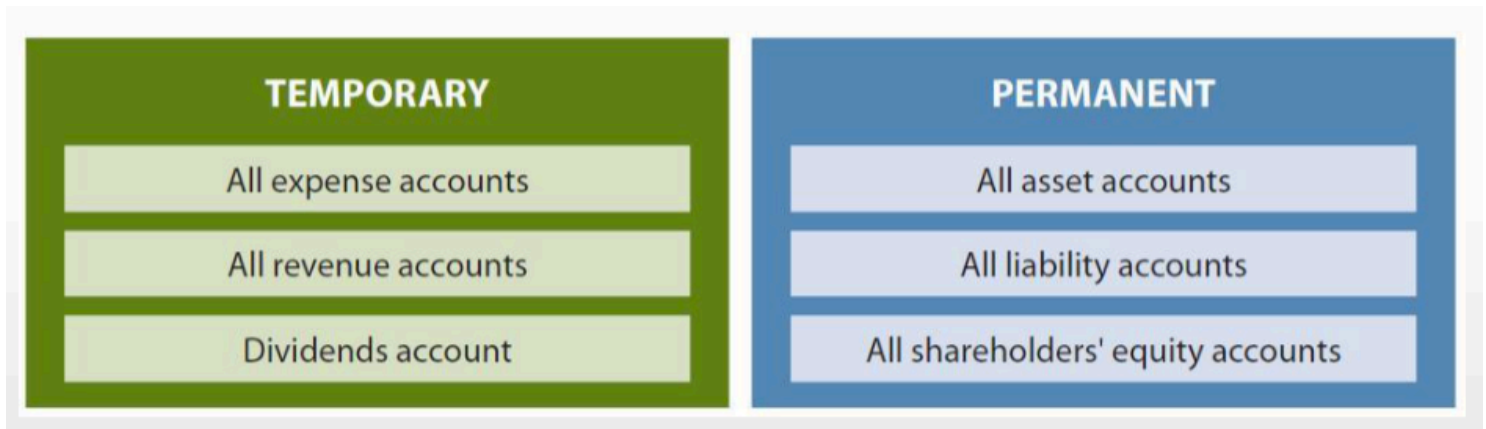
SIERRA CORPORATION Adjusted Trial Balance October 31, 2015			SIERRA CORPORATION Income Statement Month Ended October 31, 2015	
	Debit	Credit	Revenues	
Cash	\$ 7,400		Service revenue	\$20,600
Accounts receivable	15,200		Expenses	
Supplies	1,000		Salaries expense	\$6,000
Prepaid insurance	550		Supplies expense	1,500
Equipment	5,000		Rent expense	900
Accumulated depreciation— equipment		\$ 83	Depreciation expense	83
Accounts payable		1,500	Insurance expense	50
Salaries payable		2,000	Interest expense	25
Interest payable		25	Total expenses	<u>8,558</u>
Unearned revenue		800	Profit before income tax	12,042
Bank loan payable		5,000	Income tax expense	<u>1,800</u>
Common shares		10,000	Profit	<u>\$10,242</u>
Retained earnings		0		
Dividends	500			
Service revenue		20,600		
Salaries expense	6,000			
Supplies expense	1,500			
Rent expense	900			
Depreciation expense	83			
Insurance expense	50			
Interest expense	25			
Income tax expense	<u>1,800</u>			
	<u>\$40,008</u>	<u>\$40,008</u>		

SIERRA CORPORATION Statement of Changes in Equity Month Ended October 31, 2015			
	Common Shares	Retained Earnings	Total Equity
Balance, October 1	\$ 0	\$ 0	\$ 0
Issued common shares	10,000		10,000
Profit		10,242	10,242
Dividends		(500)	(500)
Balance, October 31	<u>\$10,000</u>	<u>\$9,742</u>	<u>\$19,742</u>

SIERRA CORPORATION Adjusted Trial Balance October 31, 2015			SIERRA CORPORATION Statement of Financial Position October 31, 2015	
	Debit	Credit	Assets	
Cash	\$ 7,400		Current assets	
Accounts receivable	15,200		Cash	\$ 7,400
Supplies	1,000		Accounts receivable	15,200
Prepaid insurance	550		Supplies	1,000
Equipment	5,000		Prepaid insurance	<u>550</u>
Accumulated depreciation— equipment		\$ 83	Total current assets	\$24,150
Accounts payable		1,500	Property, plant, and equipment	
Salaries payable		2,000	Equipment	\$ 5,000
Interest payable		25	Less: Accumulated depreciation	<u>83</u>
Unearned revenue		800	Total property, plant, and equipment	4,917
Bank loan payable		5,000	Total assets	<u>\$29,067</u>
Common shares		10,000	Liabilities and Shareholders' Equity	
Retained earnings		0	Liabilities	
Dividends	500		Current liabilities	
Service revenue		20,600	Accounts payable	\$ 1,500
Salaries expense	6,000		Salaries payable	2,000
Supplies expense	1,500		Interest payable	25
Rent expense	900		Unearned revenue	800
Depreciation expense	83		Bank loan payable	<u>5,000</u>
Insurance expense	50		Total liabilities	\$9,325
Interest expense	25		Shareholders' equity	
Income tax expense	<u>1,800</u>		Common shares	\$10,000
	<u>\$40,008</u>	<u>\$40,008</u>	Retained earnings	<u>9,742</u>
			Total shareholders' equity	19,742
			Total liabilities and shareholders' equity	<u>\$29,067</u>

Closing the books

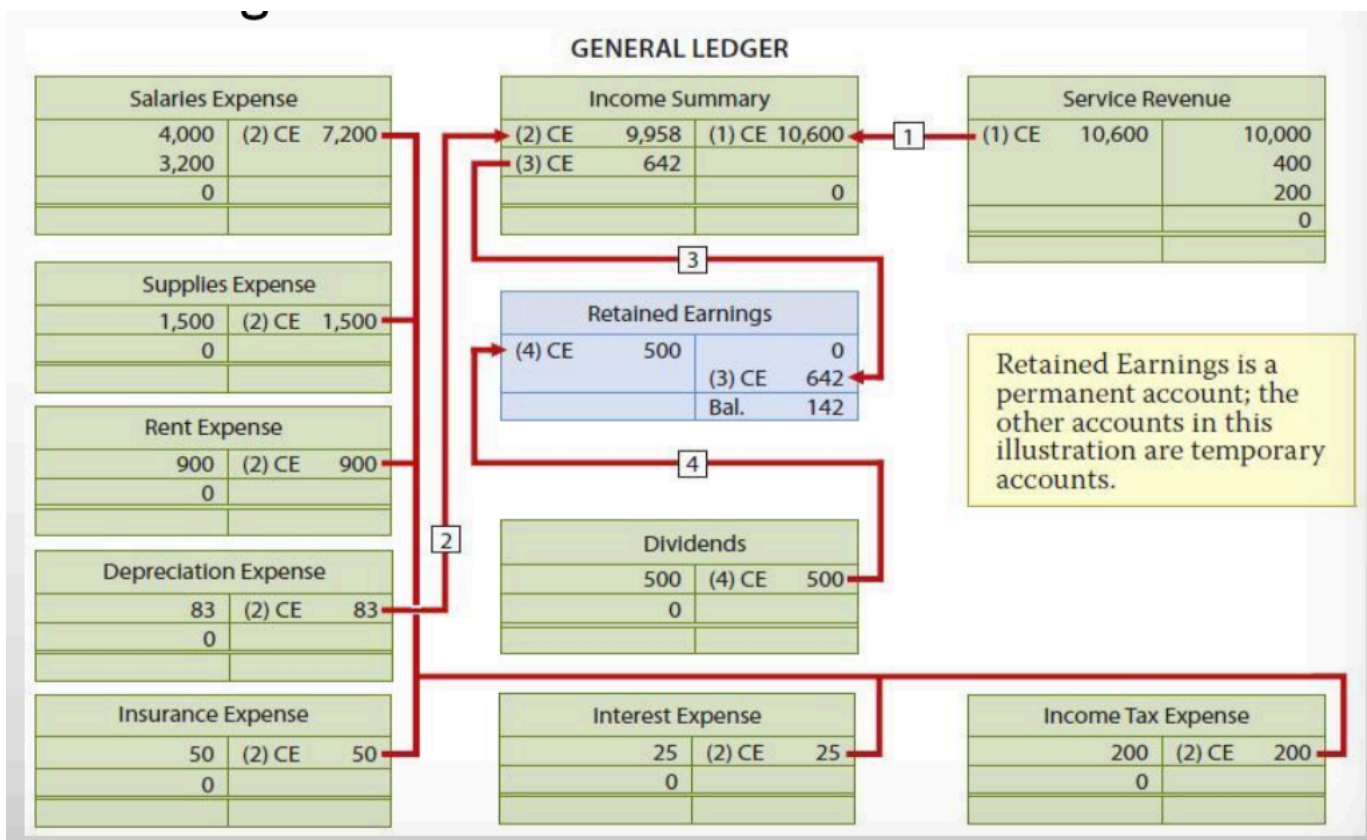
- Temporary/permanent accounts:



- At the end of each period the temporary account balances are transferred to the permanent shareholders' equity account Retained Earnings through the preparation of closing entries.

The closing process:

1. Close revenue accounts:
 - debit each individual revenue account
 - credit Income summary for total revenues.
2. Close expense accounts:
 - debit Income summary for total expenses
 - credit each individual expense account.
3. Close income summary account:
 - debit (credit) Income summary
 - credit (debit) retained earnings.
4. Close the dividend account:
 - debit retained earnings
 - credit dividends.



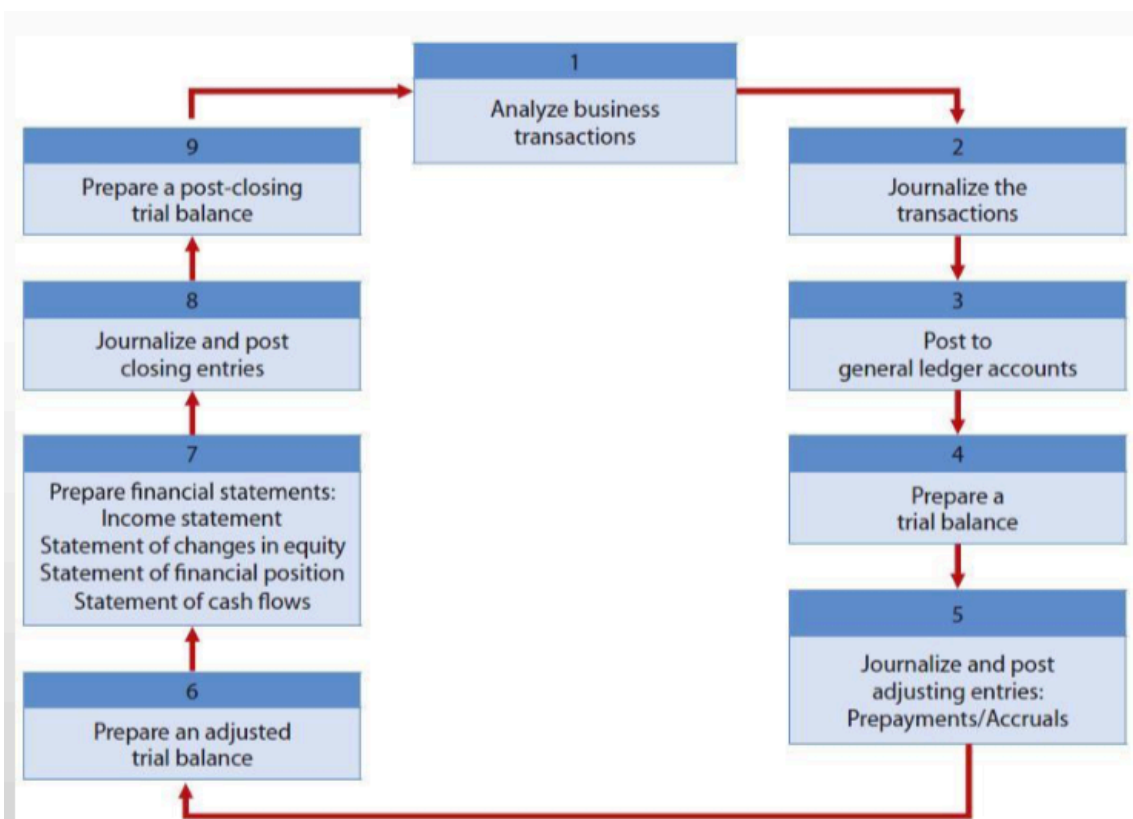
Post closing trial balance

- Lists all **permanent** accounts and their balances after closing entries are journalized and posted.
- Proves the equality of total debit balances and total credit balances after the closing entries have been made.

Example

	Debits	Credits
Cash	7,430	
Accounts receivable	19,725	
Supplies	1,400	
Prepaid insurance	3,450	
Equipment	25,600	
Accumulated depreciation—equipment		5,905
Accounts payable		7,800
Salaries payable		2,200
Interest payable		1,500
Rent payable		1,250
Income tax payable		900
Unearned revenue		700
Bank loan payable		25,000
Common shares		5,000
Retained earnings		7,350
Totals	<u>\$57,605</u>	<u>\$57,605</u>

Summary of the Accounting Cycle



Comparing IFRS and ASPE

comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Frequency of adjusting entries	Public companies must release quarterly financial statements so adjusting entries have to be made at least quarterly, although many will record adjusting entries every month.	Private companies usually release financial statements to their banker(s) and shareholder(s), along with certain financial information to the Canada Revenue Agency on an annual basis, so adjusting entries may be made only at year end, although many will record adjusting entries more frequently.
Terminology	The term <i>depreciation</i> refers to the allocation of the cost of depreciable tangible assets over their useful lives. The term <i>amortization</i> refers to the allocation of the cost of certain kinds of intangible assets over their useful lives.	The term <i>amortization</i> is used for the allocation of the cost of both depreciable tangible assets and certain kinds of intangible assets over their useful lives.

Example:

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- Paid \$6,500 on August 31 for five months' rent in advance.

1. For each of the above transactions, prepare the journal entry to record the initial transaction
2. For each of the above transactions, prepare the adjusting journal entry that is required on December 31, 2012.

June 1:

DR: prepaid insurance 1,800

CR: cats 1,800

August 31:

DR: Prepaid Rent 6,500

CR: Cash 6,500

ADJUSTING:

June 1:

DR: Insurance Expense 1,050 (1,800 x 7/12)

CR: Prepaid insurance 1,050

August 31:

DR: Rent Expense 5,200

CR: Prepaid Rent 5,200

Example

A company purchased a truck for 58,000. The truck has a useful life of 5 years and a residual value of 8,000.

1. Calculate depreciation expense per year. **10,000**
2. Prepare the adjusting journal entry

DR: dep expesne 10,000

CR: accumelated dep 10,000

Example:

A company adjusts its accounts annually. The following information is available for the year ended December 31, 2012:

On September 14, received \$3,600 cash from a corporation to sponsor a game each month for the most improved students. The amount is to be distributed evenly over nine times of playing the game, once on the first Friday of each month starting in October.

1. prepare the journal entry to record the initial transaction.
2. prepare the adjusting journal entry that is required on December 31, 2012.

DR: Cash 3,600

CR: Unearned Revenue 3,600

January 29, 2018

Adjusting:

DR: Unearned revues 1,200

CR: Sponsorship revenue 1,200
(3,600 x 3/9 games)