

# Financial Accounting



**John J. Wild**  
**Sixth Edition**



## Chapter 03

# Adjusting Accounts and Preparing Financial Statements

# Conceptual Chapter Objectives

- C1:** Explain the importance of periodic reporting and the time period assumption.
- C2:** Explain accrual accounting and how it improves financial statements.
- C3:** Identify steps in the accounting cycle.
- C4:** Explain and prepare a classified balance sheet.

# Analytical Chapter Objectives

- A1:** Explain how accounting adjustments link to financial statements.
- A2:** Compute profit margin and describe its use in analyzing company performance.
- A3:** Compute the current ratio and describe what it reveals about a company's financial condition.

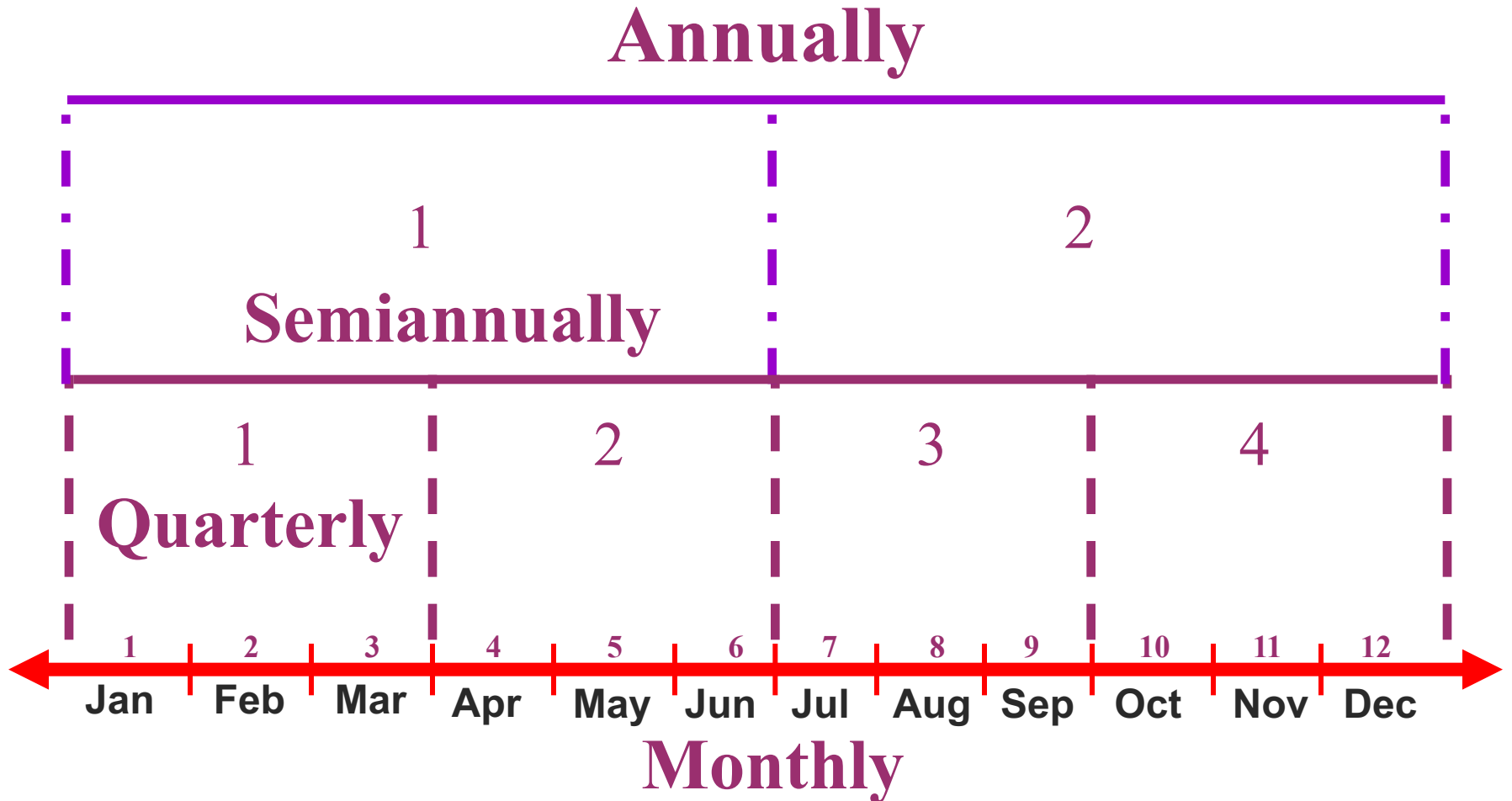
# Procedural Chapter Objectives

- P1:** Prepare and explain adjusting entries.
- P2:** Explain and prepare an adjusted trial balance.
- P3:** Prepare financial statements from an adjusted trial balance.
- P4:** Describe and prepare closing entries.
- P5:** Explain and prepare a post-closing trial balance.

# Procedural Chapter Objectives (Continued)

- P6: Appendix 3A** – Explain the alternatives in accounting for prepaids (see text for details).
- P7: Appendix 3B** – Prepare a work sheet and explain its usefulness (see text for details).
- P8: Appendix 3C** – Prepare reversing entries and explain their purpose (see text for details).

# The Accounting Period



C1

# Accrual Basis vs. Cash Basis

## Accrual Basis

Revenues are recognized when earned and expenses are recognized when incurred.

## Cash Basis

Revenues are recognized when cash is received and expenses recorded when cash is paid.

**Not GAAP**

Accounting





# Accrual Basis vs. Cash Basis

*Example:*

FastForward paid \$2,400 for a 24-month insurance policy beginning December 1, 2011.

On the cash basis the entire \$2,400 would be recognized as insurance expense in 2011. No insurance expense from this policy would be recognized in 2012 or 2013, periods covered by the policy.

Insurance Expense 2011			
Jan	Feb	Mar	Apr
\$ -	\$ -	\$ -	\$ -
May	Jun	Jul	Aug
\$ -	\$ -	\$ -	\$ -
Sep	Oct	Nov	Dec
\$ -	\$ -	\$ -	\$ 2,400

# Accrual Basis vs. Cash Basis

Insurance Expense 2011			
Jan	Feb	Mar	Apr
\$ -	\$ -	\$ -	\$ -
May	Jun	Jul	Aug
\$ -	\$ -	\$ -	\$ -
Sep	Oct	Nov	Dec
\$ -	\$ -	\$ -	\$ 100

Insurance Expense 2012			
Jan	Feb	Mar	Apr
\$ 100	\$ 100	\$ 100	\$ 100
May	Jun	Jul	Aug
\$ 100	\$ 100	\$ 100	\$ 100
Sep	Oct	Nov	Dec
\$ 100	\$ 100	\$ 100	\$ 100

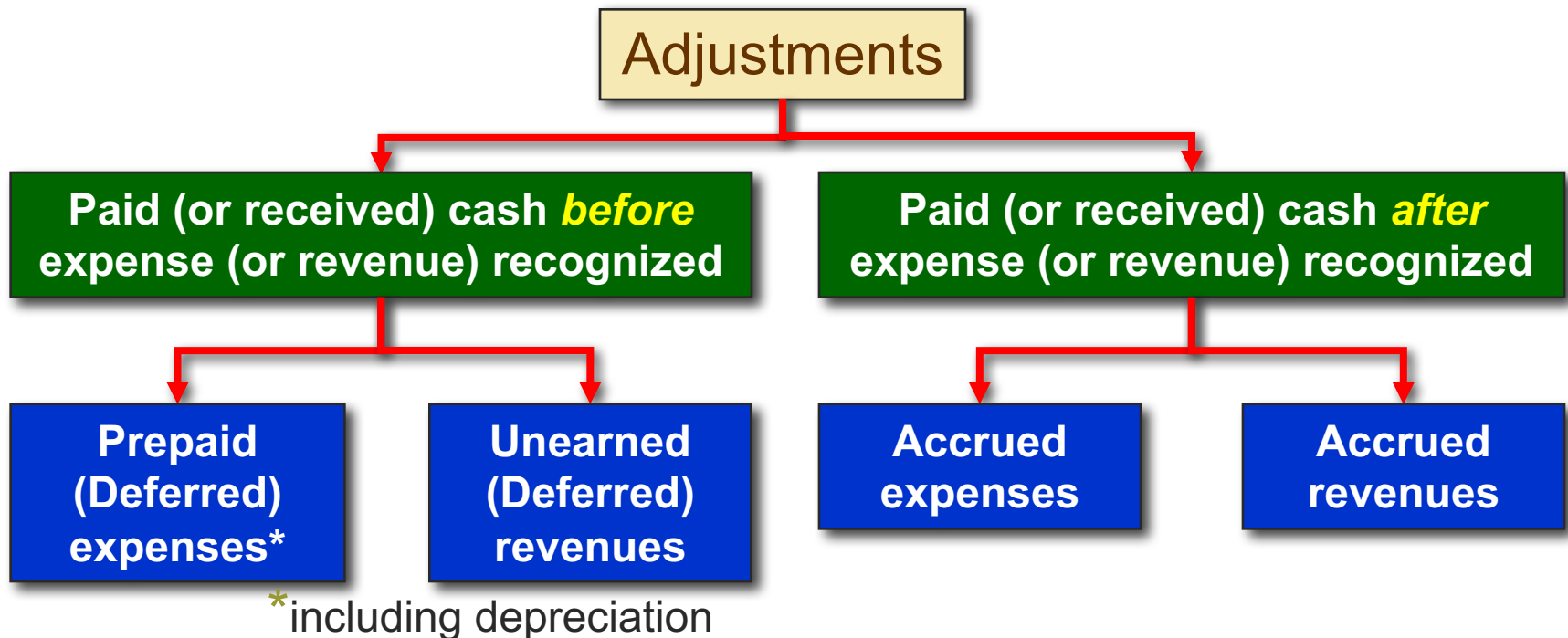
Insurance Expense 2013			
Jan	Feb	Mar	Apr
\$ 100	\$ 100	\$ 100	\$ 100
May	Jun	Jul	Aug
\$ 100	\$ 100	\$ 100	\$ 100
Sep	Oct	Nov	Dec
\$ 100	\$ 100	\$ 100	\$ -

On the accrual basis \$100 of insurance expense is recognized in 2011, \$1,200 in 2012, and \$1,100 in 2013. The expense is matched with the periods benefited by the insurance coverage.

# Adjusting Accounts

An adjusting entry is recorded to bring an asset or liability account balance to its proper amount.

## Framework for Adjustments



P1

# Prepaid (Deferred) Expenses

**Resources paid for prior to receiving the actual benefits.**

Here is the check for my first 6 months' insurance.



**Asset**

Unadjusted Balance

Credit Adjustment



**Expense**

Debit Adjustment



P1

# Supplies

During 2011, Scott Company purchased \$15,500 of supplies. Scott recorded the expenditures as Supplies. On December 31, a count of the supplies indicated \$2,655 on hand.

**What adjustment is required?**

<b>Dec. 31</b>	<b>Supplies Expense</b>	<b>12,845</b>	
	<b>Supplies</b>		<b>12,845</b>
		<i>To record supplies used during 2011</i>	

<b>Supplies</b>		<b>126</b>
<b>Bought</b>	<b>15,500</b>	<b>Dec. 31 12,845</b>
<b>Bal.</b>	<b>2,655</b>	

<b>Supplies Expense</b>		<b>652</b>
<b>Dec. 31</b>	<b>12,845</b>	

# Depreciation

Depreciation is the process of allocating the costs of plant assets over their expected useful lives.

$$\text{Straight-Line Depreciation Expense} = \frac{\text{Asset Cost} - \text{Salvage Value}}{\text{Useful Life}}$$



# Depreciation

On January 1, 2011, Barton, Inc. purchased equipment for \$62,000 cash. The equipment has an estimated useful life of 5 years and Barton expects to sell the equipment at the end of its life for \$2,000 cash.

Let's record depreciation expense for the year ended December 31, 2011.

$$\begin{array}{l} \text{2011} \\ \text{Depreciation} \\ \text{Expense} \end{array} = \frac{\$62,000 - \$2,000}{5} = \$12,000$$

# Depreciation

On January 1, 2011, Barton, Inc. purchased equipment for \$62,000 cash. The equipment has an estimated useful life of 5 years and Barton expects to sell the equipment at the end of its life for \$2,000 cash.

Let's record depreciation expense for the year ended December 31, 2011.

<b>Dec. 31</b>	<b>Depreciation Expense</b>	<b>12,000</b>	
	<b>Accumulated Depreciation - Equipment</b>		<b>12,000</b>
	<i>To record equipment depreciation</i>		

**Accumulated depreciation is a **contra asset** account.**





P1

# Depreciation

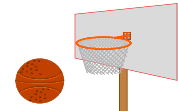
<b>BARTON, INC.</b>		
<b>Partial Balance Sheet</b>		
<b>At December 31, 2011</b>		
<b>Assets</b>		<b>\$</b>
<b>Cash</b>		
.		
<b>Equipment</b>	<b>\$ 62,000</b>	
<b>Less: accumulated deprec.</b>	<b><u>(12,000)</u></b>	<b>50,000</b>
.		
.		
<b>Total Assets</b>		<b><u><u>          </u></u></b>

Equipment is shown net of accumulated depreciation. This amount is referred to as the asset's book value.

P1

# Unearned (Deferred) Revenues

Cash received in advance of providing products or services.



Buy your season tickets for all home basketball games NOW!

*“Go Big Blue”*

Liability

Revenue

Debit Adjustment

Unadjusted Balance

Credit Adjustment



 P1

# Unearned (Deferred) Revenues

On October 1, 2011, Ox University sold 1,000 season tickets to its 20 home basketball games for \$100 each. Ox University makes the following entry:

<b>Oct. 1</b>	<b>Cash</b>	<b>100,000</b>	
	<b>Unearned Revenue</b>		<b>100,000</b>
	<i>Basketball revenue received in advance</i>		

## Unearned Revenue

Oct.1 100,000

P1

# Unearned (Deferred) Revenues

On December 31, Ox University has played 10 of its regular home games, winning 2 and losing 8.

<b>Dec. 31</b>	<b>Unearned Revenue</b>	<b>50,000</b>
	<b>Basketball Revenue</b>	<b>50,000</b>
	<i>To recognize 10-games of revenue</i>	

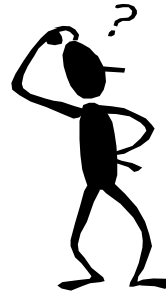
Unearned Revenue			
Dec. 31	50,000	Oct. 1	100,000
		Bal.	50,000

Basketball Revenue			
		Dec. 31	50,000

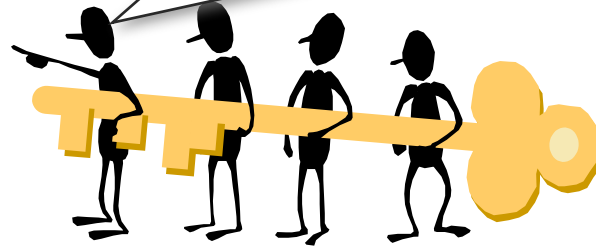
# Accrued Expenses

P1

Costs incurred in a period that are both unpaid and unrecorded.



We're about one-half done with this job and want to be paid for our work!



Expense

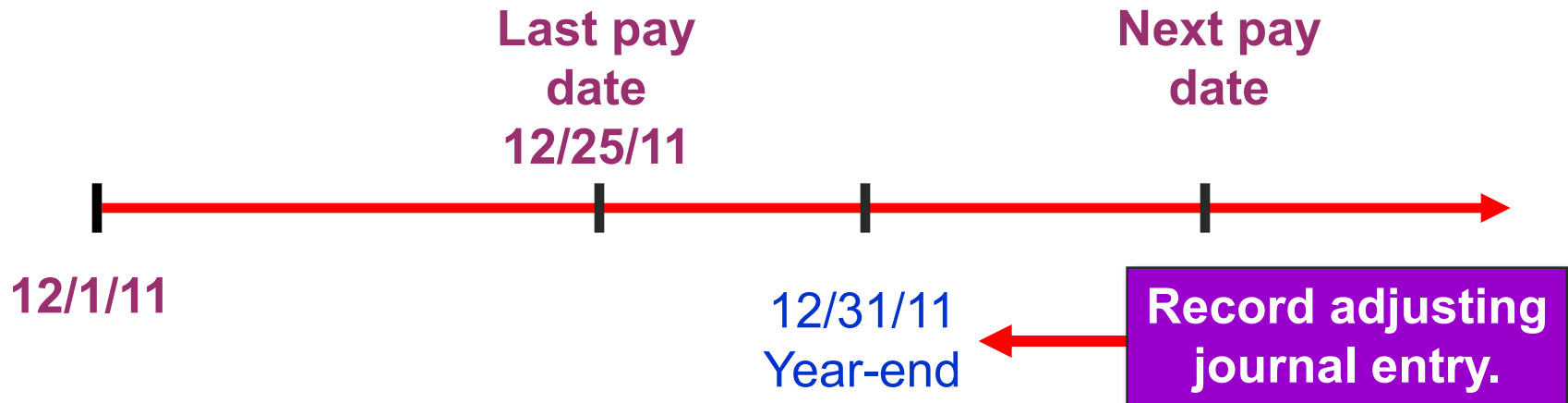
Debit Adjustment

Liability

Credit Adjustment

# Accrued Expenses

Barton, Inc. pays its employees every Friday. Year-end, 12/31/11, falls on a Thursday. As of 12/31/11, the employees have earned salaries of \$47,250 for Monday through Thursday.



# Accrued Expenses

Barton, Inc. pays its employees every Friday. Year-end, 12/31/11, falls on a Thursday. As of 12/31/11, the employees have earned salaries of \$47,250 for Monday through Thursday.

<b>Dec. 31</b>	<b>Salaries Expense</b>	<b>47,250</b>	
	<b>Salaries Payable</b>		<b>47,250</b>
	<i>To accrue 4-days' salary</i>		

<b>Salaries Expense</b>	
Other salaries	
	657,500
Dec. 31	47,250
<b>Bal.</b>	<b>704,750</b>

<b>Salaries Payable</b>	
Dec. 31	47,250

# Accrued Revenues

Smith & Jones, CPAs, had \$31,200 of work completed but not yet billed to clients. Let's make the adjusting entry necessary on December 31, 2011, the end of the firm's fiscal year.

<b>Dec. 31</b>	<b>Accounts Receivable</b>	<b>31,200</b>	
	<b>Service Revenue</b>		<b>31,200</b>
			<i>To accrue revenue earned</i>

Accounts Receivable	
Other receivables	
	1,325,268
Dec. 31	31,200
Bal.	1,356,468

Service Revenue	
Other revenues	
	6,589,500
Dec. 31	31,200
Bal .	6,620,700



A1

# Links to Financial Statements

## Summary of Adjustments and Financial Statement Links

### Before Adjustment

Type	Balance Sheet	Income	Adjusting Entry
	Account	Statement	
Prepaid Expenses	Asset Overstated Equity Overstated	Expense Understated	Dr. Expense Cr. Asset
Unearned Revenues	Liability Overstated Equity Understated	Revenue Understated	Dr. Liability Cr. Revenue
Accrued Expenses	Liability Understated Equity Overstated	Expense Understated	Dr. Expense Cr. Liability
Accrued Revenues	Asset Understated Equity Understated	Revenue Understated	Dr. Asset Cr. Revenue

# FastForward – Trial Balance - December 31, 2011

P2

	Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	3,950					
Accounts receivable	-					
Supplies	9,720					
Prepaid insurance	2,400					
Equipment	26,000	\$				
Accum. depr. - Equip.		-				
Accounts payable		6,200				
Salaries payable		-				
Unearned revenue		3,000				
Common Stock		30,000				
Retained Earnings		0				
Dividends	600					
Consulting revenue		5,800				
Rental revenue		300				
Depr. expense	-					
Salaries expense	1,400					
Insurance expense	-					
Rent expense	1,000					
Supplies expense	-					
Utilities expense	230					
<b>Totals</b>	<b>45,300</b>	<b>45,300</b>				

**First, the initial unadjusted amounts are added to the work sheet.**

P2

# FastForward – Recording Adjustments

## Trial Balance - December 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	3,950					
Accounts receivable	-		f	1,800		
Supplies	9,720			b	1,050	
Prepaid insurance	2,400			a	100	
Equipment	26,000					
Accum. depr. - Equip.		-		c	375	
Accounts payable		6,200				
Salaries payable		-		e	210	
Unearned revenue		3,000	d	250		
Common Stock		30,000				
Retained Earnings		0				
Dividends	600					
Consulting revenue		5,800		d	250	
				f	1,800	
Rental revenue		300				
Depr. expense	-		c	375		
Salaries expense	1,400		e	210		
Insurance expense	-		a	100		
Rent expense	1,000					
Supplies expense	-		b	1,050		
Utilities expense	230					
<b>Totals</b>	<b>\$45,300</b>	<b>\$45,300</b>		<b>\$3,785</b>	<b>\$3,785</b>	

**Next,  
FastForward's  
adjustments  
are added.**

P2

# FastForward – Computing the Adjusted Trial Balance - December 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	3,950				3,950	
Accounts receivable	-		f 1,800		1,800	
Supplies	9,720			b 1,050	8,670	
Prepaid insurance	2,400			a 100	2,300	
Equipment	26,000				26,000	
Accum. depr. - Equip.		-		c 375		375
Accounts payable		6,200				6,200
Salaries payable		-		e 210		210
Unearned revenue		3,000	d 250			2,750
Common Stock		30,000			-	30,000
Retained Earnings		-				-
Dividends	600				600	
Consulting revenue		5,800		d 250 f 1,800		7,850
Rental revenue		300				300
Depr. expense	-		c 375		375	
Salaries expense	1,400		e 210		1,610	
Insurance expense	-		a 100		100	
Rent expense	1,000				1,000	
Supplies expense	-		b 1,050		1,050	
Utilities expense	230				230	
<b>Totals</b>	<b>\$45,300</b>	<b>\$45,300</b>	<b>\$3,785</b>	<b>\$3,785</b>	<b>\$47,685</b>	<b>\$47,685</b>

**Finally, the totals are determined.**

# 1. Prepare Income Statement

## Adjusted Trial Balance December 31, 2011

	Dr.	Cr.
Cash	\$ 3,950	
Accounts receivable	1,800	
Supplies	8,670	
Prepaid insurance	2,300	
Equipment	26,000	
Accum. depr. - Equip.		\$ 375
Accounts payable		6,200
Salaries payable		210
Unearned revenue		2,750
Common Stock		30,000
Retained Earnings		-
Dividends	600	
Consulting revenue		7,850
Rental revenue		300
Depr. expense	375	
Salaries expense	1,610	
Insurance expense	100	
Rent expense	1,000	
Supplies expense	1,050	
Utilities expense	230	
<b>Totals</b>	<b>\$ 47,685</b>	<b>\$ 47,685</b>

## FASTFORWARD

### Income Statement

For the Month Ended December 31, 2011

#### Revenues:

Consulting revenue	\$ 7,850
Rental revenue	300

#### Operating expenses:

Depr. expense - Equip.	\$ 375
Salaries expense	1,610
Insurance expense	100
Rent expense	1,000
Supplies expense	1,050
Utilities expense	230

<b>Total expenses</b>	<b>4,365</b>
<b>Net income</b>	<b>\$ 3,785</b>

P3

## 2. Prepare Statement of Retained Earnings

**Note that net income from the Income Statement carries to the Statement of Retained Earnings.**

<b>FASTFORWARD</b>	
<b>Income Statement</b>	
<b>For the Month Ended December 31, 2011</b>	
<b>Revenues:</b>	
Consulting revenue	\$ 7,850
Rental revenue	300
<b>Total Revenues</b>	<b>8,150</b>
<b>Operating expenses:</b>	
Depr. expense - Equip. \$	375
Salaries expense	1,610
Insurance expense	100
Rent expense	1,000
Supplies expense	1,050
Utilities expense	230
<b>Total expenses</b>	<b>4,365</b>
<b>Net income</b>	<b>\$ 3,785</b>

<b>FASTFORWARD</b>	
<b>Statement of Retained Earnings</b>	
<b>For the Month Ended December 31, 2011</b>	
Retained earnings, 12/1/11	\$ -0-
<b>Add: Net income</b>	<b>3,785</b>
<b>Less: Dividends</b>	<b>600</b>
<b>Retained earnings 12/31/11</b>	<b>\$ 3,185</b>

P3

# 3. Prepare Balance Sheet

## Adjusted Trial Balance

Dr. Cr.

Cash	\$ 3,950	
Accounts receivable	1,800	
Supplies	8,670	
Prepaid insurance	2,300	
Equipment	26,000	
Accum. depr. - Equip.		\$ 375
Accounts payable		6,200
Salaries payable		210
Unearned revenue		2,750

## FASTFORWARD

### Statement of Retained Earnings

For the Month Ended December 31, 2011

Retained earnings, 12/1/11	\$ -0-
Add: Net income	3,785
Less: Dividends	600
<b>Retained earnings 12/31/11</b>	<b>\$ 3,185</b>

## FASTFORWARD Balance Sheet December 31, 2011

### Assets

Cash		\$ 3,950
Accounts receivable		1,800
Supplies		8,670
Prepaid insurance		2,300
Equipment	26,000	
Less: accum. depr.	(375)	
<b>Total assets</b>		<b>\$ 42,345</b>

### Liabilities

Accounts payable	\$ 6,200	
Salaries payable	210	
Unearned revenue	2,750	
<b>Total liabilities</b>		<b>\$ 9,160</b>

### Equity

Common stock		30,000
Retained earnings		3,185
<b>Total liabilities and equity</b>		<b>\$ 42,345</b>

# The Closing Process: Temporary and Permanent Accounts

Temporary (nominal) accounts accumulate data related to one accounting period. They include all income statement accounts, the dividends account, and the Income Summary account. These accounts are “closed” at the end of the period to get ready for the next accounting period.

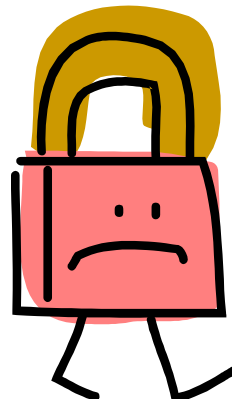


Permanent (real) accounts report activities related to one or more future accounting periods. They carry ending balances to the next accounting period and are not “closed.”



# Recording Closing Entries

1. Close **revenue** accounts.
2. Close **expense** accounts.
3. Close **income summary** account.
4. Close **dividends** account.



# Recording Closing Entries

**Salaries Expenses**

\$ 18,100

**Consulting Revenues**

\$ 25,000

**Examine the  
accounts  
presented.**

**Income Summary**

**Retained Earnings**

\$ 7,000

# Recording Closing Entries

## Salaries Expenses

\$ 18,100

## Consulting Revenues

\$ 25,000

\$ 25,000

## Income Summary

\$ 25,000

**Close revenues  
with a debit to the  
revenue account  
and a credit to  
Income Summary.**

# Recording Closing Entries

## Salaries Expenses

\$ 18,100

\$ 18,100

## Consulting Revenues

\$ 25,000

\$ 25,000

## Income Summary

\$ 18,100

\$ 25,000

**Close expense accounts with a credit to expenses and a debit to Income Summary.**

# Recording Closing Entries

## Salaries Expenses

\$ 18,100

\$ 18,100

## Consulting Revenues

\$ 25,000

\$ 25,000

## Income Summary

\$ 18,100

\$ 25,000

\$ 6,900

**Determine the  
balance in the  
Income Summary  
account.**

# Recording Closing Entries

## Salaries Expenses

\$ 18,100	\$ 18,100
-----------	-----------

**Close the Income Summary to Retained Earnings.**

## Income Summary

\$ 18,100	\$ 25,000
<b>\$ 6,900</b>	\$ 6,900

## Retained Earnings

\$ 7,000
<b>\$ 6,900</b>

# Recording Closing Entries

The dividends account is closed to Retained Earnings.

Dividends		Retained Earnings	
\$ 2,000	<b>\$ 2,000</b>	<b>\$ 2,000</b>	\$ 7,000
			6,900

# Recording Closing Entries

The dividends account is closed to Retained Earnings.

Dividends		Retained Earnings	
\$ 2,000	\$ 2,000	\$ 2,000	\$ 7,000
			6,900
			<b>\$ 11,900</b>

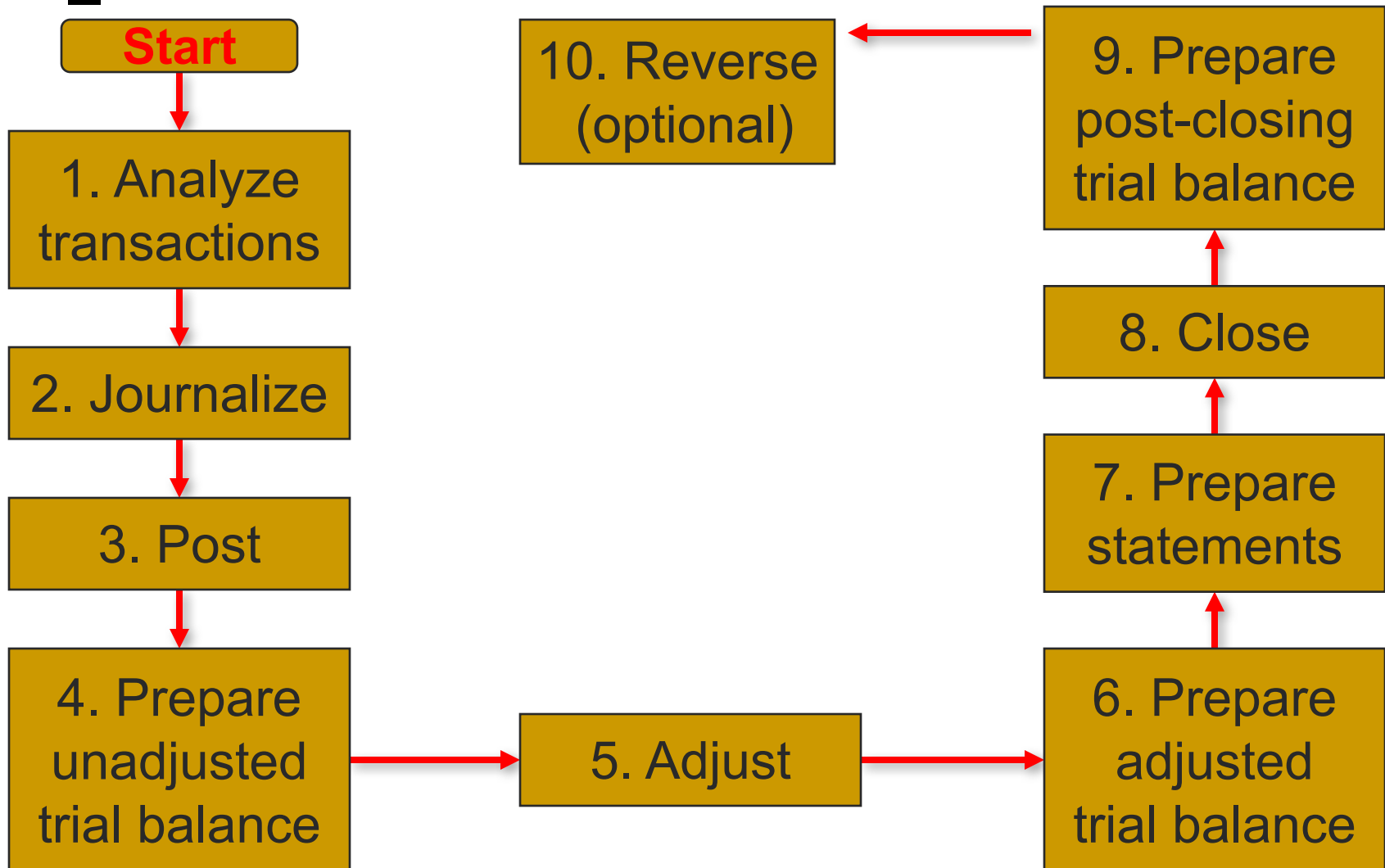
**Determine the ending balance in Retained Earnings.**



# Post-Closing Trial Balance

- Trial balance prepared after the closing entries have been posted.
- The purpose is to ensure that all nominal or temporary accounts have been closed.
- The only accounts on this trial balance should be assets, liabilities, and equity accounts.

# The Accounting Cycle



# Classified Balance Sheet

## Assets

**Current assets**

**Noncurrent assets:**

**Long-term investments**

**Plant assets**

**Intangible assets**

## Liabilities and Equity

**Current liabilities**

**Noncurrent liabilities**

**Equity**

Current items are those expected to come due (either collected or owed) within one year or the company's *operating cycle*, whichever is *longer*.

# Classified Balance Sheet

## Plant Assets

Tangible assets that are both long lived and used to produce or sell products or services. Examples include equipment, machinery, buildings, and land that are used to produce or sell products and services.

## Intangible Assets

Long-term resources that benefit business operations. They usually lack physical form and have uncertain benefits. Examples include patents, trademarks, copyrights, franchises, and goodwill.

# Liabilities

## Current Liabilities

Obligations due to be paid or settled within one year or the operating cycle, whichever is longer.

## Long-Term Liabilities

Obligations not due within one year or the operating cycle, whichever is longer.

# Classified Balance Sheet

<b>FASTFORWARD</b>		
<b>Balance Sheet</b>		
<b>December 31, 2011</b>		
<b>Assets</b>		
<b>Current Assets</b>		
Cash		\$ 3,950
Accounts receivable		1,800
Supplies		8,670
Prepaid insurance		2,300
<b>Total Current Assets</b>		<b>16,720</b>
<b>Plant Assets</b>		
Equipment	26,000	
Less: accum. depr.	(375)	25,625
<b>Total assets</b>		<b>\$ 42,345</b>
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 6,200	
Salaries payable	210	
Unearned revenue	2,750	
<b>Total liabilities</b>		<b>\$ 9,160</b>
<b>Equity</b>		
Common stock		30,000
Retained earnings		3,185
<b>Total liabilities and equity</b>		<b>\$ 42,345</b>

A2

# Profit Margin

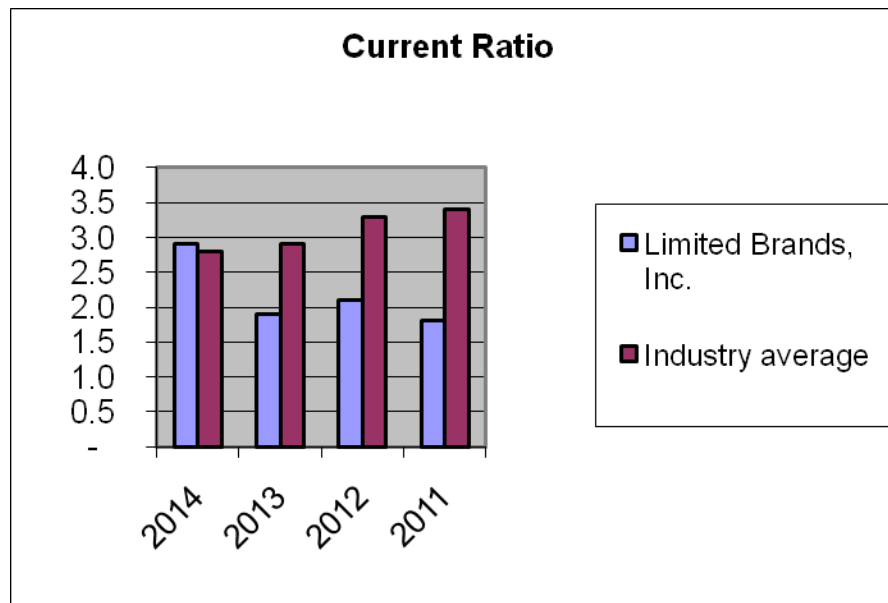
The profit margin ratio measures the company's net income to net sales.

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Net sales}}$$

# Current Ratio

This ratio is an important measure of a company's ability to pay its short-term obligations.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$





# End of Chapter 03

