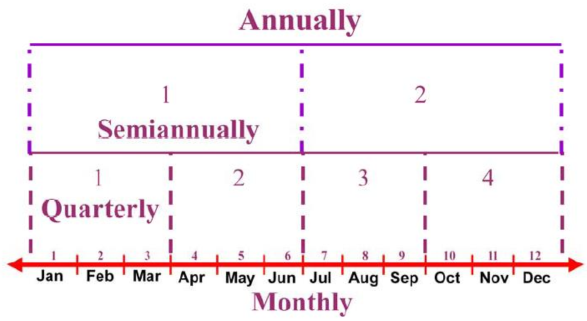
CHAPTER 3: PREPARING FINANCIAL STATEMENTS

I. TIMING AND REPORTING

A. The Accounting Period

- **Time period assumption—**an organization's activities can be divided into specific time periods.



- Examples: a month, a three-month quarter, a six-month interval, or a year
- **Accounting (Reporting) periods—**length of time covered by financial statements.
- Most companies use a year as their primary accounting period.
- **Annual financial statements—**reports covering a one-year period.
- **Interim financial statements—**covering one, three, or six months of activity.
- Many companies prepare interim financial statements.
- **Calendar year—**January to December.
- **Fiscal year—**consisting of any 12 consecutive months.
- Example: Gap's fiscal year starts in February of one year and goes till the end of January the next year.
- **Natural business year—**businesses will end their year at their lowest level of the year.
- When financial statements are prepared, to keep statements accurate within this time period assumption, certain adjustments need to be made to the statements.

❖ **EXAMPLE:** You are the owner of a heavy construction company that does major, long-term projects. You sign a contract to build the new school indoor pool facility.

The cost of the building is $1,000,000 and it is built over 2 years (2010 and 2011).

You receive $900,000 of the proceeds in 2011 when the building is done, but on **fiscal year** December 31, 2010 you prepare your 2010 financial statements to renew your insurance with the bonding company.

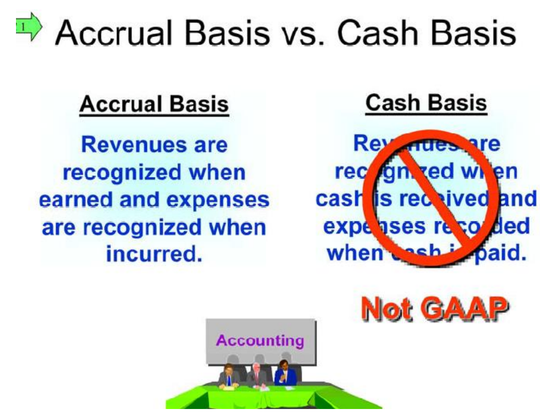
So, how much revenue would you report in 2010?

If you only reported the $100,000 ($1,000,000-900,000) in 2010 you most likely would be GROSSLY UNDERSTATING your revenue for the year.

When we divide business activities into arbitrary fixed periods of time, it is often necessary to have special accounting for transactions that cross from one time period to the next.

B. **Accrual verses Cash Basis**

1. **Accrual Basis Accounting**



- ❖ It uses the adjusting process to recognize revenues when earned and expenses when incurred (matched with revenues).
- ❖ It's a system of accounting in which revenues and expenses are recognized when they are earned and incurred as opposed to when cash is actually received or paid.
- ❖ It better reflects business performance.
- ❖ It also increases the comparability of financial statements from one period to another.

2. **Cash Basis Accounting**

- ❖ Recognizes revenues when cash is received and records expenses when cash is paid.
- ❖ Up until now, we have focused on cash basis accounting, which is used for some small businesses where the difference would be immaterial for tax purposes, but is not GAAP.

- Cash basis is not consistent with GAAP.

- Is useful for several business decisions—which is the reason companies must report a Statement of Cash Flows.

2. Accrual VS Cash Example

Accrual Example:

FastForward paid $2,400 for 24 months of insurance coverage beginning on December 1, 2009.

Accrual requires that $100 of insurance expense be reported on December's Income Statement. Another $1,200 of expense is reported in year 2010. The remaining $1,100 is reported as expense in the first 11 months of 2011.

The accrual basis Balance Sheet reports any unexpired premium as a Prepaid Insurance asset.

Accrual Accounting for Allocating Prepaid Insurance to Expense

Cash Basis Example:

A cash basis Income Statement for December 2009 reports Insurance Expense of $2,400. The Income Statements for years 2010 and 2011 report NO Insurance Expense.

The cash basis Balance Sheet NEVER reports an insurance asset because it is IMMEDIATELY expensed.

The cash basis income for 2009-2011 FAILS to match the cost of insurance with the insurance benefits received for those years and months.

Cash Accounting for Allocating Prepaid Insurance to Expense

C. **Recognizing Revenues and Expenses**

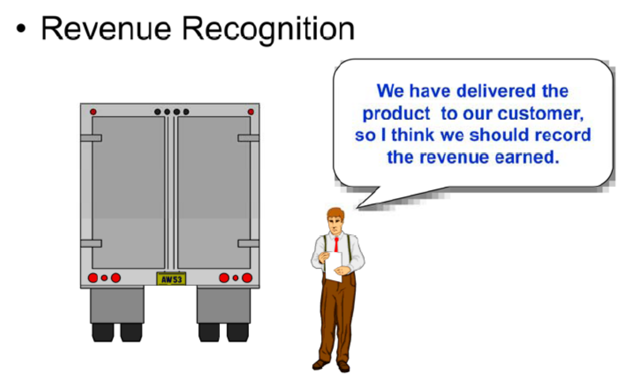
❖ With ACCRUAL BASIS, we recognize REVENUE when the product or service is delivered to our customer.

❖ Under the ACCRUAL BASIS, EXPENSES are recognized in the same period as the affiliated sale.

❖ The adjusting process helps us match the expenses incurred to generate the revenue recorded from the sales transaction.

❖ <u>We rely on two principles in the "adjusting process"</u>: Revenue Recognition and Matching.

1. Revenue Recognition Principle



❖ Requires that revenue be recorded WHEN EARNED, not before and not after.

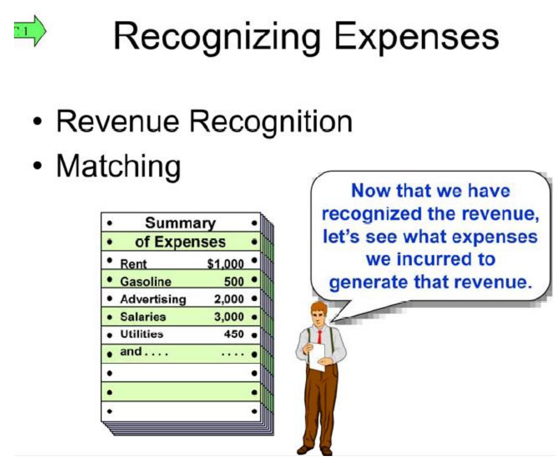
❖ The goal is to have the revenue reported in the time period when it is earned.

❖ <u>Revenue is recognized on the books of a company when two criteria are met</u>:

1) The earnings process is substantially complete.

2) Cash has either been collected or the collectability is reasonably assured.

2. Matching Principle



❖ Aims to record expenses in the same accounting period as the revenues that are earned as a result of those expenses.

❖ Matching expenses with revenues often requires us to predict certain events.

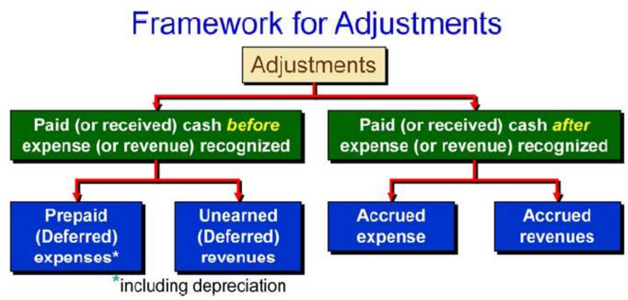
❖ When we use financial statements, we must understand that they require estimates and therefore include measures that are not precise.

❖ The concept that ALL costs and expenses that are incurred to generate revenues must be recognized in the same period as the revenues.

II. ADJUSTING ACCOUNTS

❖ **Adjusting Entry—**is recorded to bring an asset or liability account balance to its proper amount; it also updates a related expense or revenue account.

1. Framework for Adjustments



❖ Adjustments are necessary for transactions and events that extend over more than one period.

❖ At the end of the accounting period, which is generally the end of the fiscal year, to comply with GAAP and accrual accounting→companies make adjusting journal entries in order to reconcile income and expense recognition WHEN EARNED AND INCURRED according to GAAP, not necessarily when cash is received or paid.

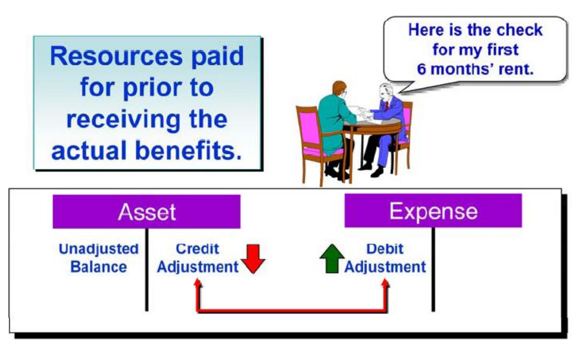
❖ All adjusting entries ultimately fall into one of 4 different categories as shown on the above graphic.

❖ <u>There are two broad categories of adjustments</u>:

1) When we pay or receive cash BEFORE the expense or revenue is recognized. This category includes prepaid or deferred expenses (including depreciation), and unearned or deferred revenues.

2) When cash is paid or received AFTER the expense or revenue is recognized. These are some very common adjustments. The category includes accrued expenses and accrued revenues.

2. Prepaid (Deferred) Expenses



❖ Are items paid for in advance of receiving their benefits.

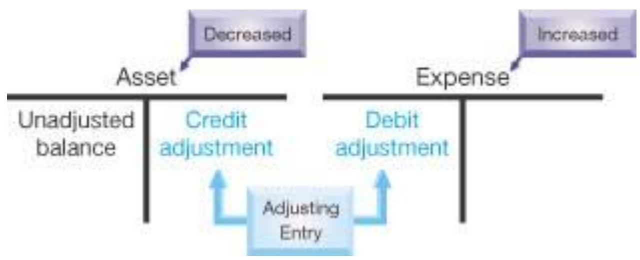
❖ You pay for something before it provides you a benefit.

❖ Prepaid expenses are assets. When these assets are used, their cost becomes expenses.

- A prepaid account is an asset, because when one pays an expense, you are giving something up that you own, so when making an adjusting entry to recognize a prepaid expense you are just reclassifying cash (an asset) that is paid out to another type of asset (prepaid).

- You still own the cash even though the vendor has it, because the service that justifies the expense has not been performed yet.

Adjusting for Prepaid Expenses



1. **Prepaid Insurance {Adjustment (a)}**

   - **<u>EXAMPLE</u>:** On December 1, we have to make a journal entry to recognize the cash paid out. Since we still OWN the cash, our total assets should not drop. We need to reclassify the cash paid to a Prepaid Expense as follows:

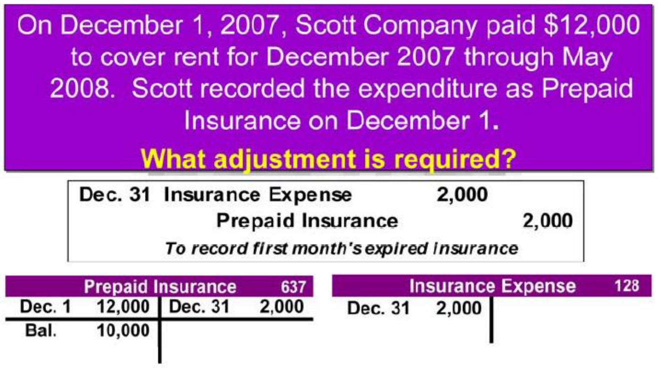
December 1	**Prepaid Insurance**	**12,000**	
	Cash		**12,000**
	Paid a 6 month insurance policy in advance.		

***This is the INITIAL ENTRY when you paid for the insurance in advance..NOT the adjustment.*

At the end of the year (Dec. 31), 1 of the 6 months of the insurance policy has been used. Therefore the insurance company has earned 2/6 of the policy premium, or $2,000. So we need to recognize an expense for the portion expired and decrease our asset (prepaid) as follows:

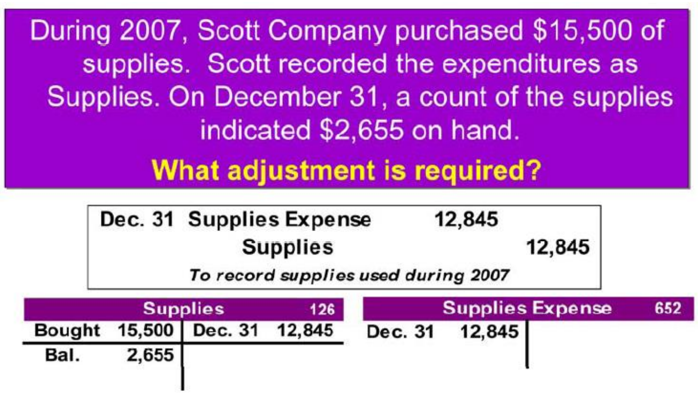
December 31	**Insurance Expense**	**2,000**	
	Prepaid Insurance		**2,000**
	To adjust & record insurance expense for 1 month.		

- See the graphic below for the actual adjustment {**Adjustment (a)**}



2. **Supplies** {**Adjustment (b)**}

- Supplies works in the same manner.



- At the beginning of the year, this company purchases (owed) $15,500 of supplies.

- When the company owns supplies, they are assets and go on the balance sheet.

- As these supplies are used, the company no longer owns them and must remove them from the balance sheet.

- The adjusting entry removes the asset used off the balance sheet and decreases the company's net worth (equity) through and expense—supplies expense.

3. **Depreciation** {**Adjustment (c)**}

- ❖ **Plant asset—**long-term tangible assets used to produce and sell products and services.

- ❖ Plant assets are expected to provide benefits for more than one period.

- ❖ <u>Examples</u>: buildings, machines, vehicles, and fixtures.

- ❖ All plant assets eventually wear out or decline in usefulness.

- ❖ **EXCEPTION:** Land

- ❖ **Depreciation—**is the process of allocating the costs of these assets over the expected useful lives.

- ❖ Depreciation is recorded with an adjusting entry similar to that for other prepaid expenses.

- ❖ **Straight-line depreciation—**allocates equal amounts of the asset's net cost to depreciation during its useful life.

- ❖ Straight-line depreciation is the most popular method used by companies.

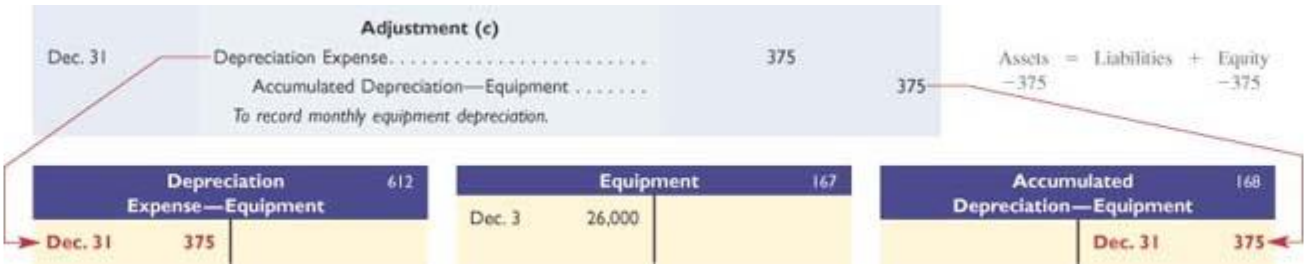
$$\text{Straight-Line Depreciation Expense} = \frac{\text{Asset Cost} - \text{Salvage Value}}{\text{Useful Life}}$$

- ❖ They determine the amount of annual depreciation by taking the **cost of the plant assets**, subtracting the **estimated salvage value** and dividing that amount by the **useful life of the asset**.

- ❖ **Salvage value—**an asset's expected value when we dispose of it at the end of its useful life.

  <u>Example:</u> Dividing the $18,000 net cost by the 48 months in the asset's useful life gives a monthly cost of $375 ($18,000/48).

<u>The following highlights the adjustment for depreciation</u>: {**Adjustment (c)**}

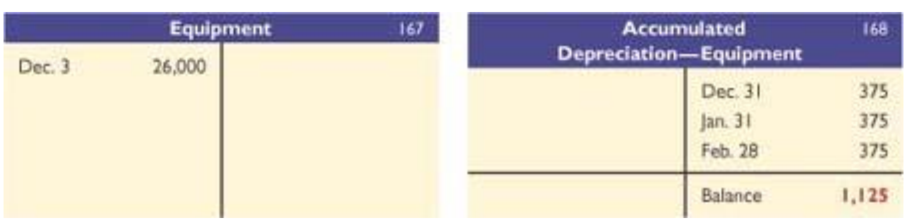


Before Adjustment	Adjustment	After Adjustment
Equipment, net = $26,000	**Deduct $375 from Equipment, net** **Add $375 to Depreciation Expense**	**Equipment, net = $25,625**
Reports $26,000 in equipment.	Record $375 in depreciation and $375 as accumulated depreciation, which is deducted from equipment.	Reports $25,625 in equipment, net of accumulated depreciation.

- **Contra account—**is an account linked with another account, it has an opposite normal balance, and it is reported as a subtraction from that other account's balance.

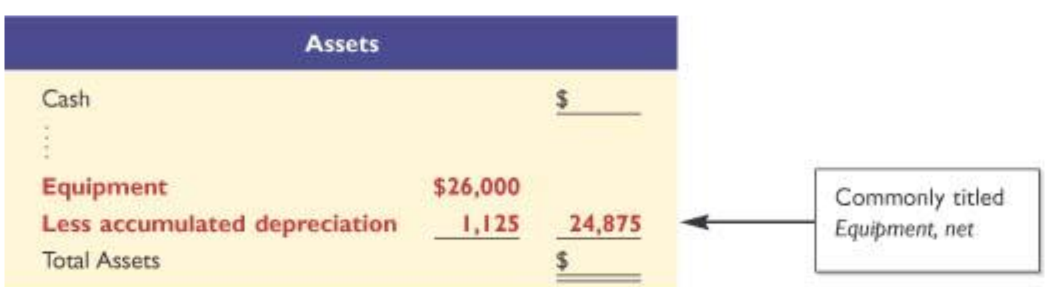
- Accumulated depreciation is kept in a separate "contra account" called Accumulated Depreciation.

Accounts after Three Months of Depreciation Adjustments

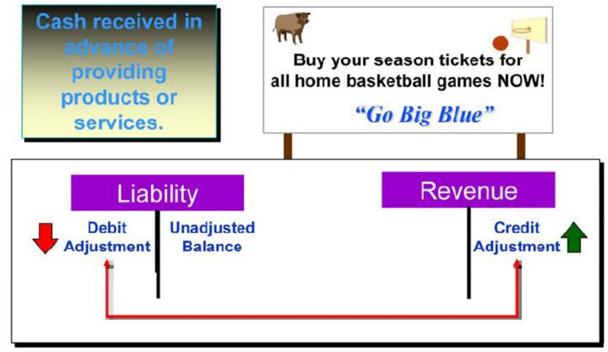


- **Book value (net amount)—**equals the asset's cost less its accumulated depreciation.

Equipment and Accumulated Depreciation on February 28 Balance Sheet



4. Unearned (Deferred) Revenue {Adjustment (d)}



- **Unearned (deferred) revenues—**refers to cash received in advance of providing products and services.

- They are liabilities.

- You collect money before you earn it.

- **<u>EXAMPLE</u>**: you are a landscaper, and a customer of yours goes to Italy for a two month vacation. Before your customer goes, s/he gives you $100 cash to cover all grass cuttings while gone.

  You can't recognize it until you actually earn it, until you earn it, you might have the $100, but it's not yours.

  Since it is not yours and is still your customers, even though it's in your possession, it's a liability to you until you cut the grass and earn it. Hence, unearned revenue.

  Since you're increasing a liability, you would have to credit the account as follows:

December 10	**Cash**	**100**	
	Unearned Revenue		**100**
	Received revenue in advance.		

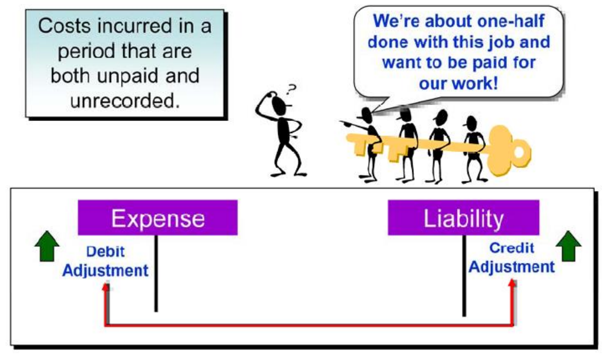
  AFTER you collect the money, you CUT THE GRASS one time a week later, it costs the customer that paid you in advance $10 per cutting. Therefore, $10 of the unearned revenue that you collected becomes revenue actually earned. Here's the journal entry:

December 20	**Unearned Revenue**	**10**	
	Revenue		**10**
	Adjusting entry to recognize revenue for one grass cutting.		

5. Accrued Expenses

- **Accrued expenses—**refer to costs that are incurred in a period but are both unpaid and unrecorded.

- They are expenses that are incurred during the accounting period, but the cash has not been paid out at the end of the period.



- Since the cash is not paid out, you owe it as of the end of the year and have generated a liability (the credit half of the journal entry).

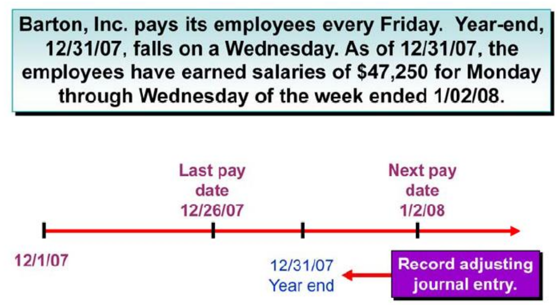
- They must be reported on the income statement of the period when incurred.

- <u>Example</u>: Payroll (Salaries) Expense

- For all accrued expense adjusting entries, we debit, or increase an expense account, and credit, or increase, a liability account.

1. Accrued Salaries Expense {**Adjustment (e)**}

- **EXAMPLE:** Barton, Inc. pays its employees every Friday. The current year end, December 31st, 2007, falls on a Wednesday.

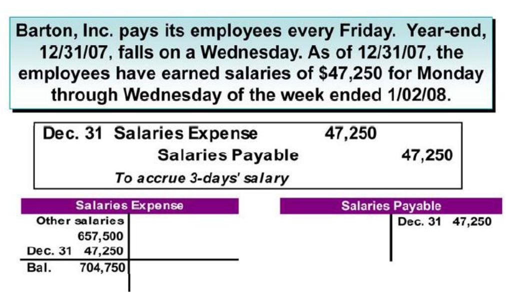
  As of December 31, 2007, the employees have earned salaries of $47,250 that will not be paid until the following Friday, January 2, 2008.

  We need to record an adjusting entry on December 31, 2007, to recognize the salaries earned by employees but not paid.

  In our adjusting journal entry we will debit, or increase, salaries expense and credit, or increase, salaries payable.

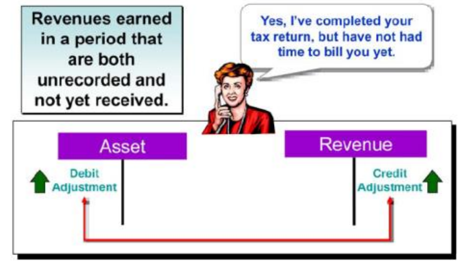
  After the adjustment, salaries expense for 2007 is stated properly.

  Salaries expense recorded during the year amounted to $657,500. After posting our adjusting entry, the new balance at the end of the year is $704,750.

  The salaries payable account will be eliminated when the employees are paid on January 2, 2008.

6. Accrued Revenues

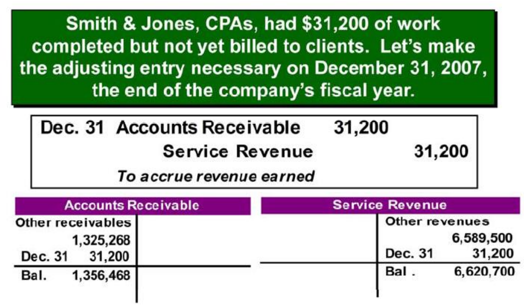


- **Accrued revenues—**refers to revenues earned in a period that are both unrecorded and not received in cash (or other assets).

- Example: a technician who bills customers only when the job is done. If one-third of a job is complete by the end of a period, then the technician must record one-third of the expected billing as revenue in that period—even though there is no billing or collection.

1. Accrued Services Revenue {**Adjustment (f)**}

- Accrued revenues are not recorded until adjusting entries are made at the end of the accounting period.



- They are earned by unrecorded because either the buyer has not yet paid for them or the seller has not yet billed the buyer.

- To record accrued revenue, we will always debit, or increase, an asset account and credit, or increase, a revenue account.

- Example: common accrued revenues are interest on CD's and investments.

- **EXAMPLE:** You own a snowplowing business. You plow a customer's driveway on the last day of the accounting period (12/31) but you don't send out the bill until the next period (after 1/1).

  The snowplower would want to recognize the revenue on 12/31, when s/he actually performed the service. Since no cash has yet been collected, we must make an adjusting entry to recognize this revenue.

  Assume it cost $20 to plow the driveway, the journal entry is as follows:

December 31	**Accounts Receivable**	**20**	
	Snowplowing Revenue		**20**
	To adjust and record revenue earned but not received.		

  Since you have earned value, but you still have not received cash, you have generated a new asset (receivable), the debit half of your journal entry.

Summary of Adjustments and Financial Statement Links

Category	BEFORE Adjusting: Balance Sheet	BEFORE Adjusting: Income Statement	Adjusting Entry
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

* For depreciation, the credit is to Accumulated Depreciation (contra asset).

† Exhibit assumes that prepaid expenses are initially recorded as assets and that unearned revenues are initially recorded as liabilities.

7. Adjusted Trial Balance

- ✪ The adjusted trial balance combines the "unadjusted" trial balance account balances with the adjustments we make.
- ✪ **Be careful when doing the math!**
- ✪ For example, look at **Entry b**. It is the entry to adjust the supplies account for the physical inventory taken at the year end.

P2

FastForward - Trial Balance - December 31, 2007

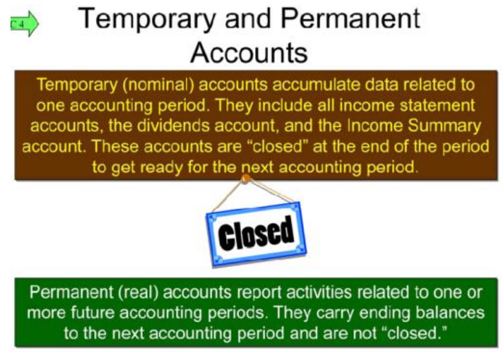
	Unadjusted Trial Balance Dr.	Unadjusted Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.
Cash	3,950				3,950	
Accounts receivable	-		f 1,800		1,800	
Supplies	9,720			b 1,050	8,670	
Prepaid insurance	2,400			a 100	2,300	
Equipment	26,000				26,000	
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	
Totals	$45,300	$45,300	$3,785	$3,785	$47,685	$47,685

Finally, the totals are determined.

- ✪ The supplies account on the "unadjusted" trial balance is $9,720. Our adjustment reduced the supplies on hand, so the adjusted trial balance account is $8,670.

III. CLOSING PROCESS

A. Temporary and Permanent Accounts



- ✪ **Temporary (or Nominal) accounts—**are income statement accounts that get closed out at the end of the period.
- ✪ They are temporary accounts that are brought to zero at the end of the accounting cycle.
- ✪ <u>They include</u>: all income statement accounts, the dividends account, and the Income Summary account.
- ✪ **Permanent (or Real) accounts—**are balance sheet accounts whose account balances are from the end of one period are carried over into the next period.
- ✪ Retained Earnings are accumulated income from prior periods.
- ✪ At the end of the accounting cycle, we must make one final adjustment to move the accounts that make up income into retained earnings hence; we must zero out all income statement accounts (revenue and expense) and move their balance to retained earnings.
- ✪ The income statement accounts that get closed out at the end of the period.
- ✪ The assets, liabilities and equity accounts are NOT CLOSED.

B. Recording Closing Entries

- ✪ **You MUST follow these steps IN ORDER, or there will be much confusion.**

1. **Step 1: Close Credit Balances in Revenue Accounts to Income Summary**
   - ✪ We close all revenue accounts into the Income Summary account.
   - ✪ We move the balance in all revenue accounts from the account to the Income Summary.

- ✪ This process will cause all revenue accounts to have a zero balance.
- ✪ Remember that revenue accounts normally have a credit balance.

2. **Step 2: Close Debit Balances in Expense Accounts to Income Summary**
   - ✪ We close all expense accounts to the Income Summary account.
   - ✪ This will zero out all of our expense accounts.
   - ✪ Expense accounts normally have a debit balance.

3. **Step 3: Close Income Summary to Retained Earnings**
   - ✪ The Income Summary account will show revenues and expenses, or in other words, the net income.
   - ✪ We must close the Income Summary account which contains the net income.
   - ✪ This process will zero out the Income Summary account.

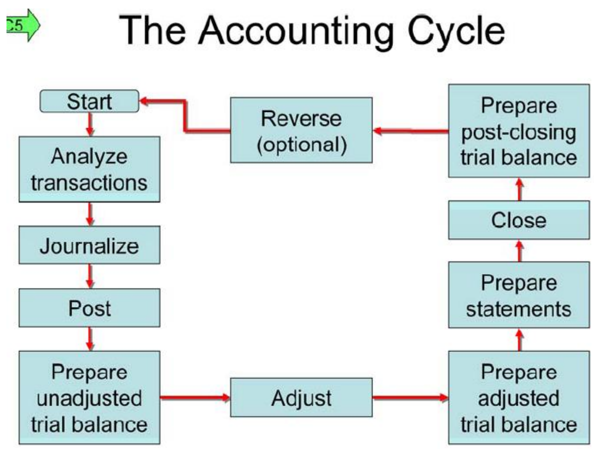
4. **Step 4: Close Dividends Account to Retained Earnings**
   - ✪ We then close the dividends account to the retained earnings account.
   - ✪ This will cause the dividends account to have a zero balance.

C. Post-Closing Trial Balance

- ✪ **Post-closing trial balance—**is a list of permanent accounts and their balance from the ledger after all closing entries have been journalized and posted.

D. Accounting Cycle Summary

- ✪ **Accounting cycle—**refers to the steps in preparing financial statements.
- ✪ It is called a "cycle" because the steps are repeated each reporting period.
- ✪ This following is a schematic of the entire accounting process. Some of the steps, like the preparation of reversing entries have been omitted from this course because they are optional.



IV. CLASSIFIED BALANCE SHEET

- **Unclassified balance sheet—**is one whose items are broadly grouped into assets, liabilities, and equity.

- **Classified balance sheet—**organizes assets and liabilities into important subgroups that provide more information to decision makers.

A. Classification Structure

- **Operating cycle—**is the time span from when CASH IS USED to acquire goods and services until CASH IS RECEIVED from the sale of goods and services.

- Operating refers to company operations.

- Cycle refers to the circular flow of cash used from company inputs and then cash received from its outputs.

B. Classification Categories

1. Current Assets

- Are cash and other resources that are expected to be sold, collected, or used within one year or the company's operating cycle, whichever is longer.

2. Long-Term (or Noncurrent) Investments

- Examples: notes receivable, investments in stocks and bonds, and land

3. Plant Assets

- ✪ Are tangible assets that are both long lived and used to produce or sell products and services.
- ✪ Examples: equipment, machinery, buildings, and land

4. Intangible Assets

- ✪ Are long-term resources that benefit business operations, usually lack physical form, and have uncertain benefits.
- ✪ Examples: patents, trademarks, copyrights, franchises

5. Current Liabilities

- ✪ Are obligations due to be paid or settled within one year or the operating cycle, whichever is longer.
- ✪ They often include: accounts payable, notes payable, wages payable, taxes payable, interest payable, and unearned revenues.

6. Long-Term Liabilities

- ✪ Are obligations NOT due within one year or the operating cycle, whichever is longer.
- ✪ Examples: notes payable, mortgages payable, bonds payable, and lease obligations

7. Equity

- ✪ Are Common Stock and Retained Earnings.