

Dutchess Community College
ACC 104 – Financial Accounting
Quiz Prep Chapter 4
Accrual Accounting Concepts

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Disclaimer

This *Quiz Prep* is provided as an outline of the key concepts from the chapter.

It is not intended to be comprehensive or exhaustive.

Quizzes may include material from the classroom lectures, the text or the homework assignments.

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Accounting Basis

There are two basis of accounting:

Cash Basis

- Revenues are recognized when cash is received
- Expenses are recognized when cash is paid

Accrual Basis

Whether or not cash is exchanged is irrelevant:

- Revenues are recognized when earned
- Expenses are recognized when incurred

Accrual Basis Accounting = GAAP Accounting

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2 (More) GAAP

Revenue Recognition Principle

Revenues are recognized (earned) when the service is performed or the goods delivered regardless of when or if they are paid for.

Matching Principal

Expenses must be matched with the revenues in the periods when efforts are made to generate revenues.

Revenue Recognition + Matching = Accrual Accounting

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General Process


Recall from Chapter 3:

- 1 – **Analyze:**
 - Is there an economic impact?
 - If yes, what accounts are affected?
- 2 – **Prepare Journal Entries:**
 - Chronological Order (diary)
 - Different journals: general, cash, etc.
- 3 – **Post to General Ledger:**
 - “Page” for each account
- 4 – **Prepare a Trial Balance:**
 - Ensure that *debits* still equal *credits*

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Adjusting Entries Process

The 4 Step Cycle must be repeated for *Adjusting Entries*.

-  1 – **Analyze:**
 - Are adjusting entries required?
- 2 – **Prepare Adjusting Journal Entries**
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4 Types of Adjusting Entries

	Revenue	Expense
Prepaid	<ul style="list-style-type: none"> • Unearned Revenue • Unearned Rent 	<ul style="list-style-type: none"> • Supplies • Prepaids <ul style="list-style-type: none"> • Insurance • Rent • Equipment <ul style="list-style-type: none"> • Depreciation
Accrued	<ul style="list-style-type: none"> • (Earned) Revenue 	<ul style="list-style-type: none"> • Utilities • Salaries • Interest

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4 Types of Adjusting Entries

Unearned Revenue Example:
Customer previously paid you \$500 for future services:
Dr Cash 500
Cr Unearned Revenue (a Liability) 500

The Trial Balance will show an *Unearned Revenue* credit balance. You have now performed the services.

Adjusting Entry:

	Dr	Cr
Unearned Revenue	500	
(Earned) Revenue		500

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4 Types of Adjusting Entries

Unearned Rent Example:

Customer previously paid you \$600 for six months rent in advance (\$100 per month):

Dr Cash 600

Cr Unearned Rent (a Liability) 600

The Trial Balance will show an *Unearned Rent* credit balance. One month has passed.

Adjusting Entry:

	Dr	Cr
Unearned Rent	100	
(Earned) Rent Revenue		100


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4 Types of Adjusting Entries

Accrued Revenue Example:

You have performed \$800 of services, have not been paid and have not yet billed the customer (i.e., you have not already booked the Accounts Receivable).

Adjusting Entry:

	Dr	Cr
Accounts Receivable	800	
Revenue		800


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4 Types of Adjusting Entries


Accrued Utility Expense Example:

The utility company bills you quarterly. One month has passed and you estimate that you have used \$300 of electricity.

Adjusting Entry:

	Dr	Cr
Utility Expense	300	
Utilities Payable		300


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 **4 Types of Adjusting Entries**

Accrued Salary Expense Example:
 Employees are paid \$1,000 on Fridays for a 5 day work week.
 The end of the month occurs on a Wednesday, therefore the employees have earned $3 / 5 * \$1,000 = \600

Adjusting Entry:

	Dr	Cr
Salary Expense	600	
Salary Payable		600

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 **4 Types of Adjusting Entries**

Accrued Salary Expense Example (cont'd):
 Employees are paid \$1,000 on Fridays for a 5 day work week.
 The end of the month occurs on a Wednesday, therefore you have accrued \$600.

End of Month Entry when salaries are paid:

	Dr	Cr
Salary Expense	400	
Salary Payable	600	
Cash		1,000

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 **4 Types of Adjusting Entries**

Accrued Interest Expense Example:
 The company has borrowed \$100,000 at 12% per year.
 3 months have passed since the last interest payment, therefore the company has incurred $\$100,000 \times 12\% / 12 \times 3 = \$3,000$ interest expense.

Adjusting Entry:

	Dr	Cr
Interest Expense	3,000	
Interest Payable		3,000

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4 Types of Adjusting Entries

Supplies Example:

You previously bought \$700 of supplies, assume for cash. The entry would have been:

Dr Supplies 700
Cr Cash 700

It is now the end of the month and you have taken an inventory of the supplies and have determined that you now have only \$240 of supplies left.

Adjusting Entry:

	Dr	Cr
Supplies Expense	460	
Supplies		460



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4 Types of Adjusting Entries

Supplies Example: (continued)

	Dr	Cr	
Supplies Expense	460		Supplies
Supplies		460	700
			240
			460

Note that the amount of the entry is **not** the ending inventory amount of \$240.

Adjusted Balance =
Inventory amount

The entry amount is the amount necessary to adjust the trial balance of \$700 to the inventory amount of \$240.



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4 Types of Adjusting Entries

Prepaid Insurance Example:

You previously paid \$1,200 for one year of coverage. The entry would have been:

Dr Prepaid Insurance 1,200
Cr Cash 1,200

Three months have now passed, therefore the company would have used prepaid insurance equal to $\$1,200 / 12 \times 3 = \300

Adjusting Entry:

	Dr	Cr
Insurance Expense	300	
Prepaid Insurance		300



Note that *Prepaid Rent* works in a similar fashion.

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4 Types of Adjusting Entries

Equipment Depreciation Example:

You previously purchased a delivery truck for \$6,000 (assume you paid cash).

Dr PP&E 6,000
 Cr Cash 6,000

It has been determined that the depreciation on the truck for this reporting period is \$250:

Adjusting Entry:

	Dr	Cr
Depreciation Expense	250	
Accumulated Depreciation		250



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4 Types of Adjusting Entries

Equipment Depreciation Example (continued):

Note that unlike in the *Supplies* example, the Cr for PP&E is to *Accumulated Depreciation*.

Accumulated Depreciation is a *Contra-Asset* account, i.e., it is “matched with” PP&E (an Asset) but has a Credit Normal Balance.

The Balance Sheet presentation would be:

PP&E 6,000
 less: Accumulated Depreciation 250
 Net PP&E 5,750



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4 Types of Adjusting Entries

Equipment Depreciation Example (continued):

Note that *depreciation* is not a valuation concept.

Depreciation is a *cost allocation* process whereby the cost of the asset is allocated to expense over the asset’s useful life in a systematic manner.



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4 Types of Adjusting Entries


Note that all 4 types of adjusting entries:

- **NEVER** affect the cash account
- Always affect
 - the Balance Sheet either increasing or decreasing assets or liabilities
 - and the Income Statement (P&L) increasing either revenues or expenses

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Adjusting Entries Process


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Make The Financial Statements

If your *Adjusted Trial Balance* is balanced you can use the amounts to make your financial statements in the order:

- Income Statement (P&L)
- Statement of Retained Earnings
- Balance Sheet
- Statement of Cash Flows

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Closing Entries Process

The 4 Step Cycle must be repeated a third time for *Closing Entries*.

➔ 1 – **Analyze:**

- Which accounts need to be closed?

2 – **Prepare Closing Journal Entries**

3 – **Post to General Ledger**

4 – **Prepare a Post-Closing Trial Balance**

- Ensure that *debits* still equal *credits*
- Ensure that *Temporary Accounts* have a zero balance

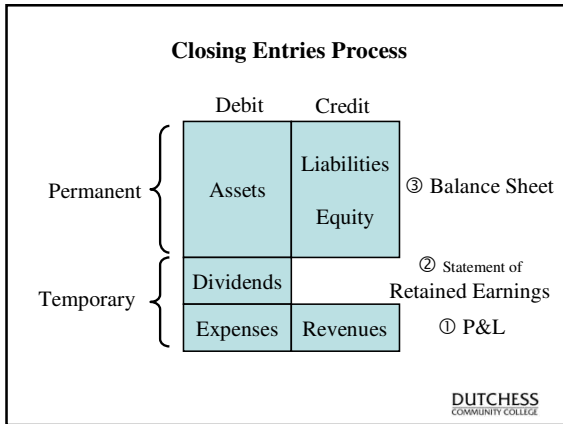
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Closing Entries Process

The *Revenues, Expenses* and *Dividends* (the *Temporary Accounts*) must be **closed** into *Retained Earnings*.

① Profit & Loss or Income Statement	② Statement of Retained Earnings	③ Balance Sheet
Revenue	Beginning RE	Assets
- Expenses	Net Income	Liabilities
= Net Income / (Loss)	- Dividends	Stockholders Equity
	= Ending RE	• Common Stock
		Retained Earnings

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Closing Entries Process

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Prepare Closing Journal Entries

Closing Entry:

	Dr	Cr	
Revenue	##		These amounts will zero the temporary accounts
Salary Expense		##	
Rent Expense		##	
Expense, etc		##	
Dividends		##	
Retained Earnings		##	← This amount will balance the Debits and Credits

A Debit will decrease Retained Earnings

A Credit will increase Retained Earnings

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Prepare a Post Closing Trial Balance

Total Debits should equal Total Credits
If the TOTALS do not equal then you definitely did something wrong.
However, being equal does NOT mean that everything is correct.

Post Closing Trial Balance		
Account	Dr	Cr
Cash	85	
A/R	435	
PP&E	1,000	
A/P		35
Common Stock		1,000
Retained Earnings		485
Revenues		0
Expenses	0	
Dividends	0	
TOTALS	1,520	1,520

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Prepare a Post Closing Trial Balance

The *Temporary Accounts* (Revenues, Expenses & Dividends) should all have zero balances

Post Closing Trial Balance		
Account	Dr	Cr
Cash	85	
A/R	435	
PP&E	1,000	
A/P		35
Common Stock		1,000
Retained Earnings		485
Revenues		0
Expenses	0	
Dividends	0	
TOTALS	1,520	1,520

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