Chapter 4: Adjusting the accounts and preparing Financial statements

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4.1 Measurement of Profit

- *Income – Expense = profit*

<u>Cash basis</u>

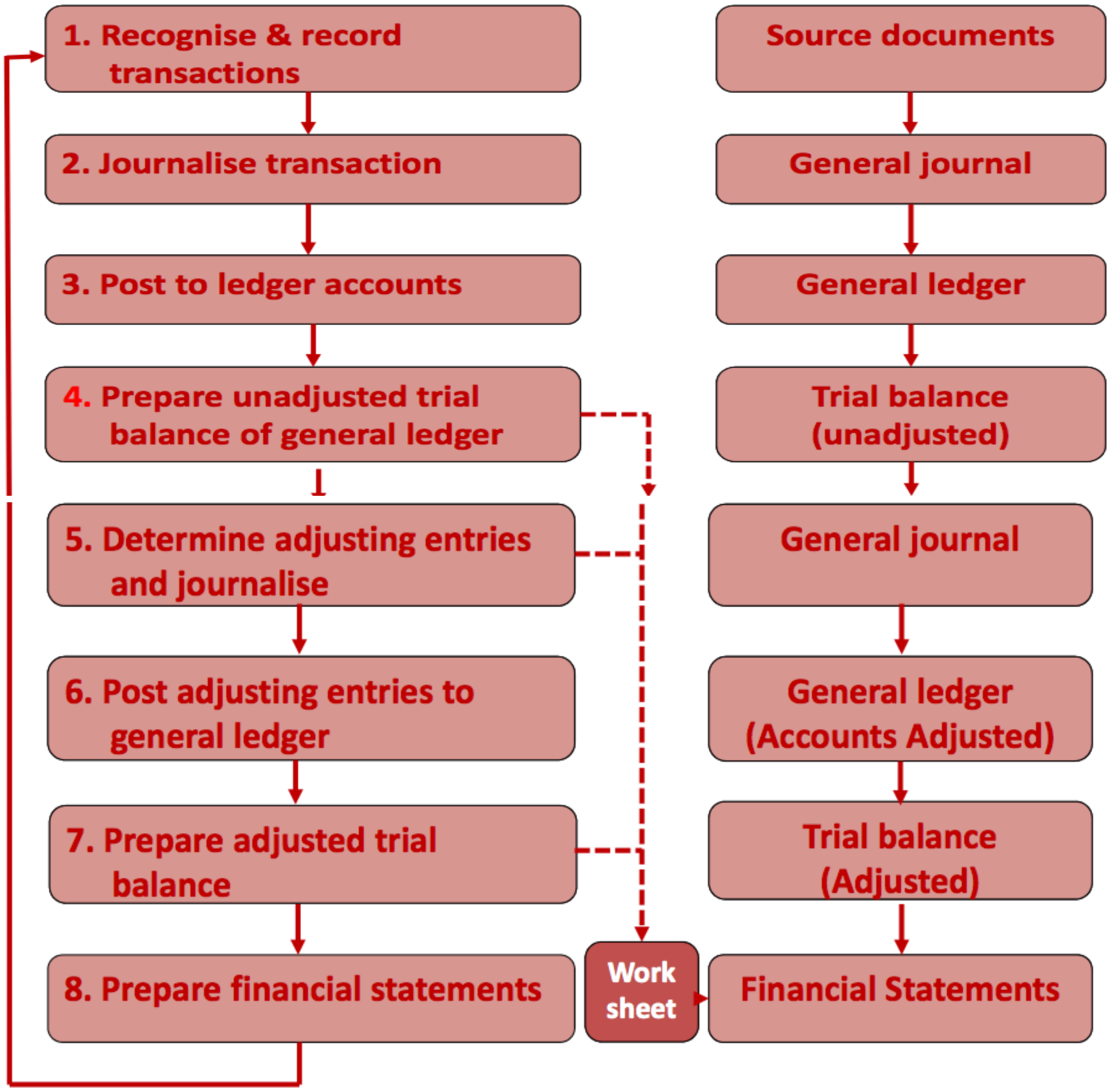
- Income is recorded wen cash is received
- Expenses are recorded when cash is paid
- Profit is the excess of cash inflows from income and cash outflows from expense

<u>Accrual basis</u>

- Income (including revenue) recognised when the anticipated inflow of economic benefit can be reliably measured
  - Income represents increases in economic benefits during the period in the form of inflows or enhancements of assets or decreases in liability that result in increases in equity
  - *Income + revenue + gains*
  - Revenues are recognized at the fair value of assets received
  - Assets received is cash
- Expenses when the consumption of benefits can be reliably measured
  - Expenses (or expired cost) are the costs of services and assets consumed in the current period
  - Unexpired cost – portion of a cost that is expected to provide economic benefits in a future period – asset
  - Expenses are recognized in the period in which the consumption of costs can be measured
  - Expenses decrease equity (however not all decreases in equity are expenses)
- Temporary (nominal) and permanent (real) accounts
  - Temporary (nominal) account:
    - Income statement accounts
    - Reduced to 0 balance at the end of each accounting period (closing the accounts)
  - Permanent (real) accounts
    - Balance sheet accounts
    - Ending balances carried forward to the next accounting period

4.2 The accounting cycle – expansion to include adjusting entries

- Adjusting entries – journal entries made at the end of the accounting period to update or correct the account balances
- The need for adjusting entries:
  - In some cases the period in which cash is paid or received does not coincide with period in which expenses and income are recognizes
  - Therefore, some accounts must be adjusted on the last day of the accounting period to correctly recognize income and expenses not reflected in cash receipts or payment



4.3 Classification of adjusting entries

- Deferrals - expenses paid in advance (prepaid expense) or revenues received in advance (unearned revenues) which need to be allocated over future accounting periods
- Accruals - the recognition of expenses incurred but not yet paid (accrued expenses) of the recognition of revenues earned by fir which cash has not yet been received (accrued revenues)

Deferrals (Prepayments)	**Prepaid Expense** Costs/expenses paid before they are consumed	**Unearned Revenue** Revenues that are collected or received but not yet earned
Accruals (Unrecorded)	**Accrued Expense** Expenses incurred but not yet paid	**Accrued Revenue** Revenue earned but not yet received

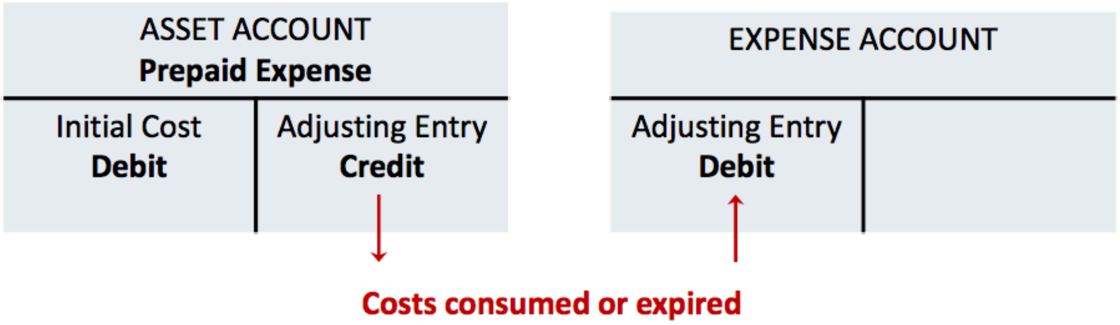
Rules of adjusting entries

- One side of the entry affects an income statement account
  - That is revenue or expense
- The other side of the entry affects an account reported in the balance sheet
  - That is asset or liability
- Cash is never adjusted as the cash flow occurs either before or after the end of the reporting period

4.4 Adjusting entries for deferrals

Prepaid expenses

- Cash paid before benefits are consumed
- Goods and services that are paid for in advance should provide benefits beyond the current period (rent, insurance, supplies), - are recorded as assets when paid
- At the end of the period the amount is consumed is expensed

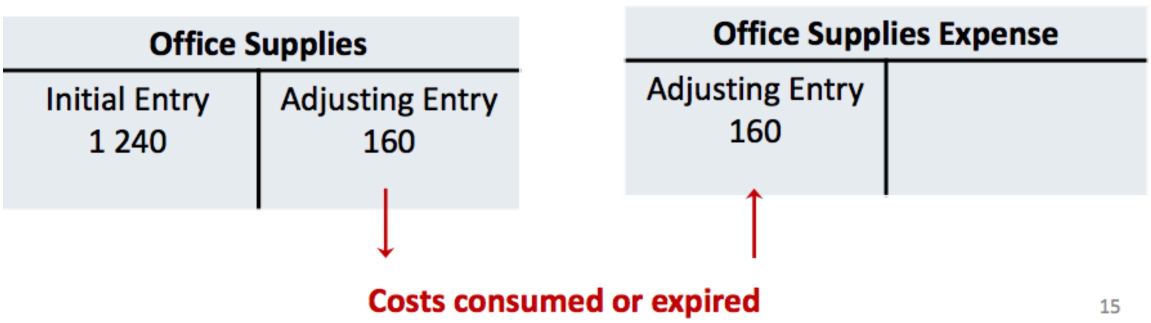


- **E.g. Office Supplies:**
  - On 5th June the following entry was made to record a tax invoice covering the purchase of office supplies:

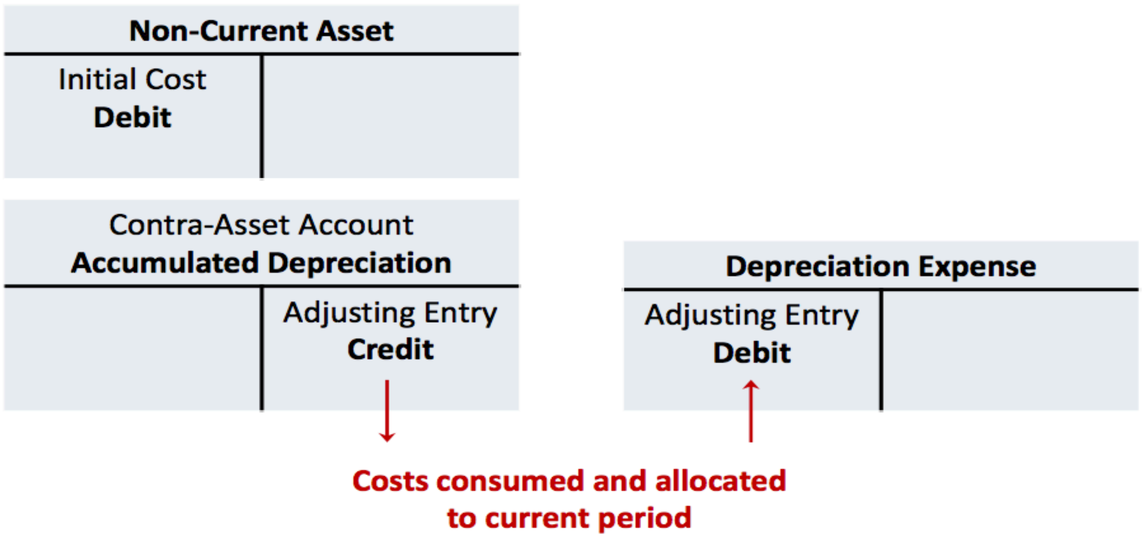
General Journal			
Jun 5	Office Supplies	1 240	
	GST Outlays	124	
	Accounts Payable		1 400
	(Office supplies purchased on credit)		

  - On 30th June it is determined that $1080 remained on hand ($160 consumed)

General Journal			
Jun 30	Office Supplies Expense	160	
	Office Supplies		160
	(Adjusting entry for office supplies)		

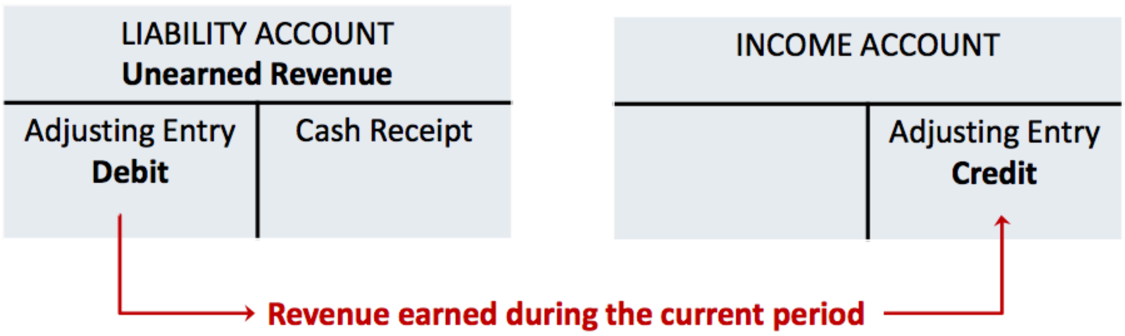


- E.g. Depreciation
  - Useful life – estimates amount of time over which he asset is expected t be consumed by the entity
  - Depreciation – portion of the assets cost assigned to expense
  - Accumulated depreciation (contra account) – reflects the proportion of the cost that has been assigned r expense and accumulated since the item was purchases
  - Contra account is reported as an offset to or a deduction from a related account.
  - Carrying amount (book value) – the difference between the original cost of the asset and its accumulated depreciation
  - *Depreciation = cost – salvage valise / estimated useful line*



<u>Precollected or Unearned Revenue</u>

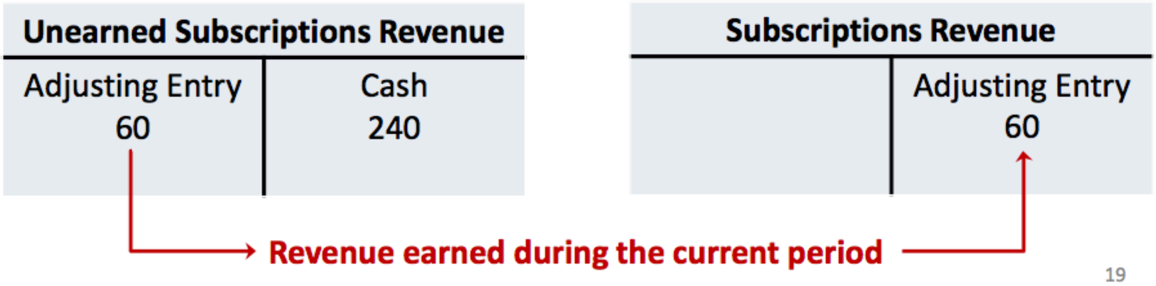
- Cash received in advance for services that are to be performed in the future
- Initially recorded as liability when received
- Recognizes as revenue as earned



- E.g. Subscription
  - Subscription revenue (income account)
  - On 8th September, a monthly magazine publisher received $264 for a 1 year subscription beginning October

General Journal			
Sept 8	Cash at Bank	264	
	GST Collections		24
	Unearned Subscription Revenue		240
	(Receipt of subscriptions in advance)		

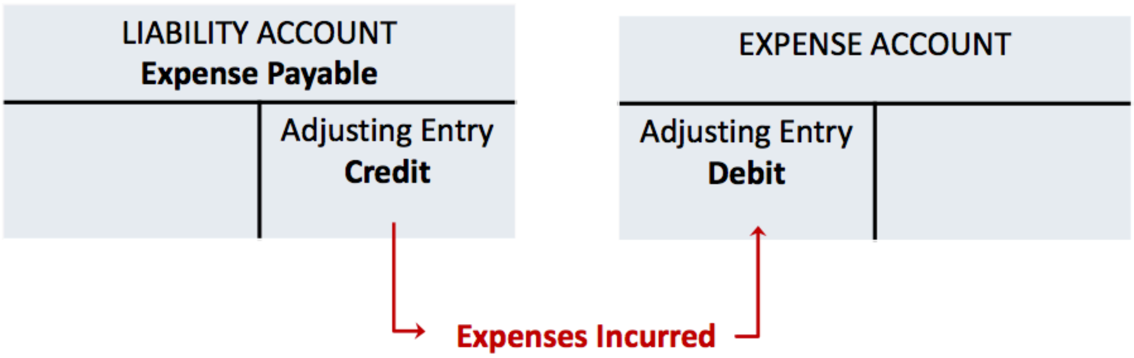
General Journal			
Dec 31	Unearned Subscriptions Revenue	60	
	Subscriptions Revenue		60
	(Adjusting entry for subscriptions earned)		



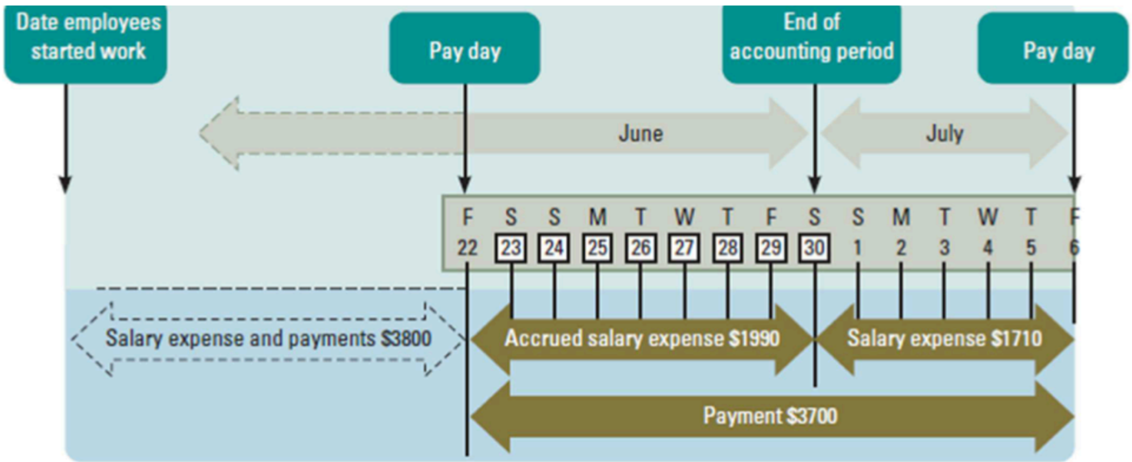
4.5 Adjusting entries for accruals

<u>Accrued or unrecorded expense</u>

- Expenses that have been consumed but payments has not been made yet
- Expenses must ne recognized along with liability for future payment



- Accrued Salaries (liability)



- E.g. Salary Expense
    - On 30th June an adjusting entry is required to correctly determine June's expenses

General Journal			
Jun 30	Salaries Expense	3 980	
	Salaries Payable		3 980
	(Adjusting entry for salaries payable)		

Salaries Payable	
	Adjusting Entry 3 980

Salaries Expense	
Adjusting Entry 3 980	

Expenses Incurred

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- E.g. Salary Payable
    - The liability is eliminates in 6th July when the next payment is made to employees

General Journal			
Jul 6	Salaries Payable	3 980	
	Salaries Expense	3 420	
	Cash at Bank		7 400
	(Payment of salaries earned 23 June to 6 July)		

- Accrued Interest (liability)
    - To calculate interest: *Principal x Rate x Time = Interest*
    - No GST outlays required
    - Account debited = interest Expense
    - Account credited: interest payable
- Accrued Electricity (liability)
    - Electricity expense is debited, electricity account payable is credited
    - Liabilities and expenses increase by equal amounts

<u>Unrecorded or accrued revenue</u>

- When a service is performed by the entity, an entry is made to recognize the transaction
    - No adjusting entry is necessary
- Any unrecorded revenue needs to be recorded

ASSET ACCOUNT **Accounts Receivable**	
Adjusting Entry **Debit**	

INCOME ACCOUNT **Revenue**	
	Adjusting Entry **Credit**

Revenue earned but not yet received

- E.g. Market service:

- On 1st June an agreement was signed to provide marketing service for a monthly fee of $800. On 30th June cash is yet to be received and no invoice has

General Journal			
Jun 30	Accounts Receivable	800	
	Marketing Services Revenue		800
	(Marketing services fee receivable for June)		

4.6 Adjusted trial balance

- Adjusting entries are posted to the general ledger
- An adjusted trial seeks to verify the equity of debits and credits in the account after posting the adjusting entries
- Debits must still equal credits

4.7 Preparation of financial statements

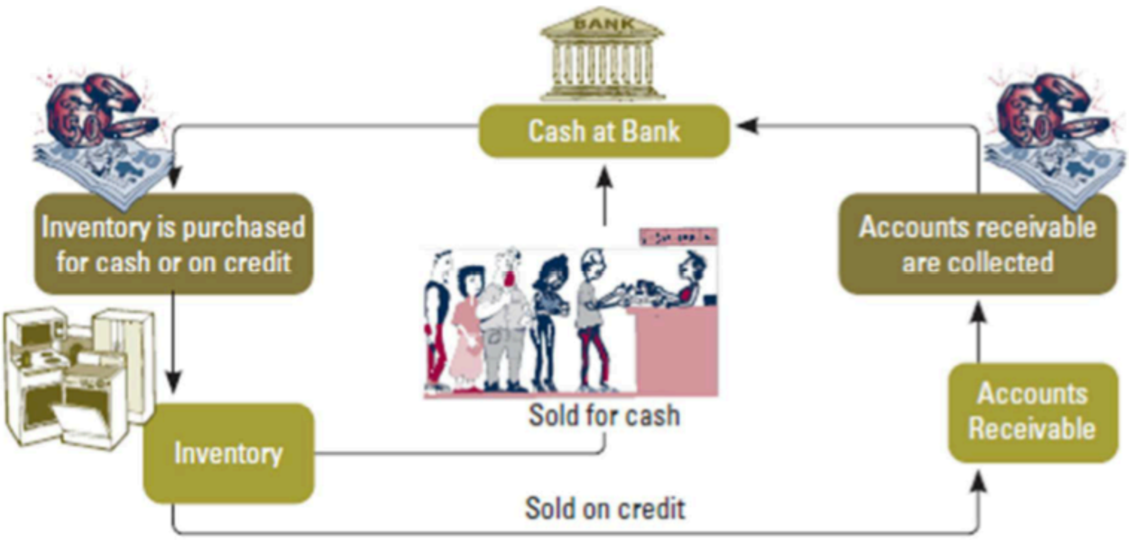
- Income statement:
    - Prepared first to determine profit or loss
    - Reflects entity's performance
- Statement of changes in equity
    - Profit (loss) must be added to (subtracted from) equity
    - Shows detail of movements in equity
    - Equity balance is reported in balance sheet
- Balance sheet
    - Reflects entity's financial position
    - Three major categories
        - Assets
        - Liabilities
        - Equity
  - Liquidity – its ability to satisfy short-term obligations as they call due
      - Assets and liabilities are classified as current (short term) and non-current (long term)

Assets	Liabilities
• Current Assets	• Current Liabilities
• Non-Current Assets • Investments	• Non-Current Liabilities
• Property, Plant & Equip. • Intangible Assets	
• Other Assets	

4.8 Distinguishing current and non-current assets and liabilities

Current assets

- Cash and other types of assets that are help primary for the purpose of sale or trading, or are reasonably expected to be converted to cash, sold of consumed by a business entity within its operating cycle, or are expected to be realized within a 12 months after the end of the entity's reporting period.
- Current assets/liabilities will be used up/paid off within single operating cycle
- Operating cycle – average length of time it takes to acquire inventory seek the inventory to customers and collect cash from the sale
- Ordered in its liquidity:
    1. Cash at bank
    2. Marketable securities
    3. Accounts relievable (trade debtors)
    4. Inventory
    5. Prepayments



Non-Current Assets

- Investment - long-term financial assets (shares)
- Property, plant, and equipment – physical nature assets (tangible)
- Intangible assets - does not have physical substance but provides future benefits
- Other assets

Current Liabilities

- Obligations of the entity that are reasonably expected to be settles in the entity's normal operating cycle or held for the purpose of being traded, or are due to be settled within 12months after the end of the reporting periods.
- Require payments in the short term (accounts payable, interest payable)

Non-Current or long-term liabilities

- Do not require payments within the entity's operating cycle or within 12 months after the end of the reporting period.

4.9 Preparing Financial Statements from a worksheet

- Important functions of a worksheet:

- Assembles all information needed to adjust the accounts and prepare financial statements
- Aids in the preparation of interim financial statements when adjusting and closing entries are not required
- Contains information needed to close off profit and loss accounts for the period

Worksheet doesn't replace the financial statement – its just a tool used to gather information

- Preparation of the worksheet:
    1. Enter ledger account titles and balances in the account title and unadjusted trial balance columns
    2. Enter the adjustment in the adjustment columns
    3. Prepare an adjusted trial balance
        - Cross-adding – adding or subtracting across the worksheet horizontally
    4. Extend adjusted balances to the financial statement columns
    5. Difference between the 2 income columns represents the profit or loss for the period. This balance is transferred to the balance sheet to balance totals
    6. Financial statements can then be prepared

4.10 Financial statements and decision-making

- Financial statements are the final output of the accounting cycle
- They are not an ends in themselves
- They allow users to make decisions
- Questions might include –
    - Has the business been profitable?
    - Is the business solvent?
    - Should more capital be invested?