

# CHAPTER 3

## THE ACCOUNTING INFORMATION SYSTEM

Intermediate Accounting  
IFRS Edition

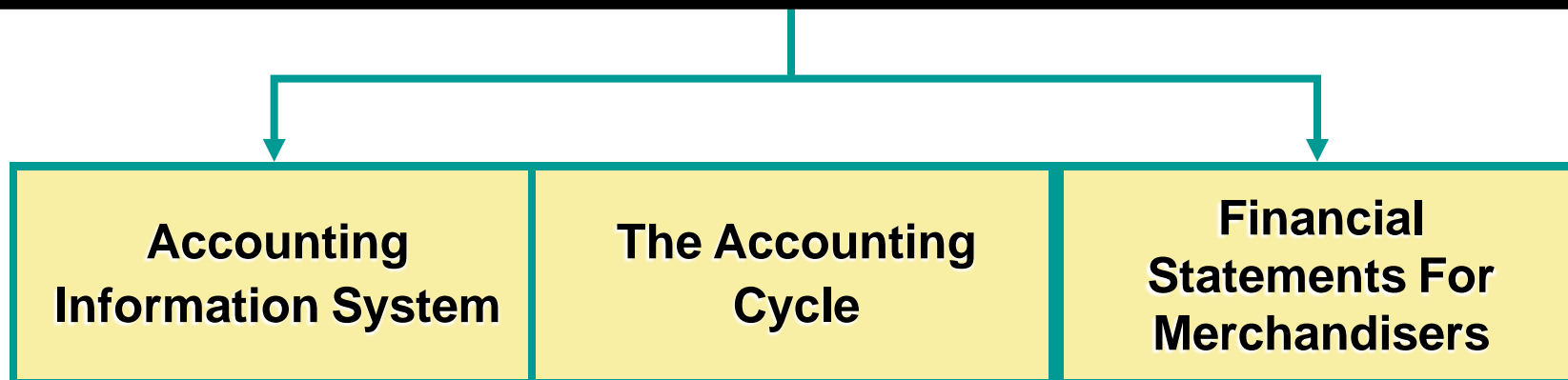
Slide  
3-1

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# Learning Objectives

1. Understand basic accounting terminology.
2. Explain double-entry rules.
3. Identify steps in the accounting cycle.
4. Record transactions in journals, post to ledger accounts, and prepare a trial balance.
5. Explain the reasons for preparing adjusting entries.
6. Prepare financial statement from the adjusted trial balance.
7. Prepare closing entries.

# The Accounting Information System



- Basic terminology
- Debits and credits
- Accounting equation
- Financial statements and ownership structure

- Identifying and recording
- Journalizing
- Posting
- Trial balance
- Adjusting entries
- Adjusted trial balance
- Preparing financial statements
- Closing
- Post-closing trial balance
- Reversing entries
- Summary

- Income statement
- Statement of retained earnings
- Statement of financial position
- Closing entries

# Accounting Information System

## Accounting Information System (AIS)

- Collects and processes transaction data.
- Disseminates the information to interested parties.

# Accounting Information System

Helps management answer such questions as:

- How much and what kind of debt is outstanding?
- Were sales higher this period than last?
- What assets do we have?
- What were our cash inflows and outflows?
- Did we make a profit last period?
- Are any of our product lines or divisions operating at a loss?
- Can we safely increase our dividends to shareholders?
- Is our rate of return on net assets increasing?

# Basic Terminology

- Event
- Transaction
- Account
- Real Account
- Nominal Account
- Ledger
- Journal
- Posting
- Trial Balance
- Adjusting Entries
- Financial Statements
- Closing Entries

# Debits and Credits

- An **Account** shows the effect of transactions on a given asset, liability, equity, revenue, or expense account.
- **Double-entry** accounting system (two-sided effect).
- Recording done by debiting at least one account and crediting another.
- **DEBITS must equal CREDITS.**

# Debits and Credits

**Account**



- An arrangement that shows the effect of transactions on an account.
- Debit = Left
- Credit = Right

**An Account can be illustrated in a T-Account form.**



| Account Name |              |
|--------------|--------------|
| Debit / Dr.  | Credit / Cr. |
|              |              |
|              |              |
|              |              |



# Debits and Credits

If Debit entries are **greater than** Credit entries, the account will have a debit balance.

| Account Name   |                 |                |
|----------------|-----------------|----------------|
| Debit / Dr.    | Credit / Cr.    |                |
| Transaction #1 | \$10,000        | Transaction #2 |
| Transaction #3 | 8,000           |                |
| Balance        | <b>\$15,000</b> |                |

# Debits and Credits



If Credit entries are **greater than** Debit entries, the account will have a credit balance.



|                | Account Name |                |                |
|----------------|--------------|----------------|----------------|
|                | Debit / Dr.  | Credit / Cr.   |                |
| Transaction #1 | \$10,000     | \$3,000        | Transaction #2 |
|                |              | 8,000          | Transaction #3 |
| Balance        |              | <b>\$1,000</b> |                |

# Debits and Credits Summary



Normal Balance  
**Debit**

Normal Balance  
**Credit**



| <b>Liabilities</b>  |   |
|---|---|
| Debit / Dr.   | Credit / Cr.  |
|  |  |
|   | <b>Normal Balance</b>   |

| <b>Assets</b>   |   |
|---|---|
| Debit / Dr.   | Credit / Cr.  |
|  |  |
| <b>Normal Balance</b>   |   |



Chapter 3-25

| <b>Equity</b>   |   |
|---|---|
| Debit / Dr.   | Credit / Cr.  |
|  |  |
|   | <b>Normal Balance</b>   |

Chapter 3-25

| <b>Expense</b>  |   |
|---|---|
| Debit / Dr.   | Credit / Cr.  |
|  |  |
| <b>Normal Balance</b>   |   |

Chapter 3-27

| <b>Revenue</b>  |   |
|---|---|
| Debit / Dr.   | Credit / Cr.  |
|  |  |
|   | <b>Normal Balance</b>   |

Chapter 3-26

# Debits and Credits Summary

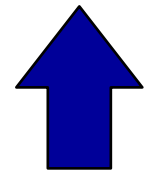
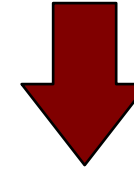
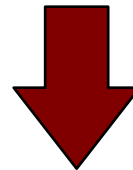
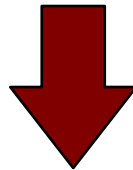
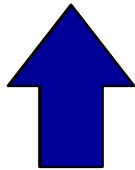
## Statement of Financial Position

## Income Statement

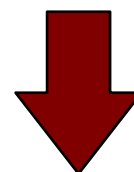
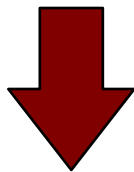
$$\underline{\text{Asset}} = \underline{\text{Liability}} + \underline{\text{Equity}}$$

$$\underline{\text{Revenue}} - \underline{\text{Expense}} =$$

Debit



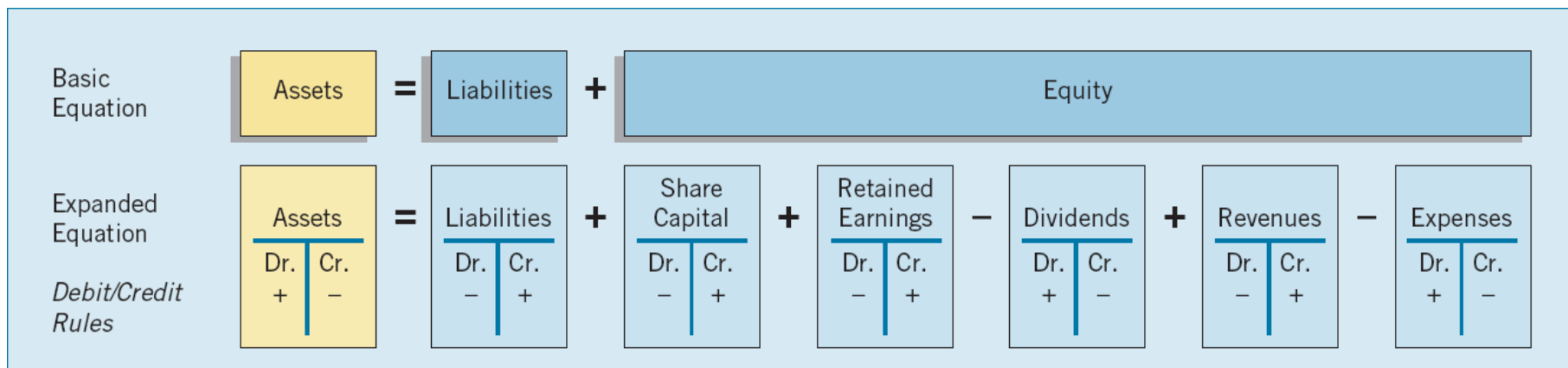
Credit



# The Accounting Equation

Relationship among the assets, liabilities and equity of a business:

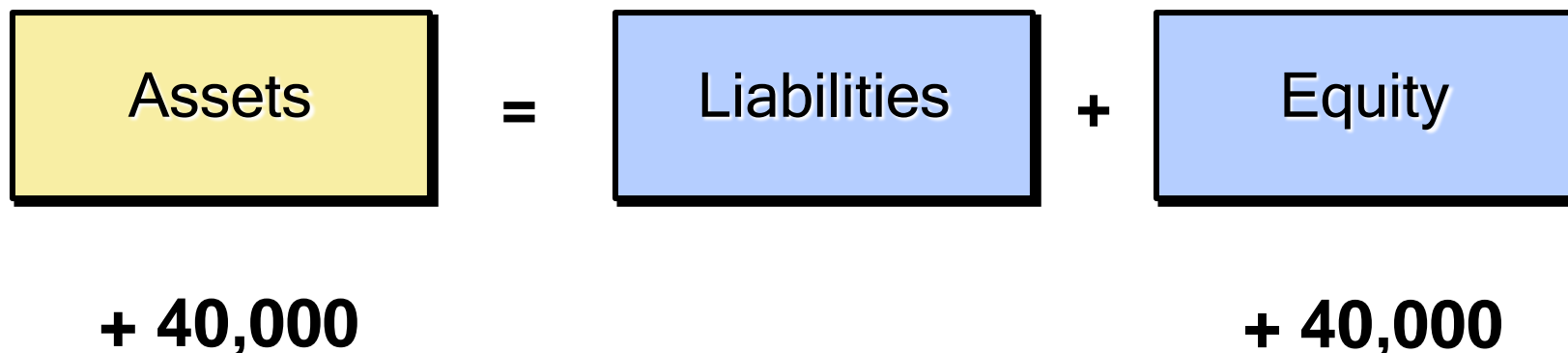
Illustration 3-3



The equation must be in balance after every transaction.  
For every **Debit** there must be a **Credit**.

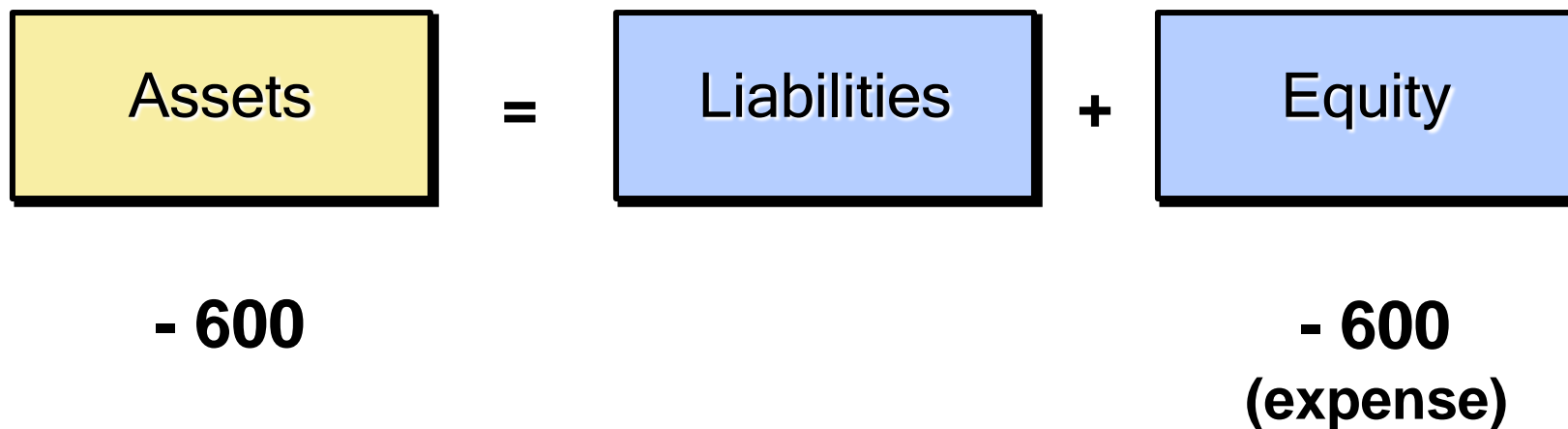
# Double-Entry System Illustration

1. Owners invest \$40,000 in exchange for share capital



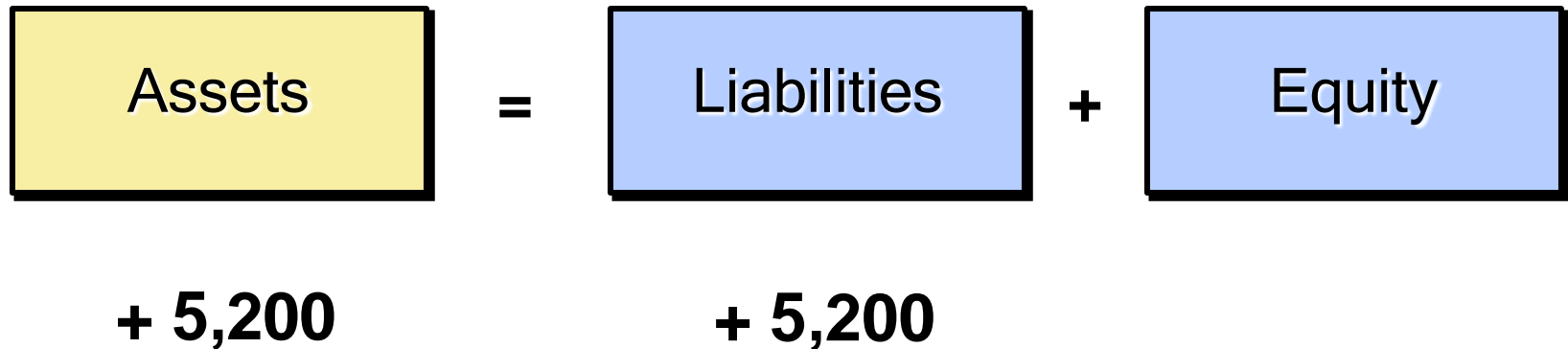
# Double-Entry System Illustration

2. Disburse \$600 cash for secretarial wages.



# Double-Entry System Illustration

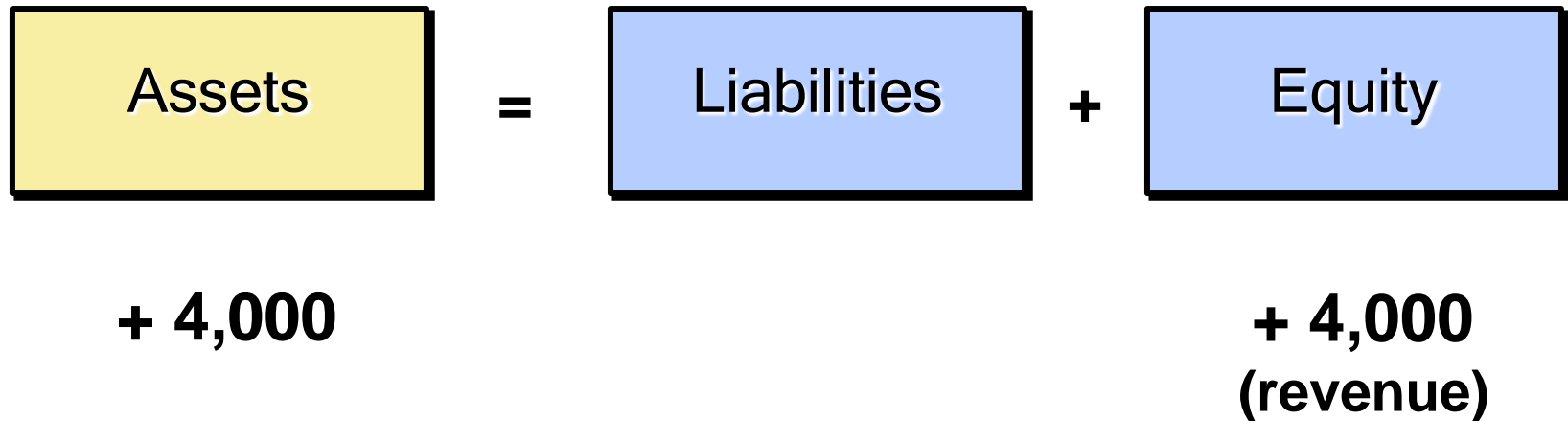
- Purchase office equipment priced at \$5,200, giving a 10 percent promissory note in exchange.





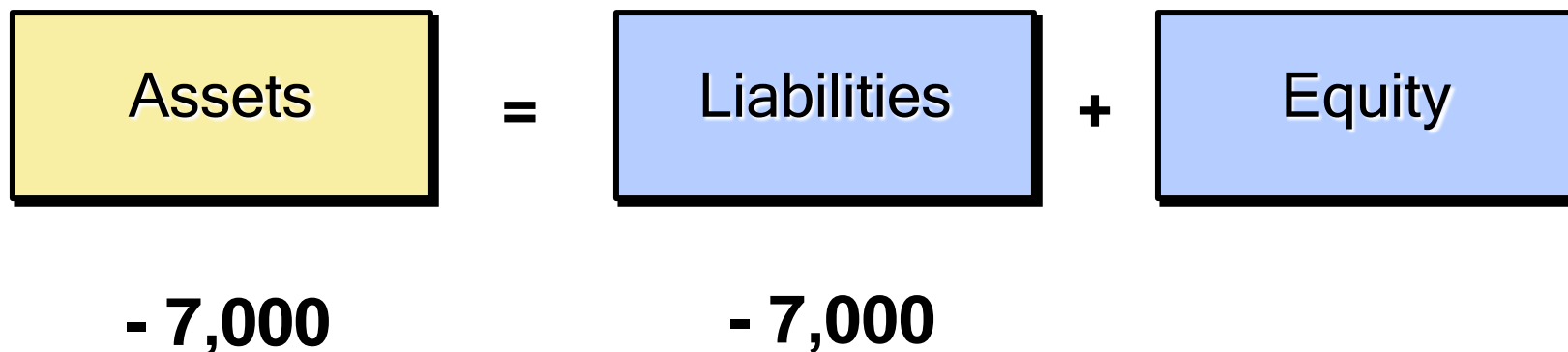
# Double-Entry System Illustration

4. Received \$4,000 cash for services rendered.



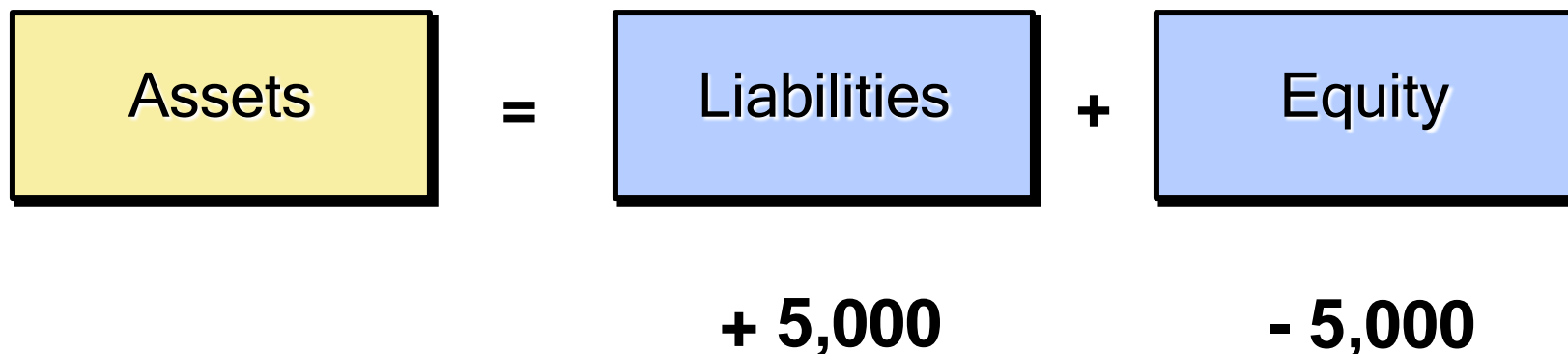
# Double-Entry System Illustration

5. Pay off a short-term liability of \$7,000.



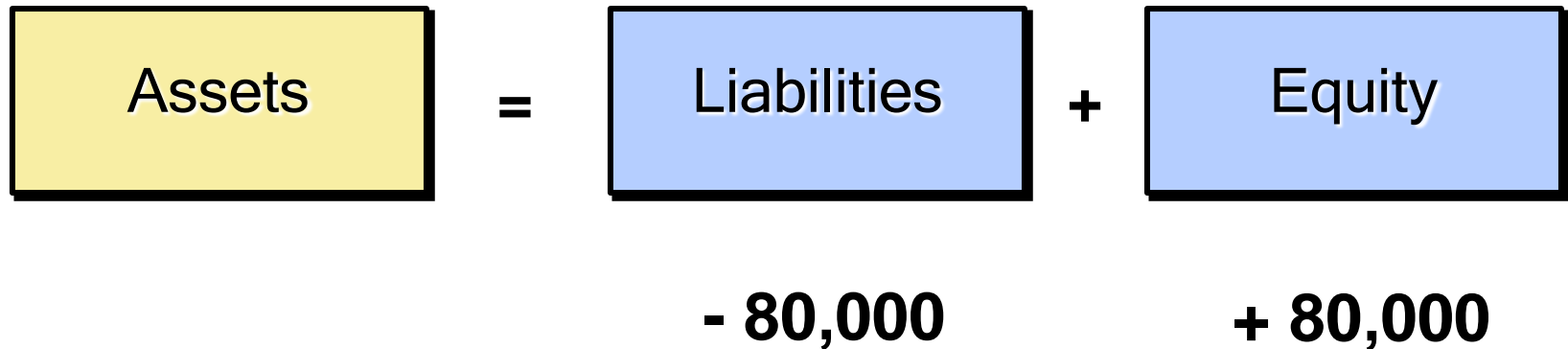
# Double-Entry System Illustration

6. Declared a cash dividend of \$5,000.



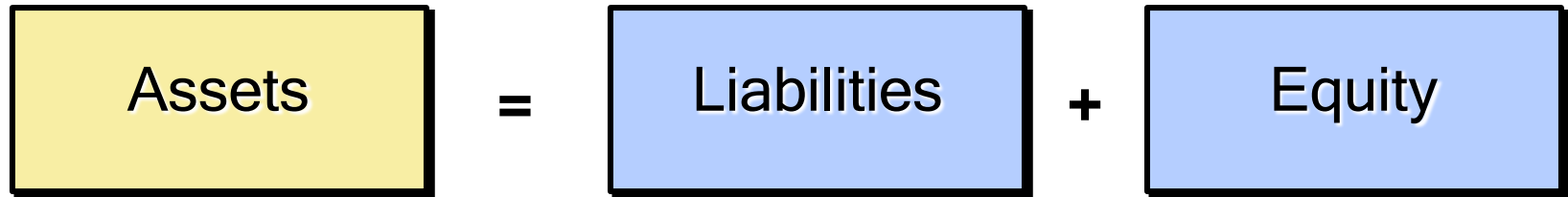
# Double-Entry System Illustration

- Convert a long-term liability of \$80,000 into ordinary shares.



# Double-Entry System Illustration

8. Pay cash of \$16,000 for a delivery van.



**- 16,000**

**+ 16,000**

Note that the accounting equation equality is maintained after recording each transaction.

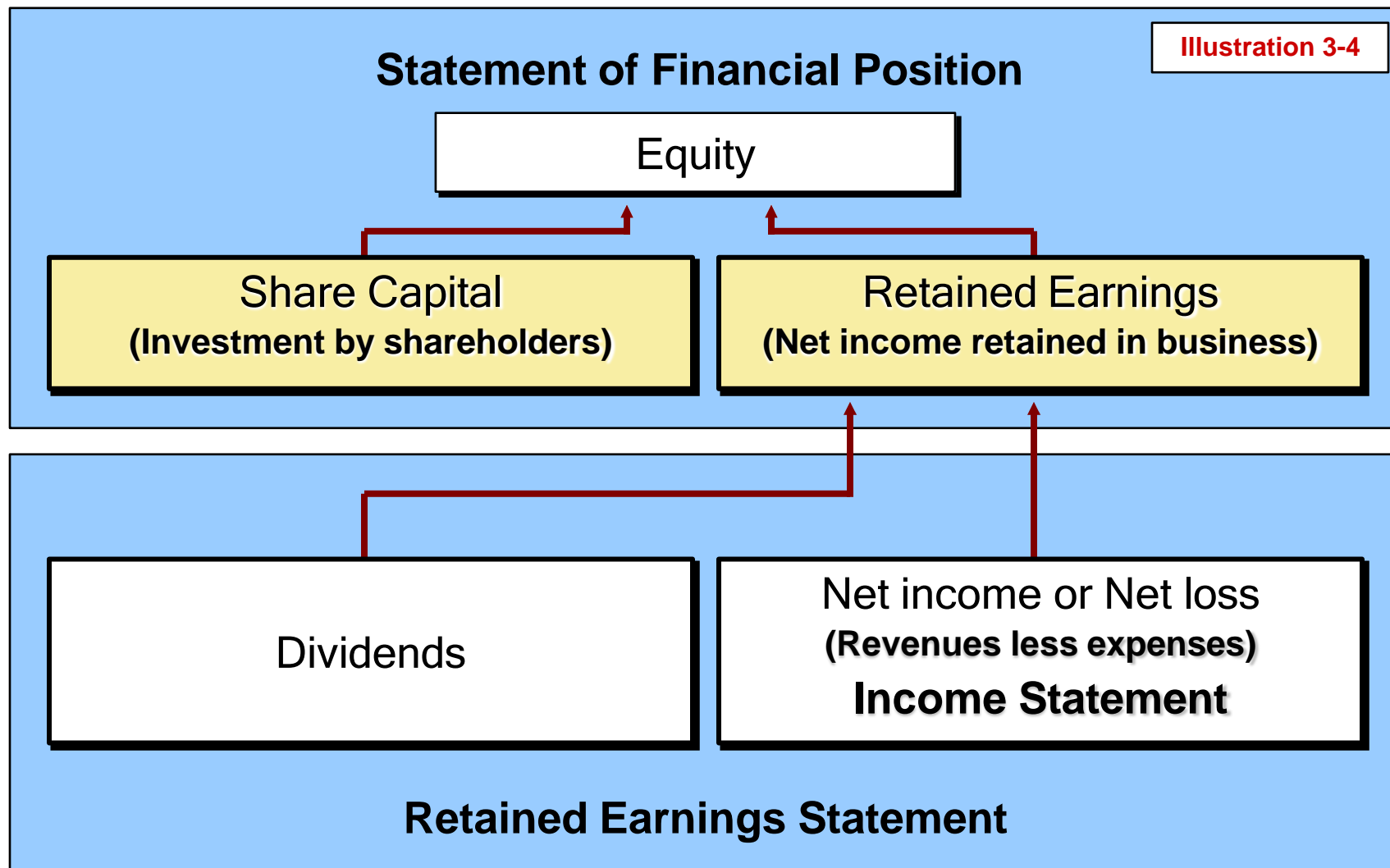
# Financial Statements and Ownership Structure

Ownership structure dictates the types of accounts that are part of the equity section.

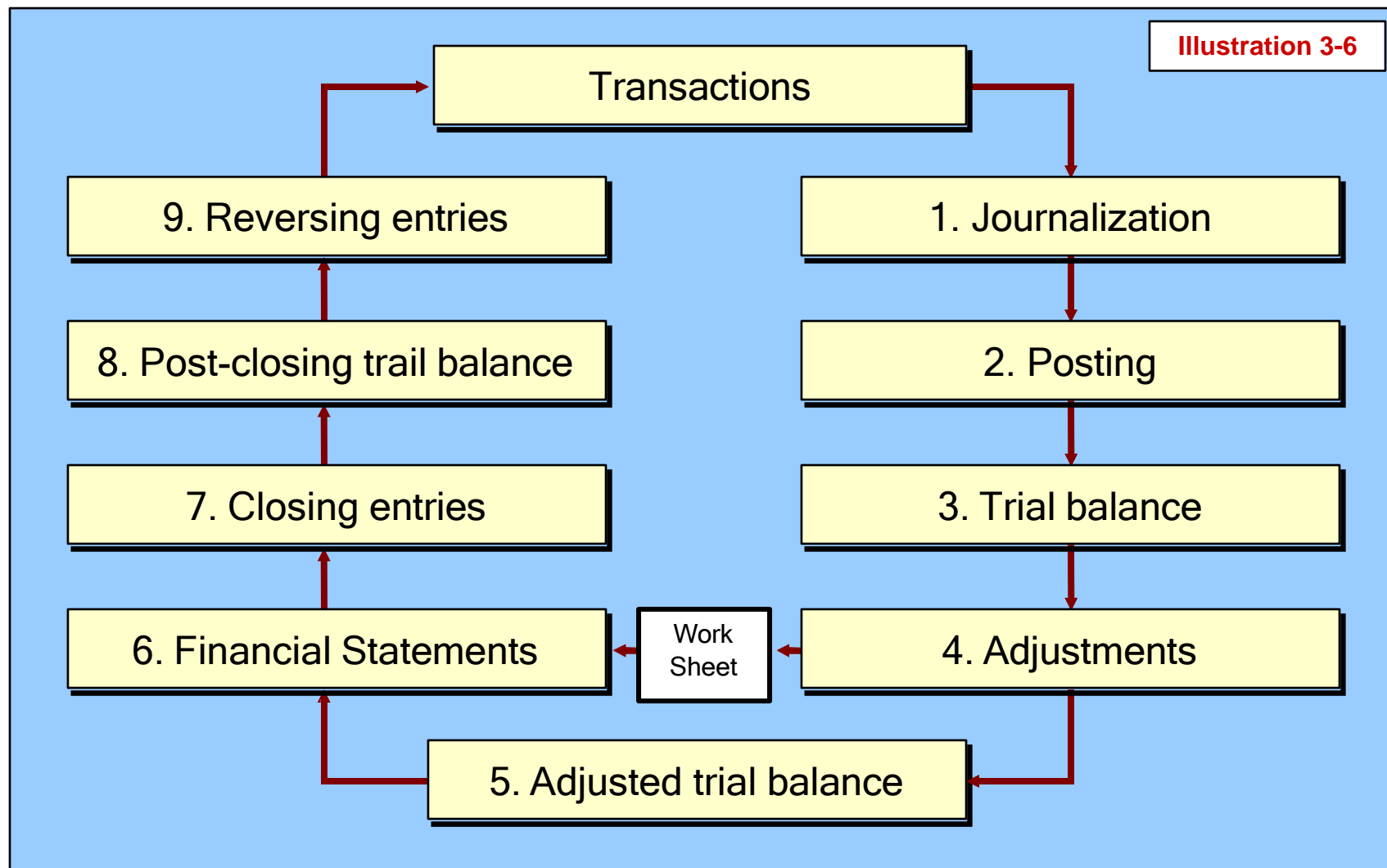
| Proprietorship or Partnership   |
|---|
| <ul style="list-style-type: none"><li>● Capital account</li><li>● Drawing account</li></ul> |

| Corporation   |
|---|
| <ul style="list-style-type: none"><li>● Share capital</li><li>● Share premium</li><li>● Dividends</li><li>● Retained Earnings</li></ul> |

# Financial Statements and Ownership Structure



# The Accounting Cycle





# Identify and Recording Transactions

## What to Record?

An item should be recognized in the financial statements if it is an element, is measurable, and is relevant and a faithful representation.



### **Underlying Concepts**

Assets are probable economic benefits controlled by a particular entity as a result of a past transaction or event. Do human resources of a company meet this definition?

# 1. Journalizing

**General Journal** - a chronological record of transactions.

**Journal Entries** are recorded in the journal.

**September 1:** Shareholders invested \$15,000 cash in the corporation in exchange for ordinary shares.

Illustration 3-7

| GENERAL JOURNAL |   |      |        |        | J1 |
|-----------------|---|------|--------|--------|----|
| Date            | Account Titles and Explanation                                      | Ref. | Debit  | Credit |    |
| 2011<br>Sept. 1 | Cash<br>Share Capital—Ordinary<br>(Issued ordinary shares for cash) |      | 15,000 | 15,000 |    |

## 2. Posting

**Posting** - the process of transferring amounts from the journal to the ledger accounts.

Illustration 3-7

| GENERAL JOURNAL |   |      |        |        | J1 |
|-----------------|---|------|--------|--------|----|
| Date            | Account Titles and Explanation                                      | Ref. | Debit  | Credit |    |
| 2011<br>Sept. 1 | Cash<br>Share Capital—Ordinary<br>(Issued ordinary shares for cash) |      | 15,000 | 15,000 |    |

GENERAL LEDGER

Illustration 3-8

| Cash |             |      |       |        |         | No. 101 |
|------|-------------|------|-------|--------|---------|---------|
| Date | Explanation | Ref. | Debit | Credit | Balance |         |
|      |             |      |       |        |         |         |

# 2. Posting

**Posting** - Transferring amounts from journal to ledger.

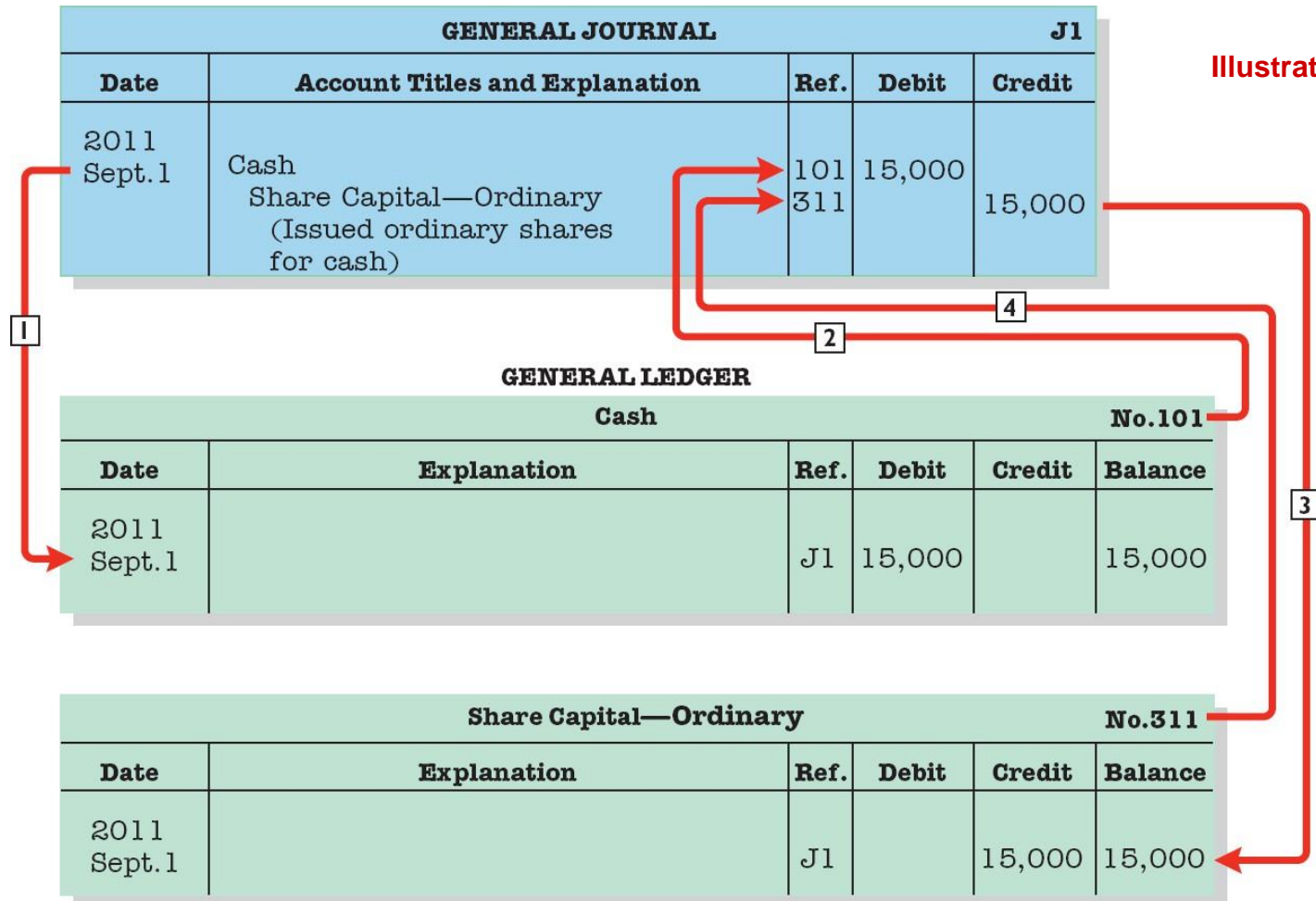


Illustration 3-8

## 2. Posting

### Expanded Example

The purpose of transaction analysis is

- (1) to identify the type of account involved, and
- (2) to determine whether a debit or a credit is required.

Keep in mind that every journal entry affects one or more of the following items: assets, liabilities, equity, revenues, or expense.

## 2. Posting

1. October 1: Shareholders invest \$100,000 cash in an advertising venture to be known as Pioneer Advertising Agency Inc.

Illustration 3-9

|        |                          |         |         |
|--------|--------------------------|---------|---------|
| Oct. 1 | Cash                     | 100,000 |         |
|        | Share capital - ordinary |         | 100,000 |

| Cash    |        | Share Capital - Ordinary |         |
|---------|--------|--------------------------|---------|
| Debit   | Credit | Debit                    | Credit  |
| 100,000 |        |                          | 100,000 |

## 2. Posting

2. October 1: Pioneer Advertising purchases office equipment costing \$50,000 by signing a 3-month, 12%, \$50,000 note payable.

Illustration 3-10

|        |                  |        |        |
|--------|------------------|--------|--------|
| Oct. 1 | Office equipment | 50,000 |        |
|        | Notes payable    |        | 50,000 |

| Office Equipment |        | Notes Payable |        |
|------------------|--------|---------------|--------|
| Debit            | Credit | Debit         | Credit |
| 50,000           |        |               | 50,000 |

## 2. Posting

3. October 2: Pioneer Advertising receives a \$12,000 cash advance from KC, a client, for advertising services that are expected to be completed by December 31.

Illustration 3-11

|        |                          |        |        |
|--------|--------------------------|--------|--------|
| Oct. 2 | Cash                     | 12,000 |        |
|        | Unearned service revenue |        | 12,000 |

| Cash    |        | Unearned Service Revenue |        |
|---------|--------|--------------------------|--------|
| Debit   | Credit | Debit                    | Credit |
| 100,000 |        |                          | 12,000 |
| 12,000  |        |                          |        |



## 2. Posting

4. October 3: Pioneer Advertising pays \$9,000 office rent, in cash, for October.

Illustration 3-12

|        |              |       |       |
|--------|--------------|-------|-------|
| Oct. 3 | Rent expense | 9,000 |       |
|        | Cash         |       | 9,000 |

| Cash    |        | Rent Expense |        |
|---------|--------|--------------|--------|
| Debit   | Credit | Debit        | Credit |
| 100,000 | 9,000  | 9,000        |        |
| 12,000  |        |              |        |

## 2. Posting

5. October 4: Pioneer Advertising pays \$6,000 for a one-year insurance policy that will expire next year on September 30.

Illustration 3-13

|        |                   |       |       |
|--------|-------------------|-------|-------|
| Oct. 4 | Prepaid insurance | 6,000 |       |
|        | Cash              |       | 6,000 |

| Cash    |        | Prepaid Insurance |        |
|---------|--------|-------------------|--------|
| Debit   | Credit | Debit             | Credit |
| 100,000 | 9,000  | 6,000             |        |
| 12,000  | 6,000  |                   |        |

## 2. Posting

6. October 5: Pioneer Advertising purchases, for \$25,000 on account, an estimated 3-month supply of advertising materials from Aero Supply.

Illustration 3-14

|        |                      |        |        |
|--------|----------------------|--------|--------|
| Oct. 5 | Advertising supplies | 25,000 |        |
|        | Accounts payable     |        | 25,000 |

| Advertising Supplies |        | Accounts Payable |        |
|----------------------|--------|------------------|--------|
| Debit                | Credit | Debit            | Credit |
| 25,000               |        |                  | 25,000 |

## 2. Posting

7. October 9: Pioneer Advertising signs a contract with a local newspaper for advertising inserts (flyers) to be distributed starting the last Sunday in November. Pioneer will start work on the content of the flyers in November. Payment of \$7,000 is due following delivery of the Sunday papers containing the flyers.

Illustration 3-15

A business transaction has not occurred. There is only an agreement between Pioneer Advertising and the newspaper for the services to be provided in November. Therefore, no journal entry is necessary in October.

## 2. Posting

8. October 20: Pioneer Advertising's board of directors declares and pays a \$5,000 cash dividend to shareholders.

Illustration 3-16

|         |           |       |       |
|---------|-----------|-------|-------|
| Oct. 20 | Dividends | 5,000 |       |
|         | Cash      |       | 5,000 |

| Cash    |        | Dividends |        |
|---------|--------|-----------|--------|
| Debit   | Credit | Debit     | Credit |
| 100,000 | 9,000  | 5,000     |        |
| 12,000  | 6,000  |           |        |
|         | 5,000  |           |        |



## 2. Posting

- 10.** October 31: Pioneer Advertising receives \$28,000 in cash and bills Copa Company \$72,000 for advertising services of \$100,000 provided in October.

Illustration 3-18

|         |                     |        |         |
|---------|---------------------|--------|---------|
| Oct. 31 | Cash                | 28,000 |         |
|         | Accounts receivable | 72,000 |         |
|         | Service revenue     |        | 100,000 |

| Cash    |        | Accounts Receivable |        | Service Revenue |         |
|---------|--------|---------------------|--------|-----------------|---------|
| Debit   | Credit | Debit               | Credit | Debit           | Credit  |
| 100,000 | 9,000  | 72,000              |        |                 | 100,000 |
| 12,000  | 6,000  |                     |        |                 |         |
| 28,000  | 5,000  |                     |        |                 |         |
|         | 40,000 |                     |        |                 |         |
| 80,000  |        |                     |        |                 |         |

# 3. Trial Balance

Illustration 3-19

**Trial Balance** —  
A list of each account and its balance; used to prove equality of debit and credit balances.

| PIONEER ADVERTISING AGENCY INC. |                  |                  |
|---------------------------------|------------------|------------------|
| TRIAL BALANCE                   |                  |                  |
| OCTOBER 31, 2011                |                  |                  |
|                                 | Debit            | Credit           |
| Cash                            | \$ 80,000        |                  |
| Accounts Receivable             | 72,000           |                  |
| Advertising Supplies            | 25,000           |                  |
| Prepaid Insurance               | 6,000            |                  |
| Office Equipment                | 50,000           |                  |
| Notes Payable                   |                  | \$ 50,000        |
| Accounts Payable                |                  | 25,000           |
| Unearned Service Revenue        |                  | 12,000           |
| Share Capital—Ordinary          |                  | 100,000          |
| Dividends                       | 5,000            |                  |
| Service Revenue                 |                  | 100,000          |
| Salaries Expense                | 40,000           |                  |
| Rent Expense                    | 9,000            |                  |
|                                 | <u>\$287,000</u> | <u>\$287,000</u> |



## 4. Adjusting Entries

Makes it possible to:

- Report on the statement of financial position the appropriate assets, liabilities, and equity at the statement date.
- Report on the income statement the proper revenues and expenses for the period.
  - **Revenues** are recorded in the period in which they are earned.
  - **Expenses** are recognized in the period in which they are incurred.

# Types of Adjusting Entries

Illustration 3-20

## Deferrals

### 1. **Prepaid Expenses.**

Expenses paid in cash and recorded as assets **before** they are used or consumed.

### 2. **Unearned Revenues.**

Revenues received in cash and recorded as liabilities **before** they are earned.

## Accruals

### 3. **Accrued Revenues.**

Revenues earned but **not yet received** in cash or recorded.

### 4. **Accrued Expenses.**

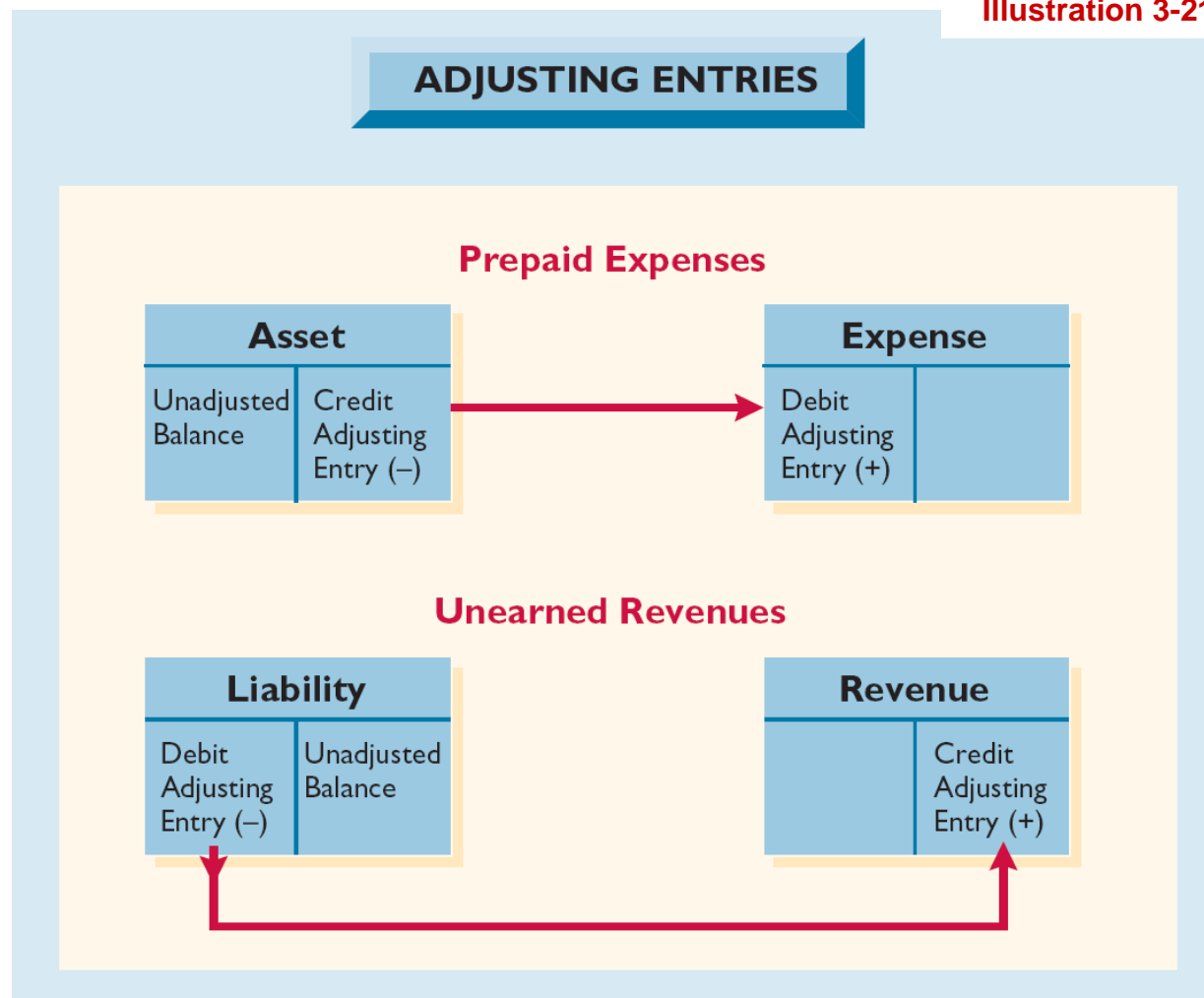
Expenses incurred but **not yet paid** in cash or recorded.

# Adjusting Entries for Deferrals

**Deferrals** are either

- **prepaid expenses** or
- **unearned revenues.**

Illustration 3-21



# Adjusting Entries for “Prepaid Expenses”

Payment of cash that is recorded as an asset because service or benefit will be received in the future.

Cash Payment

**BEFORE**

Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- purchasing buildings and equipment





# Adjusting Entries for “Prepaid Expenses”

Illustration 3-35

## Statement Presentation:

Advertising supplies identifies that portion of the asset's cost that will provide future economic benefit.



### PIONEER ADVERTISING AGENCY INC. Statement of Financial Position October 31, 2011

|                                |              | <u>Assets</u> |                         |
|--------------------------------|--------------|---------------|-------------------------|
| Office equipment               | \$50,000     |               |                         |
| Less: Accumulated depreciation | <u>400</u>   |               | \$49,600                |
| Advertising supplies           |              |               | 10,000                  |
| Prepaid insurance              |              |               | 5,500                   |
| Accounts receivable            | 74,000       |               |                         |
| Less: Allowance                | <u>1,600</u> |               | 72,400                  |
| Cash                           |              |               | <u>80,000</u>           |
| Total assets                   |              |               | <u><u>\$217,500</u></u> |

# Adjusting Entries for “Prepaid Expenses”

Illustration 3-34

## Statement Presentation:

Advertising expense identifies that portion of the asset’s cost that expired in October.



| PIONEER ADVERTISING AGENCY INC.      |          |                         |
|--------------------------------------|----------|-------------------------|
| Income Statement                     |          |                         |
| For the Month Ended October 31, 2011 |          |                         |
| Revenues                             |          |                         |
| Service Revenue                      |          | \$106,000               |
| Expenses                             |          |                         |
| Salaries expense                     | \$46,000 |                         |
| Advertising supplies expense         | 15,000   |                         |
| Rent expense                         | 9,000    |                         |
| Insurance expense                    | 500      |                         |
| Interest expense                     | 500      |                         |
| Depreciation expense                 | 400      |                         |
| Bad debt expense                     | 1,600    |                         |
| Total expenses                       |          | <u>73,000</u>           |
| Net income                           |          | <u><u>\$ 33,000</u></u> |







# Adjusting Entries for “Prepaid Expenses”

Illustration 3-35

## Statement Presentation:

Prepaid Insurance identifies that portion of the asset's cost that will provide future economic benefit.



### PIONEER ADVERTISING AGENCY INC. Statement of Financial Position October 31, 2011

|                                |              | <u>Assets</u> |                         |
|--------------------------------|--------------|---------------|-------------------------|
| Office equipment               | \$50,000     |               |                         |
| Less: Accumulated depreciation | <u>400</u>   |               | \$49,600                |
| Advertising supplies           |              |               | 10,000                  |
| Prepaid insurance              |              |               | 5,500                   |
| Accounts receivable            | 74,000       |               |                         |
| Less: Allowance                | <u>1,600</u> |               | 72,400                  |
| Cash                           |              |               | <u>80,000</u>           |
| Total assets                   |              |               | <u><u>\$217,500</u></u> |

# Adjusting Entries for “Prepaid Expenses”

Illustration 3-34

## Statement Presentation:

Insurance expense identifies that portion of the asset’s cost that expired in October.



### PIONEER ADVERTISING AGENCY INC. Income Statement For the Month Ended October 31, 2011

|                              |          |                         |
|------------------------------|----------|-------------------------|
| Revenues                     |          |                         |
| Service Revenue              |          | \$106,000               |
| Expenses                     |          |                         |
| Salaries expense             | \$46,000 |                         |
| Advertising supplies expense | 15,000   |                         |
| Rent expense                 | 9,000    |                         |
| Insurance expense            | 500      |                         |
| Interest expense             | 500      |                         |
| Depreciation expense         | 400      |                         |
| Bad debt expense             | 1,600    |                         |
| Total expenses               |          | <u>73,000</u>           |
| Net income                   |          | <u><u>\$ 33,000</u></u> |

# Adjusting Entries for “Prepaid Expenses”

**Depreciation.** Pioneer Advertising estimates depreciation on its office equipment to be \$400 per month. Accordingly, Pioneer recognizes depreciation for October by the following adjusting entry.

|         |                          |     |     |
|---------|--------------------------|-----|-----|
| Oct. 31 | Depreciation expense     | 400 |     |
|         | Accumulated depreciation |     | 400 |

| Depreciation Expense |        | Accumulated Depreciation |        |
|----------------------|--------|--------------------------|--------|
| Debit                | Credit | Debit                    | Credit |
| 400                  |        |                          | 400    |


# Adjusting Entries for “Prepaid Expenses”

Illustration 3-35

## Statement Presentation:

Accumulated Depreciation—is a contra asset account.

### PIONEER ADVERTISING AGENCY INC. Statement of Financial Position October 31, 2011

|   |                                | <u>Assets</u> |                         |
|---|--------------------------------|---------------|-------------------------|
|   | Office equipment               | \$50,000      |                         |
|  | Less: Accumulated depreciation | <u>400</u>    | \$49,600                |
|   | Advertising supplies           |               | 10,000                  |
|   | Prepaid insurance              |               | 5,500                   |
|   | Accounts receivable            | 74,000        |                         |
|   | Less: Allowance                | <u>1,600</u>  | 72,400                  |
|   | Cash                           |               | <u>80,000</u>           |
|   | Total assets                   |               | <u><u>\$217,500</u></u> |

# Adjusting Entries for “Prepaid Expenses”

Illustration 3-34

## Statement Presentation:

Depreciation expense identifies that portion of the asset’s cost that expired in October.

### PIONEER ADVERTISING AGENCY INC. Income Statement For the Month Ended October 31, 2011

|                              |                         |
|------------------------------|-------------------------|
| Revenues                     |                         |
| Service Revenue              | \$106,000               |
| Expenses                     |                         |
| Salaries expense             | \$46,000                |
| Advertising supplies expense | 15,000                  |
| Rent expense                 | 9,000                   |
| Insurance expense            | 500                     |
| Interest expense             | 500                     |
| Depreciation expense         | 400                     |
| Bad debt expense             | 1,600                   |
| Total expenses               | <u>73,000</u>           |
| Net income                   | <u><u>\$ 33,000</u></u> |

# Adjusting Entries for “Unearned Revenues”

Receipt of cash that is recorded as a liability because the revenue has not been earned.

Cash Receipt

**BEFORE**

Revenue Recorded

Unearned revenues often occur in regard to:

- rent
- magazine subscriptions
- airline tickets
- customer deposits
- school tuition



# Adjusting Entries for “Unearned Revenues”

**Unearned Revenue.** Pioneer Advertising received \$12,000 on October 2 from KC for advertising services expected to be completed by December 31. Show the journal entry to record the receipt on Oct. 2<sup>nd</sup>.

|        |                          |        |        |
|--------|--------------------------|--------|--------|
| Oct. 2 | Cash                     | 12,000 |        |
|        | Unearned service revenue |        | 12,000 |

| Cash   |        | Unearned Service Revenue |        |
|--------|--------|--------------------------|--------|
| Debit  | Credit | Debit                    | Credit |
| 12,000 |        |                          | 12,000 |

# Adjusting Entries for “Unearned Revenues”

**Unearned Revenues.** Analysis reveals that Pioneer earned \$4,000 of the advertising services in October. Thus, Pioneer makes the following adjusting entry.

|         |                          |       |       |
|---------|--------------------------|-------|-------|
| Oct. 31 | Unearned service revenue | 4,000 |       |
|         | Service revenue          |       | 4,000 |

| Service Revenue |         | Unearned Service Revenue |        |
|-----------------|---------|--------------------------|--------|
| Debit           | Credit  | Debit                    | Credit |
|                 | 100,000 |                          | 12,000 |
|                 | 4,000   | 4,000                    |        |
|                 |         |                          | 8,000  |

# Adjusting Entries for “Unearned Revenues”

Illustration 3-35

## Statement Presentation:

Unearned service revenue identifies that portion of the liability that has not been earned.



| <u>Equity and Liabilities</u> |               |  |                         |
|-------------------------------|---------------|--|-------------------------|
| Equity                        |               |  |                         |
| Share capital—ordinary        | \$100,000     |  |                         |
| Retained earnings             | <u>28,000</u> |  |                         |
| Total equity                  |               |  | \$128,000               |
| Liabilities                   |               |  |                         |
| Notes payable                 | 50,000        |  |                         |
| Accounts payable              | 25,000        |  |                         |
| Unearned service revenue      | 8,000         |  |                         |
| Salaries payable              | 6,000         |  |                         |
| Interest payable              | <u>500</u>    |  |                         |
| Total liabilities             |               |  | <u>89,500</u>           |
| Total equity and liabilities  |               |  | <u><u>\$217,500</u></u> |

# Adjusting Entries for “Unearned Revenues”

Illustration 3-34

## Statement Presentation:

Service revenue represents that portion of the liability that was earned in October.



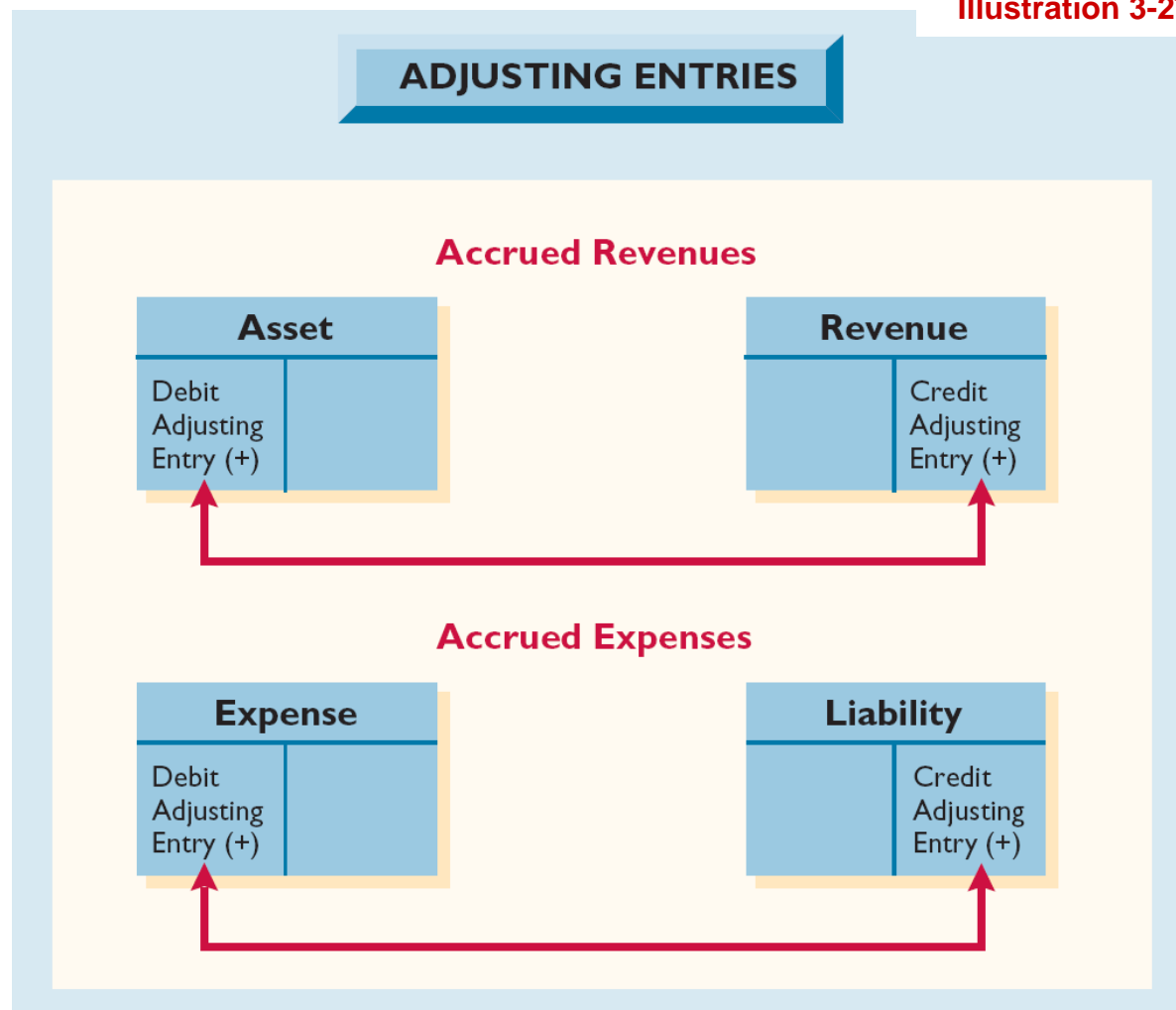
| PIONEER ADVERTISING AGENCY INC.      |          |                         |
|--------------------------------------|----------|-------------------------|
| Income Statement                     |          |                         |
| For the Month Ended October 31, 2011 |          |                         |
| Revenues                             |          |                         |
| Service Revenue                      |          | \$106,000               |
| Expenses                             |          |                         |
| Salaries expense                     | \$46,000 |                         |
| Advertising supplies expense         | 15,000   |                         |
| Rent expense                         | 9,000    |                         |
| Insurance expense                    | 500      |                         |
| Interest expense                     | 500      |                         |
| Depreciation expense                 | 400      |                         |
| Bad debt expense                     | 1,600    |                         |
| Total expenses                       |          | <u>73,000</u>           |
| Net income                           |          | <u><u>\$ 33,000</u></u> |

# Adjusting Entries for Accruals

**Accruals** are either

- **accrued revenues** or
- **accrued expenses.**

Illustration 3-27



# Adjusting Entries for “Accrued Revenues”

Revenues earned but not yet received in cash or recorded.

Adjusting entry results in:

Revenue Recorded

**BEFORE**

Cash Receipt

Accrued revenues often occur in regard to:

- rent
- interest
- services performed



# Adjusting Entries for “Accrued Revenues”

## PIONEER ADVERTISING AGENCY INC. Statement of Financial Position October 31, 2011

| <u>Assets</u>                       |                         |
|-------------------------------------|-------------------------|
| Office equipment                    | \$50,000                |
| Less: Accumulated depreciation      | 400                     |
|                                     | \$49,600                |
| Advertising supplies                | 10,000                  |
| Prepaid insurance                   | 5,500                   |
| Accounts receivable                 | 74,000                  |
| Less: Allowance                     | 1,600                   |
|                                     | 72,400                  |
| Cash                                | 80,000                  |
| <b>Total assets</b>                 | <b><u>\$217,500</u></b> |
| <u>Equity and Liabilities</u>       |                         |
| <b>Equity</b>                       |                         |
| Share capital—ordinary              | \$100,000               |
| Retained earnings                   | 28,000                  |
| <b>Total equity</b>                 | <b>\$128,000</b>        |
| <b>Liabilities</b>                  |                         |
| Notes payable                       | 50,000                  |
| Accounts payable                    | 25,000                  |
| Unearned service revenue            | 8,000                   |
| Salaries payable                    | 6,000                   |
| Interest payable                    | 500                     |
| <b>Total liabilities</b>            | <b><u>89,500</u></b>    |
| <b>Total equity and liabilities</b> | <b><u>\$217,500</u></b> |



## PIONEER ADVERTISING AGENCY INC. Income Statement For the Month Ended October 31, 2011

|                              |                         |
|------------------------------|-------------------------|
| <b>Revenues</b>              |                         |
| Service Revenue              | \$106,000               |
| <b>Expenses</b>              |                         |
| Salaries expense             | \$46,000                |
| Advertising supplies expense | 15,000                  |
| Rent expense                 | 9,000                   |
| Insurance expense            | 500                     |
| Interest expense             | 500                     |
| Depreciation expense         | 400                     |
| Bad debt expense             | 1,600                   |
| <b>Total expenses</b>        | <b><u>73,000</u></b>    |
| <b>Net income</b>            | <b><u>\$ 33,000</u></b> |

Illustration 3-34

## Statement Presentation

Illustration 3-35



# Adjusting Entries for “Accrued Expenses”

Expenses incurred but not yet paid in cash or recorded.

Adjusting entry results in:

Expense Recorded

**BEFORE**

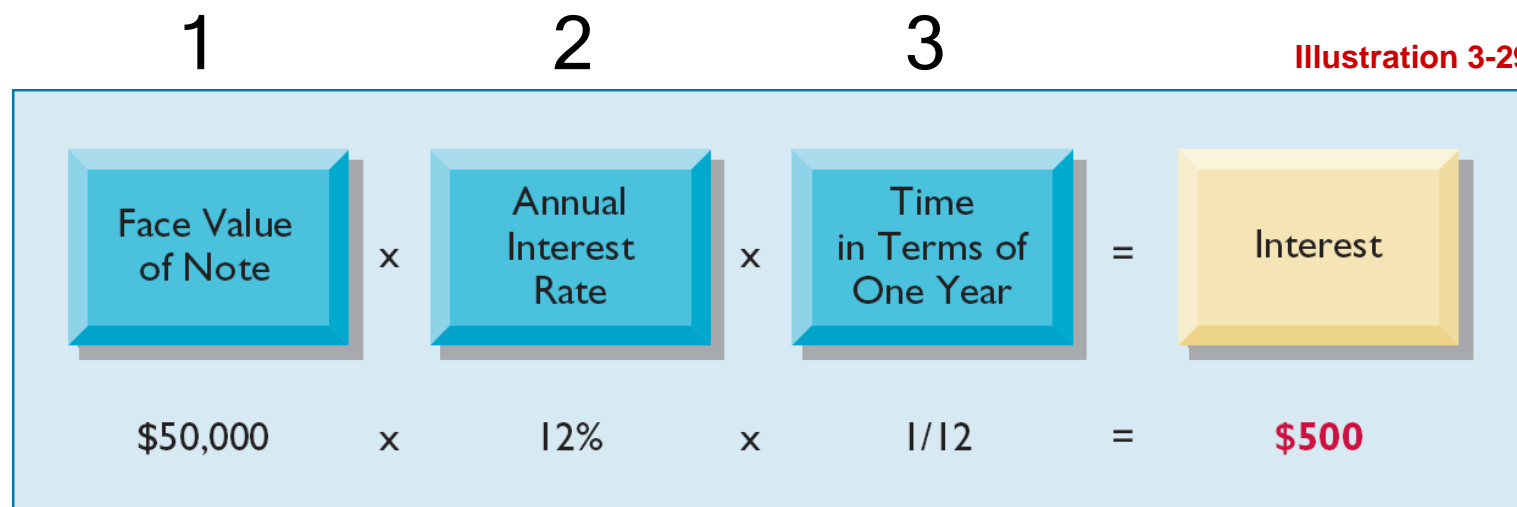
Cash Payment

Accrued expenses often occur in regard to:

- rent
- interest
- salaries
- taxes

# Adjusting Entries for “Accrued Expenses”

**Accrued Interest.** Pioneer signed a three-month, 12%, note payable in the amount of \$50,000 on October 1. The note requires interest at an annual rate of 12 percent. Three factors determine the amount of the interest accumulation:



# Adjusting Entries for "Accrued Expenses"

**Accrued Interest.** Pioneer signed a three-month, 12%, note payable in the amount of \$50,000 on October 1. Prepare the adjusting entry on Oct. 31 to record the accrual of interest.

|         |                  |     |     |
|---------|------------------|-----|-----|
| Oct. 31 | Interest expense | 500 |     |
|         | Interest payable |     | 500 |

| Interest Expense |        | Interest Payable |        |
|------------------|--------|------------------|--------|
| Debit            | Credit | Debit            | Credit |
| 500              |        |                  | 500    |

# Adjusting Entries for "Accrued Expenses"

**PIONEER ADVERTISING AGENCY INC.**  
**Statement of Financial Position**  
**October 31, 2011**

| <u>Assets</u>                       |                         |
|-------------------------------------|-------------------------|
| Office equipment                    | \$50,000                |
| Less: Accumulated depreciation      | <u>400</u> \$49,600     |
| Advertising supplies                | 10,000                  |
| Prepaid insurance                   | 5,500                   |
| Accounts receivable                 | 74,000                  |
| Less: Allowance                     | <u>1,600</u> 72,400     |
| Cash                                | <u>80,000</u>           |
| <b>Total assets</b>                 | <b><u>\$217,500</u></b> |
| <u>Equity and Liabilities</u>       |                         |
| <b>Equity</b>                       |                         |
| Share capital—ordinary              | \$100,000               |
| Retained earnings                   | <u>28,000</u>           |
| <b>Total equity</b>                 | <b>\$128,000</b>        |
| <b>Liabilities</b>                  |                         |
| Notes payable                       | 50,000                  |
| Accounts payable                    | 25,000                  |
| Unearned service revenue            | 8,000                   |
| Salaries payable                    | 6,000                   |
| Interest payable                    | <u>500</u>              |
| <b>Total liabilities</b>            | <b><u>89,500</u></b>    |
| <b>Total equity and liabilities</b> | <b><u>\$217,500</u></b> |



Slide 3-69

**PIONEER ADVERTISING AGENCY INC.**  
**Income Statement**  
**For the Month Ended October 31, 2011**

|                              |                         |
|------------------------------|-------------------------|
| <b>Revenues</b>              |                         |
| Service Revenue              | \$106,000               |
| <b>Expenses</b>              |                         |
| Salaries expense             | \$46,000                |
| Advertising supplies expense | 15,000                  |
| Rent expense                 | 9,000                   |
| Insurance expense            | 500                     |
| Interest expense             | 500                     |
| Depreciation expense         | 400                     |
| Bad debt expense             | <u>1,600</u>            |
| <b>Total expenses</b>        | <b><u>73,000</u></b>    |
| <b>Net income</b>            | <b><u>\$ 33,000</u></b> |

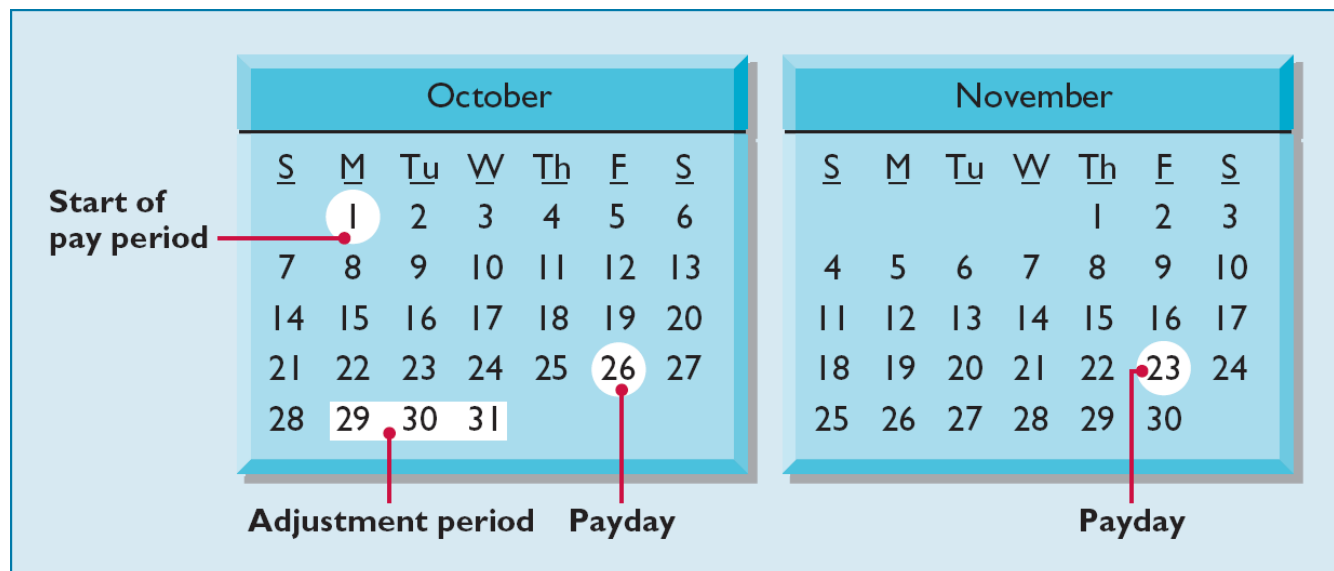


Illustration 3-34

## Statement Presentation

Illustration 3-35

# Adjusting Entries for “Accrued Expenses”



**Accrued Salaries.** At October 31, the salaries for these days represent an accrued expense and a related liability to Pioneer. The employees receive total salaries of \$10,000 for a five-day work week, or \$2,000 per day.



# Adjusting Entries for “Accrued Expenses”

**PIONEER ADVERTISING AGENCY INC.**  
**Statement of Financial Position**  
**October 31, 2011**

| Assets                              |                         |
|-------------------------------------|-------------------------|
| Office equipment                    | \$50,000                |
| Less: Accumulated depreciation      | <u>400</u> \$49,600     |
| Advertising supplies                | 10,000                  |
| Prepaid insurance                   | 5,500                   |
| Accounts receivable                 | 74,000                  |
| Less: Allowance                     | <u>1,600</u> 72,400     |
| Cash                                | 80,000                  |
| <b>Total assets</b>                 | <b><u>\$217,500</u></b> |
| Equity and Liabilities              |                         |
| Equity                              |                         |
| Share capital—ordinary              | \$100,000               |
| Retained earnings                   | <u>28,000</u>           |
| <b>Total equity</b>                 | <b>\$128,000</b>        |
| Liabilities                         |                         |
| Notes payable                       | 50,000                  |
| Accounts payable                    | 25,000                  |
| Unearned service revenue            | 8,000                   |
| Salaries payable                    | 6,000                   |
| Interest payable                    | <u>500</u>              |
| <b>Total liabilities</b>            | <b><u>89,500</u></b>    |
| <b>Total equity and liabilities</b> | <b><u>\$217,500</u></b> |



Slide 3-72

**PIONEER ADVERTISING AGENCY INC.**  
**Income Statement**  
**For the Month Ended October 31, 2011**

|                              |                         |
|------------------------------|-------------------------|
| Revenues                     |                         |
| Service Revenue              | \$106,000               |
| Expenses                     |                         |
| Salaries expense             | \$46,000                |
| Advertising supplies expense | 15,000                  |
| Rent expense                 | 9,000                   |
| Insurance expense            | 500                     |
| Interest expense             | 500                     |
| Depreciation expense         | 400                     |
| Bad debt expense             | <u>1,600</u>            |
| <b>Total expenses</b>        | <b><u>73,000</u></b>    |
| <b>Net income</b>            | <b><u>\$ 33,000</u></b> |



Illustration 3-34

## Statement Presentation

Illustration 3-35

# Adjusting Entries for “Accrued Expenses”

**Accrued Salaries.** On November 23, Pioneer will again pay total salaries of \$40,000. Prepare the entry to record the payment of salaries on November 23.

|         |                  |        |        |
|---------|------------------|--------|--------|
| Nov. 23 | Salaries payable | 6,000  |        |
|         | Salaries expense | 34,000 |        |
|         | Cash             |        | 40,000 |

| Salaries Expense |        | Salaries Payable |        |
|------------------|--------|------------------|--------|
| Debit            | Credit | Debit            | Credit |
| 34,000           |        | 6,000            | 6,000  |



# Adjusting Entries for “Accrued Expenses”

**Bad Debts.** Assume Pioneer reasonably estimates a bad debt expense for the month of \$1,600. It makes the adjusting entry for bad debts as follows.

|                                      |         |       |       |
|--------------------------------------|---------|-------|-------|
|                                      | Oct. 31 |       |       |
| Bad Debt Expense                     |         | 1,600 |       |
| Allowance for Doubtful Accounts      |         |       | 1,600 |
| (To record monthly bad debt expense) |         |       |       |

After Pioneer posts the adjusting entry, the accounts show the following.

**Illustration 3-32**

| Accounts Receivable             |            |       |            |
|---------------------------------|------------|-------|------------|
| 10/ 1                           | 72,000     |       |            |
| 31                              | Adj. 2,000 |       |            |
| Allowance for Doubtful Accounts |            |       |            |
|                                 |            |       |            |
|                                 |            | 10/31 | Adj. 1,600 |

| Bad Debt Expense |  |       |            |
|------------------|--|-------|------------|
|                  |  |       |            |
|                  |  | 10/31 | Adj. 1,600 |

# 5. Adjusted Trial Balance

Shows the balance of all accounts, after adjusting entries, at the end of the accounting period.

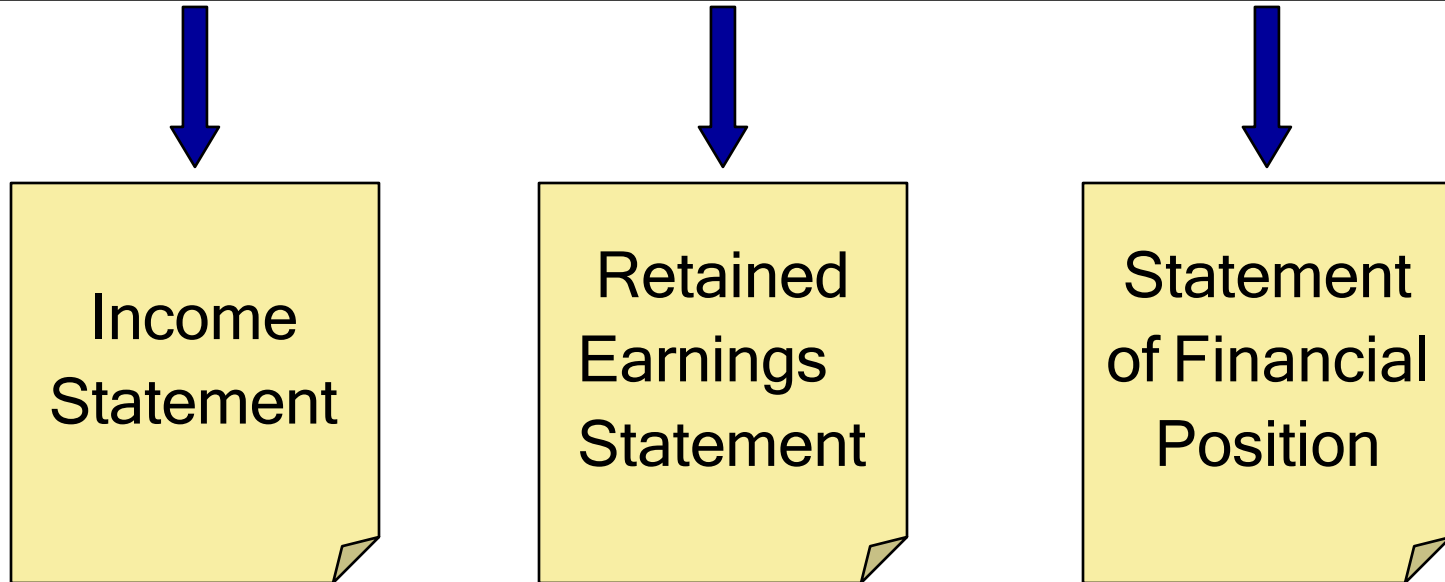
**PIONEER ADVERTISING AGENCY INC.**  
**ADJUSTED TRIAL BALANCE**  
**OCTOBER 31, 2011**

**Illustration 3-33**

|   | Debit            | Credit           |
|---|------------------|------------------|
| Cash  | \$ 80,000        |                  |
| Accounts Receivable                           | 74,000           |                  |
| Allowance for Doubtful Accounts               |                  | \$ 1,600         |
| Advertising Supplies                          | 10,000           |                  |
| Prepaid Insurance                             | 5,500            |                  |
| Office Equipment                              | 50,000           |                  |
| Accumulated Depreciation—<br>Office Equipment |                  | 400              |
| Notes Payable                                 |                  | 50,000           |
| Accounts Payable                              |                  | 25,000           |
| Interest Payable                              |                  | 500              |
| Unearned Service Revenue                      |                  | 8,000            |
| Salaries Payable                              |                  | 6,000            |
| Share Capital—Ordinary                        |                  | 100,000          |
| Dividends                                     | 5,000            |                  |
| Service Revenue                               |                  | 106,000          |
| Salaries Expense                              | 46,000           |                  |
| Advertising Supplies Expense                  | 15,000           |                  |
| Rent Expense                                  | 9,000            |                  |
| Insurance Expense                             | 500              |                  |
| Interest Expense                              | 500              |                  |
| Depreciation Expense                          | 400              |                  |
| Bad Debt Expense                              | 1,600            |                  |
|   | <b>\$297,500</b> | <b>\$297,500</b> |

## 6. Preparing Financial Statements

Financial Statements are prepared directly from the Adjusted Trial Balance.



# 6. Preparing Financial Statements

Illustration 3-34

## PIONEER ADVERTISING AGENCY INC.

### Adjusted Trial Balance

October 31, 2011

| Account                                       | Debit            | Credit           |
|---|------------------|------------------|
| Cash  | \$80,000         |                  |
| Accounts Receivable                           | 74,000           |                  |
| Allowance for Doubtful Accounts               |                  | \$ 1,600         |
| Advertising Supplies                          | 10,000           |                  |
| Prepaid Insurance                             | 5,500            |                  |
| Office Equipment                              | 50,000           |                  |
| Accumulated Depreciation—<br>Office Equipment |                  | 400              |
| Notes Payable                                 |                  | 50,000           |
| Accounts Payable                              |                  | 25,000           |
| Unearned Service Revenue                      |                  | 8,000            |
| Salaries Payable                              |                  | 6,000            |
| Interest Payable                              |                  | 500              |
| Share Capital—Ordinary                        |                  | 100,000          |
| Retained Earnings                             |                  | -0-              |
| Dividends                                     | 5,000            |                  |
| Service Revenue                               |                  | 106,000          |
| Salaries Expense                              | 46,000           |                  |
| Advertising Supplies Expense                  | 15,000           |                  |
| Rent Expense                                  | 9,000            |                  |
| Insurance Expense                             | 500              |                  |
| Interest Expense                              | 500              |                  |
| Depreciation Expense                          | 400              |                  |
| Bad Debt Expense                              | 1,600            |                  |
|   | <u>\$297,500</u> | <u>\$297,500</u> |

## PIONEER ADVERTISING AGENCY INC.

### Income Statement

For the Month Ended October 31, 2011

|                              |                  |
|------------------------------|------------------|
| Revenues                     |                  |
| Service Revenue              | \$106,000        |
| Expenses                     |                  |
| Salaries expense             | \$46,000         |
| Advertising supplies expense | 15,000           |
| Rent expense                 | 9,000            |
| Insurance expense            | 500              |
| Interest expense             | 500              |
| Depreciation expense         | 400              |
| Bad debt expense             | 1,600            |
| Total expenses               | <u>73,000</u>    |
| Net income                   | <u>\$ 33,000</u> |

## PIONEER ADVERTISING AGENCY INC.

### Retained Earnings Statement

For the Month Ended October 31, 2011

|                               |                 |
|-------------------------------|-----------------|
| Retained earnings, October 1  | \$ -0-          |
| Add: Net income               | <u>33,000</u>   |
|                               | 33,000          |
| Less: Dividends               | <u>5,000</u>    |
| Retained earnings, October 31 | <u>\$28,000</u> |

To the statement of  
financial position

# 6. Preparing Financial Statements

**Illustration 3-35**
**PIONEER ADVERTISING AGENCY INC.**  
**Adjusted Trial Balance**  
**October 31, 2011**

| Account                                       | Debit            | Credit           |
|---|------------------|------------------|
| Cash  | \$80,000         |                  |
| Accounts Receivable                           | 74,000           |                  |
| Allowance for Doubtful Accounts               |                  | \$ 1,600         |
| Advertising Supplies                          | 10,000           |                  |
| Prepaid Insurance                             | 5,500            |                  |
| Office Equipment                              | 50,000           |                  |
| Accumulated Depreciation—<br>Office Equipment |                  | 400              |
| Notes Payable                                 |                  | 50,000           |
| Accounts Payable                              |                  | 25,000           |
| Unearned Service Revenue                      |                  | 8,000            |
| Salaries Payable                              |                  | 6,000            |
| Interest Payable                              |                  | 500              |
| Share Capital—Ordinary                        |                  | 100,000          |
| Retained Earnings                             |                  | -0-              |
| Dividends                                     | 5,000            |                  |
| Service Revenue                               |                  | 106,000          |
| Salaries Expense                              | 46,000           |                  |
| Advertising Supplies Expense                  | 15,000           |                  |
| Rent Expense                                  | 9,000            |                  |
| Insurance Expense                             | 500              |                  |
| Interest Expense                              | 500              |                  |
| Depreciation Expense                          | 400              |                  |
| Bad Debt Expense                              | 1,600            |                  |
|   | <u>\$297,500</u> | <u>\$297,500</u> |

**PIONEER ADVERTISING AGENCY INC.**  
**Statement of Financial Position**  
**October 31, 2011**

| Assets                         |                     |
|--------------------------------|---------------------|
| Office equipment               | \$50,000            |
| Less: Accumulated depreciation | <u>400</u> \$49,600 |
| Advertising supplies           | 10,000              |
| Prepaid insurance              | 5,500               |
| Accounts receivable            | 74,000              |
| Less: Allowance                | <u>1,600</u> 72,400 |
| Cash                           | 80,000              |
| Total assets                   | <u>\$217,500</u>    |
| Equity and Liabilities         |                     |
| Equity                         |                     |
| Share capital—ordinary         | \$100,000           |
| Retained earnings              | <u>28,000</u>       |
| Total equity                   | \$128,000           |
| Liabilities                    |                     |
| Notes payable                  | 50,000              |
| Accounts payable               | 25,000              |
| Unearned service revenue       | 8,000               |
| Salaries payable               | 6,000               |
| Interest payable               | <u>500</u>          |
| Total liabilities              | 89,500              |
| Total equity and liabilities   | <u>\$217,500</u>    |

Balance at Oct. 31  
from retained earnings  
statement in Illustration 3-34

## 7. Closing Entries

- To reduce the balance of the income statement (**revenue** and **expense**) accounts to zero.
- To transfer net income or net loss to equity.
- Statement of financial position (**asset**, **liability**, and **equity**) accounts are not closed.
- Dividends are closed directly to the Retained Earnings account.

# 7. Closing Entries

| GENERAL JOURNAL |  |         | J3      |
|-----------------|--|---------|---------|
| Date            | Account Titles and Explanation             | Debit   | Credit  |
|                 | <u>Closing Entries</u>                     |         |         |
|                 | (1)  |         |         |
| Oct. 31         | Service Revenue                            | 106,000 |         |
|                 | Income Summary                             |         | 106,000 |
|                 | (To close revenue account)                 |         |         |
|                 | (2)  |         |         |
| 31              | Income Summary                             | 73,000  |         |
|                 | Advertising Supplies Expense               |         | 15,000  |
|                 | Depreciation Expense                       |         | 400     |
|                 | Insurance Expense                          |         | 500     |
|                 | Salaries Expense                           |         | 46,000  |
|                 | Rent Expense                               |         | 9,000   |
|                 | Interest Expense                           |         | 500     |
|                 | Bad Debt Expense                           |         | 1,600   |
|                 | (To close expense accounts)                |         |         |
|                 | (3)  |         |         |
| 31              | Income Summary                             | 33,000  |         |
|                 | Retained Earnings                          |         | 33,000  |
|                 | (To close net income to retained earnings) |         |         |
|                 | (4)  |         |         |
| 31              | Retained Earnings                          | 5,000   |         |
|                 | Dividends                                  |         | 5,000   |
|                 | (To close dividends to retained earnings)  |         |         |

Illustration 3-36

# 7. Closing Entries

|                                  |     |        |
|----------------------------------|-----|--------|
| Advertising Supplies Expense 631 |     |        |
| 15,000                           | (2) | 15,000 |

|                          |     |     |
|--------------------------|-----|-----|
| Depreciation Expense 711 |     |     |
| 400                      | (2) | 400 |

|                       |     |     |
|-----------------------|-----|-----|
| Insurance Expense 722 |     |     |
| 500                   | (2) | 500 |

|                      |     |        |
|----------------------|-----|--------|
| Salaries Expense 726 |     |        |
| 40,000               | (2) | 46,000 |
| 6,000                |     |        |
| 46,000               |     |        |

|                  |     |       |
|------------------|-----|-------|
| Rent Expense 729 |     |       |
| 9,000            | (2) | 9,000 |

|                      |     |     |
|----------------------|-----|-----|
| Interest Expense 905 |     |     |
| 500                  | (2) | 500 |

|                      |     |       |
|----------------------|-----|-------|
| Bad Debt Expense 910 |     |       |
| 1,600                | (2) | 1,600 |

Illustration 3-37

|                    |             |  |
|--------------------|-------------|--|
| Income Summary 350 |             |  |
| (2) 73,000         | (1) 106,000 |  |
| (3) 33,000         |             |  |
| 106,000            | 106,000     |  |

|                     |         |  |
|---------------------|---------|--|
| Service Revenue 400 |         |  |
| (1) 106,000         | 100,000 |  |
|                     | 4,000   |  |
|                     | 2,000   |  |
| 106,000             | 106,000 |  |

|                       |             |  |
|-----------------------|-------------|--|
| Retained Earnings 320 |             |  |
| (4) 5,000             | 0           |  |
|                       | (3) 33,000  |  |
|                       | Bal. 28,000 |  |

|               |           |  |
|---------------|-----------|--|
| Dividends 332 |           |  |
| 5,000         | (4) 5,000 |  |

- Key:
- 1 Close Revenues to Income Summary.
  - 2 Close Expenses to Income Summary.
  - 3 Close Income Summary to Retained Earnings.
  - 4 Close Dividends to Retained Earnings.



# 8. Post-Closing Trial Balance

**PIONEER ADVERTISING AGENCY INC.  
POST-CLOSING TRIAL BALANCE  
OCTOBER 31, 2011**

**Illustration 3-38**

| Account                                   | Debit            | Credit           |
|---|------------------|------------------|
| Cash                                      | \$ 80,000        |                  |
| Accounts Receivable                       | 74,000           |                  |
| Allowance for Doubtful Accounts           |                  | \$ 1,600         |
| Advertising Supplies                      | 10,000           |                  |
| Prepaid Insurance                         | 5,500            |                  |
| Office Equipment                          | 50,000           |                  |
| Accumulated Depreciation—Office Equipment |                  | 400              |
| Notes Payable                             |                  | 50,000           |
| Accounts Payable                          |                  | 25,000           |
| Unearned Service Revenue                  |                  | 8,000            |
| Salaries Payable                          |                  | 6,000            |
| Interest Payable                          |                  | 500              |
| Share Capital—Ordinary                    |                  | 100,000          |
| Retained Earnings                         |                  | 28,000           |
|   | <u>\$219,500</u> | <u>\$219,500</u> |

## 9. Reversing Entries

After preparing the financial statements and closing the books, a company may reverse some of the adjusting entries before recording the regular transactions of the next period.

# Accounting Cycle Summarized

1. Enter the transactions of the period in appropriate journals.
2. Post from the journals to the ledger (or ledgers).
3. Take an unadjusted trial balance (trial balance).
4. Prepare adjusting journal entries and post to the ledger(s).
5. Take a trial balance after adjusting (adjusted trial balance).
6. Prepare the financial statements from the second trial balance.
7. Prepare closing journal entries and post to the ledger(s).
8. Take a trial balance after closing (post-closing trial balance).
9. Prepare reversing entries (**optional**) and post to the ledger(s).

# Financial Statements for a Merchandising Company

**UPTOWN CABINET CORP.**  
**INCOME STATEMENT**  
**FOR THE YEAR ENDED DECEMBER 31, 2011**

**Illustration 3-39**

|  |              |                         |
|--|--------------|-------------------------|
| Net sales                                    |              | \$400,000               |
| Cost of goods sold                           |              | <u>316,000</u>          |
| Gross profit on sales                        |              | 84,000                  |
| Selling expenses                             |              |                         |
| Sales salaries expense                       | \$20,000     |                         |
| Traveling expense                            | 8,000        |                         |
| Advertising expense                          | <u>2,200</u> | 30,200                  |
| Administrative expenses                      |              |                         |
| Salaries, office and general                 | 19,000       |                         |
| Depreciation expense—furniture and equipment | 6,700        |                         |
| Property tax expense                         | 5,300        |                         |
| Rent expense                                 | 4,300        |                         |
| Bad debt expense                             | 1,000        |                         |
| Telephone and Internet expense               | 600          |                         |
| Insurance expense                            | <u>360</u>   | 37,260                  |
| Other income and expense                     |              |                         |
| Interest revenue                             |              | <u>800</u>              |
| Income from operations                       |              | 17,340                  |
| Interest expense                             |              | <u>1,700</u>            |
| Income before income tax                     |              | 15,640                  |
| Income tax                                   |              | <u>3,440</u>            |
| <b>Net income</b>                            |              | <b><u>\$ 12,200</u></b> |

# Financial Statements of a Merchandising Company

Illustration 3-40

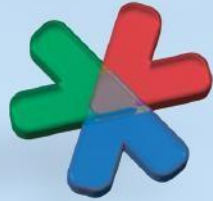
**UPTOWN CABINET CORP.  
RETAINED EARNINGS STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2011**

|                                |                        |
|--------------------------------|------------------------|
| Retained earnings, January 1   | \$16,200               |
| Add: Net income                | <u>12,200</u>          |
|                                | 28,400                 |
| Less: Dividends                | <u>2,000</u>           |
| Retained earnings, December 31 | <u><u>\$26,400</u></u> |

# Financial Statements of a Merchandising Company

Illustration 3-41

| UPTOWN CABINET CORP.<br>STATEMENT OF FINANCIAL POSITION<br>AS OF DECEMBER 31, 2011 |              |               |                         |
|--|--------------|---------------|-------------------------|
| <b>Assets</b>  |              |               |                         |
| Non-current assets   |              |               |                         |
| Property, plant, and equipment   |              |               |                         |
| Furniture and equipment  |              | \$67,000      |                         |
| Less: Accumulated depreciation   |              | <u>18,700</u> |                         |
| Total property, plant, and equipment   |              |               | \$ 48,300               |
| Current assets   |              |               |                         |
| Merchandise inventory  |              | 40,000        |                         |
| Prepaid insurance  |              | 540           |                         |
| Prepaid rent expense   |              | 500           |                         |
| Notes receivable   | \$16,000     |               |                         |
| Accounts receivable  | 41,000       |               |                         |
| Interest receivable  | 800          |               |                         |
| Less: Allowance for doubtful accounts  | <u>3,000</u> | 54,800        |                         |
| Cash   |              | <u>1,200</u>  |                         |
| Total current assets   |              |               | <u>97,040</u>           |
| <b>Total assets</b>  |              |               | <b><u>\$145,340</u></b> |
| <b>Equity and Liabilities</b>  |              |               |                         |
| Equity   |              |               |                         |
| Share capital—ordinary, \$5.00 par value, issued<br>and outstanding, 10,000 shares |              |               |                         |
|  |              | \$50,000      |                         |
| Retained earnings  |              | <u>26,400</u> |                         |
| Total equity   |              |               | \$ 76,400               |
| Non-current liabilities  |              |               |                         |
| Bonds payable, due June 30, 2018   |              |               |                         |
|  |              | 30,000        |                         |
| Current liabilities  |              |               |                         |
| Notes payable  | \$20,000     |               |                         |
| Accounts payable   | 13,500       |               |                         |
| Property tax payable   | 2,000        |               |                         |
| Income tax payable   | <u>3,440</u> |               |                         |
| Total current liabilities  |              | <u>38,940</u> |                         |
| Total liabilities  |              |               | <u>68,940</u>           |
| <b>Total equity and liabilities</b>  |              |               | <b><u>\$145,340</u></b> |



# CONVERGENCE CORNER

## ACCOUNTING INFORMATION SYSTEMS



### RELEVANT FACTS

- Internal controls are a system of checks and balances designed to prevent and detect fraud and errors. Both of these actions are required under SOX.
- Companies find that internal control review is a costly process. One study estimates the cost for U.S. companies at over \$35 billion, with audit fees doubling in the first year of compliance.
- The enhanced internal control standards apply only to large public companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply.

## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

Most companies use **accrual-basis accounting**

- recognize revenue when it is earned and
  - expenses in the period incurred,
- without regard to the time of receipt or payment of cash.

Under the strict cash basis, companies

- record revenue only when they receive cash, and
- record expenses only when they disperse cash.

Cash basis financial statements are not in conformity with IFRS.



## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

**Illustration:** Quality Contractor signs an agreement to construct a garage for \$22,000. In January, Quality begins construction, incurs costs of \$18,000 on credit, and by the end of January delivers a finished garage to the buyer. In February, Quality collects \$22,000 cash from the customer. In March, Quality pays the \$18,000 due the creditors.

Illustration 3A-1

| QUALITY CONTRACTOR          |         |          |       |       |
|-----------------------------|---------|----------|-------|-------|
| INCOME STATEMENT—CASH BASIS |         |          |       |       |
| For the Month of            |         |          |       |       |
|                             | January | February | March | Total |
| Cash receipts               |         |          |       |       |
| Cash payments               |         |          |       |       |
| Net income (loss)           |         |          |       |       |

## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

**Illustration:** Quality Contractor signs an agreement to construct a garage for \$22,000. In January, Quality begins construction, incurs costs of \$18,000 on credit, and by the end of January delivers a finished garage to the buyer. In February, Quality collects \$22,000 cash from the customer. In March, Quality pays the \$18,000 due the creditors.

Illustration 3A-2

| QUALITY CONTRACTOR             |         |          |       |       |
|--------------------------------|---------|----------|-------|-------|
| INCOME STATEMENT—ACCRUAL BASIS |         |          |       |       |
| For the Month of               |         |          |       |       |
|                                | January | February | March | Total |
| Revenues                       |         |          |       |       |
| Expenses                       |         |          |       |       |
| Net income (loss)              |         |          |       |       |

## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

## Conversion From Cash Basis To Accrual Basis

**Illustration:** Dr. Diane Windsor, like many small business owners, keeps her accounting records on a cash basis. In the year 2010, Dr. Windsor received \$300,000 from her patients and paid \$170,000 for operating expenses, resulting in an excess of cash receipts over disbursements of \$130,000 (\$300,000 - \$170,000). At January 1 and December 31, 2010, she has accounts receivable, unearned service revenue, accrued liabilities, and prepaid expenses as shown in Illustration 3A-5.

**Illustration 3A-5**

|                          | <u>January 1, 2011</u> | <u>December 31, 2011</u> |
|--------------------------|------------------------|--------------------------|
| Accounts receivable      | \$12,000               | \$9,000                  |
| Unearned service revenue | -0-                    | 4,000                    |
| Accrued liabilities      | 2,000                  | 5,500                    |
| Prepaid expenses         | 1,800                  | 2,700                    |

## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

## Conversion From Cash Basis To Accrual Basis

**Illustration:** Calculate service revenue on an accrual basis.

Illustration 3A-8

|                              |       |           |
|------------------------------|-------|-----------|
| Cash receipts from customers |       | \$300,000 |
| Service revenue (accrual)    | _____ | _____     |

Illustration 3A-5

|                          | <u>January 1, 2011</u> | <u>December 31, 2011</u> |
|--------------------------|------------------------|--------------------------|
| Accounts receivable      | \$12,000               | \$9,000                  |
| Unearned service revenue | -0-                    | 4,000                    |
| Accrued liabilities      | 2,000                  | 5,500                    |
| Prepaid expenses         | 1,800                  | 2,700                    |

## APPENDIX 3A

# CASH-BASIS ACCOUNTING VERSUS ACCRUAL-BASIS ACCOUNTING

## Conversion From Cash Basis To Accrual Basis

**Illustration:** Calculate operating expenses on an accrual basis.

Illustration 3A-11

|                                  |       |           |
|----------------------------------|-------|-----------|
| Cash paid for operating expenses |       | \$170,000 |
| Operating expenses (accrual)     | _____ | =====     |

Illustration 3A-5

|                          | <u>January 1, 2011</u> | <u>December 31, 2011</u> |
|--------------------------|------------------------|--------------------------|
| Accounts receivable      | \$12,000               | \$9,000                  |
| Unearned service revenue | -0-                    | 4,000                    |
| Accrued liabilities      | 2,000                  | 5,500                    |
| Prepaid expenses         | 1,800                  | 2,700                    |

## APPENDIX 3A

CASH-BASIS ACCOUNTING VERSUS  
ACCRUAL-BASIS ACCOUNTING

## Conversion From Cash Basis To Accrual Basis

Illustration 3A-12

DIANE WINDSOR, D.D.S.  
Conversion of Income Statement Data from Cash Basis to Accrual Basis  
For the Year 2011

|    | A  | B          | C           |          | D | E             |
|----|--|------------|-------------|----------|---|---------------|
| 1  |  | Cash Basis | Adjustments |          |   | Accrual Basis |
|    |  |            | Add         | Deduct   |   |               |
| 2  | Collections from customers                               | \$300,000  |             |          |   |               |
| 3  | – Accounts receivable, Jan. 1                            |            |             | \$12,000 |   |               |
| 4  | + Accounts receivable, Dec. 31                           |            | \$9,000     |          |   |               |
| 5  | + Unearned service revenue, Jan. 1                       |            | —           | —        |   |               |
| 6  | – Unearned service revenue, Dec. 31                      |            |             | 4,000    |   |               |
| 7  | Service revenue  |            |             |          |   | \$293,000     |
| 8  | Disbursement for expenses                                | 170,000    |             |          |   |               |
| 9  | + Prepaid expenses, Jan. 1                               |            | 1,800       |          |   |               |
| 10 | – Prepaid expenses, Dec. 31                              |            |             | 2,700    |   |               |
| 11 | – Accrued liabilities, Jan. 1                            |            |             | 2,000    |   |               |
| 12 | + Accrued liabilities, Dec. 31                           |            | 5,500       |          |   |               |
| 13 | Operating expenses                                       |            |             |          |   | 172,600       |
| 14 | Excess of cash collections over disbursements—cash basis | \$130,000  |             |          |   |               |
| 15 | Net income—accrual basis                                 |            |             |          |   | \$120,400     |

Sheet1 / Sheet2 / Sheet3

## Theoretical Weaknesses of the Cash Basis

Today's economy is considerably more lubricated by credit than by cash.

The accrual basis, not the cash basis, recognizes all aspects of the credit phenomenon.

Investors, creditors, and other decision makers seek timely information about an enterprise's *future* cash flows.

## APPENDIX 3B

## USING REVERSING ENTRIES

## Illustration of Reversing Entries—Accruals

Illustration 3B-1

| REVERSING ENTRIES NOT USED     |                   |       |       | REVERSING ENTRIES USED |                  |       |       |
|--------------------------------|-------------------|-------|-------|------------------------|------------------|-------|-------|
| <u>Initial Salary Entry</u>    |                   |       |       |                        |                  |       |       |
| Oct. 24                        | Salaries Expense  | 4,000 |       | Oct. 24                | Salaries Expense | 4,000 |       |
|                                | Cash              |       | 4,000 |                        | Cash             |       | 4,000 |
| <u>Adjusting Entry</u>         |                   |       |       |                        |                  |       |       |
| Oct. 31                        | Salaries Expense  | 1,200 |       | Oct. 31                | Salaries Expense | 1,200 |       |
|                                | Salaries Payable  |       | 1,200 |                        | Salaries Payable |       | 1,200 |
| <u>Closing Entry</u>           |                   |       |       |                        |                  |       |       |
| Oct. 31                        | Income Summary    | 5,200 |       | Oct. 31                | Income Summary   | 5,200 |       |
|                                | Salaries Expense  |       | 5,200 |                        | Salaries Expense |       | 5,200 |
| <u>Reversing Entry</u>         |                   |       |       |                        |                  |       |       |
| Nov. 1                         | No entry is made. |       |       | Nov. 1                 | Salaries Payable | 1,200 |       |
|                                |                   |       |       |                        | Salaries Expense |       | 1,200 |
| <u>Subsequent Salary Entry</u> |                   |       |       |                        |                  |       |       |
| Nov. 8                         | Salaries Payable  | 1,200 |       | Nov. 8                 | Salaries Expense | 2,500 |       |
|                                | Salaries Expense  | 1,300 |       |                        | Cash             |       | 2,500 |
|                                | Cash              |       | 2,500 |                        |                  |       |       |



## APPENDIX 3B

## USING REVERSING ENTRIES

## Illustration of Reversing Entries—Deferrals

Illustration 3B-2

| REVERSING ENTRIES NOT USED                |                         |        |        | REVERSING ENTRIES USED |                         |        |        |
|---|-------------------------|--------|--------|------------------------|-------------------------|--------|--------|
| <u>Initial Purchase of Supplies Entry</u> |                         |        |        |                        |                         |        |        |
| Dec. 10                                   | Office Supplies         | 20,000 |        | Dec. 10                | Office Supplies Expense | 20,000 |        |
|   | Cash                    |        | 20,000 |                        | Cash                    |        | 20,000 |
| <u>Adjusting Entry</u>                    |                         |        |        |                        |                         |        |        |
| Dec. 31                                   | Office Supplies Expense | 15,000 |        | Dec. 31                | Office Supplies         | 5,000  |        |
|   | Office Supplies         |        | 15,000 |                        | Office Supplies Expense |        | 5,000  |
| <u>Closing Entry</u>                      |                         |        |        |                        |                         |        |        |
| Dec. 31                                   | Income Summary          | 15,000 |        | Dec. 31                | Income Summary          | 15,000 |        |
|   | Office Supplies Expense |        | 15,000 |                        | Office Supplies Expense |        | 15,000 |
| <u>Reversing Entry</u>                    |                         |        |        |                        |                         |        |        |
| Jan. 1                                    | No entry                |        |        | Jan. 1                 | Office Supplies Expense | 5,000  |        |
|   |                         |        |        |                        | Office Supplies         |        | 5,000  |

## Summary of Reversing Entries

1. All accruals should be reversed.
2. All deferrals for which a company debited or credited the original cash transaction to an expense or revenue account should be reversed.
3. Adjusting entries for depreciation and bad debts are not reversed.

Recognize that reversing entries do not have to be used. Therefore, some accountants avoid them entirely.

A company prepares a worksheet either on

- columnar paper or
- within an electronic spreadsheet.

A company uses the worksheet to adjust

- account balances and
- to prepare financial statements.

## Worksheet Columns

A company prepares a worksheet either on

- columnar paper or
- within an electronic spreadsheet.

## APPENDIX 3C

## USING A WORKSHEET: THE ACCOUNTING CYCLE REVISITED

Adjusted  
Trial  
Balance

| UPTOWN CABINET CORP.<br>Ten-Column Worksheet for The Year Ended December 31, 2011 |  |                    |                |                  |               |                             |                |                       |                |                                      |                |
|---|--|--------------------|----------------|------------------|---------------|-----------------------------|----------------|-----------------------|----------------|--------------------------------------|----------------|
| 1   | A<br>Accounts  | B<br>Trial Balance |                | D<br>Adjustments |               | F<br>Adjusted Trial Balance |                | H<br>Income Statement |                | J<br>Statement of Financial Position |                |
|   |  | Dr.                | Cr.            | Dr.              | Cr.           | Dr.                         | Cr.            | Dr.                   | Cr.            | Dr.                                  | Cr.            |
| 2   | Cash   | 1,200              |                |                  |               | 1,200                       |                |                       |                |                                      | 1,200          |
| 3   | Notes receivable                                     | 16,000             |                |                  |               | 16,000                      |                |                       |                |                                      | 16,000         |
| 4   | Accounts receivable                                  | 41,000             |                |                  |               | 41,000                      |                |                       |                |                                      | 41,000         |
| 5   | Allowance for doubtful accounts                      |                    | 2,000          | (b) 1,000        |               |                             | 3,000          |                       |                |                                      | 3,000          |
| 6   | Merchandise inventory                                | 40,000             |                |                  |               | 40,000                      |                |                       |                |                                      | 40,000         |
| 7   | Prepaid insurance                                    | 900                |                | (c) 360          |               | 540                         |                |                       |                |                                      | 540            |
| 8   | Furniture and equipment                              | 67,000             |                |                  |               | 67,000                      |                |                       |                |                                      | 67,000         |
| 9   | Accumulated depreciation—<br>furniture and equipment |                    | 12,000         | (a) 6,700        |               |                             | 18,700         |                       |                |                                      | 18,700         |
| 10  | Notes payable  |                    | 20,000         |                  |               |                             | 20,000         |                       |                |                                      | 20,000         |
| 11  | Accounts payable                                     |                    | 13,500         |                  |               |                             | 13,500         |                       |                |                                      | 13,500         |
| 12  | Bonds payable  |                    | 30,000         |                  |               |                             | 30,000         |                       |                |                                      | 30,000         |
| 13  | Share capital—ordinary                               |                    | 50,000         |                  |               |                             | 50,000         |                       |                |                                      | 50,000         |
| 14  | Retained earnings,<br>Jan. 1, 2010                   |                    | 16,200         |                  |               |                             | 16,200         |                       |                |                                      | 16,200         |
| 15  | Dividends  | 2,000              |                |                  |               | 2,000                       |                |                       |                | 2,000                                |                |
| 16  | Sales  |                    | 400,000        |                  |               |                             | 400,000        |                       | 400,000        |                                      |                |
| 17  | Cost of goods sold                                   | 316,000            |                |                  |               | 316,000                     |                | 316,000               |                |                                      |                |
| 18  | Sales salaries expense                               | 20,000             |                |                  |               | 20,000                      |                | 20,000                |                |                                      |                |
| 19  | Advertising expense                                  | 2,200              |                |                  |               | 2,200                       |                | 2,200                 |                |                                      |                |
| 20  | Traveling expense                                    | 8,000              |                |                  |               | 8,000                       |                | 8,000                 |                |                                      |                |
| 21  | Salaries, office and general                         | 19,000             |                |                  |               | 19,000                      |                | 19,000                |                |                                      |                |
| 22  | Telephone and Internet<br>expense                    | 600                |                |                  |               | 600                         |                | 600                   |                |                                      |                |
| 23  | Rent expense   | 4,800              |                | (e) 500          |               | 4,300                       |                | 4,300                 |                |                                      |                |
| 24  | Property tax expense                                 | 3,300              |                | (f) 2,000        |               | 5,300                       |                | 5,300                 |                |                                      |                |
| 25  | Interest expense                                     | 1,700              |                |                  |               | 1,700                       |                | 1,700                 |                |                                      |                |
| 26  | <b>Totals</b>  | <b>543,700</b>     | <b>543,700</b> |                  |               |                             |                |                       |                |                                      |                |
| 27  | Depreciation expense—<br>furniture and equipment     |                    |                | (a) 6,700        |               | 6,700                       |                | 6,700                 |                |                                      |                |
| 28  | Bad debt expense                                     |                    |                | (b) 1,000        |               | 1,000                       |                | 1,000                 |                |                                      |                |
| 29  | Insurance expense                                    |                    |                | (c) 360          |               | 360                         |                | 360                   |                |                                      |                |
| 30  | Interest receivable                                  |                    |                | (d) 800          |               | 800                         |                |                       |                | 800                                  |                |
| 31  | Interest revenue                                     |                    |                |                  | (d) 800       |                             | 800            |                       | 800            |                                      |                |
| 32  | Prepaid rent expense                                 |                    |                | (e) 500          |               | 500                         |                |                       |                | 500                                  |                |
| 33  | Property tax payable                                 |                    |                |                  | (f) 2,000     |                             | 2,000          |                       |                |                                      | 2,000          |
| 34  | Income tax expense                                   |                    |                | (g) 3,440        |               | 3,440                       |                | 3,440                 |                |                                      |                |
| 35  | Income tax payable                                   |                    |                |                  | (g) 3,440     |                             | 3,440          |                       |                |                                      | 3,440          |
| 36  | <b>Totals</b>  |                    |                | <b>14,800</b>    | <b>14,800</b> | <b>557,640</b>              | <b>557,640</b> | <b>388,600</b>        | <b>400,800</b> |                                      |                |
| 37  | Net income   |                    |                |                  |               |                             |                |                       | 12,200         |                                      | 12,200         |
| 38  | <b>Totals</b>  |                    |                |                  |               |                             |                | <b>400,800</b>        | <b>400,800</b> | <b>169,040</b>                       | <b>169,040</b> |

## Preparing Financial Statements from a Worksheet

### The Worksheet:

- Provides information needed for preparation of the financial statements.
- Sorts data into appropriate columns, which facilitates the preparation of the statements.

## APPENDIX 3C

## USING A WORKSHEET: THE ACCOUNTING CYCLE REVISITED

**UPTOWN CABINET CORP.**  
**INCOME STATEMENT**  
**FOR THE YEAR ENDED DECEMBER 31, 2011**

**Illustration 3-39**

|  |              |                         |
|--|--------------|-------------------------|
| Net sales                                    |              | \$400,000               |
| Cost of goods sold                           |              | <u>316,000</u>          |
| Gross profit on sales                        |              | 84,000                  |
| Selling expenses                             |              |                         |
| Sales salaries expense                       | \$20,000     |                         |
| Traveling expense                            | 8,000        |                         |
| Advertising expense                          | <u>2,200</u> | 30,200                  |
| Administrative expenses                      |              |                         |
| Salaries, office and general                 | 19,000       |                         |
| Depreciation expense—furniture and equipment | 6,700        |                         |
| Property tax expense                         | 5,300        |                         |
| Rent expense                                 | 4,300        |                         |
| Bad debt expense                             | 1,000        |                         |
| Telephone and Internet expense               | 600          |                         |
| Insurance expense                            | <u>360</u>   | 37,260                  |
| Other income and expense                     |              |                         |
| Interest revenue                             |              | <u>800</u>              |
| Income from operations                       |              | 17,340                  |
| Interest expense                             |              | <u>1,700</u>            |
| Income before income tax                     |              | 15,640                  |
| Income tax                                   |              | <u>3,440</u>            |
| <b>Net income</b>                            |              | <b><u>\$ 12,200</u></b> |

Illustration 3-40

**UPTOWN CABINET CORP.  
RETAINED EARNINGS STATEMENT  
FOR THE YEAR ENDED DECEMBER 31, 2011**

|                                |                        |
|--------------------------------|------------------------|
| Retained earnings, January 1   | \$16,200               |
| Add: Net income                | <u>12,200</u>          |
|                                | 28,400                 |
| Less: Dividends                | <u>2,000</u>           |
| Retained earnings, December 31 | <u><u>\$26,400</u></u> |



## APPENDIX 3C

## USING A WORKSHEET: THE ACCOUNTING CYCLE REVISITED

Illustration 3-41

| UPTOWN CABINET CORP.<br>STATEMENT OF FINANCIAL POSITION<br>AS OF DECEMBER 31, 2011 |              |               |                         |
|--|--------------|---------------|-------------------------|
| <b>Assets</b>  |              |               |                         |
| Non-current assets   |              |               |                         |
| Property, plant, and equipment   |              |               |                         |
| Furniture and equipment  |              | \$67,000      |                         |
| Less: Accumulated depreciation   |              | <u>18,700</u> |                         |
| Total property, plant, and equipment   |              |               | \$ 48,300               |
| Current assets   |              |               |                         |
| Merchandise inventory  |              | 40,000        |                         |
| Prepaid insurance  |              | 540           |                         |
| Prepaid rent expense   |              | 500           |                         |
| Notes receivable   | \$16,000     |               |                         |
| Accounts receivable  | 41,000       |               |                         |
| Interest receivable  | 800          |               |                         |
| Less: Allowance for doubtful accounts  | <u>3,000</u> | 54,800        |                         |
| Cash   |              | <u>1,200</u>  |                         |
| Total current assets   |              |               | <u>97,040</u>           |
| <b>Total assets</b>  |              |               | <b><u>\$145,340</u></b> |
| <b>Equity and Liabilities</b>  |              |               |                         |
| Equity   |              |               |                         |
| Share capital—ordinary, \$5.00 par value, issued<br>and outstanding, 10,000 shares |              |               |                         |
|  |              | \$50,000      |                         |
| Retained earnings  |              | <u>26,400</u> |                         |
| Total equity   |              |               | \$ 76,400               |
| Non-current liabilities  |              |               |                         |
| Bonds payable, due June 30, 2018   |              |               |                         |
|  |              | 30,000        |                         |
| Current liabilities  |              |               |                         |
| Notes payable  | \$20,000     |               |                         |
| Accounts payable   | 13,500       |               |                         |
| Property tax payable   | 2,000        |               |                         |
| Income tax payable   | <u>3,440</u> |               |                         |
| Total current liabilities  |              | <u>38,940</u> |                         |
| Total liabilities  |              |               | <u>68,940</u>           |
| <b>Total equity and liabilities</b>  |              |               | <b><u>\$145,340</u></b> |

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