

Accounting Building Business Skills

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Chapter Three: Accrual Accounting Concepts

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Learning Objectives

- Explain criteria for revenue recognition and expense recognition.
- Differentiate between the cash basis and the accrual basis of accounting.
- Explain why adjusting entries are needed and identify the major types of adjusting entries.
- Prepare adjusting entries for prepayments and accruals.

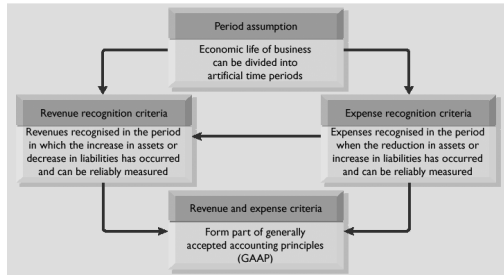
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Learning Objectives

- Describe the nature and purpose of the adjusted trial balance.
- Explain the purpose of closing entries.
- Describe the required steps in the accounting cycle.
- Describe the purpose and the basic form of a worksheet.

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Revenue & expense recognition criteria



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Accrual v Cash basis of Accounting

Accrual Accounting

- Revenue recognised when goods/services are provided
- Expenses recognised when assets consumed or liabilities incurred

Cash basis Accounting

- Revenue and expenses recognised when the cash is received or paid

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Accrual v Cash basis of Accounting

example:

	Year 1	Year 2
Activity	 Purchased paint, painted building, paid employees	 Received payment for work done in year 1
Accrual basis	Revenue \$80 000 Expense 50 000 Profit <u>\$30 000</u>	Revenue \$ — Expense — Profit <u>\$ —</u>
Cash basis	Revenue \$ — Expense 50 000 Loss <u>\$(50 000)</u>	Revenue \$80 000 Expense — Profit <u>\$80 000</u>

Adjusting entries

Adjusting entries make the
revenue recognition &
matching principles

HAPPEN!

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Types of adjusting entries

Prepayments

- Amounts paid in cash and recorded as assets until used
- Revenue received from customers and recorded as a liability until services performed/goods delivered

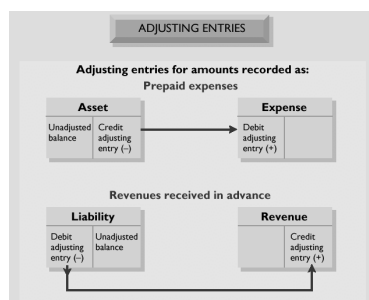
Accruals

- Amounts not yet received and recorded for which goods/services have been provided
- Amounts not yet paid or recorded for goods/services already received

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Prepayments

Prepaid expenses or revenue received in advance



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Prepayments

Example: Wong Pty. Ltd

Supplies on hand 31 October \$1,000
(expense \$2,500 originally recorded as an asset)

Journal entry:

Oct. 31	Advertising Supplies Expense	1 500	
	Advertising Supplies		1 500
	(To record supplies used)		

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Prepayments

Wong Pty. Ltd

Supplies on hand 31 October \$1,000

General Ledger entry:

Advertising Supplies			
Oct. 5	2 500	Oct. 31	Adj. Advertising Supplies Expense 1 500
			cross-reference
Advertising Supplies Expense			
Oct. 31	Adj. Advertising Supplies 1 500		
	cross-reference		

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Prepayments

Wong Pty. Ltd

Insurance paid for 1 year in advance \$600

Insurance for October $\$600/12 = \50

Journal entry:

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50
	(To record insurance expired)		

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Prepayments

Wong Pty. Ltd

Insurance paid for 1 year in advance \$600

Insurance for October $\$600/12 = \50

General Ledger:

Prepaid Insurance				Insurance Expense			
Oct. 4	600	Oct. 31 Adj.	50	Oct. 31 Adj.	50		

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Depreciation

Allocation of the cost of the asset to expense over its useful life

Example: Wong Pty. Ltd.

Depreciation of office equipment

\$480 p.a. or \$40 monthly

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Depreciation

Wong Pty. Ltd.

Journal entry

Oct. 31	Depreciation Expense	40	
	Accumulated Depreciation—Office Equipment		40
	(To record monthly depreciation)		

General Ledger:

Office Equipment				Accumulated Depreciation—Office Equipment				Depreciation Expense			
Oct. 2	5 000										
		Oct. 31 Adj.	40			Oct. 31 Adj.	40				

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Depreciation

Wong Pty. Ltd.

Statement of Financial Position

Office equipment	\$5 000
Less: Accumulated Depreciation	<u>40</u>
carrying Value	<u>\$4 960</u>

Note: depreciation is an allocation concept – not a valuation concept.

There is no change in the value of the asset

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Revenue received in advance

Revenue received in advance for goods/services not yet provided

Example: Wong Pty. Ltd.

\$100 received 2 October for advertising services to be completed 31 December

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Revenue received in advance

Example: Wong Pty. Ltd.

\$100 received 2 October for advertising services to be completed 31 December

Journal entry

Oct. 31	Service Revenue Received in Advance	400	
	Service Revenue		400
	(To record revenue)		

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Revenue received in advance

Example: Wong Pty. Ltd.

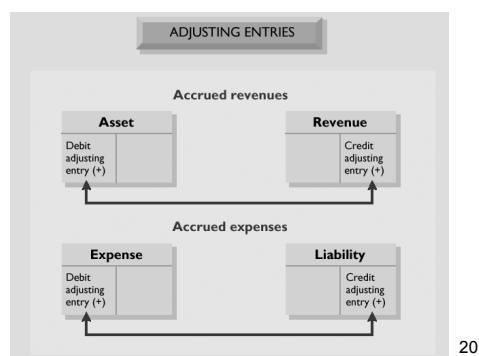
\$100 received 2 October for advertising services to be completed 31 December

General Ledger:

Service Revenue Received in Advance			Service Revenue		
Oct. 31	Adj.	400	Oct. 2		1 200
			Oct. 31	Adj.	400

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Accruals



Accrued Revenue

Revenue earned from goods/services provided but not yet recorded

Example: Wong Pty. Ltd.

Commission revenue earned, not yet received or recorded \$200

Journal entry

Oct. 31	Commissions Receivable	200	
	Commissions Revenue		200
	(To accrue commissions revenue not recorded or collected)		

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Accrued Revenue

Example: Wong Pty. Ltd.
Commission revenue earned, not yet received or recorded \$200

General Ledger:

Commissions Receivable			Commissions Revenue		
Oct. 31	Adj.	200	Oct. 31	Adj.	200

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Accrued Expenses

Expenses incurred not yet paid or recorded

Example: Wong Pty. Ltd.
interest owing on loan of \$5,000
interest rate 12% p.a.
interest owing: $\$5,000 \times 12\% \times 1/12$
= \$50

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Accrued Expenses

Example: Wong Pty. Ltd.
interest owing on loan \$50

Journal entry

Oct. 31	Interest Expense	50	
	Interest Payable		50
	(To accrue interest on bank loan)		

General Ledger

Interest Expense			Interest Payable		
Oct. 31	Adj.	50	Oct. 31	Adj.	50

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Accrued Expenses

Accrued Salaries

Example: Wong Pty. Ltd.

Salaries outstanding for October \$1,200
(3 days x \$400)

	October							November						
	S	M	Tu	W	Th	F	S	S	M	Tu	W	Th	F	S
	1	2	3	4	5	6						1	2	3
	7	8	9	10	11	12	13	4	5	6	7	8	9	10
	14	15	16	17	18	19	20	11	12	13	14	15	16	17
	21	22	23	24	25	26	27	18	19	20	21	22	23	24
	28	29	30	31				25	26	27	28	29	30	
Start of pay period	Adjustment period							Payday						

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Accrued Expenses

Example: Wong Pty. Ltd.

Salaries outstanding for October \$1,200

Journal entry

Oct. 31	Salaries Expense	1 200	
	Salaries Payable		1 200
	(To record accrued salaries)		

General Ledger

Salaries Expense		Salaries Payable	
Oct. 26	4 000		
31 Adj.	1 200	Oct. 31	Adj. 1 200

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Adjustments Summary

Type of adjustment	Accounts before adjustment	Adjusting entry
<i>Prepaid expenses</i>		
If amount paid is initially recorded as an asset	Assets overstated	Dr Expenses
	Expenses understated	Cr Assets
If amount paid is initially recorded as an expense	Expenses overstated	Dr Assets
	Assets understated	Cr Expenses
<i>Revenues received in advance</i>		
If amount received is initially recorded as a liability	Liabilities overstated	Dr Liabilities
	Revenues understated	Cr Revenues
If amount received is initially recorded as revenue	Revenues overstated	Dr Revenues
	Liabilities understated	Cr Liabilities
<i>Accrued revenues</i>	Assets understated	Dr Assets
	Revenues understated	Cr Revenues
<i>Accrued expenses</i>	Expenses understated	Dr Expenses
	Liabilities understated	Cr Liabilities

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Adjusted Trial Balance

- Trial Balance after all adjusting entries have been made
- used to prove the equity of total debit balances and total credit balances after the adjusting entries have been made
- Financial Statements can be easily prepared from the adjusted trial balance

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Adjusted Trial Balance

WONG PTY LTD Trial Balances as at 31 October 2003				
	Before adjustment		After adjustment	
	Dr	Cr	Dr	Cr
Cash	\$15 200		\$ 15 200	
Commissions Receivable			200	
Advertising Supplies	2 500		1 000	
Prepaid Insurance	600		550	
Office Equipment	5 000		5 000	
Accumulated Depreciation—Office Equipment				\$ 40
Accounts Payable		\$ 2 500		2 500
Interest Payable				50
Service Revenue Received in Advance		1 200		800
Salaries Payable				1 200
Bank Loan		5 000		5 000
Share Capital		10 000		10 000
Retained Profits				
Dividends	500		500	
Service Revenue		10 000		10 400
Commissions Revenue				200
Salaries Expense	4 000		5 200	
Advertising Supplies Expense			1 500	
Rent Expense	900		900	
Insurance Expense			50	
Interest Expense			50	
Depreciation Expense			40	
Net profit	\$28 700	\$28 700	\$30 190	\$30 190

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Financial Statement Preparation

- Statement of Financial Performance prepared from Revenue & expense accounts
- Current Period Profit and dividends paid transferred to Retained Profits account
- Statement of Financial Position prepared from Asset, Liability, Equity and balance of Retained Earnings accounts

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Financial Statement Preparation

WONG PTY LTD Adjusted Trial Balance as at 31 October 2003			WONG PTY LTD Statement of Financial Position for the month ended 31 October 2003	
Account	Debit	Credit		
Cash	\$15 200		Revenues	
Commissions Receivable	200		Service revenue	\$10 400
Advertising Supplies	1 000		Commissions revenue	200
Prepaid Insurance	500			<u>\$10 600</u>
Office Equipment	5 000		Expenses	
Accumulated Depreciation—			Salaries expense	\$5 200
Office Equipment	\$ 40		Advertising supplies expense	1 500
Accounts Payable	2 500		Rent expense	900
Interest Payable	50		Insurance expense	50
Service Revenue Received			Interest expense	50
in Advance	800		Depreciation expense	40
Salaries Payable	5 000			<u>2 740</u>
Bank Loan	1 200		Total expenses	
Share Capital	10 000			<u>\$ 2 860</u>
Retained Profits			Profit	
Dividends	800			
Service Revenue		10 400		
Commissions Revenue		200		
Salaries Expense	5 200			
Advertising Supplies Expense	1 500			
Rent Expense	900			
Insurance Expense	50			
Interest Expense	50			
Depreciation Expense	40			
	<u>\$30 190</u>	<u>\$30 190</u>		

WONG PTY LTD Calculation of Retained Profits for the month ended 31 October 2003		
Retained profits, 1 October	\$	—
Add: Profit		2 860
Less: Dividends		<u>800</u>
Retained profits, 31 October		<u>\$ 2 360</u>

Financial Statement Preparation

WONG PTY LTD Adjusted Trial Balance as at 31 October 2003			WONG PTY LTD Statement of Financial Position as at October 2003	
Account	Debit	Credit	Assets	
Cash	\$15 200		Cash	\$15 200
Commissions Receivable	200		Commissions receivable	200
Advertising Supplies	1 000		Advertising supplies	1 000
Prepaid Insurance	500		Prepaid insurance	500
Office Equipment	5 000		Office equipment	5 000
Accumulated Depreciation—			Less: Accumulated depreciation	40
Office Equipment	\$ 40		Total assets	<u>\$21 910</u>
Accounts Payable	2 500		Liabilities and shareholders' equity	
Interest Payable	50		Liabilities	
Service Revenue Received			Accounts payable	\$ 2 500
in Advance	800		Interest payable	50
Salaries Payable	1 200		Service revenue received in advance	800
Bank Loan	5 000		Salaries payable	1 200
Share Capital	10 000		Bank loan	<u>5 000</u>
Retained Profits	500		Total liabilities	
Dividends				<u>\$ 9 550</u>
Service Revenue		10 400	Shareholders' equity	
Commissions Revenue		200	Share capital	10 000
Salaries Expense	5 200		Retained profits	<u>2360</u>
Advertising Supplies Expense	1 500		Total shareholders' equity	<u>12 360</u>
Rent Expense	900		Total liabilities and shareholders' equity	<u>\$21 910</u>
Insurance Expense	50			
Interest Expense	50			
Depreciation Expense	40			
	<u>\$30 190</u>	<u>\$30 190</u>		

Closing the Books

Closing entries transfer the temporary account balances to the Owner's Equity account...

and reduce the balances in the temporary accounts to zero.

Closing the Books



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Preparing Closing Entries

- Transfer of profit/loss and dividend to Retained Earnings account
- Balances of all temporary accounts set to nil and closed

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Post-closing Trial Balance

- List of all permanent accounts and balances
- To prove the equality of permanent account balances carried forward to next accounting period

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The Accounting Cycle

- Analyse transactions
- Journalise transactions
- Post to ledger accounts
- Prepare a trial balance
- Journalise and post adjusting entries: prepayments/accruals
- Prepare an adjusted Trial Balance

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The Accounting Cycle

- Prepare financial statements
- Journalise and post closing entries
- Prepare a post-closing trial balance

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