BRIEF EXERCISE 4-1

	Cash	Net Income
(a)	$–100	$0
(b)	0	–20
(c)	0	+1,300
(d)	+800	0
(e)	–2,500	0
(f)	0	–600

BRIEF EXERCISE 4-2

(a) Prepaid Insurance—to recognize insurance expired during the period.

(b) Depreciation Expense—to allocate the cost of an asset to expense during the current period.

(c) Unearned Service Revenue—to account for unearned revenue that has been earned during the period.

(d) Interest Payable—to recognize interest accrued but unpaid on notes payable during the current period.

BRIEF EXERCISE 4-3

Item	(1) Type of Adjustment	(2) Accounts Before Adjustment
(a)	Prepaid Expenses	Assets Overstated Expenses Understated
(b)	Accrued Revenues	Assets Understated Revenues Understated
(c)	Accrued Expenses	Expenses Understated Liabilities Understated
(d)	Unearned Revenues	Liabilities Overstated Revenues Understated

BRIEF EXERCISE 4-4

Dec. 31	Supplies Expense	7,700	
	Supplies		7,700

Supplies

	8,800	12/31	7,700
12/31 Bal.	1,100		

Supplies Expense

12/31	7,700		

BRIEF EXERCISE 4-5

Dec. 31	Depreciation Expense	2,750	
	Accumulated Depreciation—Equipment		2,750

Depreciation Expense

12/31	2,750		

Accumulated Depreciation—Equipment

		12/31	2,750

Balance Sheet:

Equipment	$22,000	
Less: Accumulated Depreciation—Equipment	2,750	$19,250

BRIEF EXERCISE 4-6

July 1	Prepaid Insurance	12,400	
	Cash		12,400
Dec. 31	Insurance Expense ($12,400 X 6/24)	3,100	
	Prepaid Insurance		3,100

Prepaid Insurance

7/1	12,400	12/31	3,100
12/31 Bal.	9,300		

Insurance Expense

12/31	3,100		

BRIEF EXERCISE 4-7

July 1	Cash	12,400	
	Unearned Service Revenue		12,400
Dec. 31	Unearned Service Revenue	3,100	
	Service Revenue ($12,400 X 6/24)		3,100

Unearned Service Revenue

12/31	3,100	7/1	12,400
		12/31 Bal.	9,300

Service Revenue

		12/31	3,100

BRIEF EXERCISE 4-8

(a)	Dec. 31	Interest Expense	300	
		Interest Payable		300
(b)	31	Accounts Receivable	1,700	
		Service Revenue		1,700
(c)	31	Salaries and Wages Expense	780	
		Salaries and Wages Payable		780

BRIEF EXERCISE 4-9

	Account	(1) Type of Adjustment	(2) Related Account
(a)	Accounts Receivable	Accrued Revenues	Service Revenue
(b)	Prepaid Insurance	Prepaid Expenses	Insurance Expense
(c)	Equipment	Not required	
(d)	Accum. Depreciation—Equipment	Prepaid Expenses	Depreciation Expense
(e)	Notes Payable	Not required	
(f)	Interest Payable	Accrued Expenses	Interest Expense
(g)	Unearned Service Revenue	Unearned Revenues	Service Revenue

BRIEF EXERCISE 4-10

HANLON CORPORATION
Income Statement
For the Year Ended December 31, 2012

Revenues		
Service revenue		$32,000
Expenses		
Salaries and wages expense	$14,000	
Rent expense	3,900	
Insurance expense	1,800	
Supplies expense	1,500	
Depreciation expense	1,000	
Total expenses		22,200
Net income		$ 9,800

BRIEF EXERCISE 4-11

HANLON CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2012

Retained earnings, January 1	$17,200
Add: Net income	10,400
	27,600
Less: Dividends	6,000
Retained earnings, December 31	$21,600

BRIEF EXERCISE 4-12

	Account	
(a)	Accumulated Depreciation	Balance Sheet
(b)	Depreciation Expense	Income Statement
(c)	Retained Earnings	Retained Earnings Statement
(d)	Dividends	Retained Earnings Statement
(e)	Service Revenue	Income Statement
(f)	Supplies	Balance Sheet
(g)	Accounts Payable	Balance Sheet

BRIEF EXERCISE 4-13

The accounts that will appear in the post-closing trial balance are:

Accumulated Depreciation
Retained Earnings
Supplies
Accounts Payable

BRIEF EXERCISE 4-14

(a) **Closing Entries**

July 31	Service Revenue	16,000	
	Income Summary		16,000
	(To close revenue account)		
	Income Summary	11,900	
	Salaries and Wages Expense		8,400
	Maintenance and Repairs		
	Expense		2,500
	Income Tax Expense		1,000
	(To close expense accounts)		
	Income Summary	4,100	
	Retained Earnings		4,100
	(To close net income to retained earnings)		
	Retained Earnings	1,300	
	Dividends		1,300
	(To close dividends to retained earnings)		

(b)

Retained Earnings

1,300	7/1 Bal.	20,000
		4,100
	7/31 Bal.	22,800

BRIEF EXERCISE 4-15

The proper sequencing of the required steps in the accounting cycle is as follows:

1. (c) Analyze business transactions.
2. (e) Journalize the transactions.
3. (i) Post to ledger accounts.
4. (d) Prepare a trial balance.
5. (h) Journalize and post adjusting entries.
6. (b) Prepare an adjusted trial balance.
7. (g) Prepare financial statements.
8. (f) Journalize and post closing entries.
9. (a) Prepare a post-closing trial balance.

Chapter Outline

Study Objective 1 - Explain the Revenue Recognition Principle and the Expense Recognition Principle

- Determining the amount of revenues and expenses to report in a given accounting period can be difficult.
  - Proper reporting requires an understanding of the nature of the company's business.
    - Two principles are used as guidelines:
      1. **revenue recognition principle**
      2. **expense recognition principle**

- The **revenue recognition principle** requires that **revenue** be recognized in the accounting period in which it is earned.
  - A service company recognizes (records) revenue when the services are **performed**.

TEACHING TIP

Service businesses recognize revenue when the services are performed, although many customers may have been billed for the services (on account). The cash has not been received; however, the services have been performed. Therefore, revenue should be recognized.

Does Delta Airlines record revenue when you buy a plane ticket on May 1 for a flight on June 15? Has the service been provided? The answer to both of these questions is no. Delta cannot recognize revenue on May 1 because the service has not been provided. The revenue will be recognized on June 15 when the ticket holder takes the flight.

- The **expense recognition principle** requires that efforts (**expenses)** be matched with accomplishments (**revenues**).
  - The critical issue is determining when the expense makes its contribution to revenue.

TEACHING TIP

Returning to the service business example, suppose employees are paid every two weeks. When preparing financial statements for May, the accountant realizes that employees were last paid on Friday, May 22. By May 31, nine days have elapsed and many of the employees have worked seven or more days. The wages of these employees must be included in expenses.

The same accountant, however, notices that on May 1 the business renewed its insurance coverage by paying the $12,000 premium on a one-year insurance policy. Is all of the $12,000 an expense of May? No. The insurance policy will be in effect for 12 months. Therefore, $1,000 ($12,000/12 months) should be recognized as expense each month.

Study Objective 2 - Differentiate Between the Cash Basis and the Accrual Basis of Accounting

- With **cash basis accounting**, **revenue** is recognized (recorded) when cash is received. **Expenses** are recognized (recorded) only when cash is paid.

- **Accrual basis accounting** requires accountants to adhere to the **revenue recognition principle** and the **expense recognition principle.**

- **Cash basis accounting** does not satisfy the requirements of **Generally Accepted Accounting Principles (GAAP)**, whereas **accrual basis accounting** does.
  - Accrual basis accounting provides an objective measurement of net income.

TEACHING TIP

Return to the illustration of service businesses and the airlines. If the service business used cash basis accounting, revenue would be recognized only when cash was received. Delta would recognize revenue on May 1 when the ticket was purchased. All expenses of both a service business and Delta would be recorded when cash was paid. Point out that with cash basis accounting, the net income figure is easy to manipulate.

TEACHING TIP

Explain to students that many businesses use the cash basis of accounting. These businesses outgrow the method when accounts receivable and accounts payable become substantial. Also, if the businesses need audited financial statements, they must comply with GAAP and use the accrual basis. Remind them that companies can use the cash method and that its use does not mean that income is being manipulated. Without this discussion, some students may unfairly criticize an employer, relative or friend who is using the cash basis of accounting.

Study Objective 3 - Explain why Adjusting Entries are Needed, and Identify the Major Types of Adjusting Entries

- **Adjusting entries** are needed to ensure that the **revenue recognition** and **expense recognition principles are followed**.
- The **trial balance** may not contain up-to-date and complete data for several reasons:
  - Some events are not recorded daily because it is not efficient to do so.
  - Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions.
  - Some items may be unrecorded.
- **Adjusting entries** are required every time a company prepares financial statements.
  - Every adjusting entry will include one income statement account and one balance sheet account.

- **Adjusting entries** can be classified as either **deferrals** or **accruals**. Each of these classes has two subcategories.

> **TEACHING TIP**
>
> Explain that cash is not adjusted at the end of the accounting period, thus students should not use cash in the adjusting process.

Study Objective 4 - Prepare Adjusting Entries for Deferrals

Deferrals fall into two categories—**prepaid expenses** and **unearned revenues.**

1. **Prepaid expenses** - expenses paid in cash and recorded as assets until they are used or consumed. Prepaid expenses are costs that expire with the passage of time (i. e. rent and insurance) or through use (i. e. supplies).
2. **Unearned revenues** – cash received and recorded as liabilities before the revenue is earned.

- An **adjusting entry** for **prepaid expenses** will result in an increase (a debit) to an expense account and a decrease (a credit) to an asset account.
- An **adjusting entry** for **unearned revenues** will result in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account.
- An **adjusting entry** for **deferrals (prepaid expenses or unearned revenues)** will decrease a balance sheet account and increase an income statement account.

> **TEACHING TIP**
>
> Go through the examples of adjusting entries for the following deferrals including; insurance, supplies, depreciation, and unearned revenue. Review the concepts of depreciation, depreciation expense and accumulated depreciation.

> **TEACHING TIP**
>
> Discuss the effects on the income statement and balance sheet if adjustments are not made.

Study Objective 5 - Prepare Adjusting Entries for Accruals

- **Accruals** fall into two categories—**accrued revenues** and **accrued expenses**.
  - **Accrued revenues** - revenues earned but not yet received in cash or recorded at the statement date.
    - an **adjusting entry** for **accrued revenues** will result in an increase (a debit) in an asset account and an increase (a credit) to a revenue account.
  - **Accrued expenses** - expenses incurred but not yet paid in cash or recorded at the statement date.
    - an **adjusting entry** for **accrued expenses** results in an increase (a debit) to an expense account and an increase (a credit) to a liability account.
    - an **adjusting entry for accruals (accrued revenues or accrued expenses)** increases both a balance sheet and an income statement account.

TEACHING TIP

Go through the examples of adjusting entries for accrued interest, accrued salaries and accrued revenues.

TEACHING TIP

Discuss the effects on the income statement and balance sheet if adjustments are not made.

Summary of basic relationships:

Type of Adjustment	**Accounts Before Adjustment**	**Adjusting Entry**
Prepaid expenses	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
Unearned revenues	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated Revenues understated	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated Liabilities understated	Dr. Expenses Cr. Liabilities

Study Objective 6 - Describe the Nature and Purpose of the Adjusted Trial Balance

- The **adjusted trial balance** is prepared after all adjusting entries have been journalized and posted.

- The adjusted trial balance shows the balances of all accounts, including those that have been adjusted, at the end of the accounting period.

- The purpose of the adjusted trial balance is to prove the equality of the total debit balances and total credit balances in the ledger after all adjustments.

- Financial statements are prepared from the adjusted trial balance.

> **TEACHING TIP**
>
> Show students an adjusted trial balance and demonstrate how easy it is to prepare financial statements from the information contained in the trial balance.

Study Objective 7 - Explain the Purpose of Closing Entries

- **Closing entries** transfer net income (or net loss) and dividends to Retained Earnings.
  - This causes the ending balance of Retained Earnings (amount shown on the Balance Sheet) to agree with the balance shown on the Retained Earnings Statement.
    - Close the revenue accounts to the Income Summary account.
    - Close the expense accounts to the Income Summary account.
    - Close the Income Summary account to Retained Earnings.
    - Close Dividends to Retained Earnings.
- Closing entries produce a zero balance in each **temporary account** (revenues, expenses, and dividends)
  - These accounts are then ready to accumulate data for the next accounting period.
  - **Permanent accounts** (assets, liabilities, common stock and retained earnings) are not closed.

> **TEACHING TIP**
>
> Tell students to look at the date on the income statement. The date is “For the Period Ending October 31, 2012.” How can one be sure the revenues and expenses reported on the income statement are just for that period? Closing entries transfer the temporary account balances to the stockholders’ equity account and reduce the balances in the temporary accounts to zero. Therefore, at the beginning of the period the temporary accounts have a balance of zero and the revenues and expenses accumulated are for that particular period.

- After the closing entries have been journalized and posted, a post-closing trial balance is prepared.
  - The post-closing trial balance shows the balances of all of the permanent accounts.
  - The permanent account balances are carried forward to the next accounting period.

Study Objective 8 - Describe the Required Steps in the Accounting Cycle

- Analyze business transactions.

- Journalize the transactions.

- Post to ledger accounts.

- Prepare a trial balance.

- Journalize and post adjusting entries—deferrals and accruals.

- Prepare an adjusted trial balance.

- Prepare financial statements:
  - Income statement
  - Retained earnings statement
  - Balance sheet

- Journalize and post closing entries.

- Prepare a post-closing trial balance.

TEACHING TIP

Encourage students not to memorize the steps in the accounting cycle. Rather, they should think about what must be done in order to "capture" the financial transactions and to make sure the transactions are ultimately reported in the financial statements.

- **Quality of Earnings**
  - Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income.
  - The **quality of earnings** is greatly affected when a company manages earnings up or down to meet some targeted earnings number.
    - A company that has a high quality of earnings provides full and transparent information that will not confuse or mislead users of the financial statements.
    - A company with questionable quality of earnings may mislead investors and creditors, who believe they are relying on **relevant and reliable information**.

- Companies manage earnings in a variety of ways:
  - Use of one-time items to prop up earnings numbers (i.e. nonrecurring gains)
  - Inflate revenue numbers in the short-run (to the detriment of the long-run)
  - Improper adjusting entries
- As the result of investor pressure and the **Sarbanes-Oxley Act**, many companies are trying to improve the quality of their financial reporting.

Study Objective 9 – Understand the Causes of Differences Between Net Income and Cash Provided by Operating Activities

- Net income is based on accrual basis accounting and is accomplished through the adjusting entry process.
- Cash provided by operating activities is determined by comparing cash received from operating activities to cash expenditures from operating activities.

  - Cash provided by operating activities is essentially net income determined under the cash-basis of accounting.

TEACHING TIP

Discuss the example provided, paying particular attention to the differences between cash-basis and accrual-basis accounting when recognizing revenues and expenses.

*Study Objective 10 – Describe the Purpose and the Basic Form of a Worksheet

- The **worksheet** is a multiple-column form that may be used in the adjustment process and in preparing financial statements. Today most accountants use computer spreadsheets.
- A worksheet is not a permanent accounting record.

TEACHING TIP

Use the worksheet provided in the appendix to discuss its parts and how it facilitates preparation of the financial statements.