



CHAPTER

8

Completing the Accounting Cycle

8.1 ► The Adjustment Process

Financial statements are used extensively to assist in making business decisions. Therefore, it is important for financial statements to be accurate, current, and consistent from year to year. Responsibility for these documents rests entirely with the company's accountants.

Accountants Must Ensure That:

1. Accountants are brought up to date.
2. Late Transactions are taken into account.
3. Calculates have been made correctly.
4. Accounting principles and standards have been followed.

Accounting Principles and Standards

The accountant's ultimate aim is to produce financial statements that are completely accurate from both a mathematical and theoretical point of view.

Canada is making the transitions from Canadian Accepted Accounting Principles (**CAAP**) to International Financial Reporting Standards (**IFRS**).

Public Companies ● → Use IFRS

Private Companies ● → Use IFRS or ASPE
(Accounting Standards for Private Enterprise)

ASPE is believed to be a transition step to IFRS

Accounting Principles and Standards

- Financial Statement Must be:**
- Relevant
 - Reliable
 - Comparable

➔ Readers of Financial statements want a current picture of a business's important features (**relevancy**).

➔ They want the financial figures to be based on solid evidence (**reliability**).

➔ They want to make meaningful comparisons of the dollar amounts- from one year to the next, from business to business (**comparability**).

Accrual Accounting

Accrual ●————→ To grow or accumulate over time.

Revenue and Expenses accrual over time.

However expenses need to produce revenue and to support revenue -making activities.

Accrual Accounting

Accounting clerks do not wait until cash is received before recording revenue. Nether do they wait for cheques to be written before recording expenses as they occur.



SO...

Accrual accounting means attempting to record revenues and expenses as they occur.

Accrual Accounting

At certain points in time, financial position and performance must be measured, and this measurement must be theoretically accurate.

Time period concept



The accounting principle that directs accountants to regularly measure and report financial position.

The chunks of time used for financial measurement.



Fiscal Periods

Fiscal Year or Fiscal Quarters

Financial Statement Comparability

Time period concept ensures that the comparability objective in accounting is met. If reporting periods are NOT divided into equal portions of time, then a business's financial statement could NOT be compared to the performance of another- at least not in a meaningful way

This process still needs senior accounting staff to step in.

Adjusting the Accounts

Is a journal entry that assigns an amount of revenue or expense to the appropriate accounting period; at the same time, it is an entry that brings a balance sheet account to its true value.

There are two perspectives that influence accountants...

The two perspectives that influence accountants

1. Income statement perspective

————→ Revenue and Expenses

2. Balance sheet perspective

————→ Assets, Liabilities and Equity

Prepaid Expenses

An item paid for in advance, but one where the benefits extend into the future. An example of this would be insurance, where it's paid in advance and carries over into another fiscal year.

When prepaid expenses are purchased they are usually debited. Prepaid expenses have value and are classified as an asset.

Adjusting Entry for Late-Arriving Purchase Invoice

Goods and services are usually bought near the end of an accounting period.

However

Most financial statements are calculated within two or three weeks after the fiscal period has ended.

Adjusting Entry for Unearned Revenue

So far, the income statement portion of your adjusting entries has belonged to the expense category. There are times when you will also want to adjust revenue. For example, suppose Markell Company deposited a cheque for \$5000 on December 23, 20–3, for work to be performed in January and February of 20–4. Following the regular bookkeeping routines for a deposit, the accounting clerk debited Bank and credited Fees Earned.

When examining the sales invoices in December, the senior accountant notices that Markell Company had not yet provided a service to earn any portion of the \$5000. It was a payment in advance. Recording this deposit as revenue would violate the revenue recognition principle. Therefore, the senior accountant acts to remove the \$5000 from the Fees Earned account, an action that is accomplished by the following adjusting entry:

| Fees Earned #401 | | Unearned Revenue #235 | |
|------------------|--------------|-----------------------|-------|
| Dr | Cr | Dr | Cr |
| Dec 23, 20–3 | 5 000 | 0 | 5 000 |
| | Dec 31, 20–3 | | |

You can see that the \$5000 debit to Fees Earned cancels the effect of the accounting clerk's entry. As well, the \$5000 credit to Unearned Revenue creates a liability. The liability account makes sense because Markell Company deposited a \$5000 cheque from a customer. The customer has a claim on those funds (a liability) until Markell Company provides the promised services.

Once again, notice that the adjusting entry has an income statement portion and a balance sheet portion.

Review Questions
page 275-276

Exercises 1&2

CHAPTER 8 Completing the Accounting Cycle**SECTION 8.1 REVIEW QUESTIONS** (page 275)

1. Year-end financial statements are superior to interim financial statements because all accounts are brought up to date, all late transactions are taken into account, all calculations have been made correctly, and all accounting principles and standards have been followed.
2. The aim of accounting principles and standards is to produce financial statements that are theoretically and mathematically accurate.
3. According to the International Financial Reporting Standards, a financial statement must be relevant, reliable, and comparable.
4. Accrual accounting is the practice of recording revenues and expenses when they happen regardless of whether cash is received or paid.
5. Dividing financial reporting into equal periods of time allows businesses to compare current financial statements to previous ones.
6. An adjusting entry is a journal entry that assigns an amount of revenue or expense to the appropriate accounting period and brings a related balance sheet account to its true value.
7. Adjusting entries are necessary because they bring the accounts to their true value. This means the financial statements for that period will be accurate and up-to-date.
8. Accounts are allowed to be inexact between statement dates because it too time consuming and expensive to keep the accounts exact all the time.
9. From the income statement perspective, adjusting entries allow the correct expenses to be subtracted from revenue, which produces a correct net income.
10. From the balance sheet perspective, the chief aim of adjusting entries is to accurately state assets, liabilities, and equity.
11. Knowledge of the income statement and balance sheet perspectives is helpful when learning about adjusting entries because every adjusting entry will affect at least one income statement account and at least one balance sheet account.
12. To determine the balance of the Supplies account at the end of the fiscal period, take an inventory of the supplies that remain in the business and then calculate their dollar value.
13. A prepaid expense is an expense paid for in advance that will be used up in the future.
14. The most common prepaid expense is insurance.

SECTION 8.1 REVIEW QUESTIONS (continued)

15. *Prepaid expenses are listed under current assets on the balance sheet.*
16. *Prepaid Insurance is debited when insurance is paid for in advance.*
17. *To determine the balance of Prepaid Insurance at the end of the fiscal period, calculate the amount of insurance used during the fiscal period and subtract it from the total amount paid. This will give you the amount of prepaid insurance that has yet to be used.*
18. *A late-arriving purchase invoice is an invoice that arrived in the current fiscal period but belongs to the previous fiscal period.*
19. *The matching principle states that expenses are to be recognized in the same fiscal period as the revenue that they helped to earn.*
20. *During the two to three weeks after year-end, the accounting department examines all purchase invoices in order to find the ones that affect the fiscal period that just ended. These are the late-arriving purchase invoices.*
21. *Accounts Payable is credited when preparing the adjusting entry for late-arriving invoices.*
22. *Unearned Revenue is a liability account. This classification makes sense because a customer has a claim on the company's funds until the company provides the promised services that the customer bought.*

SECTION 8.1 EXERCISES (page 276)
Exercise 1, p. 276

| Supplies | | | |
|----------|-----------------------|--------------------|---------------------|
| | Unadjusted Balance | Inventory Count | Supplies Expense |
| 1. | \$ 300 | \$100 | <i>\$200</i> |
| 2. | \$1 400 | \$650 | <i>\$750</i> |
| 3. | <i>\$ 425</i> | \$175 | \$250 |
| 4. | \$ 950 | <i>\$210</i> | \$740 |

Name _____ Date _____

SECTION 8.1 EXERCISES (continued)
Exercise 1, p. 276 (continued)

| Prepaid Insurance | | | |
|-------------------|-----------------------|---------------------------------|----------------------|
| | Unadjusted Balance | Year-end Prepaid Calculation | Insurance Expense |
| 1. | \$ 875 | \$325 | <i>\$ 550</i> |
| 2. | \$9 600 | \$800 | <i>\$8800</i> |
| 3. | \$ 925 | <i>\$610</i> | \$ 315 |
| 4. | <i>\$ 785</i> | \$410 | \$ 375 |

Exercise 2, p. 277
A.

| | Balance Sheet Adjustments | | Income Statement Adjustments | |
|---------------|----------------------------------|--------|-------------------------------------|--------------|
| 1. | Supplies | | Supplies Expense | |
| | Dr | Cr | Dr | Cr |
| Dec. 31, 20-3 | 5 050 | | 3 600 | |
| | <u>1 450</u> | 3 600 | | |
| 2. | Prepaid Insurance | | Insurance Expense | |
| | Dr | Cr | Dr | Cr |
| Dec. 31, 20-3 | 2 100 | | 1 050 | |
| | <u>1 050</u> | 1 050 | | |
| 3. | Accounts Payable | | Advertising Expense | |
| | Dr | Cr | Dr | Cr |
| | | 10 000 | 10 000 | |
| 4. | Unearned Revenue | | Fees Earned | |
| | Dr | Cr | Dr | Cr |
| | | 14 000 | 14 000 | 20 000 |
| | | | | <u>6 000</u> |

Dec. 15, 20-3

SECTION 8.1 EXERCISES (continued)
Exercise 2, p. 277 (continued)

B.

| | | GENERAL JOURNAL | | | | PAGE | | | | | |
|---------|--|-----------------|-------|---|---|------|--------|----|---|---|---|
| DATE | PARTICULARS | PR. | DEBIT | | | | CREDIT | | | | |
| Dec. 31 | Supplies Expense | | 3 | 6 | 0 | 0 | - | | | | |
| | Supplies | | | | | | | 3 | 6 | 0 | 0 |
| | <i>To adjust for the inventory count of \$1450</i> | | | | | | | | | | |
| 31 | Insurance Expense | | 1 | 0 | 5 | 0 | - | | | | |
| | Prepaid Insurance | | | | | | | 1 | 0 | 5 | 0 |
| | <i>To adjust for six months of expired insurance</i> | | | | | | | | | | |
| 31 | Advertising Expense | | 10 | 0 | 0 | 0 | - | | | | |
| | Accounts Payable | | | | | | | 10 | 0 | 0 | 0 |
| | <i>To record a 20-3 invoice that arrived in 20-4</i> | | | | | | | | | | |
| 31 | Fees Earned | | 14 | 0 | 0 | 0 | - | | | | |
| | Unearned Revenue | | | | | | | 14 | 0 | 0 | 0 |
| | <i>To adjust for the cash advances received</i> | | | | | | | | | | |

C.

| Adjustment Omission | Assets | Liabilities | Net Income |
|---------------------|-------------------------|-------------------------|-------------------|
| 1. Supplies | <i>overstated</i> | <i>correctly stated</i> | <i>overstated</i> |
| 2. Insurance | <i>overstated</i> | <i>correctly stated</i> | <i>overstated</i> |
| 3. Late Invoices | <i>correctly stated</i> | <i>understated</i> | <i>overstated</i> |
| 4. Unearned Revenue | <i>correctly stated</i> | <i>understated</i> | <i>overstated</i> |