WILEY

weygandt
kimmel
kieso
team for success

FINANCIAL ACCOUNTING 3e

IFRS EDITION

Prepared by
Coby Harmon
University of California, Santa Barbara
Westmont College

PREVIEW OF CHAPTER 3

ADJUSTING THE ACCOUNTS

Timing Issues	The Basics of Adjusting Entries	The Adjusted Trial Balance and Financial Statements
• Fiscal and calendar years • Accrual- vs. cash-basis accounting • Recognizing revenues and expenses	• Types of adjusting entries • Adjusting entries for deferrals • Adjusting entries for accruals • Summary of basic relationships	• Preparing the adjusted trial balance • Preparing financial statements

CHAPTER

3 Adjusting the Accounts

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain the time period assumption.
2. Explain the accrual basis of accounting.
3. Explain the reasons for adjusting entries.
4. Identify the major types of adjusting entries.
5. Prepare adjusting entries for deferrals.
6. Prepare adjusting entries for accruals.
7. Describe the nature and purpose of an adjusted trial balance.

The Adjusted Trial Balance and Financial Statements

Learning Objective 7
Describe the nature and purpose of an adjusted trial balance.

Preparing the Adjusted Trial Balance

- Prepared **after all adjusting entries** are journalized and posted.
- Purpose is to **prove the equality** of debit balances and credit balances in the ledger.
- Is the **primary basis for the preparation of financial statements**.

YAZICI ADVERTISING A.Ş.
Adjusted Trial Balance
October 31, 2017

	Debit	Credit
Cash	₺ 15,200	
Accounts Receivable	**200**	
Supplies	**1,000**	
Prepaid Insurance	**550**	
Equipment	5,000	
Accumulated Depreciation—Equipment		**₺ 40**
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		**50**
Unearned Service Revenue		**800**
Salaries and Wages Payable		**1,200**
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	**5,200**	
Supplies Expense	**1,500**	
Rent Expense	900	
Insurance Expense	**50**	
Interest Expense	**50**	
Depreciation Expense	**40**	
	₺30,190	**₺30,190**

Illustration 3-25
Adjusted trial balance

LO 7

Preparing the Adjusted Trail Balance

Question

Which of the following statements is incorrect concerning the adjusted trial balance?

a. (a) An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.

b. The adjusted trial balance provides the primary basis for the preparation of financial statements.

c. The adjusted trial balance lists the account balances segregated by assets and liabilities.

d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.

LO 7

Preparing Financial Statements

Financial Statements are prepared directly from the **Adjusted Trial Balance.**

Income Statement

Retained Earnings Statement

Statement of Financial Position

YAZICI ADVERTISING A.Ş.
Adjusted Trial Balance
October 31, 2017

Account	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	₺30,190	₺30,190

YAZICI ADVERTISING A.Ş.
Income Statement
For the Month Ended October 31, 2017

Revenues		
Service revenue		₺10,600
Expenses		
Salaries and wages expense	₺5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		₺ 2,860

YAZICI ADVERTISING A.Ş.
Retained Earnings Statement
For the Month Ended October 31, 2017

Retained earnings, October 1	₺ –0–
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	₺2,360

To statement of financial position

Illustration 3-26
Preparation of the income statement and retained earnings statement from the adjusted trial balance

YAZICI ADVERTISING A.Ş.
Adjusted Trial Balance
October 31, 2017

Account	Debit	Credit
Cash	₺15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		₺ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Share Capital—Ordinary		10,000
Retained Earnings		–0–
Dividends	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	₺30,190	₺30,190

YAZICI ADVERTISING A.Ş.
Statement of Financial Position
October 31, 2017

Assets		
Equipment	₺5,000	
Less: Accumulated depreciation—equip.	40	₺ 4,960
Prepaid insurance		550
Supplies		1,000
Accounts receivable		200
Cash		15,200
Total assets		₺21,910
Equity and Liabilities		
Equity		
Share capital—ordinary	₺10,000	
Retained earnings	2,360	₺12,360
Liabilities		
Notes payable	5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	9,550
Total equity and liabilities		₺21,910

Balance at Oct. 31 from retained earnings statement in Illustration 3-26

Illustration 3-27
Preparation of the statement of financial position from the adjusted trial balance

> DO IT!

Kang Company was organized on April 1, 2017. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below. (Amounts are in millions.)

	Debit		Credit
Cash	₩ 6,700	Accumulated Depreciation—Equipment	₩ 850
Accounts Receivable	600	Notes Payable	5,000
Prepaid Rent	900	Accounts Payable	1,510
Supplies	1,000	Salaries and Wages Payable	400
Equipment	15,000	Interest Payable	50
Dividends	600	Unearned Rent Revenue	500
Salaries and Wages Expense	9,400	Share Capital—Ordinary	14,000
Rent Expense	1,500	Service Revenue	14,200
Depreciation Expense	850	Rent Revenue	800
Supplies Expense	200		
Utilities Expense	510		
Interest Expense	50		
	₩37,310		₩37,310

> DO IT!

(a) Determine the net income for the quarter April 1 to June 30.

Revenues		
Total revenues		
Expenses		
Total expenses		
Net income		

> DO IT!

(b) Determine the total assets and total liabilities at June 30, 2017, for Skolnick Co.

Assets		Liabilities	
Total assets		Total liabilities	

> DO IT!

(c) Determine the amount that appears for retained earnings at June 30, 2017.

Retained earnings, April 1	
Retained earnings, June 30	

Learning Objective 8
Prepare adjusting entries for the alternative treatment of deferrals.

Alternate Treatment

- When a company prepays an expense, it debits that amount to **an expense account**.
- When it receives payment for future services, it credits the amount to **a revenue account**.

Prepaid Expenses

Company may choose to **debit (increase) an expense account** rather than an asset account. This alternative treatment is simply more convenient.

Prepayment Initially Debited to Asset Account (per chapter)				**Prepayment Initially Debited to Expense Account (per appendix)**			
Oct. 5	Supplies	2,500		Oct. 5	Supplies Expense	2,500	
	Accounts Payable		2,500		Accounts Payable		2,500
Oct. 31	Supplies Expense	1,500		Oct. 31	Supplies	1,000	
	Supplies		1,500		Supplies Expense		1,000

Illustration 3A-2
Adjustment approaches–a comparison

Unearned Revenues

Company may **credit (increase) a revenue account** when they receive cash for future services.

Unearned Service Revenue Initially Credited to Liability Account (per chapter)				Unearned Service Revenue Initially Credited to Revenue Account (per appendix)			
Oct. 2	Cash	1,200		Oct. 2	Cash	1,200	
	Unearned Service Revenue		1,200		Service Revenue		1,200
Oct. 31	Unearned Service Revenue	400		Oct. 31	Service Revenue	800	
	Service Revenue		400		Unearned Service Revenue		800

Illustration 3A-5
Adjustment approaches—a comparison

Summary of Additional Adjustments Relationships

Type of Adjustment	Reason for Adjustment	Accounts before Adjustment	Adjusting Entry
Prepaid expenses	(a) Prepaid expenses initially recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets
	(b) **Prepaid expenses initially recorded in expense accounts have not been used.**	**Assets understated. Expenses overstated.**	**Dr. Assets Cr. Expenses**
Unearned revenues	(a) Unearned revenues initially recorded in liability accounts are now recognized as revenue.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues
	(b) **Unearned revenues initially recorded in revenue accounts are still unearned.**	**Liabilities understated. Revenues overstated.**	**Dr. Revenues Cr. Liabilities**

Illustration 3A-7
Summary of basic relationships for deferrals

Learning Objective 9
Discuss financial reporting concepts.

Qualities of Useful Information

Two fundamental qualities, **relevance** and **faithful representation**.

Relevance

- Make a difference in a business decision.
- Provides information that has **predictive value** and **confirmatory value**.
- **Materiality** is a company-specific aspect of relevance.
  - An item is material when its **size** makes it likely to influence the decision of an investor or creditor.

Qualities of Useful Information

Two fundamental qualities, **relevance** and **faithful representation**.

Faithful Representation

- Information accurately depicts what really happened.
- Information must be
  - **complete** (nothing important has been omitted),
  - **neutral** (is not biased toward one position or another), and
  - **free from error**.

Qualities of Useful Information

ENHANCING QUALITIES

Comparability results when different companies use the same accounting principles.

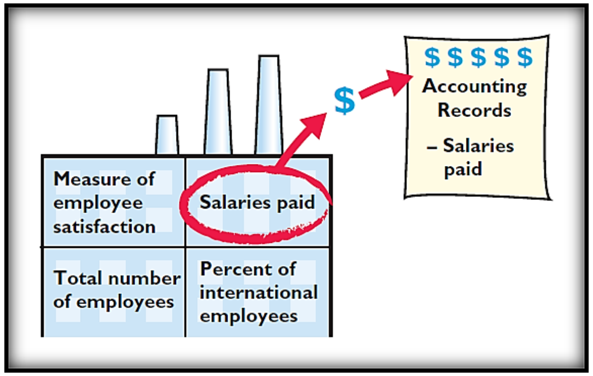
Information is **verifiable** if independent observers, using the same methods, obtain similar results.

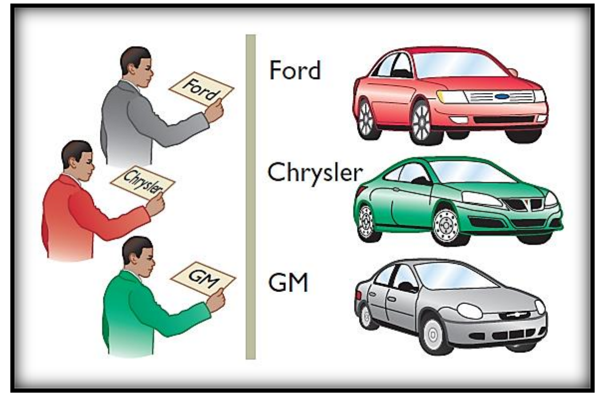
Information has the quality of **understandability** if it is presented in a clear and concise fashion.

Consistency means that a company uses the same accounting principles and methods from year to year.

For accounting information to have relevance, it must be **timely**.

Assumptions in Financial Reporting





Monetary Unit

Requires that only those things that can be expressed in money are included in the accounting records.

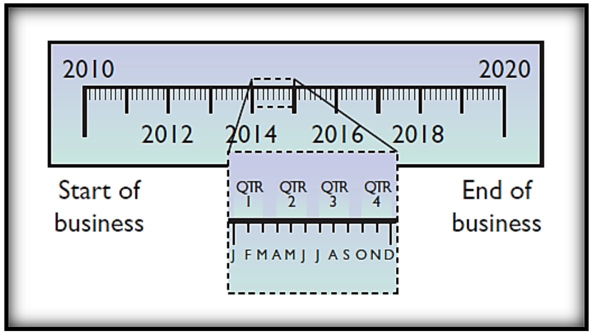
Economic Entity

States that every economic entity can be separately identified and accounted for.

Illustration 3B-2
Key assumptions in financial reporting

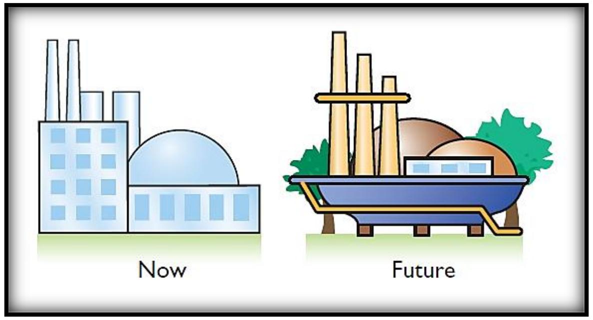
LO 9

Assumptions in Financial Reporting



Time Period

States that the life of a business can be divided into artificial time periods.



Going Concern

The business will remain in operation for the foreseeable future.

Illustration 3B-2
Key assumptions in financial reporting

LO 9

Principles of Financial Reporting

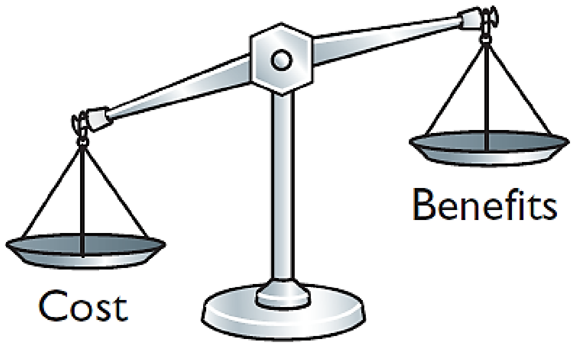
MEASUREMENT PRINCIPLES

Historical Cost	Fair Value
Or cost principle, dictates that companies record assets at their cost.	Indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

Principles of Financial Reporting

REVENUE RECOGNITION PRINCIPLE	EXPENSE RECOGNITION PRINCIPLE	FULL DISCLOSURE PRINCIPLE
Requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.	Dictates that efforts (expenses) be matched with results (revenues). Thus, expenses follow revenues.	Requires that companies disclose all circumstances and events that would make a difference to financial statement users.

Cost Constraint



Cost Constraint

Accounting standard-setters weigh the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.

LO 9

A Look at U.S. GAAP

Learning Objective 10
Compare the procedures for the adjusting entries under IFRS and U.S. GAAP.

Key Points

Similarities

- Like IFRS, companies applying GAAP use accrual-basis accounting to ensure that they record transactions that change a company's financial statements in the period in which events occur.
- Similar to IFRS, cash-basis accounting is not in accordance with GAAP.
- GAAP also divides the economic life of companies into artificial time periods. Under both GAAP and IFRS, this is referred to as the *time period assumption*. GAAP requires that companies present a complete set of financial statements, including comparative information annually.
- The form and content of financial statements are very similar under GAAP and IFRS. Any significant differences will be discussed in those chapters that address specific financial statements.
- Revenue recognition fraud is a major issue in U.S. financial reporting. The same situation exists for most other countries as well.

A Look at U.S. GAAP

Key Points

Differences

- Prior to the issuance of a new joint revenue recognition standard by the IASB and the FASB, GAAP had more than 100 rules dealing with revenue recognition. Many of these rules were industry-specific. Revenue recognition under IFRS was determined primarily by a single standard, IAS 18. Despite this large disparity in the detailed guidance devoted to revenue recognition, the general revenue recognition principles required by IFRS were similar to those under GAAP.
- Internal controls are a system of checks and balances designed to detect and prevent fraud and errors. The Sarbanes-Oxley Act requires U.S. companies to enhance their systems of internal control. However, many foreign companies do not have this requirement.

A Look at U.S. GAAP

Key Points

Differences

- Under IFRS, revaluation to fair value of items such as land and buildings is permitted. This is not permitted under GAAP.
- Under IFRS, the term “income” includes both revenues, which arise during the normal course of operating activities, and gains, which arise from activities outside of the normal sales of goods and services. The term income is not used this way under GAAP. Instead, under GAAP income refers to the net difference between revenues and expenses. Expenses under IFRS include both those costs incurred in the normal course of operations, as well as losses that are not part of normal operations. This is in contrast to GAAP, which defines each separately.

A Look at U.S. GAAP

Looking to the Future

In May 2014, the IASB and FASB completed a joint project on revenue recognition. The purpose of this project was to develop comprehensive guidance on when to recognize revenue. This approach focuses on changes in assets and liabilities as the basis for revenue recognition. It is hoped that this approach will lead to more consistent accounting in this area.

A Look at U.S. GAAP

IFRS Self-Test Questions

GAAP:

a) provides the same type of guidance as IFRS for revenue recognition.

b) provides only general guidance on revenue recognition, compared to the detailed guidance provided by IFRS.

c) allows revenue to be recognized when a customer makes an order.

d) requires that revenue not be recognized until cash is received.

A Look at U.S. GAAP

IFRS Self-Test Questions

Which of the following statements is **false**?

a) GAAP employs the time period assumption.

b) GAAP employs accrual accounting.

c) GAAP requires that revenues and costs must be capable of being measured reliably.

d) GAAP uses the cash basis of accounting.

A Look at U.S. GAAP

IFRS Self-Test Questions

Which of the following statements is **false**?

a) Under IFRS, the term *income* describes both revenues and gains.

b) Under IFRS, the term *expenses* includes losses.

c) Under IFRS, firms do not engage in the closing process.

d) IFRS has fewer standards than GAAP that address revenue recognition.

Copyright