ACCT 101 – Fundamentals of Accounting
Chapter 3 – Adjusting Accounts and Preparing Financial Statements

Overview: Much of this chapter should be a review for you. However, there may be some new terminology related to adjustments. In addition, the Statement of Retained Earnings will be new to you.

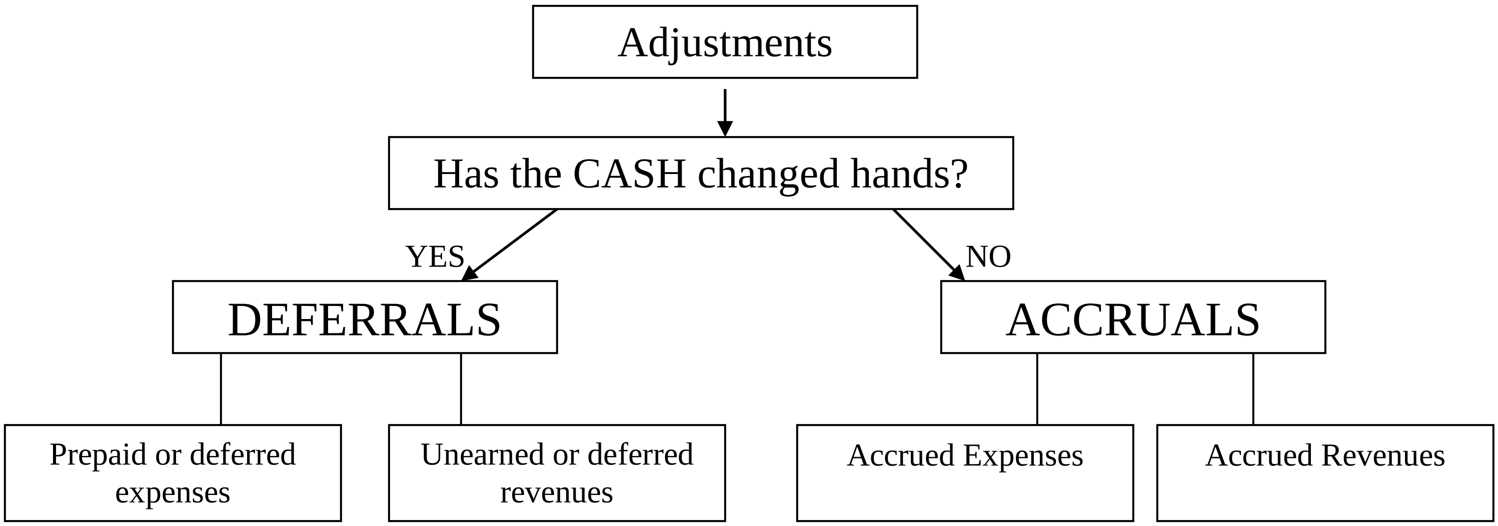
Accounting Periods – important to determine because users need information frequently and promptly. Regular intervals for information are necessary. Annual financial statements are needed, but more frequent interim statements are also usually necessary.

Cash Basis	Accrual Basis
Recognizes revenues when cash is received	Recognizes revenues when the revenues are earned, not when received
Recognizes expenses when cash is paid	Recognizes expenses when they are incurred, regardless of when paid
Not GAAP	Required by GAAP
Net Income = Cash Receipts – Cash Paid	Net Income = Revenues Earned – Expenses incurred. Does not match cash balance.
Comparability questionable over periods	Comparability is increased
Cash basis accounting may be useful for business decisions, so that's why we now have a statement of cash flows	Profitability determined by accrual basis accounting is required by GAAP. The income statement, in addition to a statement of cash flows tells investors and other users much information about a company.

Adjusting Accounts

- Is necessary under accrual basis of accounting.
- Necessary for transactions that extend over more than one account period.
- Affect an income statement account and a balance sheet account.
- Process is to determine what the current balance is, decide what balance should be, and make an adjustment for the difference.
- All adjustments can be categorized as deferrals or accruals.
- Key question to ask is "Has the Cash Changed Hands?" If so, it's a deferral, if not, it's an accrual.

Overview of Framework



Prepaid or deferred expenses – Items paid for in advance or things you pay for ahead of time and receive benefits later. Examples are insurance, advertising, supplies, and even depreciation. If you pay for season tickets to sporting events to entertain clients, this is a prepaid asset until the game is played.

Unearned or deferred revenues – Cash received in advance of providing products or services. When cash is received ahead a time, an obligation or liability is received to provide something later. If you receive money for the season tickets, then you have an obligation to provide a game. In this respect, it’s the flipside of a prepaid. The amount received is a liability until the game is played.

Accrued Expenses - Costs that are incurred in one period but are unpaid and unrecorded. Accrued expenses must be reported in the period incurred. Examples of accrued expenses are salaries, interest, taxes.

Accrued Revenues – Revenues earned in a period that are unrecorded and for which no cash has yet been received. Accrued revenues usually arise from services and products that have been performed/delivered but not yet billed. Also arises from interest that you have earned but not yet received.

Prepaid or deferred expenses	Unearned or deferred revenues	Accrued Expenses	Accrued Revenues
What Is it? Paid for something in advance of benefit	Cash received in advance of providing goods or services	Costs incurred in one period but not paid for until another	Revenues earned in one period but cash not received until another
Accounts Affected: One asset and one expense are affected	A revenue and a liability are affected	One expense and a liability account	An asset and a revenue account
Types of AJE's Prepaid Insurance	Subscriptions	Salary Accruals	Unbilled amounts
Supplies	Tickets	Interest on amounts owed	Partially completed work
Depreciation	Anything else where cash is received ahead of time	Taxes owed	Interest earned but not paid on investments
JE's: Insurance Used: Dr. Insurance Exp. Cr. Prepaid Ins	Subscriptions Earned Dr. Unearned Subs. Cr. Subsc Income	Wage Accrual Dr. Salary Exp. Cr. Salaries Pybl	Unbilled Items Dr. A/R Cr. Fees Earned
Supplies Used: Dr. Supplies Exp Cr. Supplies	Tickets – Games Played Dr. Unearned Tkt Inc Cr. Ticker Income	Interest on Debt Dr. Interest Exp. Cr. Interest Pybl	
Assets Used Up: Dr. Depn Exp. Cr. Accum Depn		Taxes owed Dr. Tax Expense Cr. Taxes Pybl	

Closing Entries:

You learned how to do these in Acct 100.

Why: (1) to get certain accounts ready for the next accounting period
(2) to update the Retained earnings account for net income and dividends

How: (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

After: Prepare a post closing trial balance. The only accounts that should have balances are assets, liability, and equity accounts.

Classified Balance Sheet

- Assets should be classified into Current Assets, Long Term investments, and Plan Assets.
- Liabilities should be classified into current liabilities and long-term liabilities.
- Equity is classified into two main subsections, Common Stock (contributed capital) and Retained earnings.

Ratios

Profit Margin – return on sales – very common. It represents the percentage of profit for each dollar in sales.

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$