CHAPTER 4
Accrual Accounting Concepts

Study Objectives

Explain the revenue recognition principle and the matching principle.

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.

Prepare adjusting entries for accruals.

Describe the nature and purpose of the adjusted trial balance.

Explain the purpose of closing entries.

Describe the required steps in the accounting cycle.
Chapter Outline

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

1. The revenue recognition principle dictates that revenue be recognized in the accounting period in which it is earned.
   - Revenue is considered earned when the service has been provided or when the goods are delivered.

2. The matching principle requires that expenses be recorded in the same period in which the revenues they helped produce are recorded.

Recall the example in the Chapter Three Study guide. Suppose sales personnel 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 retail establishment 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

1. With cash basis accounting, revenue is recognized when cash is received. Expenses are recognized only when cash is paid.

2. Accrual basis Accounting requires accountants to adhere to the revenue recognition principle and the matching principle.

3. Cash basis accounting does not satisfy the requirements of Generally Accepted Accounting Principles (GAAP), whereas accrual basis accounting does.

Study Objective 3 - Explain why Adjusting Entries are Needed and Identify the major types of Adjusting Entries

1. Adjusting entries are needed to ensure that the revenue recognition and matching principles are followed.

2. Adjusting entries can be classified as either prepayments or accruals. Each of these classes has two subcategories.

Study Objective 4 - Prepare Adjusting Entries for Prepayments

Prepayments 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 expire with the passage of time (i.e., rent and insurance) or they are consumed (i.e., supplies).

2. Unearned revenues - revenues received in cash and recorded as liabilities before they are earned.
   - An adjusting entry for prepaid expenses will result in an increase or a debit to an expense account and a decrease or a credit to an asset account.

   - An adjusting entry for unearned revenues will result in a decrease or a debit to a liability account and an increase or a credit to a revenue account.

   - An adjusting entry for prepayments (prepaid expenses or unearned revenues) will decrease a balance sheet account and increase an income statement account.
Study Objective 5 - Prepare Adjusting Entries Accruals

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

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

1. The adjusted trial balance is prepared after all adjusting entries have been journalized and posted.
2. The adjusted trial balance shows the balances of all accounts, including those that have been adjusted at the end of the accounting period.
3. The purpose of the adjusted trial balance is to prove the equity of the total debit balances and total credit balances in the ledger after the adjusting entries have been made.
4. Financial statements are prepared from the adjusted trial balance.

Study Objective 7 - Explain the Purpose of Closing Entries

1. Closing entries transfer the temporary account balances to the permanent stockholders' equity account—retained earnings.

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

1. Analyze and journalize the transactions.
2. Post to ledger accounts.
3. Prepare a trial balance.
4. Journalize and post adjusting entries and closing entries such as prepayments and accruals.
5. Prepare the post-closing trial balance.
6. Prepare financial statements:
   - Income statement
   - Balance Sheet
   - Retained earnings statement (Optional statement; amplifies information @ RE)
   - Statement of Cash flows
Chapter 4 Review

✓ What is the revenue recognition principle? The matching principle?

✓ What are the differences in the cash basis and the accrual basis of accounting?

✓ Why are adjusting entries needed? What are the major types of adjusting entries?

✓ Provide an example of an adjusting entry for a prepayment.

✓ Provide an example of an adjusting entry for accruals.

✓ Describe the nature and purpose of the adjusted trial balance.

✓ Discuss the purpose and importance of closing entries.

✓ List the required steps in the accounting cycle.
The _______________ _______________ _______________ dictates that revenue be recognized in the accounting period in which it is earned. In a service company, revenue is considered to be earned at the time the _______________ is _______________.

The practice of expense recognition is referred to as the _______________ _______________ because it dictates that efforts (______________) be matched with accomplishments (_____________).

Application of the revenue recognition and matching principles results in _______________ _______________ _______________. Accrual basis accounting means that transactions that change a company's financial statements are recorded in the _______________ in which the _______________ _______________, rather than in the periods in which the company _______________ or _______________.

Under _______________ _______________ _______________, revenue is recorded only when the cash is received, and an expenses is recorded only when cash is paid. An income statement presented under the cash basis of accounting does not satisfy _______________ _______________ _______________ _______________. Why? Because it fails to record _______________ that has been earned but for which the cash has not been received, thus violating the _______________ _______________ _______________. In addition, expenses are also not matched with earned revenues, and therefore the _______________ _______________ is violated.
The revenue recognition principle dictates that revenue be recognized in the accounting period in which it is earned. In a service company, revenue is considered to be earned at the time the service is performed.

The practice of expense recognition is referred to as the matching principle because it dictates that efforts (expenses) be matched with accomplishments (revenues).

Application of the revenue recognition and matching principles results in accrual basis accounting. Accrual basis accounting means that transactions that change a company’s financial statements are recorded in the periods in which the events occur, rather than in the periods in which the company receives or pays.

Under cash basis accounting, revenue is recorded only when the cash is received, and an expense is recorded only when cash is paid. An income statement presented under the cash basis of accounting does not satisfy general accepted accounting principles. Why? Because it fails to record revenue that has been earned but for which the cash has not been received, thus violating the revenue recognition principle. In addition, expenses are also not matched with earned revenues, and therefore the matching principle is violated.
Chapter 4

In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred, _______________ _______________ are made to revenue and expense accounts at the end of the _______________ _______________. In short, adjusting entries are needed to ensure that the _______________ _______________ and the _______________ _______________ are followed.

Adjusting entries can be classified as either _______________ or _______________. Prepayments are either prepaid _______________ or unearned _______________. Adjusting entries for accruals are required in order to record _______________ earned and _______________ incurred in the current accounting period that have not been recognized through daily entries and thus are not reflected in the accounts.
Solutions to Reading Comprehension Check II

Chapter 4

In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred, adjusting entries are made to revenue and expense accounts at the end of the accounting period. In short, adjusting entries are needed to ensure that the revenue recognition and the matching principles are followed.

Adjusting entries can be classified as either prepayments or accruals. Prepayments are either prepaid expenses or unearned revenue. Adjusting entries for accruals are required in order to record revenue earned and expenses incurred in the current accounting period that have not been recognized through daily entries and thus are not reflected in the accounts.
1. Expenses paid in cash and recorded as assets before they are used or consumed.

2. Entries at the end of an accounting period to transfer the balances of temporary accounts to a permanent stockholders’ equity account, retained earnings.

3. The process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner.

4. Cash received before revenue was earned and recorded as liabilities.

5. The principle that dictates that efforts (expenses) be matched with accomplishments (revenues).

6. Accounting basis in which transactions that change a company’s financial statements are recorded in the periods in which the events occur, rather than in the periods in which the company receives or pays cash.

7. The principle that revenue be recognized in the accounting period in which it is earned.

8. Entries made at the end of an accounting period to ensure that the revenue recognition and matching principles are followed.

9. An account that is offset against an asset account on the balance sheet.

10. Revenue is recorded only when cash is received, and an expenses is recorded only when cash is paid.
Solutions to Vocabulary Quiz

Chapter 4

1. Prepaid expenses
2. Closing entries
3. Depreciation
4. Unearned revenues
5. Matching principle
6. Accrual basis accounting
7. Revenue recognition principle
8. Matching principle
9. Contra asset account
10. Cash basis accounting
Chapter 4

1. Accounts have developed two principles to use as guidelines in determining the amount of revenues and expenses to be reported in a given period. These principles are the:
   a. cash basis accounting principle.
   b. revenue recognition principle.
   c. matching principle.
   d. both b and c above.

2. Which of the following is NOT true concerning cash basis accounting?
   a. Does not follow GAAP.
   b. Records revenue when cash received.
   c. Matches expenses with the revenues they help to produce.
   d. Records expenses when cash is paid.

3. In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred:
   a. adjusting entries are made.
   b. cash basis accounting is used.
   c. closing entries are made.
   d. none of the above.

4. Unearned revenues are:
   a. prepayments.
   b. liabilities.
   c. temporary accounts.
   d. both a and b above.

5. All of the following are examples of prepaid expenses except:
   a. prepaid rent.
   b. prepaid insurance.
   c. supplies.
   d. unearned revenues.

6. Depreciation is:
   a. the wearing away of an asset.
   b. the process of an asset becoming obsolete.
   c. a valuation process.
   d. The process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner.

7. Accumulated depreciation is a:
   a. contra asset account.
   b. contra revenue account.
   c. unearned revenue account.
   d. expense account.
8. Which of the following companies would probably not have unearned revenue:
   a. Delta Airlines.
   c. Poppa John's Pizza.
   d. All State Insurance Company.

9. Adjusting entries for accruals:
   a. are required in order to record revenues earned and expenses incurred in the current accounting period
      that have not been recognized through daily entries and thus are not yet reflected in the accounts.
   b. will increase both a balance sheet and an income statement account.
   c. are not required under GAAP.
   d. both a and b above.

10. An assumption that the economic life of a business can be divided into artificial time periods:
    a. cash basis assumption.
    b. accrual assumption.
    c. calendar year assumption.
    d. time period assumption.
Solutions to Multiple Choice Quiz

Chapter 4

1. d
2. c
3. a
4. d
5. d
6. d
7. a
8. c
9. d
10. d
Refer to the financial statements in the Annual Report of Ben & Jerry’s to answer the following questions. You may find the annual report in your school library or on the World Wide Web. If researching the Web, go to www.benjerry.com, click on Company Info, Financial Info, and finally Annual Reports & Other Financial Statements.

1. What is the date of the financial statements?

2. What is the exact title of Ben & Jerry’s Income Statement?

3. Which of the accounts found on the income statement and balance sheet have, most likely, been adjusted?

4. Which of the accounts found on the income statement and balance sheet have been created as a result of adjusting entries?

5. What is the name of the accounting firm that conduct the external audit of Ben & Jerry’s?

Solutions: Information available on website

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.
Chapter 4

Your roommate, an accounting major, is working part time at Modern Dry Cleaners. She just came home from work and is complaining because the owner wants her to prepare year-end adjusting entries. "Roomie" contends that because the business is relatively small and because they will not make "too significant" an impact on the financial condition of the business, adjusting entries should not be prepared.

Use the space provided to try to convince your roommate that adjusting entries should be made.

Solution:

Unless adjusting entries are made, financial statements will not be correct. Failure to record adjusting entries violates the revenue recognition principle and the matching principle. In addition, accrual basis accounting is not being followed if adjusting entries are not made.

Failure to record adjusting entries will, more than likely, cause revenues, expenses, assets, liabilities, and owners' equity accounts to be over- or under-stated.
Chapter 4

Return to the financial statements prepared for the new business in Campus Town USA in earlier chapters in answering the following questions:

1. Determine which accounts should be adjusted and make the necessary adjustments.

1. What would have been the consequences had you not made these entries? Be specific.

3. Make the required closing entries.

4. What would have been the consequences had you not made the closing entries?

(This activity is intended for group assignment)
James Drummand Dole founded the Hawaiian Pineapple Company in 1851 with an initial investment of $1,000. Today the name Dole is synonymous with pineapple. Research your school library or the World Wide Web to obtain an annual report for Dole. If you are researching the Web go to www.dole.com. Using information found in the financial statements of the Annual Report, make the following closing entries:

Using information found in the financial statements of the Annual Report, make the following closing entries:

1. Make journal entries to close the revenue and expense accounts.

2. Make a journal entry to close the income summary account.

3. Make a journal entry to close the dividend account.

4. What is the date of the closing entries?

Solutions: Information available on website

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.
Refer to the Income Statement prepared for Joe’s Tees in Exercise 7 of Chapter 2. Does the income statement prepared in Chapter 2 violate rules of accrual accounting? (Pay particular attention to the requirements of the matching principle.)

1. Amend the Income Statement so that it better conforms to the practice of accrual accounting.

2. Explain why the statements that you just prepared are superior to those you prepared in Chapter 2.
Obtain an annual report for Tootsie Roll from your school library or on the World Wide Web. If you are researching the Web go to www.tootsie.com. Does Tootsie Roll use cash or accrual accounting? Provide evidence to support your answer.

Solutions: Information available on website

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.
Chapter 4

You have just graduated from the local University and landed what you had thought was a great job as an accountant for Crazy House Interiors, an upscale design studio. Your apartment is wonderful and you have made a lot of new friends. However, your boss has just asked you to "do him a favor." Crazy House is planning to ask one of the local banks for a loan. However, there is some concern because this year’s revenues are considerably lower than the revenues of the previous year.

One of the more talented designers has just landed a contract for a large, profitable project. Half of the fee for the project is to be collected when the contract is signed at the end of this week, with the remainder of the money due when the project is completed. Work will begin on the project when the contract is signed.

Your boss has asked you to record the initial payment of $125,000 as revenue at the time the money is received. Not wanting to disappoint the boss, you originally agreed to record the transaction as he requested. However, you are having second thoughts about recording the transaction and your ethical responsibilities.

What should you do? Why?

Solution:

Refuse to record the $125,000 advance as revenue until it is earned. The $125,000 should be recorded as unearned revenue, a liability account, until the job (or a portion of the job) is completed. In Chapter 1 of this text, you learned that generally accepted accounting principles (GAAP) require accounting information to be reliable. In order to be reliable accounting information must be verifiable and make a faithful representation. Information is verifiable only if it is free of error. Faithful representation means that the information is factual. If the $125,000 advance is reported as revenue before the job is started the accounting information is neither "free of error" nor "factual." What makes this situation worse is the fact that individuals external to the business are depending on this information in a decision making scenario. The decision the bankers make will affect the bank, the banks' stockholders, and the banks' employees.
1. Name at least four industries in which businesses would have unearned revenue?

2. What is the source of these unearned revenues? Be specific in the examples you cite.

3. When is the revenue recognized and what journal entry would be made at the time of recognition?

Solutions:

1. Airlines, magazine publishers, and insurance companies.

2. Cash received for airline tickets purchased on June 1 for trips to be taken July 4 with a return on July 8, would be classified as unearned revenue.

   Cash received on April 1 for 12-month subscriptions to a magazine would be classified as unearned revenue.

   Insurance companies have unearned revenue when they receive insurance premiums covering policies of 3 month, 6 month, or 12 month periods.

3. When the revenue is earned (i.e. when the airline trip is taken, when the magazine mailed, or when a portion of the time covered by the insurance policy passes), the revenue can be recognized. The journal entry to recognize revenue would be to decrease unearned revenue (debit unearned revenue) and increase revenue (credit revenue).