



Chapter 3

Accrual Accounting Concepts

Learning Objectives

After studying this chapter, you should be able to...

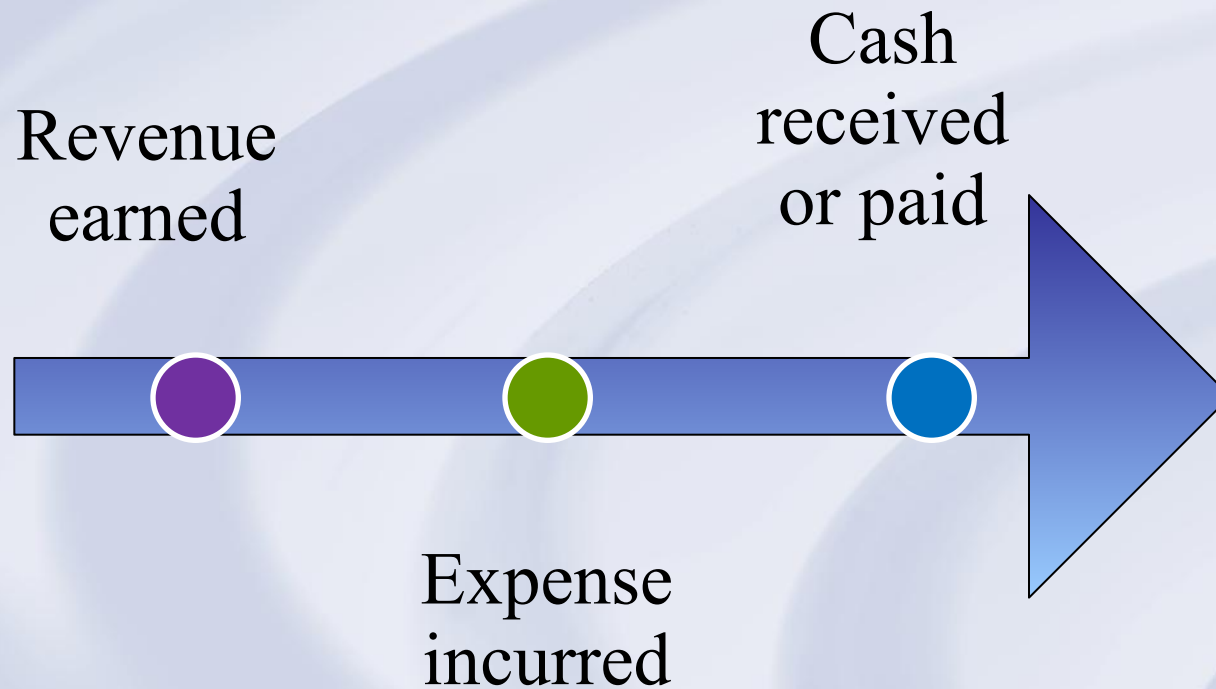
- Describe basic accrual accounting concepts, including the matching concept
- Use accrual concepts of accounting to analyze, record, and summarize transactions
- Describe and illustrate the end-of-period adjustment process
- Prepare financial statements using accrual concepts of accounting, including a classified balance sheet
- Describe how the accrual basis of accounting enhances the interpretation of financial statements



Learning Objective 1

Describe the basic accrual accounting concepts, including the matching concept

Why is Accrual Accounting Needed?



Accruing Revenue



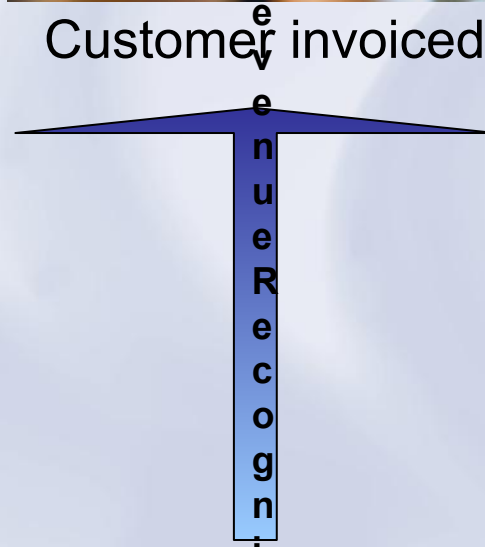
Service provided



Customer invoiced



Cash received



Accruing Revenue



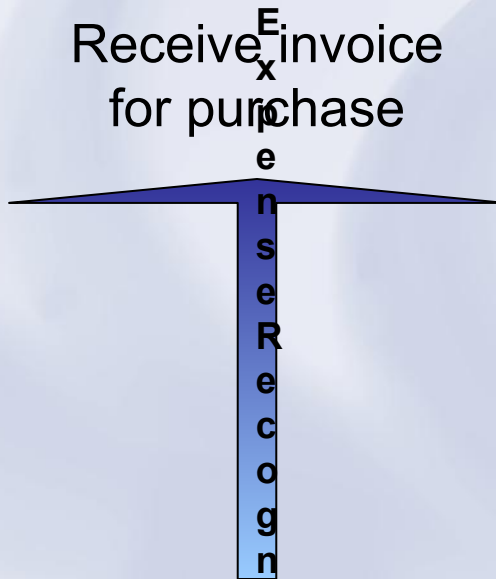
Materials purchased



Receive invoice
for purchase



Invoice paid



Matching Principle



**Expenses incurred
to generate revenue**





Learning Objective 2

**Use accrual concepts of accounting to
analyze, record, and summarize
transactions**

Accrual Concepts – Family Health Care Transactions



- Services are provided to patients
- Insurance is filed, payment to be received in the future
- Revenue is earned when the service is provided to the patient
- Expenses are incurred for items such as supplies where payment may be made in the future
- Expenses are recorded as they are incurred, not as they are paid

Family Health Care – Rent Received in Advance

- Family Health Care, P.C. receives a rent payment of \$1,800 in cash from ILS for use of its land.

<i>Statement of Cash Flows</i>	<i>Balance Sheet</i>							<i>Income Statement</i>			
	<i>Assets</i>		=	<i>Liabilities</i>		+	<i>Stockholders' Equity</i>				
	<i>Cash</i>	+	<i>Land</i>	=	<i>Notes Payable</i>	+	<i>Unearned Revenue</i>		+	<i>Capital Stock</i>	+
Balances, Nov. 1	7,320		12,000	=	10,000				6,000		3,320
a. Received rent in advance	1,800			=			1,800				
Balances	9,120		12,000	=	10,000		1,800		6,000		3,320

<i>Statement of Cash Flows</i>	
a. Operating	1,800

Amount received reported as a liability until the revenue is actually earned.

Family Health Care – Prepaid Expenses

- Family Health Care, P.C. buys a 2-year business insurance policy and pays \$2,400 in cash.

Statement of Cash Flows	Balance Sheet							Income Statement			
	Assets			=	Liabilities	+	Stockholders' Equity				
	Cash	Prepaid Insurance	Land	=	Notes Payable	+	Unearned Revenue		+	Capital Stock	+
Balances	9,120		12,000	=	10,000	+	1,800	+	6,000	+	3,320
b. Paid insurance for 2 yrs.	-2,400	2,400		=		+		+		+	
Balances	6,720	2,400	12,000	=	10,000	+	1,800	+	6,000	+	3,320

Statement of Cash Flows	
b. Operating	-2,400

Amount paid is reported as a prepaid expense until the insurance is actually used up.

Family Health Care – Prepaid Expenses

- Family Health Care, P.C. buys a 6-month medical malpractice insurance policy and pays a premium in cash of \$6,000.

Statement of Cash Flows	Balance Sheet							Income Statement	
	Assets			=	Liabilities		+ Stockholders' Equity		
	Cash	Prepaid Insurance	+ Land	=	Notes Payable	+ Unearned Revenue	+ Capital Stock		+ Retained Earnings
Balances	6,720	2,400	12,000	=	10,000	1,800	6,000	3,320	
c. Paid insurance for 6 mos.	-6,000	6,000		=					
Balances	720	8,400	12,000	=	10,000	1,800	6,000	3,320	

Statement of Cash Flows	
c. Operating	-6,000

Amount paid is reported as a prepaid expense until the insurance is actually used up.

Family Health Care – Additional Capital Investment

- Dr. Landry invests an additional \$5,000 in the business and receives capital stock.

Statement of Cash Flows	Balance Sheet							Income Statement	
	Assets			=	Liabilities		+ Stockholders' Equity		
	Cash	+ Prepaid Insurance	+ Land	=	Notes Payable	+ Unearned Revenue	+ Capital Stock		+ Retained Earnings
Balances	720	8,400	12,000	=	10,000	1,800	6,000	3,320	
d. Issued capital stock	5,000			=			5,000		
Balances	5,720	8,400	12,000	=	10,000	1,800	11,000	3,320	

Statement of Cash Flows	
d. Financing	5,000

Family Health Care – Purchase on Account

- Family Health Care, P.C. purchases \$240 of supplies on account.

Statement of Cash Flows	Balance Sheet									Income Statement	
	Assets				=	Liabilities			+ Stockholders' Equity		
	Cash	Prepaid Insurance	Supplies	Land	Notes Payable	Accounts Payable	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	5,720	8,400		12,000	10,000		1,800	11,000	3,320		
e. Purchased supplies			240			240					
Balances	5,720	8,400	240	12,000	10,000	240	1,800	11,000	3,320		

Amount purchased is reported as an asset until the supplies are used in operations.

Amount purchased is reported as a liability.

Family Health Care – Purchase of Equipment

- Family Health Care, P.C. purchases office equipment by making a \$1,700 cash down payment and having five additional monthly installments of \$1,360.

Statement of Cash Flows	Balance Sheet										Income Statement	
	Assets					=	Liabilities			+ Stockholders' Equity		
	Cash	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	5,720	8,400	240		12,000	10,000	240	1,800	11,000	3,320		
f. Purchased office equip.	-1,700			8,500		6,800						
Balances	4,020	8,400	240	8,500	12,000	16,800	240	1,800	11,000	3,320		

Statement of Cash Flow	
f. Investing	-1,700

Cash down payment

Total Asset Value

Remaining balance due

Family Health Care – Services Provided on Account

- Family Health Care, P.C. performed services to patients on account in the amount of \$6,100.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	4,020		8,400	240	8,500	12,000	16,800	240	1,800	11,000	3,320		
g. Fees earned on acct.		6,100									6,100	g.	
Balances	4,020	6,100	8,400	240	8,500	12,000	16,800	240	1,800	11,000	9,420		

Income Statement	
g. Fees earned	6,100

Revenue is recorded when service is earned and invoiced

Family Health Care – Services Provided for Cash

- Family Health Care, P.C. performed services to patients who paid with cash in the amount of \$5,500.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	4,020	6,100	8,400	240	8,500	12,000	16,800	240	1,800	11,000	9,420		
<i>h.</i> Fees earned for cash	5,500											5,500	<i>h.</i>
Balances	9,520	6,100	8,400	240	8,500	12,000	16,800	240	1,800	11,000	14,920		
Statement of Cash Flows											Income Statement		
<i>h.</i> Operating	5,500											<i>h.</i> Fees earned	5,500

Family Health Care – Collection of Accounts Receivable

- Family Health Care, P.C. received \$4,200 in cash payments from patients' insurance companies for prior services performed.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash +	Accts. Rec. +	Prepaid Insur. +	Supp. +	Office Equip. +	Land +	Notes Pay. +	Accts. Pay. +	Unearned Revenue +	Capital Stock +	Retained Earnings		
Balances	9,520	6,100	8,400	240	8,500	12,000	16,800	240	1,800	11,000	14,920		
i. Collected cash on acct.	4,200	-4,200											
Balances	13,720	1,900	8,400	240	8,500	12,000	16,800	240	1,800	11,000	14,920		

Statement of Cash Flows	
i. Operating	4,200

Family Health Care – Payment of Accounts Payable

- Family Health Care, P.C. paid \$100 for supplies previously purchased on account.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	13,720	1,900	8,400	240	8,500	12,000	16,800	240	1,800	11,000	14,920		
j. Paid on account	-100							-100					
Balances	13,620	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	14,920		

Statement of Cash Flows	
j. Operating	-100

Family Health Care – Expenses Paid in Cash

- Family Health Care, P.C. incurred expenses for the month of November and paid cash for a total of \$4,690.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash +	Accts. Rec. +	Prepaid Insur. +	Supp. +	Office Equip. +	Land +	Notes Pay. +	Accts. Pay. +	Unearned Revenue +	Capital Stock +	Retained Earnings		
Balances	13,620	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	14,920		
k. Paid expenses	-4,690											-4,690	
Balances	8,930	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	10,230		

Statement of Cash Flows		Income Statement	
k. Operating	-4,690	k. Wages expense	-2,790
		Rent expense	-800
		Utilities expense	-580
		Interest expense	-100
		Misc. expense	-420

Family Health Care – Dividends Paid in Cash

- Family Health Care, P.C. paid dividends of \$1,200.

Statement of Cash Flows	Balance Sheet										Income Statement	
	Assets					=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock		Retained Earnings
Balances	8,930	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	10,230	
I. Paid dividends	-1,200										-1,200	
Balances	7,730	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	9,030	

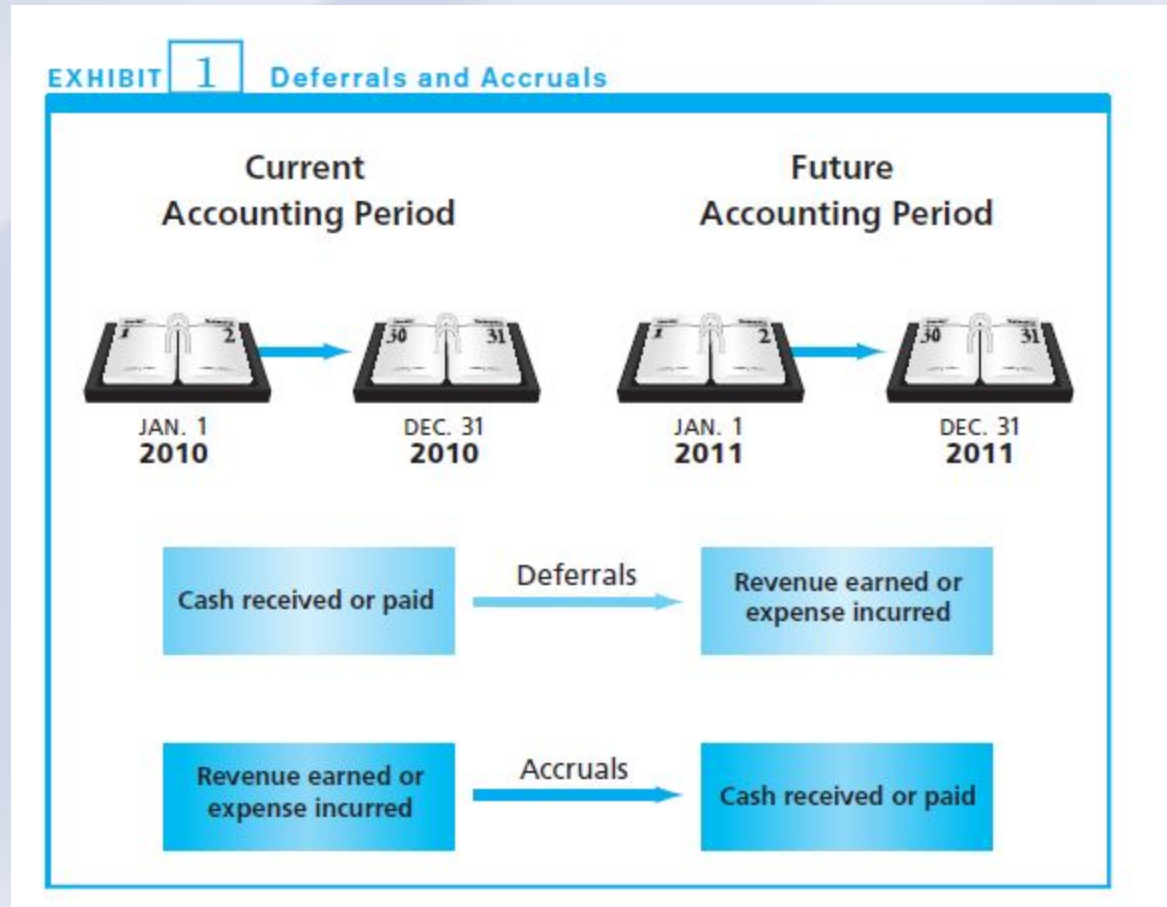
Statement of Cash Flows	
I. Financing	-1,200



Learning Objective 3

**Describe and illustrate the
end-of-period adjustment process**

Summary of Accruals and Deferrals



Deferrals



Accruals



Deferred Expenses – Prepaid Insurance

- As prepaid insurance expires, the asset Prepaid Insurance decreases.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash +	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock		Retained Earnings
Balances	7,730	1,900	8,400	240	8,500	12,000	16,800	140	1,800	11,000	9,030		
a1. Insurance expense			-1,100									-1,100	a1.
Balances	7,730	1,900	7,300	240	8,500	12,000	16,800	140	1,800	11,000	7,930		

Income Statement	
a1. Insurance exp.	-1,100

Adjustments affect both a balance sheet account and an income statement account

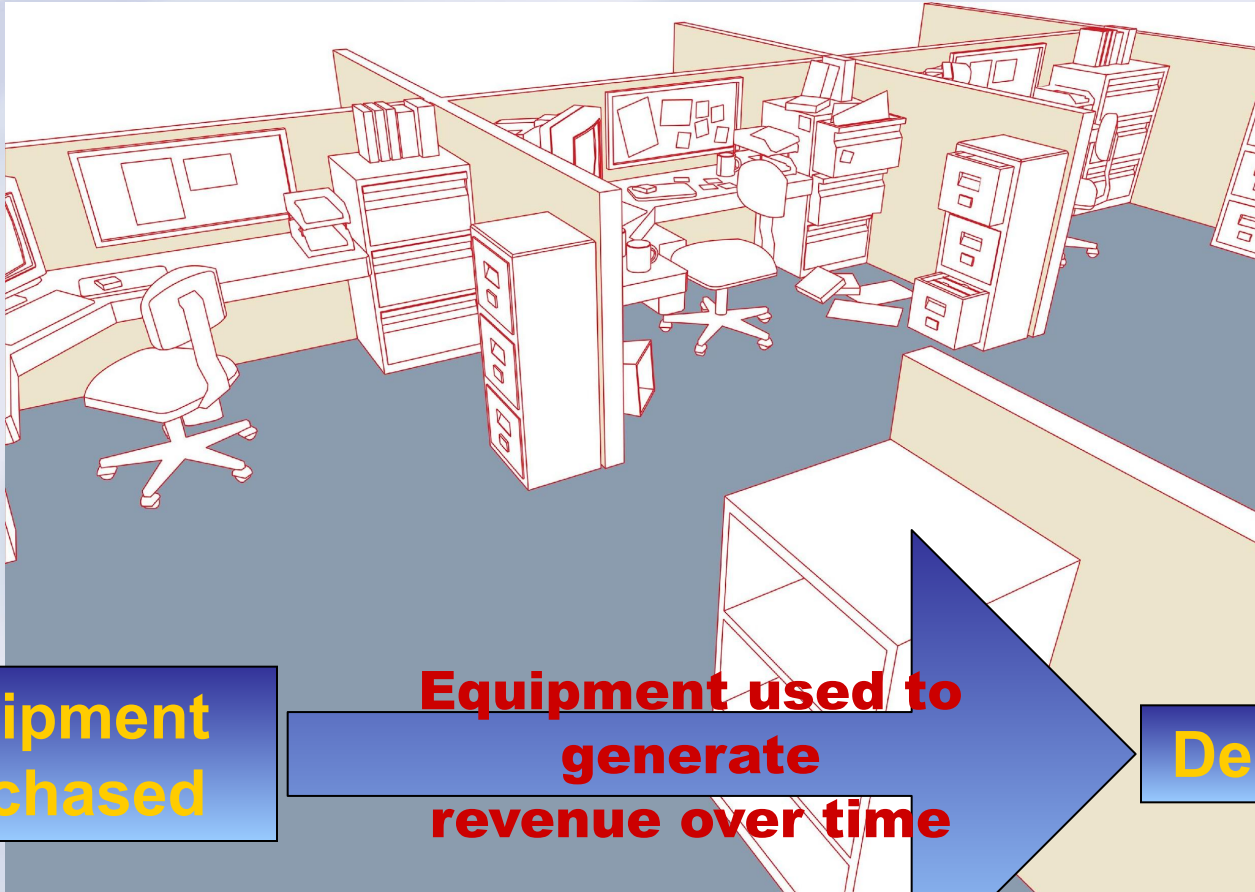
Deferred Expenses – Supplies

- During November, \$150 of supplies was used in operations leaving a balance of \$90.

Statement of Cash Flows	Balance Sheet											Income Statement	
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	7,730	1,900	7,300	240	8,500	12,000	16,800	140	1,800	11,000	7,930		
a2. Supplies expense				-150								-150	a2.
Balances	7,730	1,900	7,300	90	8,500	12,000	16,800	140	1,800	11,000	7,780		

Income Statement	
a2. Supplies exp.	-150

Fixed Assets and Depreciation



**Equipment
purchased**

**Equipment used to
generate
revenue over time**

Depreciation

Deferred Expenses – Depreciation

- The depreciation on Office Equipment for Family Health Care is assumed to be \$160 per month.

Statement of Cash Flows	Balance Sheet												Income Statement	
	Assets							=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Acc. Dep.	Land	Notes Pay.	Accts. Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	7,730	1,900	7,300	90	8,500		12,000	16,800	140	1,800	11,000	7,780		
a3. Depreciation exp.						-160						-160	a3.	
Balances	7,730	1,900	7,300	90	8,500	-160	12,000	16,800	140	1,800	11,000	7,620		

Income Statement		
a3. Depreciation exp.		-160

Deferred Revenue – Unearned Rent

- On November 1, Family Health Care received \$1,800 from ILS for rental of land for five months.

Statement of Cash Flows	Balance Sheet						Income Statement				
	Assets		=	Liabilities		+		Stockholders' Equity			
	Cash	+	Land	=	Notes Payable	+		Unearned Revenue	+	Capital Stock	+
Balances, Nov. 1	7,320		12,000		10,000				6,000		3,320
a. Received rent in advance	1,800						1,800				
Balances	9,120		12,000		10,000		1,800		6,000		3,320

Statement of Cash Flows	
a. Operating	1,800

Accrued Expenses – Wages Owed



Wages earned



Pay Day

End of month

Accrued Expenses – Wages Owed

- The amount owed for wages not paid is \$220.

Statement of Cash Flows	Balance Sheet													Income Statement	
	Assets							=	Liabilities			+ Stockholders' Equity			
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Acc. Dep.	Land	Notes Pay.	Accts. Pay.	Wages Pay.	Unearned Revenue	Capital Stock	Retained Earnings		
Balances	7,730	1,900	7,300	90	8,500	-160	12,000	16,800	140		1,440	11,000	7,980		
a5. Wages exp.										220			-220	a5.	
Balances	7,730	1,900	7,300	90	8,500	-160	12,000	16,800	140	220	1,440	11,000	7,760		

Income Statement	
a5. Wages expense	-220

Accrued Revenues – Patient Services

- Family Health Care provides services worth \$750 to patients and have not billed for these services at the end of the month.

Statement of Cash Flows	Balance Sheet													Income Statement	
	Assets							=	Liabilities			+	Stockholders' Equity		
	Cash +	Accts. Rec. +	Prepaid Insur. +	Supp. +	Office Equip. +	Acc. Dep. -	Land +	Notes Pay. =	Accts. Pay. +	Wages Pay. +	Unearned Revenue +	Capital Stock +	Retained Earnings		
Balances	7,730	1,900	7,300	90	8,500	-160	12,000	16,800	140	220	1,440	11,000	7,760		
a6. Fees earned		750											750	a6.	
Balances	7,730	2,650	7,300	90	8,500	-160	12,000	16,800	140	220	1,440	11,000	8,510		

Income Statement	
a6. Fees earned	750



Learning Objective 4

**Prepare financial statements using
accrual concepts of accounting,
including a classified balance sheet**

Summary of Transactions for Family Health Care

- Family Health Care, P.C. prepares the four required financial statements to summarize November activity after adjustments.

EXHIBIT 2 Family Health Care Summary of Transactions and Adjustments for November

Statement of Cash Flows	Balance Sheet											Income Statement		
	Assets						=			Liabilities			+ Stockholders' Equity	
	Cash +	Accts. Rec. +	Prepaid Insur. +	Supp. +	Office Equip. -	Acc. Dep. +	Land =	Notes Pay. +	Accts. Pay. +	Wages Pay. +	Unearned Revenue +		Capital Stock +	Retained Earnings
Balances, Nov. 1	7,320						12,000	10,000			6,000	3,320		
a. Rental rev.	1,800									1,800				
b. Paid insurance	-2,400		2,400											
c. Paid insurance	-6,000		6,000											
d. Investment	5,000										5,000			
e. Pur. supplies				240					240					
f. Pur. off. equip.	-1,700				8,500			6,800						
g. Fees earned		6,100										6,100		
h. Fees earned	5,500											5,500		
i. Collected cash	4,200	-4,200												
j. Paid on acct.	-100								-100					
k. Paid expenses	-4,690											-4,690		
l. Dividends	-1,200											-1,200		
a1. Insurance exp.			-1,100									-1,100		
a2. Supplies exp.				-150								-150		
a3. Deprec. exp.					-160							-160		
a4. Rental revenue										-360		360		
a5. Wages exp.									220			-220		
a6. Fees earned		750										750		
Balances, Nov. 30	7,730	2,650	7,300	90	8,500	-160	12,000	16,800	140	220	1,440	11,000	8,510	

Statement of Cash Flows		Income Statement	
a. Operating	1,800	g. Fees earned	6,100
b. Operating	-2,400	h. Fees earned	5,500
c. Operating	-6,000	k. Wages exp.	-2,790
d. Financing	5,000	Rent exp.	-800
f. Investing	-1,700	Utilities exp.	-580
h. Operating	5,500	Interest exp.	-100
i. Operating	4,200	Misc. exp.	-420
j. Operating	-100	a1. Insur. exp.	-1,100
k. Operating	-4,690	a2. Supplies exp.	-150
l. Financing	-1,200	a3. Deprec. exp.	-160
Increase in cash	410	a4. Rental rev.	360
Nov. 1 cash bal.	7,320	a5. Wages exp.	-220
Nov. 30 cash bal.	7,730	a6. Fees earned	750
		Net income	6,390

Income Statement after Adjustments

EXHIBIT 3 Family Health Care Income Statement for November

FAMILY HEALTH CARE, P.C. Income Statement For the Month Ended November 30, 2011		
Fees earned		\$12,350
Operating expenses:		
Wages expense	\$3,010	
Insurance expense	1,100	
Rent expense	800	
Utilities expense	580	
Depreciation expense	160	
Supplies expense	150	
Interest expense	100	
Miscellaneous expense	420	
Total operating expenses		<u>6,320</u>
Operating income		\$ 6,030
Other income:		
Rental revenue		<u>360</u>
Net income		<u><u>\$ 6,390</u></u>

Retained Earnings Statement after Adjustments

EXHIBIT 4 Family Health Care Retained Earnings Statement for November

FAMILY HEALTH CARE, P.C. Retained Earnings Statement For the Month Ended November 30, 2011

Retained earnings, November 1, 2011		\$3,320
Net income for November	\$6,390	
Less dividends	<u>1,200</u>	<u>5,190</u>
Retained earnings, November 30, 2011		<u><u>\$8,510</u></u>

Balance Sheet after Adjustments

EXHIBIT 5 Family Health Care Balance Sheet for November

FAMILY HEALTH CARE, P.C. Balance Sheet November 30, 2011			
Assets			
Current assets:			
Cash		\$ 7,730	
Accounts receivable		2,650	
Prepaid insurance		7,300	
Supplies		90	
Total current assets			\$17,770
Fixed assets:			
Office equipment	\$8,500		
Less accumulated depreciation	<u>160</u>	\$ 8,340	
Land		<u>12,000</u>	
Total fixed assets			<u>20,340</u>
Total assets			<u><u>\$38,110</u></u>
Liabilities			
Current liabilities:			
Accounts payable		\$ 140	
Wages payable		220	
Notes payable		6,800	
Unearned revenue		<u>1,440</u>	
Total current liabilities			\$ 8,600
Long-term liabilities:			
Notes payable			<u>10,000</u>
Total liabilities			\$18,600
Stockholders' Equity			
Capital stock		\$11,000	
Retained earnings		<u>8,510</u>	
Total stockholders' equity			<u>19,510</u>
Total liabilities and stockholders' equity			<u><u>\$38,110</u></u>

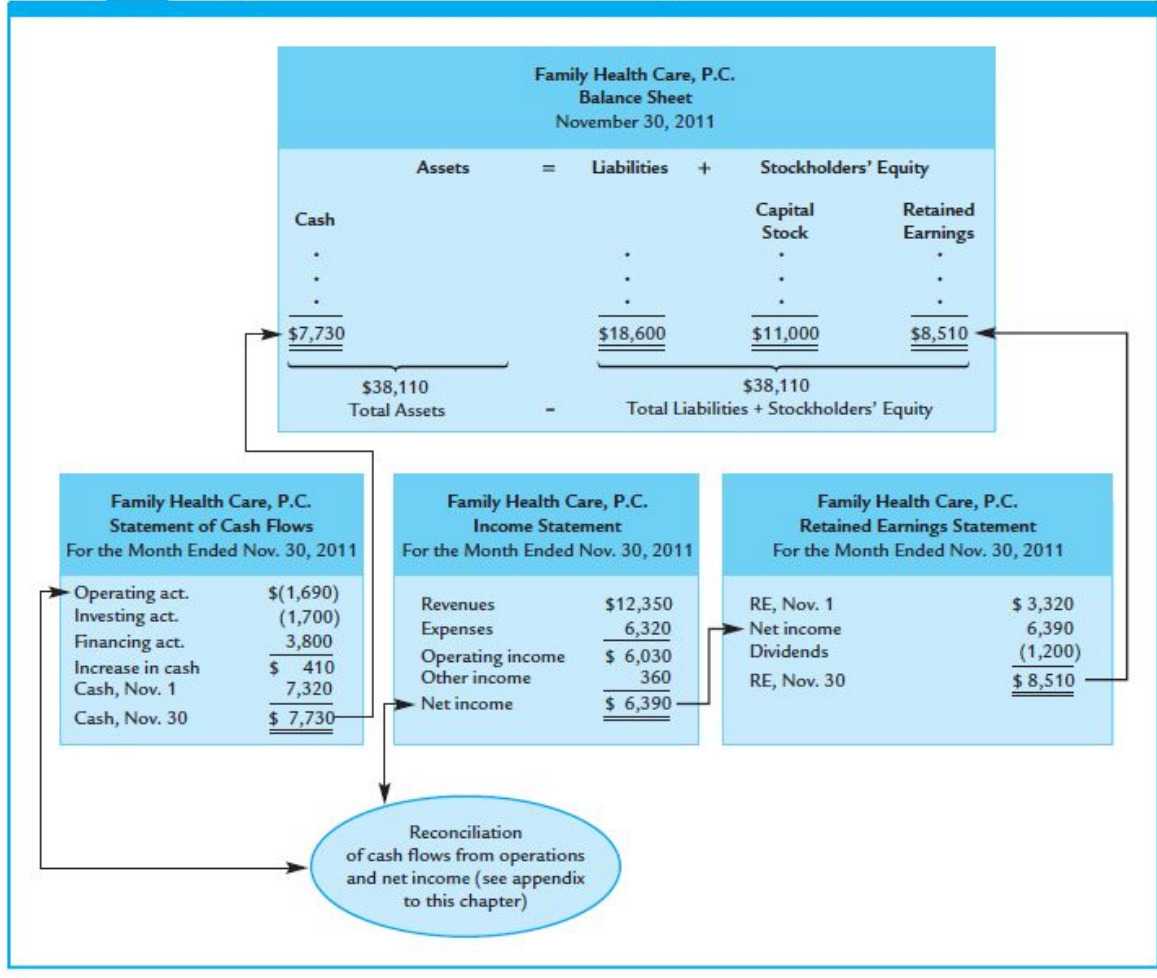
Statement of Cash Flows after Adjustments

EXHIBIT **6** Family Health Care Statement of Cash Flows for November

FAMILY HEALTH CARE P.C. Statement of Cash Flows For the Month Ended November 30, 2011		
Cash flows from operating activities:		
Cash received from patients	\$ 9,700	
Cash received from rental of land	<u>1,800</u>	\$ 11,500
Deduct cash payments for expenses		<u>(13,190)</u>
Net cash flow used in operating activities		\$ (1,690)
Cash flows from investing activities:		
Purchase of office equipment		(1,700)
Cash flows from financing activities:		
Additional issuance of capital stock	\$ 5,000	
Deduct cash dividends	<u>(1,200)</u>	
Net cash flow from financing activities		<u>3,800</u>
Net increase in cash		\$ 410
November 1, 2011 cash balance		<u>7,320</u>

How the Financial Statements Integrate:

EXHIBIT 7 Integrated Financial Statements—Family Health Care



Learning Objective 5

Describe how the accrual basis of accounting enhances the interpretation of financial statements

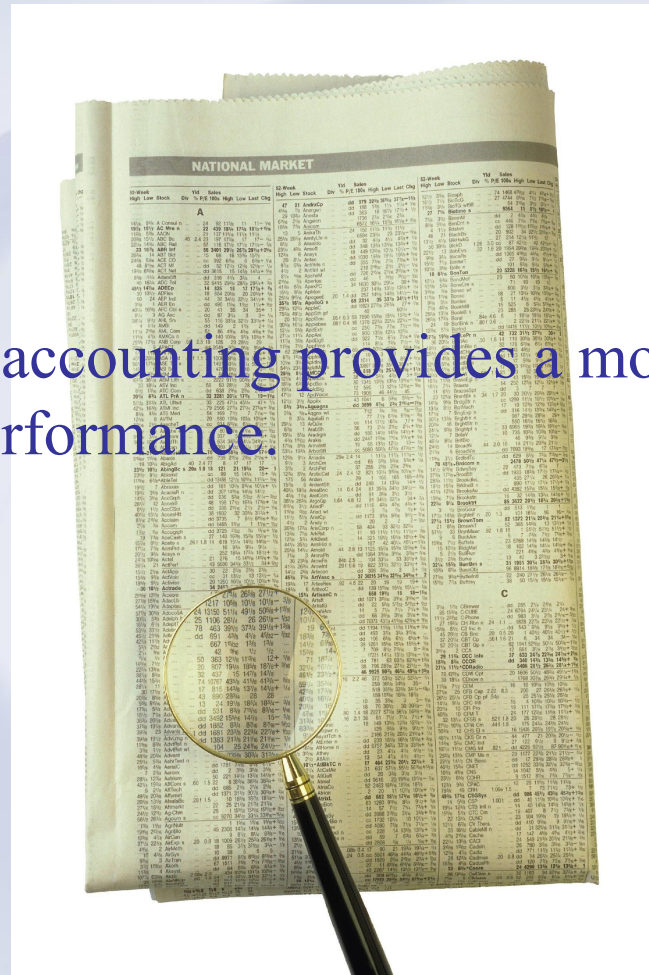
Cash vs. Accrual Basis of Accounting

EXHIBIT 8 Cash versus Accrual Accounting

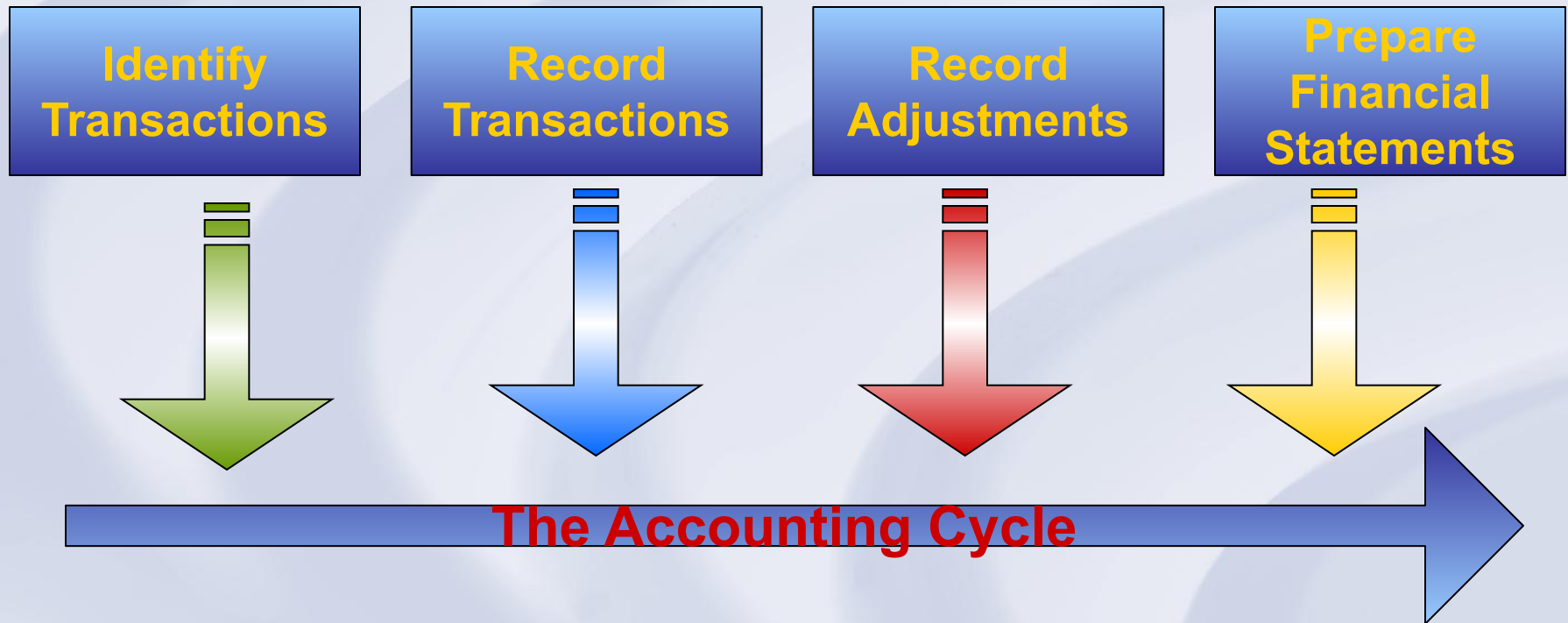
	Cash Basis	Accrual Basis
Revenue is recorded	When cash is received	When revenue is earned
Expense is recorded	When cash is paid	When expense is incurred in generating revenue
Adjusting entries	Not required	Required in order to prepare financial statements

Importance of Accrual Based Accounting

- Accrual based accounting provides a more accurate measure of company performance.



Accrual Accounting and the Accounting Cycle





End of Chapter 3