

Financial Accounting

Prepared by Dr. Sara Ahmed

MGM 611

Lecture 3





مجموعة جامعة
الجميع الذكية
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MIDOCEAN
UNIVERSITY
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Adjusting Accounts for Financial Statements

Lecture 3

MGM 611

Prepared by
Dr. Sara Ahmed

www.midocean.ae

TOPIC
03

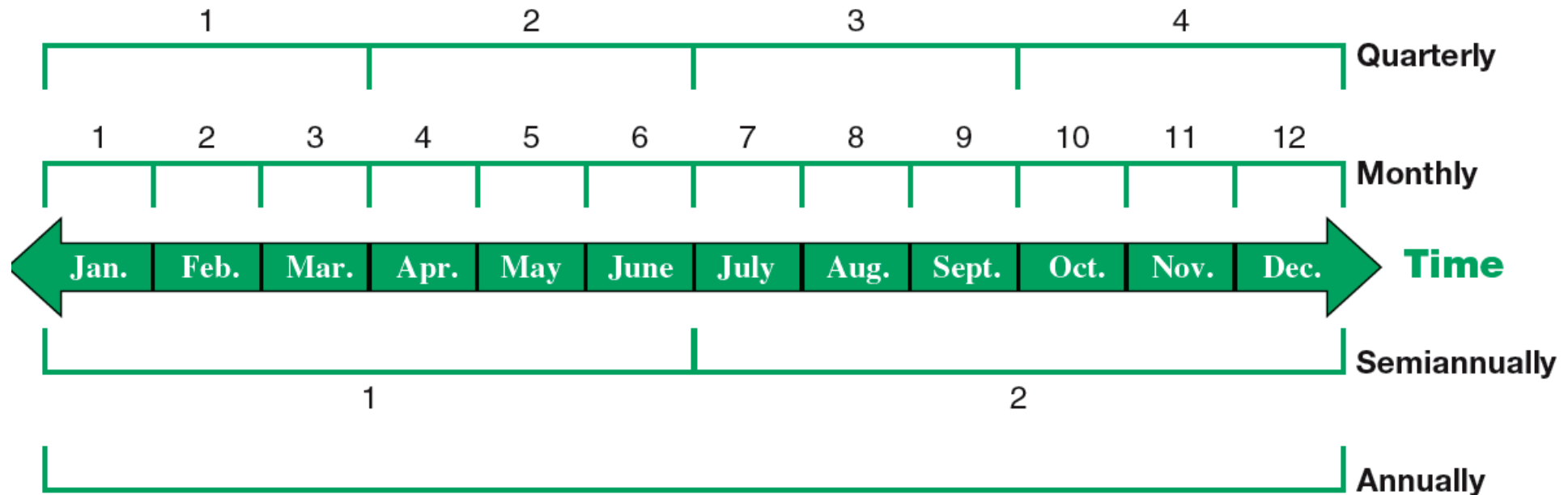
LEARNING OBJECTIVES

- Explain the importance of periodic reporting and the time period assumption.
- Explain accrual accounting and how it improves financial statements.
- Identify the types of adjustments and their purpose.
- Explain how accounting adjustments link to financial statements.
- Compute the profit margin and describe its use in analyzing company performance.

Learning Objective

Explain the importance of periodic reporting and the role of accrual accounting.

The Accounting Period



Learning Objective

Explain accrual accounting and how it improves financial statements.

Accrual Basis versus Cash Basis

Accrual Basis

Revenues are recognized when earned and expenses are recognized when incurred.

Cash Basis

Revenues are recognized when cash is received and expenses are recorded when cash is paid.

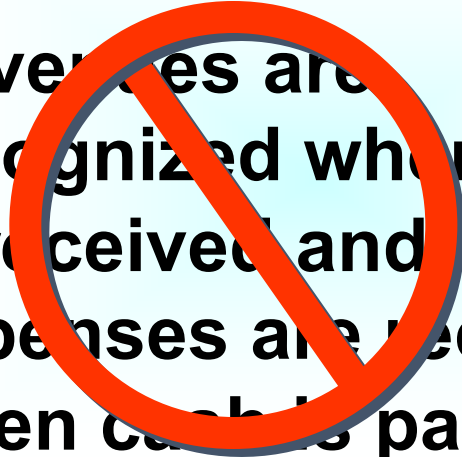
Accrual Basis versus Cash Basis

Accrual Basis

Revenues are recognized when earned and expenses are recognized when incurred.

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Non-GAAP

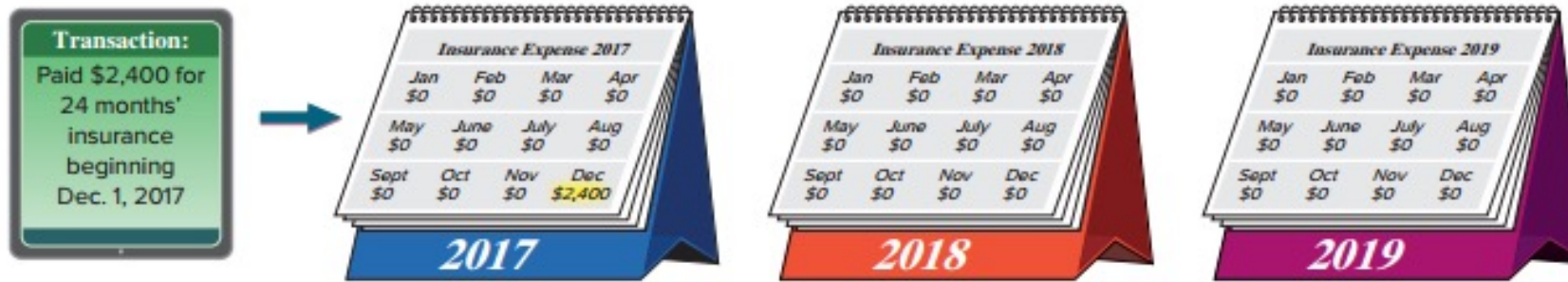
Accrual Basis versus Cash Basis



On December 1, 2017, FastForward paid \$2,400 cash for a twenty-four month business insurance policy.

Using the cash basis, the entire \$2,400 would be recognized as insurance expense in 2017. No insurance expense from this policy would be recognized in 2018 or 2019, periods covered by the policy.

Accrual Basis versus Cash Basis



On the accrual basis, \$100 of insurance expense is recognized in 2017, \$1,200 in 2018, and \$1,100 in 2019. The expense is matched with the periods benefited by the insurance coverage.

Recognizing Revenues

The revenue recognition principle requires that revenue be recorded when goods or services are provided to customers and at an amount expected to be received from customers.

Recognizing Expenses

The expense recognition (or matching) principle aims to record expenses in the same accounting period as the revenues that are earned as a result of those expenses. This matching of expenses with the revenue benefits is a major part of the adjusting process.

Learning Objective

Identify the types of adjustments and their purpose.

Framework for Adjustments

Four types of adjustments for transactions that extend over more than one period.



Adjustments made using a 3-step process:

Step 1: Determine what the current account balance *equals*.

Step 2: Determine what the current account balance *should equal*.

Step 3: Record an adjusting entry to get from step 1 to step 2.

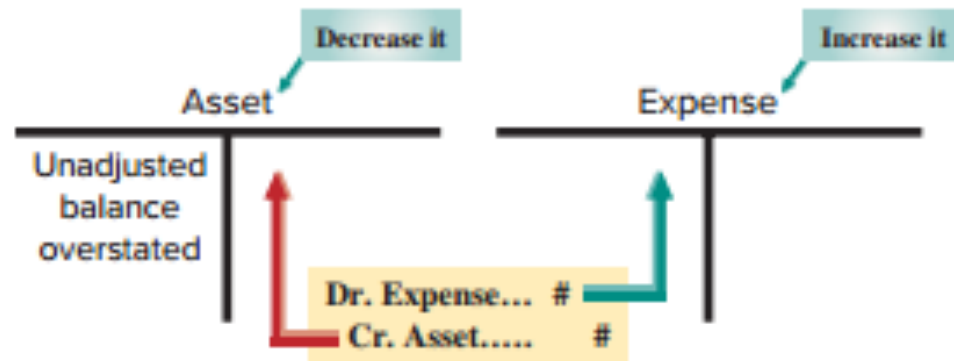
Learning Objective

Prepare and explain
adjusting entries.

Prepaid (Deferred) Expenses

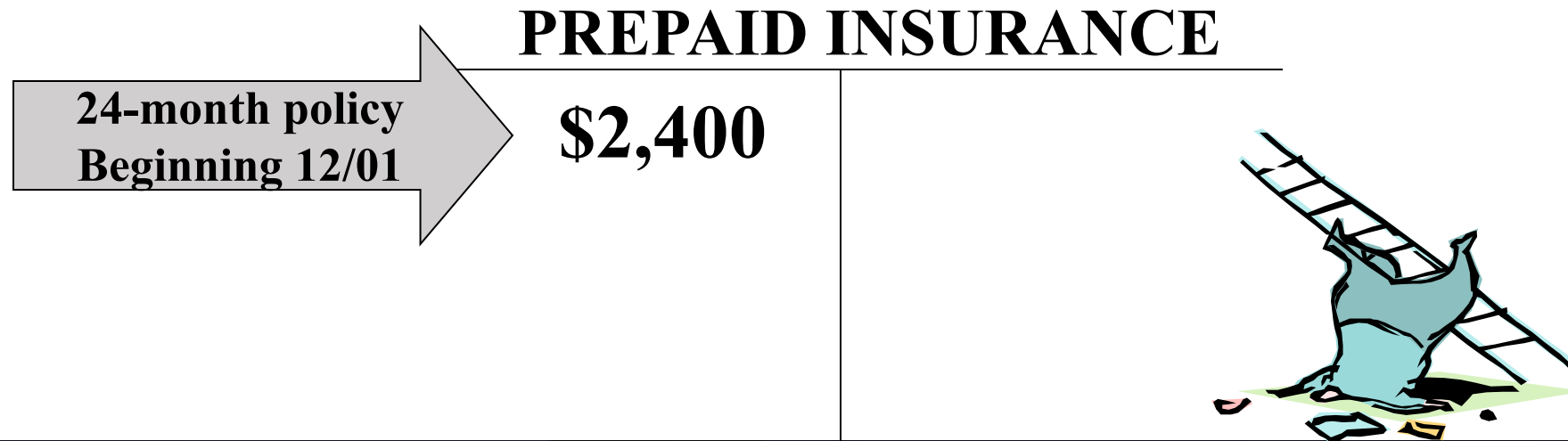
Prepaid expenses are assets paid for in advance of receiving their benefits.

Examples: Prepaid Insurance, Prepaid Rent, Supplies



Prepaid Insurance

On 12/01/2017, FastForward paid \$2,400 to cover insurance for 24 months that began on 12/01/2017.
Recorded as *Prepaid Insurance* on 12/01/17.



Prepaid Insurance

On 12/31, one month's worth of insurance has expired.

Step 1: Current balance = \$2,400

Step 2: Balance in balance in prepaid insurance should equal \$2,300.

Step 3: Current prepaid insurance balance $\$2,400 - 100 = \$2,300$

PREPAID INSURANCE

\$2,400

\$100

INSURANCE EXPENSE

\$100

$\$2,400 / 24 \text{ months} = \100

Insurance Expense is debited
\$100 to recognize the amount
of insurance coverage for Dec. and
Prepaid Insurance is credited for \$100
to reduce it's balance.

Prepaid Insurance

(Balance Sheet)

PREPAID INSURANCE

\$2,400

\$100 adj

Bal. **\$2,300**

The Balance Sheet will show
\$2,300 (23 months) of
Prepaid Insurance remaining!

(Income Statement)

INSURANCE EXPENSE

adj \$100

The Income Statement will
show \$100 (1 month) of
insurance expired!

Adjusting Entry for Expired Insurance

The general journal adjustment on Dec. 31 and general ledger account balances are as follows:

Prepaid Insurance		128
Dec. 1	2,400	Dec. 31 100
Bal.	2,300	

Insurance Expense		637
Dec. 31	100	

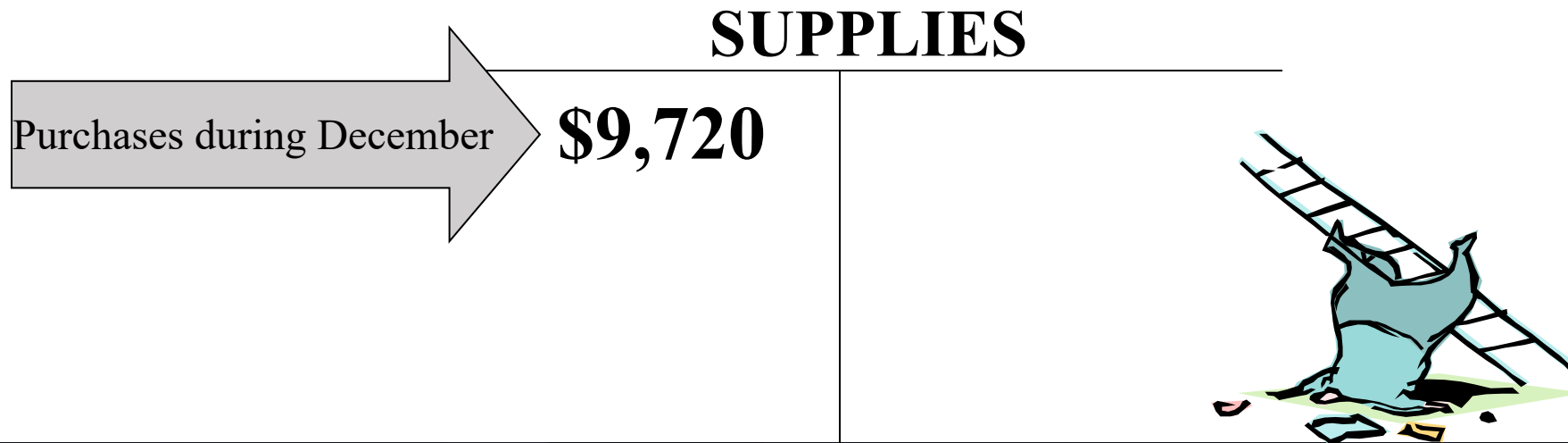
Dec. 31	Insurance Expense	100	
	Prepaid Insurance		100
	<i>To record first month's expired insurance</i>		

Supplies

Step 1: FastForward purchased \$9,720 of supplies in December.
Some of these were used during December.

Step 2: A physical count shows that unused supplies equal \$8,670.

Step 3: Adjusting entry reduces Supplies by \$1,050 or the difference between the beginning balance and the physical count.



Supplies

(Balance Sheet)

SUPPLIES

\$9,720

\$1,050 adj

Bal. **\$8,670**

The Balance Sheet will show
\$8,670 of supplies remaining!

(Income Statement)

SUPPLIES EXPENSE

adj \$1,050

The Income Statement will
show \$1,050 (1 month) of
Supplies expired!

Adjusting Entry for Expired Supplies

We've seen the adjustment in the T-accounts but we need to record the adjustment on Dec. 31, in the *General Journal*

Supplies		126
Dec.	9,720	Dec. 31 1,050
Bal.	8,670	

Supplies Expense		652
Dec. 31	1,050	

Dec. 31	Supplies Expense	1,050	
	Supplies		1,050
<i>To record supplies used</i>			

Depreciation

Instead of expensing the cost of a plant asset (equipment, building, cars, etc.) in the year it is purchased we allocate or spread out the cost over their expected useful lives.

The formula for *straight-line* depreciation is:

$$\begin{array}{l} \text{Straight-Line} \\ \text{Depreciation} \\ \text{Expense} \end{array} = \frac{\text{Asset Cost} - \text{Salvage Value}}{\text{Useful Life}}$$



Useful Life

- The period of time that an asset is expected to help produce revenues.
- Useful life expires as a result of wear and tear, or because it no longer satisfies the needs of the business.

Salvage Value

- The expected market value or selling price of an asset at the end of its useful life
- Also called:
 - Scrap Value or
 - Residual Value



Straight-line Method

Formula to compute net cost (amount to depreciate):

$$\begin{array}{rcccl} \text{Original} & & \text{Salvage} & & \\ \text{Cost} & - & \text{Value} & = & \text{Net Cost} \\ \$26,000 & - & \$8,000 & = & \$18,000 \end{array}$$

Depreciation Expense

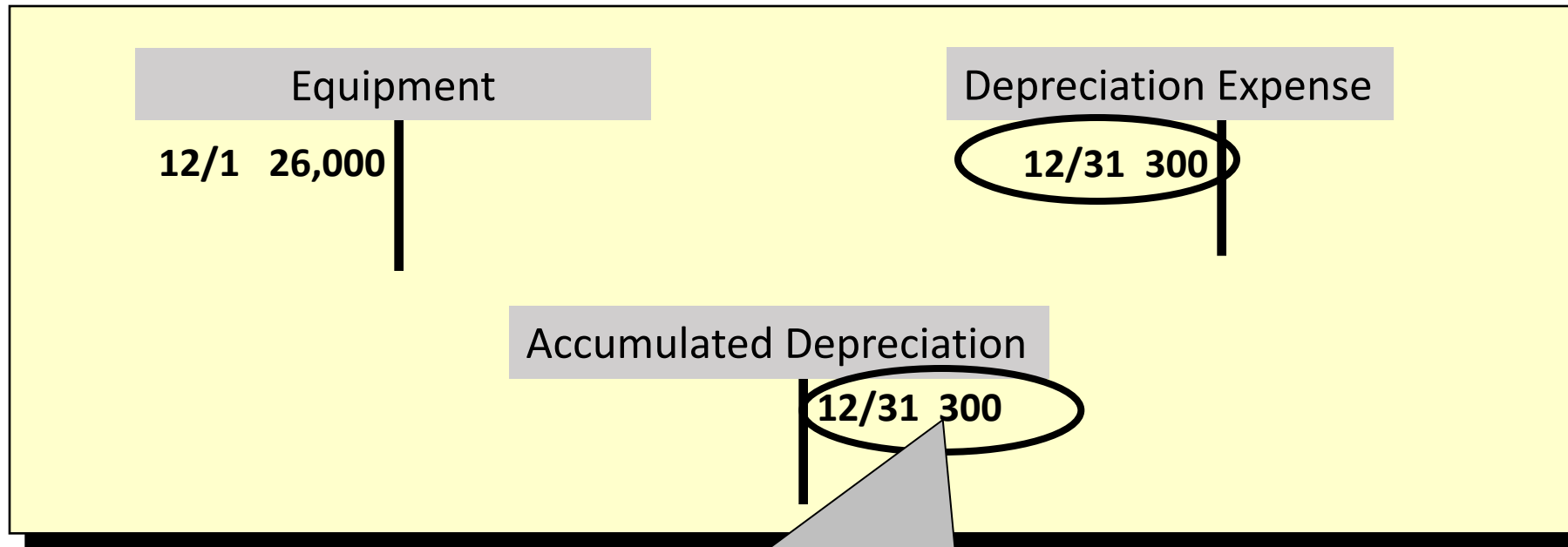
Step 1: FastForward purchased equipment on Dec 1 for \$26,000.

Step 2: Equipment has an useful live of 5 years. The equipment is expected to be worth \$8,000 at the end of five years. FastForward using straight-line depreciation. \$18,000 (\$26,000 – 8,000) of the cost needs to be spread over the next 60 months.

One month = $\$18,000 / 60 = \300 .

Step 3: Record adjusting entry for \$300 for one month.

Depreciation adjustment in T-accounts



The depreciation amount of \$300 is credited to the accumulated depreciation account instead of the asset, Equipment.

Adjusting Entry for Depreciation

Step 3: Record adjusting entry for \$300 for one month.

Equipment		Depreciation Expense	
12/1	26,000	12/31	300
		Accumulated Depreciation-Equipment	
		12/31	300

Dec. 31	Depreciation Expense	300	
	Accumulated Depreciation - Equipment		300
<i>To record monthly equipment depreciation</i>			

Depreciation on Balance Sheet

Depreciation would show up on our balance sheet like this:

FastForward Partial Balance Sheet At February 28, 2018		
Assets		
Cash		\$
.		
Equipment	\$ 26,000	
Less: accumulated deprec.	(900)	25,100
.		
.		
Total Assets		

After three month's of depreciation have been taken, the Equipment is shown net of accumulated depreciation.

For each separate case below, follow the three-step process for adjusting the prepaid asset account.

Step 1: Determine what the current account balance equals.

Step 2: Determine what the current account balance should equal.

Step 3: Record an adjusting entry to get from step 1 to step 2.

Assume no other adjusting entries are made during the year.

Prepaid Insurance. The Prepaid Insurance account has a \$5,000 debit balance to start the year. A review of insurance policies and payments shows that \$1,000 of unexpired insurance remains at year-end.

Prepaid Rent. On October 1 of the current year, the company prepaid \$12,000 for one year of rent for facilities being occupied from that day forward. The company debited Prepaid Rent and credited Cash for \$12,000. December 31 year-end statements must be prepared.

Supplies. The Supplies account has an \$1,000 debit balance to start the year. Supplies of \$2,000 were purchased during the current year and debited to the Supplies account. A December 31 physical count shows \$500 of supplies remaining.

Accumulated Depreciation. The company has only one fixed asset (equipment) that it purchased at the start of this year. That asset had cost \$38,000, had an estimated life of 10 years, and is expected to be valued at \$8,000 at the end of the 10-year life.

Prepaid Insurance. The Prepaid Insurance account has a \$5,000 debit balance to start the year. A review of insurance policies and payments shows that \$1,000 of unexpired insurance remains at year-end.

Step 1: Determine what the current account balance equals. \$5,000

Step 2: Determine what the current account balance should equal. \$1,000

Prepaid Insurance			
Unadj.	5,000	Adjustment	4,000
Adj.	1,000		

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Insurance expense	4,000	
	Prepaid Insurance		4,000

Income Statement

Revenue

Debit Expense

Balance Sheet

Credit Asset

Liability

Prepaid Rent. On October 1 of the current year, the company prepaid \$12,000 for one year of rent for facilities being occupied from that day forward. The company debited Prepaid Rent and credited Cash for \$12,000. December 31 year-end statements must be prepared.

Step 1: Determine what the current account balance equals. \$12,000

Step 2: Determine what the current account balance should equal. \$9,000

Prepaid Rent			
Oct. 1	12,000		
		Adjustment	3,000
Dec. 31	9,000		

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Rent Expense	3,000	
	Prepaid Rent		3,000

Income Statement

Revenue

Debit Expense

Balance Sheet

Credit Asset

Liability

Supplies. The Supplies account has a \$1,000 debit balance to start the year. Supplies of \$2,000 were purchased during the current year and debited to the Supplies account. A December 31 physical count shows \$500 of supplies remaining.

- Step 1: Determine what the current account balance equals.

\$3,000
- Step 2: Determine what the current account balance should equal.

\$500

Supplies			
Unadj.	3,000	Adjustment	2,500
Dec. 31	500		

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Supplies Expense	2,500	
	Supplies		2,500

Income Statement

Revenue

Debit Expense

Balance Sheet

Credit Asset

Liability

Accumulated Depreciation. The company has only one fixed asset (equipment) that it purchased at the start of this year. That asset had cost \$38,000, had an estimated life of 10 years, and is expected to be valued at \$8,000 at the end of the 10-year life.

Step 1: Determine what the current account balance equals. \$0

Step 2: Determine what the current account balance should equal. \$3,000

Accumulated Depreciation		
	Unadj.	0
	Adjustment	3,000
	Dec. 31	3,000
		$\frac{(\$38,000 - \$8,000)}{10 \text{ years}}$

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Depreciation Expense	3,000	
	Accumulated Depreciation		3,000

Income Statement

Revenue

Debit Expense

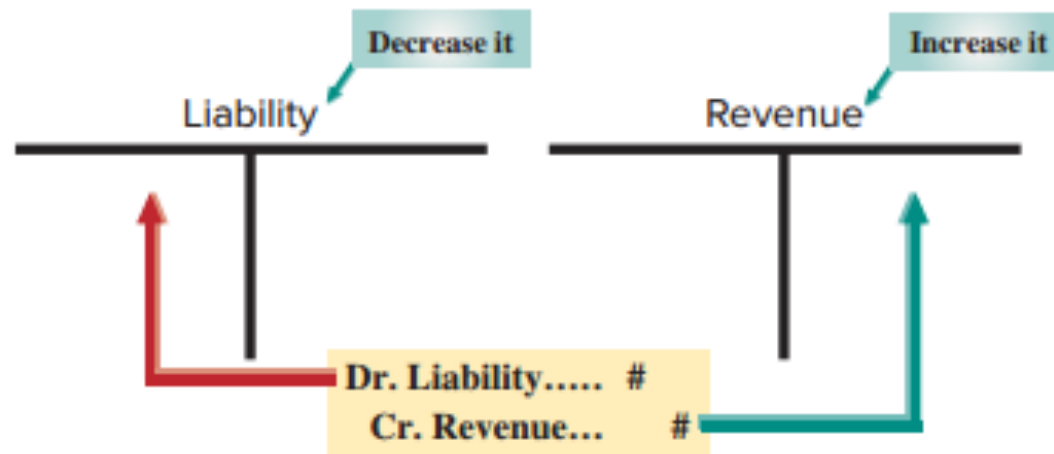
Balance Sheet

Credit Asset

Liability

Unearned (Deferred) Revenues

Cash received in advance of providing products or services.



Unearned (Deferred) Revenues

Step 1: FastForward's client paid 60-day fee in advance covering the period from 12/27 – 2/24 and recorded:

Dec. 26	Cash	3,000	
	Unearned Consulting Revenue		3,000
	<i>Received advance payment for services</i>		

Step 2: FastForwards earns payment as time passes. At 12/31, 5 days' service is earned or $5/60 \times \$3,000 = \250 .

Step 3: Adjusting entry reduces liability, Unearned Consulting Revenue, by \$250 or 5 days' worth of revenue. Also, Consulting Revenue of \$250 is earned.

Unearned (Deferred) Revenue

(Balance Sheet)

UNEARNED CONSULTING REVENUE

	\$3,000
adj \$250	
	\$2,750 Bal.

The Balance Sheet will show
\$2,750 of Unearned Consulting
Revenue unearned.

(Income Statement)

CONSULTING REVENUE

	\$5,800
	250
	\$6,050 Bal.

The Income Statement will
show \$6,050 total Consulting
Revenue earned.

Adjusting Entry for Unearned Revenue

Adjusting entry recorded on Dec. 31 to transfer \$250 from unearned to earned consulting revenue.

Dec. 31	Unearned Consulting Revenue	250	
	Consulting Revenue		250
	<i>To record earned revenue received in advance</i>		

For each separate case below, follow the three-step process for adjusting the unearned revenue liability account.

Step 1: Determine what the current account balance equals.

Step 2: Determine what the current account balance should equal.

Step 3: Record an adjusting entry to get from step 1 to step 2.

Assume no other adjusting entries are made during the year.

Unearned Rent Revenue. The company collected \$24,000 rent in advance on September 1, debiting Cash and crediting Unearned Rent Revenue. The tenant was paying 12 months rent in advance and occupancy began September 1.

Unearned Services Revenue. The company charges \$100 per month to spray a house for insects. A customer paid \$600 on November 1 in advance for six treatments, which was recorded with a debit to Cash and a credit to Unearned Services Revenue. At year-end, the company has applied two treatments for the customer.

Unearned Rent Revenue. The company collected \$24,000 rent in advance on September 1, debiting Cash and crediting Unearned Rent Revenue. The tenant was paying 12 months rent in advance and occupancy began September 1.

Step 1: Determine what the current account balance equals. \$24,000

Step 2: Determine what the current account balance should equal. \$16,000

Unearned Rent Revenue			
		Sept. 1	24,000
Adjustment	8,000		
		Dec. 31	16,000 (8 mos. @ \$2,000)

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Unearned Rent Revenue	8,000	
	Rent Revenue		8,000

Income Statement

Credit Revenue
Expense

Balance Sheet

Asset
Debit Liability

Unearned Services Revenue. The company charges \$100 per month to spray a house for insects. A customer paid \$600 on November 1 in advance for six treatments, which was recorded with a debit to Cash and a credit to Unearned Services Revenue. At year-end, the company has applied two treatments for the customer.

Step 1: Determine what the current account balance equals. \$600

Step 2: Determine what the current account balance should equal. \$400

Unearned Services Revenue			
		Nov. 1	600
Adjustment	200		
		Dec. 31	400

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Unearned Services Revenue	200	
	Services Revenue		200

Income Statement

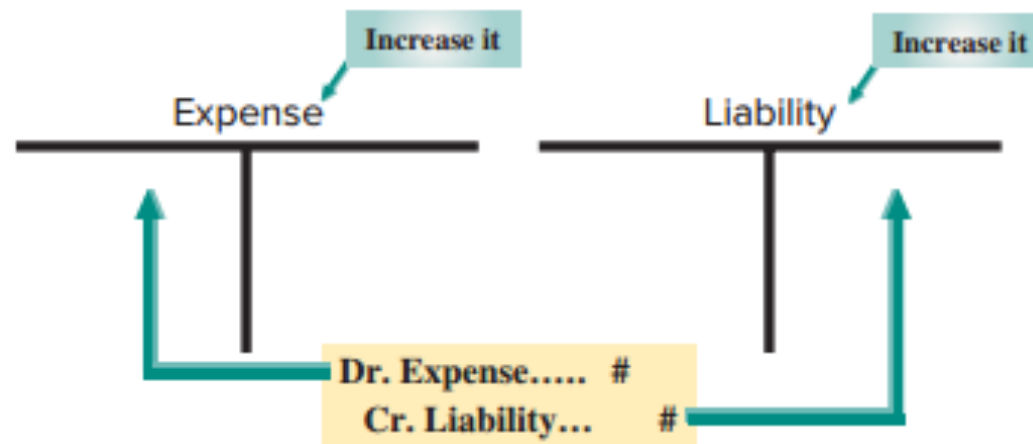
Credit Revenue
Expense

Balance Sheet

Asset
Debit Liability

Accrued Expenses

Costs incurred in a period
that are
both unpaid and unrecorded.



Accrued Salaries Expense

Step 1: FastForward's pays its employee \$70 per day, or \$350 for a five-day work. Salaries are paid every two weeks on a Friday.

Step 2: 12/31 is a Wednesday, so three day's salaries are owed at year end which equals $\$70 \times 3 = \210 .

Step 3: Adjusting entry increases a liability, Salaries Payable, and increases the Salaries Expense account for \$210 with the following journal entry:

Dec. 31	Salaries Expense	210	
	Salaries Payable		210
	<i>To record three days' accrued salaries</i>		

Accrued Salaries Expense

(Balance Sheet)

SALARIES PAYABLE

	\$210 adj
	\$210 Bal.

The Balance Sheet will show \$210 of Salaries Payable owed.

(Income Statement)

SALARIES EXPENSE

\$1,400	
adj 210	
Bal. \$1,610	

The Income Statement will show \$1,610 total Salaries Expense.

Future Payment of Accrued Expenses

Accrued expenses at the end of one period result in a cash payment in a future period.

On 12/31, FastForward recorded accrued salaries of \$210.

On 1/9 of the next year, the following entry will reduce the accrued liability, salaries payable, and record the expense for 7 days work in January.

Jan 9	Salaries Payable (3 x \$70)	210	
	Salaries Expense (7 x \$70)	490	
	Cash		700
	<i>To record earned revenue received in advance</i>		

For each separate case below, follow the three-step process for adjusting the accrued expense account.

Step 1: Determine what the current account balance equals.

Step 2: Determine what the current account balance should equal.

Step 3: Record an adjusting entry to get from step 1 to step 2.

Assume no other adjusting entries are made during the year.

Salaries Payable. At year-end, salaries expense of \$5,000 has been incurred by the company, but is not yet paid to employees.

Interest Payable. At its December 31 year-end, the company holds a mortgage payable that has incurred \$1,000 in annual interest that is neither recorded nor paid. The company intends to pay the interest on January 3 of the next year.

Salaries Payable. At year-end, salaries expense of \$5,000 has been incurred by the company, but is not yet paid to employees.

Step 1: Determine what the current account balance equals. \$0

Step 2: Determine what the current account balance should equal. \$5,000

Salaries Payable		
	Unadj.	0
	Adjustment	5,000
	Dec. 31	5,000

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Salaries Expense	5,000	
	Salaries Payable		5,000

Income Statement

Revenue

Debit Expense

Balance Sheet

Asset

Credit Liability

Interest Payable. At its December 31 year-end, the company holds a mortgage payable that has incurred \$1,000 in annual interest that is neither recorded nor paid. The company intends to pay the interest on January 3 of the next year.

Step 1: Determine what the current account balance equals. \$0

Step 2: Determine what the current account balance should equal. \$1,000

Interest Payable		
	Unadj.	0
	Adjustment	1,000
	Dec. 31	1,000

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Interest Expense	1,000	
	Interest Payable		1,000

Income Statement

Revenue

Debit Expense

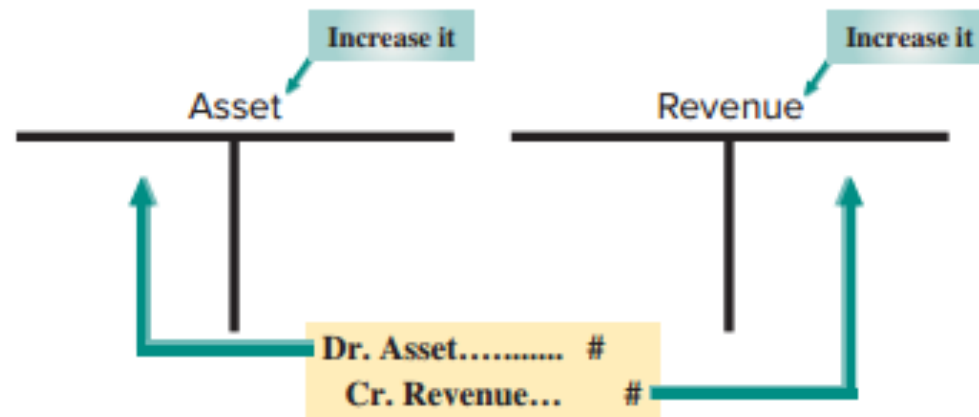
Balance Sheet

Asset

Credit Liability

Accrued Revenues

Accrued revenues are revenues earned in a period that are both unrecorded and not yet received in cash or other assets.



Accrued Services Revenue

Step 1: On 12/12, FastForward's customer agreed to pay \$2,700 on 1/10 of the next year for future services over the next 30 days.

Step 2: 12/31, 20 days worth of services have been provided and earned which totals \$1,800 ($\$2,700 \times 20/30$ days).

Step 3: Adjusting entry increases an asset, Accounts Receivable, and increases the Consulting Revenue account for \$1,800 with the following journal entry:

Dec. 31	Accounts Receivable	1,800	
	Consulting Revenue		1,800
	<i>To record 20 days' accrued revenue.</i>		

Accrued Services Revenue

(Balance Sheet)

ACCOUNTS RECEIVABLE

adj	\$1,800	
Bal.	\$1,800	

The Balance Sheet will show
\$1,800 of Accounts Receivable.

(Income Statement)

CONSULTING REVENUE

	\$6,050
	1,800 adj
	\$7,850 Bal.

The Income Statement will
show \$7,850 total
Consulting Revenue

Future Receipt of Accrued Revenues

Accrued revenue at the end of one period results in a cash receipt in a future period.

On 12/31, FastForward recorded accrued revenue earned of \$1,800.

On 1/10 of the next year, the following entry will reduce the accounts receivable, record revenue earned for 10 days and receipt of \$2,700 cash.

Jan 10	Cash	2,700	
	Accounts Receivable (20 days)	1,800	
	Consulting Revenue (10 days)	900	
	<i>To record earned revenue received in advance</i>		

For each separate case below, follow the three-step process for adjusting the accrued revenue account.

Step 1: Determine what the current account balance equals.

Step 2: Determine what the current account balance should equal.

Step 3: Record an adjusting entry to get from step 1 to step 2.

Assume no other adjusting entries are made during the year.

Accounts Receivable. At year-end, the company has completed services of \$1,000 for a client, but the client has not yet been billed for those services.

Interest Receivable. At year-end, the company has earned, but not yet recorded, \$500 of interest earned from its investments in government bonds.

Accounts Receivable. At year-end, the company has completed services of \$1,000 for a client, but the client has not yet been billed for those services.

Step 1: Determine what the current account balance equals. \$0

Step 2: Determine what the current account balance should equal. \$1,000

Accounts Receivable	
Unadj.	0
Adjustment	1,000
Dec. 31	1,000

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Accounts Receivable	1,000	
	Services Revenue		1,000

Income Statement

Credit Revenue
Expense

Balance Sheet

Debit Asset
Liability

Interest Receivable. At year-end, the company has earned, but not yet recorded, \$500 of interest earned from its investments in government bonds.

Step 1: Determine what the current account balance equals. \$0

Step 2: Determine what the current account balance should equal. \$500

Interest Receivable	
Unadj.	0
Adjustment	500
Dec. 31	500

Step 3: Record an adjusting entry to get from step 1 to step 2.

Date	General Journal	Debit	Credit
Dec. 31	Interest Receivable	500	
	Interest Revenue		500

Income Statement

Credit Revenue
Expense

Balance Sheet

Debit Asset
Liability

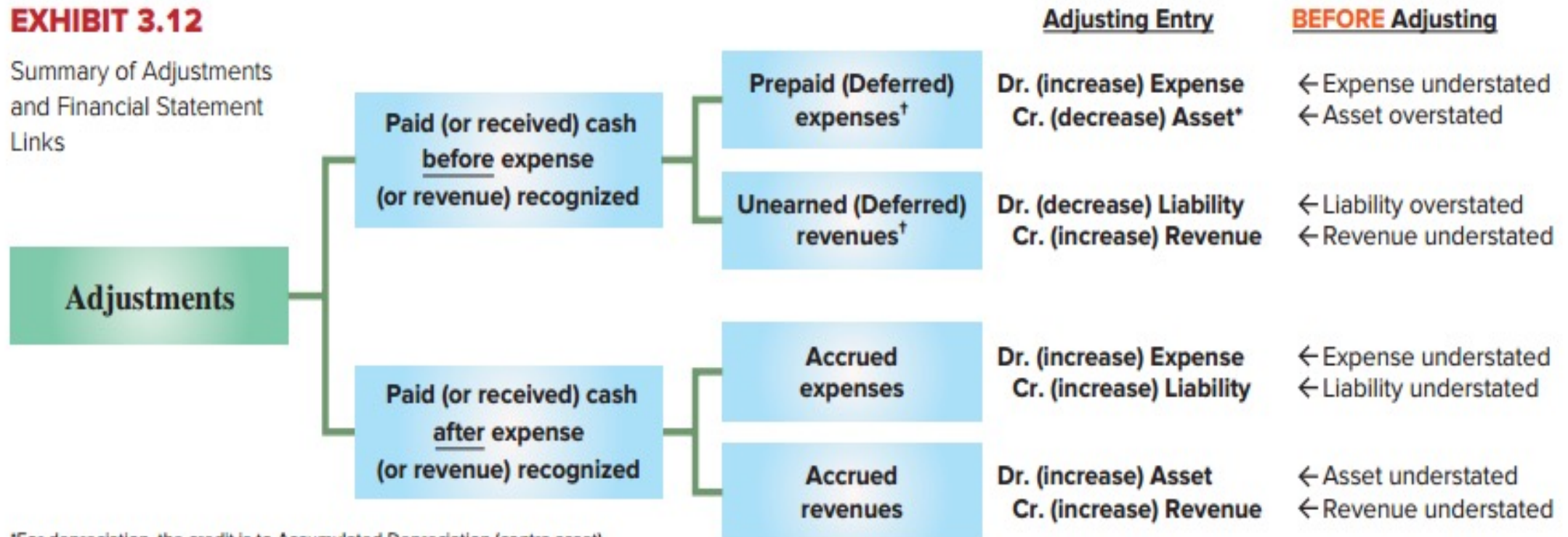
Learning Objective

Explain how accounting adjustments link to financial statements.

Links to Financial Statements

EXHIBIT 3.12

Summary of Adjustments
and Financial Statement
Links



*For depreciation, the credit is to Accumulated Depreciation (contra asset).

[†]Exhibit assumes that prepaid expenses are initially recorded as assets and that unearned revenues are initially recorded as liabilities.

Learning Objective

Explain and prepare an adjusted trial balance.

Adjusted Trial Balance

FASTFORWARD Trial Balances December 31, 2017							
		Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Acct. No.	Account Title						
101	Cash	\$ 4,275				\$ 4,275	
106	Accounts receivable	0		(f) \$1,800		1,800	
126	Supplies	9,720			(b) \$1,050	8,670	
128	Prepaid insurance	2,400			(a) 100	2,300	
167	Equipment	26,000				26,000	
168	Accumulated depreciation—Equip.		\$ 0		(c) 300		\$ 300
201	Accounts payable		6,200				6,200
209	Salaries payable		0		(e) 210		210
236	Unearned consulting revenue		3,000	(d) 250			2,750
301	C. Taylor, Capital		30,000				30,000
302	C. Taylor, Withdrawals	200				200	
403	Consulting revenue		5,800		(d) 250 (f) 1,800		7,850
406	Rental revenue		300				300
612	Depreciation expense—Equip.	0		(c) 300		300	
622	Salaries expense	1,400		(e) 210		1,610	
637	Insurance expense	0		(a) 100		100	
640	Rent expense	1,000				1,000	
652	Supplies expense	0		(b) 1,050		1,050	
690	Utilities expense	305				305	
	Totals	\$45,300	\$45,300	\$3,710	\$3,710	\$47,610	\$47,610

Learning Objective

Prepare financial statements from an adjusted trial balance.

Preparing Financial Statements from an Adjusted Trial Balance

- Step 1— Prepare income statement using revenue and expense accounts from trial balance.**
- Step 2—Prepare statement of owner's equity using capital and withdrawals accounts from trial balance; and pull net income from step 1.**
- Step 3—Prepare balance sheet using asset and liability account from trial balance; and pull updated capital balance.**
- Step 4—Prepare statement of cash flows from changes in cash flows for the period (illustrated later in the book).**

Preparing Financial Statements from an Adjusted Trial Balance

FASTFORWARD Adjusted Trial Balance December 31, 2017				
Acct. No.	Account Title	Debit	Credit	
101	Cash	\$ 4,275		
106	Accounts receivable	1,800		
126	Supplies	8,670		
128	Prepaid insurance	2,300		
167	Equipment	26,000		
168	Accumulated depreciation—Equip.		\$ 300	
201	Accounts payable		6,200	
209	Salaries payable		210	
236	Unearned consulting revenue		2,750	
301	C. Taylor, Capital		30,000	
302	C. Taylor, Withdrawals	200		
403	Consulting revenue		7,850	
406	Rental revenue		300	
612	Depreciation expense—Equip.	300		
622	Salaries expense	1,610		
637	Insurance expense	100		
640	Rent expense	1,000		
652	Supplies expense	1,050		
690	Utilities expense	305		
	Totals	<u>\$47,610</u>	<u>\$47,610</u>	

Step 3 Prepare balance sheet

FASTFORWARD Balance Sheet December 31, 2017		
Assets		
Cash		\$ 4,275
Accounts receivable		1,800
Supplies		8,670
Prepaid insurance		2,300
Equipment	\$26,000	
Less accumulated depreciation	<u>300</u>	<u>25,700</u>
Total assets		<u>\$ 42,745</u>
Liabilities		
Accounts payable		\$ 6,200
Salaries payable		210
Unearned consulting revenue		<u>2,750</u>
Total liabilities		9,160
Equity		
C. Taylor, Capital		<u>33,585</u>
Total liabilities and equity		<u>\$ 42,745</u>

Step 2 Prepare statement of owner's equity

FASTFORWARD Statement of Owner's Equity For Month Ended December 31, 2017		
C. Taylor, Capital, December 1		\$ 0
Plus: Investments by owner	\$30,000	
Net income	<u>3,785</u>	
		33,785
Less: Withdrawals by owner		<u>200</u>
C. Taylor, Capital, December 31		<u>\$33,585</u>

Step 1 Prepare income statement

FASTFORWARD Income Statement For Month Ended December 31, 2017		
Revenues		
Consulting revenue	\$7,850	
Rental revenue	<u>300</u>	
Total revenues		\$8,150
Expenses		
Depreciation expense—Equip.	300	
Salaries expense	1,610	
Insurance expense	100	
Rent expense	1,000	
Supplies expense	1,050	
Utilities expense	<u>305</u>	
Total expenses		<u>4,365</u>
Net income		<u>\$3,785</u>

Steps to Prepare Financial Statements

Step 1 Prepare income statement using revenue and expense accounts from trial balance

Step 2 Prepare statement of owner's equity using capital and withdrawals accounts from trial balance; and pull net income from step 1

Step 3 Prepare balance sheet using asset and liability account from trial balance; and pull updated capital balance from step 2

Step 4 Prepare statement of cash flows from changes in cash flows for the period (illustrated later in the book)

Use the following adjusted trial balance of Magic Company to prepare its (1) income statement, (2) statement of owner's equity, and (3) balance sheet (unclassified), for the year ended, or date of, December 31, 2017. The Magic, Capital account balance is \$75,000 at December 31, 2016.

Magic Company		
Trial Balance		
December 31, 2017		
	Debit	Credit
Cash	\$13,000	
Accounts receivable	17,000	
Land	85,000	
Accounts payable		\$12,000
Long-term notes payable		33,000
Magic, Capital		75,000
Magic, Withdrawals	20,000	
Fees earned		79,000
Salaries expense	56,000	
Office supplies expense	8,000	
Totals	<u>\$199,000</u>	<u>\$199,000</u>

	Debit	Credit
Cash	\$13,000	
Accounts receivable	17,000	
Land	85,000	
Accounts payable		\$12,000
Long-term notes payable		33,000
Magic, Capital		75,000
Magic Withdrawals	20,000	
Fees earned		79,000
Salaries expense	56,000	
Office supplies expense	<u>8,000</u>	
Totals	<u>\$199,000</u>	<u>\$199,000</u>

Magic Company	
Income Statement	
For Year Ended December 31, 2017	
Fees earned	\$79,000
Expenses	
Salaries expense	\$56,000
Office supplies expense	<u>8,000</u>
	<u>64,000</u>
Net income	<u>\$15,000</u>

	Debit	Credit
Cash	\$13,000	
Accounts receivable	17,000	
Land	85,000	
Accounts payable		\$12,000
Long-term notes payable		33,000
Magic, Capital		75,000
Magic Withdrawals	20,000	
Fees earned		79,000
Salaries expense	56,000	
Office supplies expense	8,000	
Totals	<u>\$199,000</u>	<u>\$199,000</u>

Magic Company
Income Statement
For Year Ended December 31, 2017

Fees earned	\$79,000
Expenses	
Salaries expense	\$56,000
Office supplies expense	<u>8,000</u>
	64,000
Net income	<u>\$15,000</u>

Magic Company
Statement of Owner's Equity
For Year Ended December 31, 2017

Magic, Capital, Dec. 31 20X1	\$75,000
Plus: Net income	15,000
Less: Magic, Withdrawals	<u>(20,000)</u>
Magic, Capital, Dec. 31 20X2	<u>\$70,000</u>

	Debit	Credit
Cash	\$13,000	
Accounts receivable	17,000	
Land	85,000	
Accounts payable		\$12,000
Long-term notes payable		33,000
Magic, Capital		75,000
Magic Withdrawals	20,000	
Fees earned		79,000
Salaries expense	56,000	
Office supplies expense	8,000	
Totals	<u>\$199,000</u>	<u>\$199,000</u>

Magic Company
Income Statement
For Year Ended December 31, 2017

Fees earned	\$79,000
Expenses	
Salaries expense	\$56,000
Office supplies expense	<u>8,000</u>
	64,000
Net income	<u>\$15,000</u>

Magic Company
Statement of Owner's Equity
For Year Ended December 31, 2017

Magic, Capital, Dec. 31 20X1	\$75,000
Plus: Net income	15,000
Less: Magic, Withdrawals	<u>(20,000)</u>
Magic, Capital, Dec. 31 20X2	<u>\$70,000</u>

Magic Company
Balance Sheet
December 31, 2017

Assets		Liabilities	
Cash	\$13,000	Accounts payable	\$12,000
Accounts receivable	17,000	Long-term notes payable	<u>33,000</u>
Land	85,000	Total liabilities	45,000
		Equity	

Magic, Capital 70,000

Total assets

\$115,000 www.midocean.ae equity

115,000

Learning Objective

Compute profit margin
and describe its use in
analyzing company
performance.

Profit Margin

The profit margin ratio measures the company's net income to net sales.

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

Limited Brands, Inc.

\$ millions	2015	2014	2013	2012	2011
Net income	\$ 1,042	\$ 903	\$ 753	\$ 850	\$ 805
Net sales	\$11,454	\$10,773	\$10,459	\$10,364	\$9,613
Profit margin	9.1%	8.4%	7.2%	8.2%	8.4%
Industry profit margin	2.8%	2.5%	2.0%	2.2%	2.1%



مجموعة جامعة
الجميع الذكية
للتعليم القابضة

MIDOCEAN
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Thank You

