

Survey of Accounting, 9e

Carl S. Warren and
Amanda G. Farmer



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SURVEY OF ^{9E}
ACCOUNTING
WITH WARREN'S METRIC ANALYSIS

CARL S. WARREN
AMANDA G. FARMER

Chapter 3

Basic Accounting Systems: Accrual Basis

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Learning Objectives

- Describe accrual accounting concepts, including the matching concept, revenue recognition, and expense recognition principles
- Use the accrual basis of accounting to analyze, record, and summarize transactions
- Describe and illustrate the end-of-period adjustment process
- Prepare financial statements using the accrual basis of accounting, including a classified balance sheet
- Describe why generally accepted accounting principles (GAAP) require the accrual basis of accounting
- Describe and illustrate the use of the quick ratio in assessing a company's liquidity

Learning Objective 1

Describe accrual accounting concepts, including the matching concept, revenue recognition, and expense recognition principles

Accrual Basis of Accounting

- Records revenue as it is earned and matches expenses against the revenue they generate
 - Helps avoid misleading information arising from the timing of cash receipts and payments
- Revenue is recognized when services are provided even though the cash is to be received later
- Liabilities are recognized when a business incurs the obligation to pay for services or goods purchased

Revenue and Expense Recognition Principle

- **Revenue recognition principle:** Revenue is recorded when services have been provided or when a product has been delivered to a customer
- **Expense recognition principle:** Expenses are recorded in the same period that they generate revenue
 - Required by the **matching concept**

Learning Objective 2

Use the accrual basis of accounting to analyze, record, and summarize transactions

Family Health Care's November Transactions

- Integrated financial statement framework is used to analyze and record transactions
- **Accounts:** Financial statement elements
- **Quick assets:** Include cash and other assets that can be readily converted to cash such as receivables and marketable securities
 - Normally do not include inventory since inventory must be sold and any related receivable collected before it is converted to cash

Transaction a: Rent Received in Advance

- On November 1, Family Health Care, P.C., received \$1,800 from ILS Company as rent for the use of Family Health Care's land as a temporary parking lot from November 20Y5 through March 20Y6

BALANCE SHEET								
	Assets		=	Liabilities		+	Stockholders' Equity	
	Cash	+ Land	=	Notes Payable	+ Unearned Revenue	+	Common Stock	+ Retained Earnings
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

INCOME STATEMENT	

Transaction b: Prepaid Insurance

- On November 1, Family Health Care, P.C., paid a premium of \$2,400 for a two-year general business insurance policy that covers risks from fire and theft

BALANCE SHEET							
	Assets			=	Liabilities		+ Stockholders' Equity
	Cash	Prepaid Insurance	Land	=	Notes Payable	Unearned Revenue	Common Stock + Retained Earnings
Balances	9,120		12,000	=	10,000	1,800	6,000 + 3,320
<i>b.</i> Paid insurance for two years	(2,400)	2,400		=			
Balances	6,720	2,400	12,000	=	10,000	1,800	6,000 + 3,320

STATEMENT OF CASH FLOWS	
<i>b.</i> Operating	(2,400)

INCOME STATEMENT	

Transaction c: Insurance Premium

- On November 1, Family Health Care, P.C., paid \$6,000 for an insurance premium on a six-month medical malpractice policy

BALANCE SHEET							
	Assets			=	Liabilities	+	Stockholders' Equity
	Cash	Prepaid Insurance	Land	=	Notes Payable	Unearned Revenue	Common Stock + Retained Earnings
Balances	6,720	2,400	12,000	=	10,000	1,800	6,000 + 3,320
c. Paid insurance for two years	(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)

INCOME STATEMENT	

Transaction d: Additional Capital Investment

- Dr. Landry invested an additional \$5,000 in the business in exchange for common stock

BALANCE SHEET							
	Assets			=	Liabilities		+ Stockholders' Equity
	Cash	Prepaid Insurance	Land	=	Notes Payable	Unearned Revenue	Common Stock + Retained Earnings
Balances	720	8,400	12,000	=	10,000	1,800	6,000 + 3,320
d. Issued common 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

INCOME STATEMENT	

Transaction e: Purchases on Account

- Family Health Care, P.C., purchased supplies for \$240 on account

BALANCE SHEET										
	Assets				=	Liabilities			+ Stockholders' Equity	
	Cash	Prepaid Insurance	Supplies	Land	=	Accounts Payable	Notes Payable	Unearned Revenue	Common 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	=	240	10,000	1,800	11,000	3,320

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	

Transaction f: Purchase of Equipment

- Family Health Care, P.C., purchased \$8,500 of office equipment
 - Paid \$1,700 cash as a down payment, with the remaining \$6,800 due in five monthly installments of \$1,360 beginning January 1, 20Y6

BALANCE SHEET											
	Assets					=	Liabilities			+ Stockholders' Equity	
	Cash	Prepaid		Office Equip.	Land	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings	
		Insur.	Supp.								
Balances	5,720	8,400	240		12,000	240	10,000	1,800	11,000	3,320	
<i>f.</i> Purchased office equipment	(1,700)				8,500		6,800				
Balances	4,020	8,400	240		8,500	240	16,800	1,800	11,000	3,320	

STATEMENT OF CASH FLOWS	
<i>f.</i> Investing	(1,700)

INCOME STATEMENT	

Cash down payment

Total Asset Value

Remaining balance due

Transaction g: Services Provided on Account

- Family Health Care, P.C., provided services of \$6,100 to patients on account

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Accts. Cash	Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	4,020		8,400	240	8,500	12,000	=	240	16,800	1,800	11,000	3,320
<i>g.</i> Fees earned on acct.		6,100					=					6,100
Balances	4,020	6,100	8,400	240	8,500	12,000	=	240	16,800	1,800	11,000	9,420

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
<i>g.</i> Fees earned	6,100

Transaction h: Services Provided for Cash

- Family Health Care, P.C., received \$5,500 for services provided to patients who paid cash

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

STATEMENT OF CASH FLOWS	
<i>h.</i> Operating	5,500

INCOME STATEMENT	
<i>h.</i> Fees earned	5,500

Transaction i: Collection of Accounts Receivable

- Family Health Care, P.C., received \$4,200 from insurance companies that paid on patients' accounts for services that had been provided

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings	
Balances	9,520	6,100	8,400	240	8,500	12,000	240	16,800	1,800	11,000	14,920	
<i>i.</i> Collected receivables	4,200	(4,200)										
Balances	13,720	1,900	8,400	240	8,500	12,000	240	16,800	1,800	11,000	14,920	

STATEMENT OF CASH FLOWS	
<i>i.</i> Operating	4,200

INCOME STATEMENT	

Transaction j: Accounts Payable

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

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	13,720	1,900	8,400	240	8,500	12,000	=	140	16,800	1,800	11,000	14,920
<i>j.</i> Paid on acct.	(100)						=	(100)				
Balances	13,620	1,900	8,400	240	8,500	12,000	=	140	16,800	1,800	11,000	14,920

STATEMENT OF CASH FLOWS	
<i>j.</i> Operating	(100)

INCOME STATEMENT	

Transaction k: Expenses Paid in Cash

- Family Health Care, P.C., paid expenses worth \$4,690 for the month of November in cash

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	13,620	1,900	8,400	240	8,500	12,000	=	140	16,800	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	=	140	16,800	1,800	11,000	10,230

STATEMENT OF CASH FLOWS	
k. Operating	(4,690)

INCOME STATEMENT	
k. Wages expense	(2,790)
Rent expense	(800)
Utilities expense	(580)
Interest expense	(100)
Misc. expense	(420)

Transaction I: Dividends Paid in Cash

- Family Health Care, P.C., paid dividends of \$1,200 to stockholders (Dr. Landry)

BALANCE SHEET													
	Assets						=	Liabilities			+ Stockholders' Equity		
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings	
Balances	8,930	1,900	8,400	240	8,500	12,000	=	140	16,800	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	=	140	16,800	1,800	11,000	9,030	

STATEMENT OF CASH FLOWS	
I. Financing	(1,200)

INCOME STATEMENT	

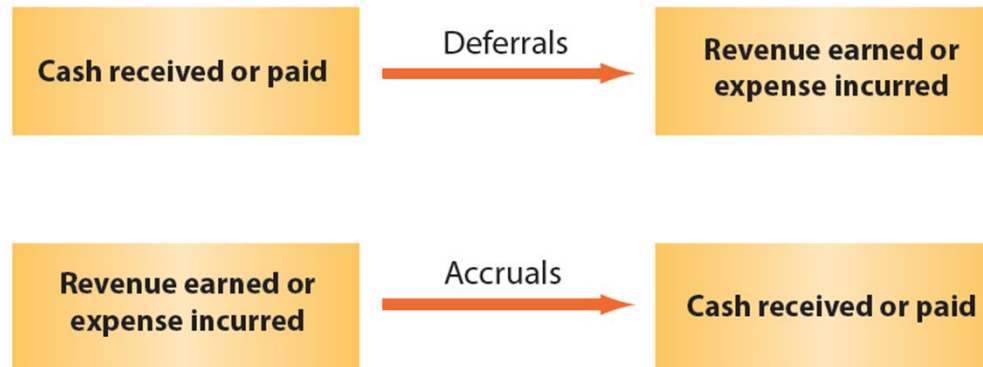
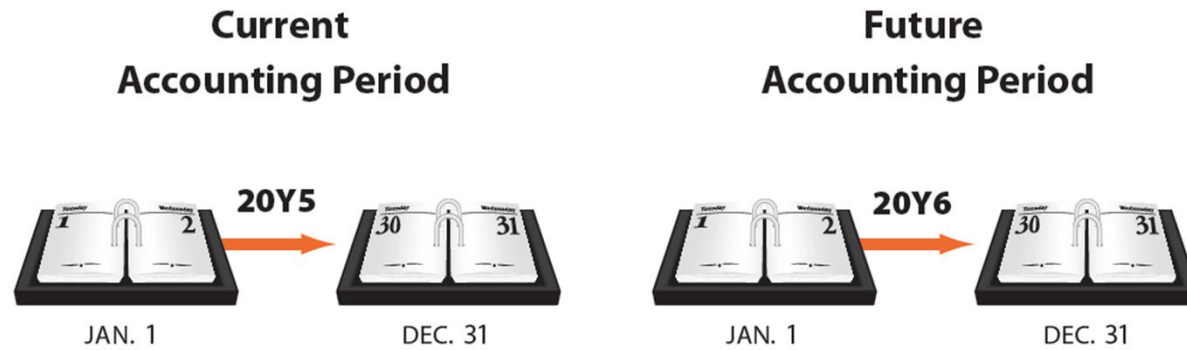
Learning Objective 3

Describe and illustrate the end-of-period adjustment process

Adjustment Process

- Process of updating accounting records prior to preparing financial statements
 - Accrual accounting requires updating to match revenues and expenses
- Adjustments are necessary to update elements of the accounting equation

Exhibit 1: Deferrals and Accruals



Deferrals and Accruals

- Deferrals
 - **Prepaid or deferred expenses**
 - **Unearned or deferred revenues**
- Accruals
 - **Accrued expenses or liabilities**
 - **Accrued revenues or assets**

Adjustment a1: Prepaid Insurance Expired

- Portion of the prepaid insurance purchased on November 1 expired

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings	
Balances	7,730	1,900	8,400	240	8,500	12,000	140	16,800	1,800	11,000	9,030	
a1. Insurance expense			(1,100)								(1,100)	
Balances	7,730	1,900	7,300	240	8,500	12,000	140	16,800	1,800	11,000	7,930	

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a1. Insurance exp.	(1,100)

Adjustments affect both the balance sheet account and the income statement account

Adjustment a2: Supplies Used

- As of November 30, supplies worth \$150 were used in operations, leaving a balance of \$90

BALANCE SHEET												
	Assets						=	Liabilities			+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	7,730	1,900	7,300	240	8,500	12,000	=	140	16,800	1,800	11,000	7,930
a2. Supplies expense				(150)								(150)
Balances	7,730	1,900	7,300	90	8,500	12,000	=	140	16,800	1,800	11,000	7,780

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a2. Supplies exp.	(150)

Depreciation

- Reduction in the ability of a fixed asset to provide service over time
 - Estimated based on the asset's useful life
- **Accumulated depreciation**
 - A contra asset account
 - Added to the Balance Sheet column to maintain a record of the original cost of a fixed asset for tax and other purposes

Adjustment a3: Depreciation

- Depreciation on office equipment for Family Health Care is assumed to be \$160 per month

BALANCE SHEET													
	Assets							=	Liabilities			+ Stockholders' Equity	
	Accts. Cash +	Rec.	Prepaid + Insur.	Supp.	Office + Equip.	Acc. - Depr.	Land	=	Accts. Pay.	Notes Pay.	Unearned + Revenue	Common + Stock	Retained + Earnings
Balances	7,730	1,900	7,300	90	8,500		12,000		140	16,800	1,800	11,000	7,780
a3. Depr. exp.						(160)							(160)
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000		140	16,800	1,800	11,000	7,620

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a3. Depreciation exp.	(160)

Depreciation: Important Points

Land is not depreciated, because it usually does not lose its ability to provide service

The cost of the equipment is a type of deferred expense that is recognized as an expense over the fixed asset's useful life

The cost of the fixed asset less the balance of its accumulated depreciation is called the asset's **book value**, or carrying value

Adjustment a4: Unearned Revenue Earned

- Adjustment assumes that of the \$1,800 received for rental of the land for five months (November through March), one-fifth, or \$360, would have been earned as of November 30

BALANCE SHEET													
	Assets							=	Liabilities			+ Stockholders' Equity	
	Accts. Cash	Rec.	Prepaid Insur.	+ Supp.	Office Equip.	Acc. Depr.	+ Land	=	Accts. Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000	140	16,800	1,800	11,000	7,620	
a4. Rent rev.										(360)		360	
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000	140	16,800	1,440	11,000	7,980	

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a4. Rent revenue	360

Adjustment a5: Wages Owed

- Amount owed as wages but not paid to employees is \$220

BALANCE SHEET														
Assets								=	Liabilities				+ Stockholders' Equity	
	Cash	Accts. Rec.	Prepaid Insur.	Supp.	Office Equip.	Acc. Depr.	Land	=	Accts. Pay.	Wages Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000	140			16,800	1,440	11,000	7,980
a5. Wages exp.										220				(220)
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000	140	220		16,800	1,440	11,000	7,760

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a5. Wages expense	(220)

Adjustment a6: Services Provided

- Family Health Care provided services worth \$750 to patients
 - Services were not billed at the end of the month

BALANCE SHEET														
	Assets							=	Liabilities				+ Stockholders' Equity	
	Accts. Cash	Prepaid Rec.	Insur.	Supp.	Office Equip.	Acc. Depr.	Land	=	Accts. Pay.	Wages Pay.	Notes Pay.	Unearned Revenue	Common Stock	Retained Earnings
Balances	7,730	1,900	7,300	90	8,500	(160)	12,000	=	140	220	16,800	1,440	11,000	7,760
a6. Fees earned		750						=						750
Balances	7,730	2,650	7,300	90	8,500	(160)	12,000	=	140	220	16,800	1,440	11,000	8,510

STATEMENT OF CASH FLOWS	

INCOME STATEMENT	
a6. Fees earned	750

Exhibit 3: Transaction Metric Effects—November

LIQUIDITY

Transaction and Adjustments	Quick Assets
a. Received rent	\$1,800
b. Paid insurance	(2,400)
c. Paid insurance	(6,000)
d. Issued stock	5,000
e. Pur. supplies	–
f. Pur. office equip.	(1,700)
g. Fees earned	6,100
h. Fees earned	5,500
i. Collected receivable	–
j. Paid on account	(100)
k. Paid expenses	(4,690)
l. Paid dividends	(1,200)

PROFITABILITY

Net Income – Accrual Basis	
a. Received rent	–
b. Paid insurance	–
c. Paid insurance	–
d. Issued stock	–
e. Pur. supplies	–
f. Pur. office equip.	–
g. Fees earned	\$6,100
h. Fees earned	5,500
i. Collected receivable	–
j. Paid on account	–
k. Paid expenses	(4,690)
l. Paid dividends	–

Exhibit 3: Transaction Metric Effects—November (continued)

Adjustments	
Adj. a1. Insurance exp.	–
Adj. a2. Supplies exp.	–
Adj. a3. Depr. exp.	–
Adj. a4. Rent revenue	–
Adj. a5. Wages exp.	–
Adj. a6. Fees earned	750
Total	<u>\$3,060</u>

Adjustments	
Adj. a1. Insurance exp.	(1,100)
Adj. a2. Supplies exp.	(150)
Adj. a3. Depr. exp.	(160)
Adj. a4. Rent revenue	360
Adj. a5. Wages exp.	(220)
Adj. a6. Fees earned	750
Total	<u>\$6,390</u>

Quick Assets increased by \$3,060 and Net Income – Accrual Basis was \$6,390 for November. The net income of \$6,390 will be reported on Family Health Care’s November income statement.

Learning Objective 4

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

Exhibit 4: Family Health Care Income Statement for November

Family Health Care, P.C.
Income Statement
For the Month Ended November 30, 20Y5

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 revenue:		
Rent revenue		<u>360</u>
Net income		<u><u>\$ 6,390</u></u>

Exhibit 5: Family Health Care Statement of Stockholders' Equity for November

**Family Health Care, P.C.
Statement of Stockholders' Equity
For the Month Ended November 30, 20Y5**

	Common Stock	Retained Earnings	Total
Balances, Nov. 1, 20Y5.....	\$ 6,000	\$3,320	\$ 9,320
Common stock issued.....	5,000		5,000
Net income.....		6,390	6,390
Dividends.....		(1,200)	(1,200)
Balances, Nov. 30, 20Y5.....	<u>\$11,000</u>	<u>\$8,510</u>	<u>\$19,510</u>

Classified Balance Sheets: Types of Assets and Liabilities

Types of assets

- Current assets, fixed assets, and intangible assets

Types of liabilities

- Current liabilities and long-term liabilities

Exhibit 6: Family Health Care Balance Sheet for November

**Family Health Care, P.C.
Balance Sheet
November 30, 20Y5**

Assets

Current assets:

Cash	\$ 7,730	
Accounts receivable	2,650	
Prepaid insurance	7,300	
Supplies	<u>90</u>	
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>

Exhibit 6: Family Health Care Balance Sheet for November (continued)

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		<u>\$18,600</u>
Stockholders' Equity		
Common 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>

Exhibit 7: Family Health Care Statement of Cash Flows

**Family Health Care, P.C.
Statement of Cash Flows
For the Month Ended November 30, 20Y5**

Cash flows from (used for) operating activities:		
Cash received from patients.....	\$ 9,700	
Cash received from rental of land.....	1,800	
Cash paid for expenses.....	<u>(13,190)</u>	
Net cash flows used for operating activities.....		\$ (1,690)
Cash flows from (used for) investing activities:		
Cash paid for office equipment.....		(1,700)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock.....	\$ 5,000	
Cash paid as dividends.....	<u>(1,200)</u>	
Net cash flows from financing activities.....		<u>3,800</u>
Net increase in cash.....		\$ 410
Cash as of November 1, 20Y5.....		<u>7,320</u>
Cash as of November 30, 20Y5.....		<u><u>\$ 7,730</u></u>

Exhibit 8: Integrated Financial Statements—Family Health Care

Family Health Care, P.C. Balance Sheet November 30, 20Y5									
Assets			=	Liabilities	+	Stockholders' Equity			
Cash	+	Noncash Assets	=			Common Stock	+	Retained Earnings	
•				•		•		•	
•				•		•		•	
•				•		•		•	
<u>\$7,730</u>		<u>\$30,380</u>		<u>\$18,600</u>		<u>\$11,000</u>		<u>\$8,510</u>	
\$38,110				\$38,110					
Total Assets			=	Total Liabilities + Stockholders' Equity					

Family Health Care, P.C. Statement of Cash Flows For the Month Ended Nov. 30, 20Y5		Family Health Care, P.C. Income Statement For the Month Ended Nov. 30, 20Y5		Family Health Care, P.C. Statement of Stockholders' Equity For the Month Ended Nov. 30, 20Y5			
Operating act.	\$ (1,690)	Revenues	\$ 12,350		Common Stock	Retained Earnings	Total
Investing act.	(1,700)	Expenses	<u>(6,320)</u>	Bal. Nov. 1	\$ 6,000	\$ 3,320	\$ 9,320
Financing act.	<u>3,800</u>	Net income	\$ 6,030	Issued common stock	5,000		5,000
Increase in cash	\$ 410	Other revenue	<u>360</u>	Net income		6,390	6,390
Cash, Nov. 1	<u>7,320</u>	Net income	<u>\$ 6,390</u>	Dividends		<u>(1,200)</u>	<u>(1,200)</u>
Cash, Nov. 30	<u>\$ 7,730</u>			Bal. Nov. 30	<u>\$ 11,000</u>	<u>\$ 8,510</u>	<u>\$ 19,510</u>

Learning Objective 5

Describe why generally accepted accounting principles (GAAP) require the accrual basis of accounting

Exhibit 9: 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

Differences between Accrual and Cash Basis Financial Statements

Accrual basis of accounting

- Net income and net cash flows from operating activities may be significantly different

Cash basis of accounting

- Net income and net cash flows from operating activities are equal

Need for Accrual Basis by GAAP

- Accrual accounting is generally a better predictor of the profitability of a company
- Use of net cash flows from operating activities
 - Generally accepted accounting principles (GAAP) require reporting net cash flows from operating activities as well as net income
 - Business is required to generate positive cash flows from operating activities in the long term in order to survive
- Long-run profitability is best analyzed using accrual accounting and net income

Accounting Cycle

- Process that begins with analyzing transactions and ends with preparing financial statements
- Varies based on the type of accounting for which it is used
 - Cash basis of accounting
 - Accrual basis of accounting
- More complex for a double-entry accounting system
 - Double-entry system: Transactions are recorded in separate accounts using rules of debit and credit

Learning Objective 6

Describe and illustrate the use of the quick ratio in assessing a company's liquidity

Metric-Based Analysis

- **Quick assets**
 - Liquidity metric that measures the amount of cash and other assets that a company has on hand to pay current liabilities
- **Quick ratio**
 - Computed as quick assets divided by current liabilities
 - Quick ratio of at least 1.0 is normal for any industry

Computation of Quick Assets and Quick Ratio

	Fly Creek Company	Huron Inc.
Current assets:		
Cash	\$ 60,000	\$ 120,000
Accounts receivable	120,000	600,000
Inventories	202,000	300,000
Prepaid assets	18,000	60,000
Total current assets	<u>\$400,000</u>	<u>\$1,080,000</u>
Current liabilities	\$150,000	\$ 600,000

Computation of Quick Assets and Quick Ratio

(continued)

Fly Creek Company

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = \frac{(\$60,000 + \$120,000)}{\$150,000} = \frac{\$180,000}{\$150,000} = 1.2$$

Huron Inc.

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = \frac{(\$120,000 + \$600,000)}{\$800,000} = \frac{\$720,000}{\$800,000} = 0.9$$

End of Chapter 3