Accounting Principles

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Chapter 3

Adjusting the Accounts

Chapter Outline

Learning Objectives

LO 1 Explain the accrual basis of accounting and the reasons for adjusting entries.

LO 2 Prepare adjusting entries for deferrals.

LO 3 Prepare adjusting entries for accruals.

LO 4 Describe the nature and purpose of an adjusted trial balance.

3.1 Time Period and Going Concern Assumptions

Start of the Chapter Question

In the first chapter you have learned that companies have to prepare financial statements to know and communicate their financial performance to other related parties.

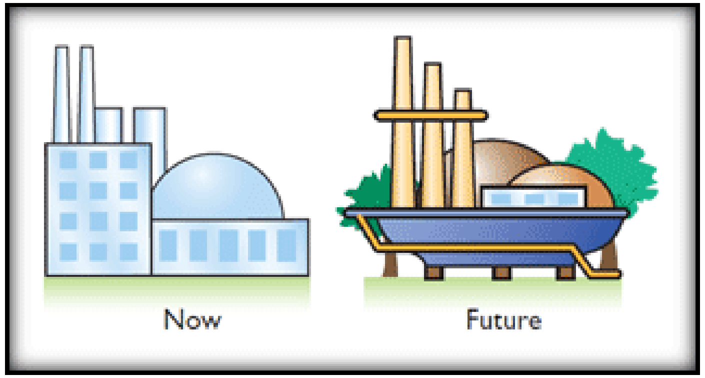
My Question is:

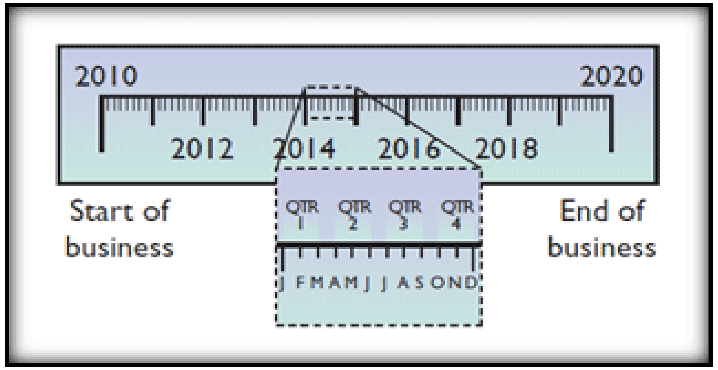
After how much time, does a company prepare its financial statement?

Is it after:

One week? One month? Two months? One year? Two years? Or any other time frame?

Assumptions in Financial Reporting





Going Concern

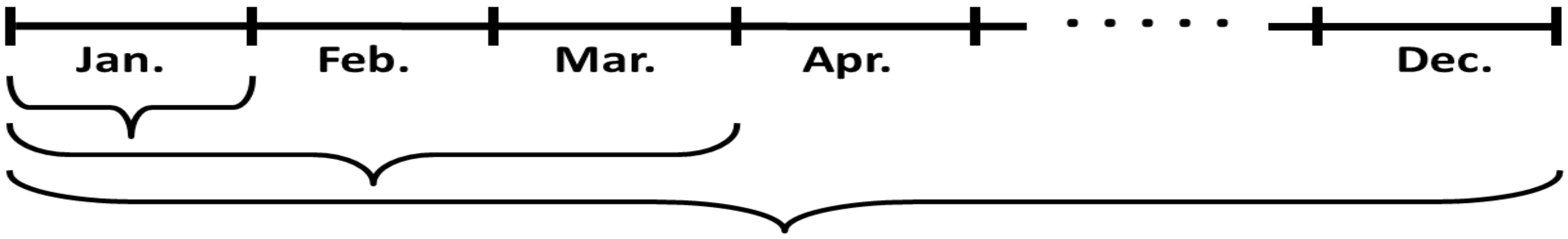
The business will remain in operation for the foreseeable future.

Time Period

States that the life of a business can be divided into artificial time periods.

Time Period Assumption/Periodicity Assumption

Accountants divide the economic life of a business into artificial time periods ().



Generally a

- **Month**,
- **Quarter/3 Months**, or
- **Year**.

Fiscal and Calendar Years

- Monthly and quarterly time periods are called **Interim Periods**
- Most large companies must prepare both **quarterly** and **annual** financial statements
- **Calendar Year** = January 1 to December 31
- **Fiscal Year** = Accounting time period that is **one year** in length

Fiscal and Calendar Years

Most companies in Bangladesh follow:

January to December or **July to June** Fiscal Year

What about the government of Bangladesh. Which fiscal year does it follow? Can you guess?

July to June.

3.2 Accrual Basis of Accounting

Accrual- versus Cash-Basis Accounting

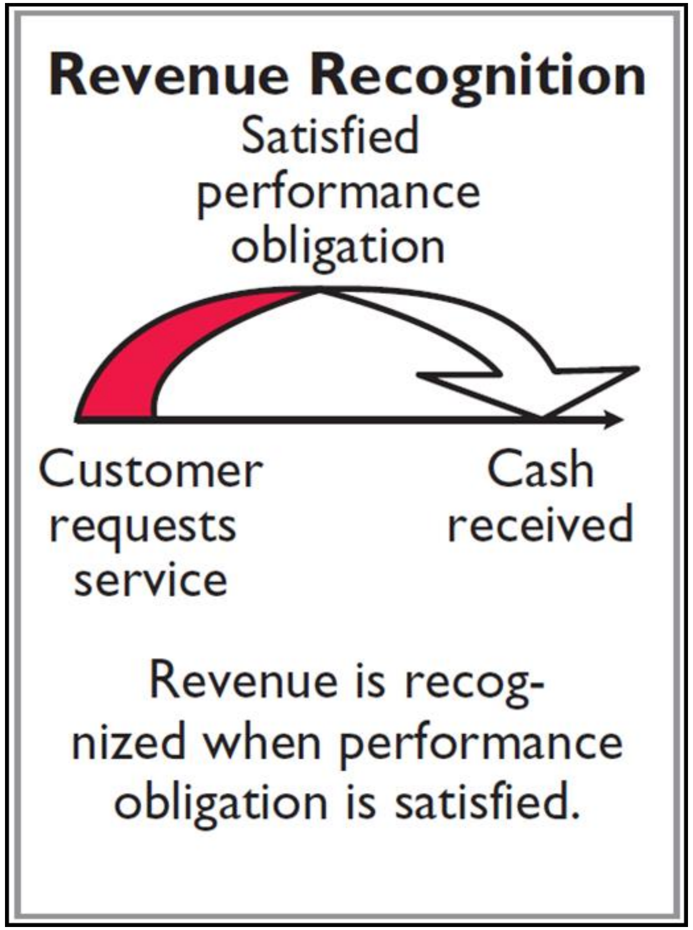
Accrual-Basis Accounting

- Transactions recorded in the **periods in which the events occur**
- Companies **recognize revenues when they perform services** (rather than when they receive cash)
- **Expenses** are recognized when **incurred** (rather than when paid)
- In accordance with **generally accepted accounting principles (GAAP)**

Recognizing Revenues and Expenses

Revenue Recognition Principle

Recognize revenue in the accounting period in which the **performance obligation** is satisfied.



Concept Check Question

Example of a car repairing and modification business

Suppose the business follows monthly accounting period. What does it mean?

May 28	June 25	July 4
A customer requested for the modification of his car.	Your business has completed the modification and billed the client tk 50,000 for the service. And the customer did not have complain about the service.	The customer has paid for the service.

In which month the revenue of 50,000 should be shown according to the revenue recognition principle? May, June, or July?

Answer to the concept check question

June

Because in June the business fulfilled satisfactory service and hence got the right to claim payment from the client.

In recognizing revenue accrual basis do not consider when the actual cash is received or paid.

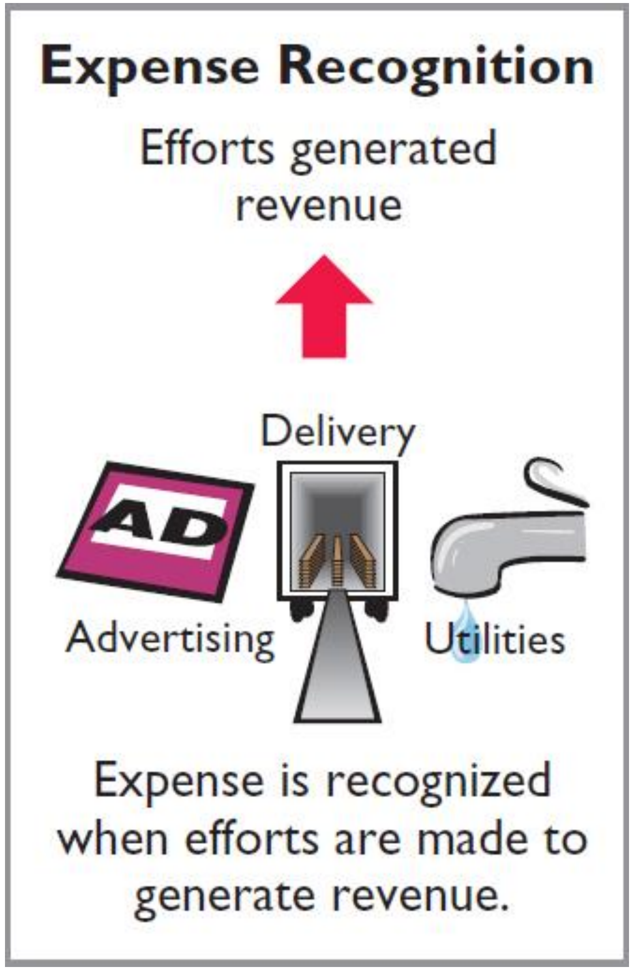
Recognizing Revenues and Expenses

Expense Recognition

Companies recognize expenses in the period in which they make efforts to generate revenue.

Matching Principle

“Let the expenses follow the revenues.”



Concept Check Question

Example of a car dealer business

May 28	June 25
The business purchased a car worth tk 20 lac to sell in the future.	The business sold the car to a customer for tk 22 lac.

Suppose the business follows monthly accounting period.

In which month the expense associated with buying the car should be shown according to the expense recognition principle? May, or June?

Answer to the concept check question

June

Since the sales revenue correspondent with the car purchase was recognized in June. In matching the expense with the related revenue, the expense has to be recognized in the month of June.

Accrual- versus Cash-Basis Accounting

Cash-Basis Accounting

- **Revenues** recognized when **cash is received**
- **Expenses** recognized when **cash is paid**
- Cash-basis accounting is **not in accordance with generally accepted accounting principles (GAAP)**

3.3 Need for and Types of Adjusting Entries

The Need for Adjusting Entries

Adjusting Entries

- Ensure that the **revenue recognition** and **expense recognition** principles are followed.
- Necessary because the **trial balance may not contain up-to-date** and complete data.

Why trial balance needs to be updated

Suppose a business follows monthly accounting period.

From your knowledge of the "Recording Process" chapter, try to tell the journal of the following transaction:

- May 01: Paid rent of tk 12,000 in advance for total 12 months.

May 01	Prepaid Rent (Asset +)	12,000	
	Cash (Asset -)		12,000

The Need for Adjusting Entries

Adjusting Entries

- **Required** every time a company prepares financial statements.
- Will include **one income statement (revenue/expense) account and one balance sheet (asset/liability) account**.

Types of Adjusting Entries

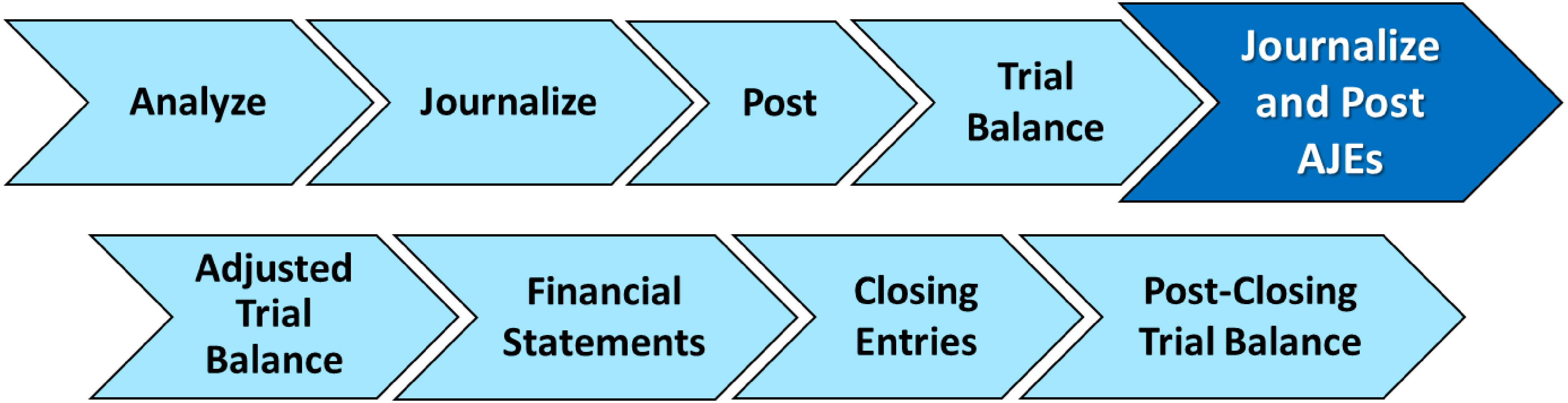
Deferrals	Accruals
1. Prepaid Expenses Expenses paid in cash before they are used or consumed. **2. Unearned Revenues** Cash received before services are performed.	**1. Accrued Revenues** Revenues for services performed but not yet received in cash or recorded. **2. Accrued Expenses** Expenses incurred but not yet paid in cash or recorded.

3.4 Prepaid Expenses (Part 1)

Adjusting Entries for Deferrals

Deferrals are **expenses or revenues** that are recognized at a date later than the point when cash was originally exchanged. There are **two types**:

Prepaid expenses & Unearned revenues



Prepaid Expenses

Payments of expenses that are recorded as an asset to show the service or benefit the company will receive in the future.

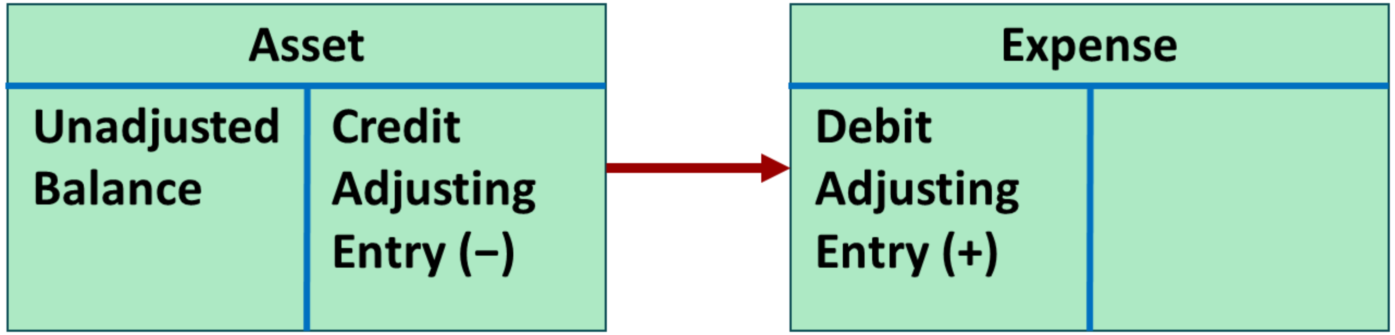
Cash Payment BEFORE Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- equipment
- buildings

Prepaid Expenses

- Expire either with the passage of time or through use
- Adjusting entry:
  - **Increase** (debit) to an **expense account** and
  - **Decrease** (credit) to an **asset account**



Prepaid Expenses

Pioneer Advertising
Trial Balance
October 31, 2020

	Debit	Credit
Cash	$15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		$ 5,000
Accounts Payable		2,500
Unearned Revenue		1,200
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	$28,700	**$28,700**

Subsequent examples are based on the October 31 trial balance from Chapter 2.

Adjustment for Supplies

Illustration: Pioneer Advertising purchased supplies costing $2,500 on October 5. Pioneer recorded the payment by increasing (debiting) the asset Supplies. This account shows a balance of $2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that $1,000 of supplies are still on hand.

Oct. 31	Supplies Expense	1,500	
	Supplies		1,500

Adjustment for Supplies

Basic Analysis

The expense Supplies Expense is increased $1,500; the asset Supplies is decreased $1,500.

Equation Analysis

	Assets	=	Liabilities	+	Owner's Equity
(1)	Supplies	=			Supplies Expense
	–$1,500				–$1,500

Debit–Credit Analysis

Debits increase expenses: debit Supplies Expense $1,500.
Credits decrease assets: credit Supplies $1,500.

Journal Entry

Oct. 31	Supplies Expense	631	1,500	
	Supplies	126		1,500
	(To record supplies used)			

Posting

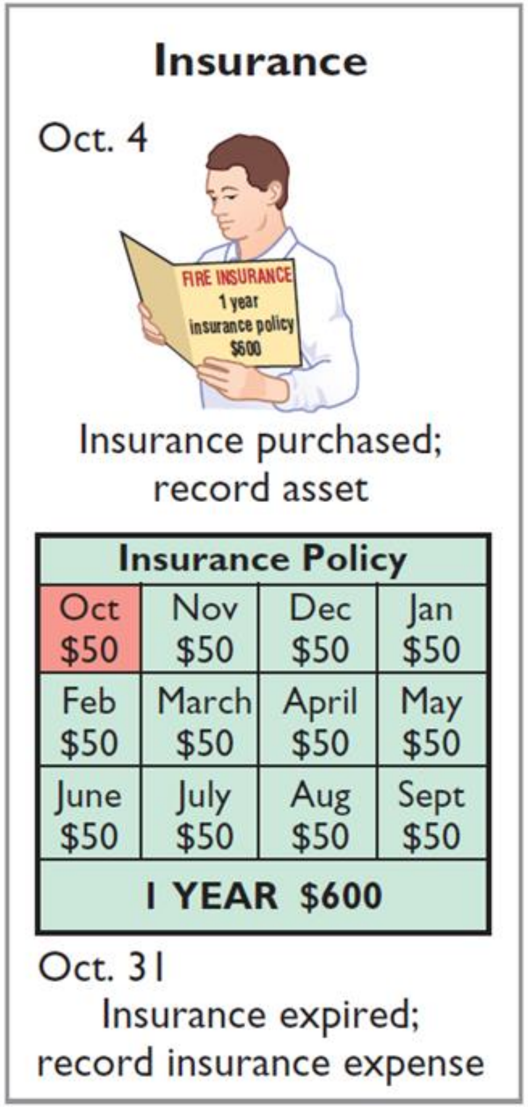
Supplies			126
Oct. 5	2,500	Oct. 31	Adj. 1,500
Oct. 31	Bal. 1,000		

Supplies Expense			631
Oct. 31	Adj. 1,500		
Oct. 31	Bal. 1,500		

Adjustment for Insurance

Illustration: On October 4, Pioneer Advertising paid $600 for a one-year fire insurance policy. Coverage began on October 1. Pioneer recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of $600 in the October 31 trial balance. Insurance of $50 ($600 ÷ 12) expires each month.

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50



Adjustment for Insurance

Basic Analysis

The expense Insurance Expense is increased $50; the asset Prepaid Insurance is decreased $50.

Equation Analysis

	Assets	=	Liabilities	+	Owner's Equity
(2)	Prepaid Insurance	=			Insurance Expense
	−$50				−$50

Debit–Credit Analysis

Debits increase expenses: debit Insurance Expense $50.
Credits decrease assets: credit Prepaid Insurance $50.

Journal Entry

Oct. 31	Insurance Expense	722	50	
	Prepaid Insurance	130		50
	(To record insurance expired)			

Posting

Prepaid Insurance			130
Oct. 4	600	Oct. 31	Adj. 50
Oct. 31	Bal. 550		

Insurance Expense			722
Oct. 31	Adj. 50		
Oct. 31	Bal. 50		

3.5 Prepaid Expenses (Part 2)

Depreciation

- **Buildings**, **equipment**, and **motor vehicles** (assets that provide service for many years) are **recorded as assets**, rather than an expense, on the date acquired
- **Depreciation** is the process of **allocating the cost of an asset to expense** over its **useful life**
- Depreciation **does not attempt** to report the actual change in the **value of the asset**
  - **Allocation concept**, not a valuation concept

Adjustment for Depreciation

Illustration: For Pioneer Advertising, assume that depreciation on the equipment is $480 a year, or $40 per month.

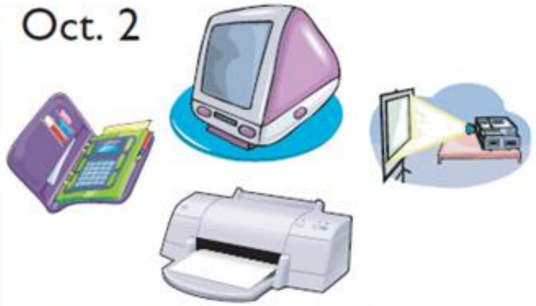
Oct. 31

Depreciation Expense	40	
Accumulated Depreciation		40

Accumulated Depreciation is called a **contra asset account.**

Depreciation

Oct. 2



Equipment purchased; record asset

Equipment			
Oct $40	Nov $40	Dec $40	Jan $40
Feb $40	March $40	April $40	May $40
June $40	July $40	Aug $40	Sept $40
Depreciation = $480/year			

Oct. 31

Depreciation recognized; record depreciation expense

Adjustment for Depreciation

Basic Analysis

The expense Depreciation Expense is increased $40; the contra asset Accumulated Depreciation—Equipment is increased $40.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Accumulated Depreciation—Equipment	=			Depreciation Expense
–$40				–$40

Debit–Credit Analysis

Debits increase expenses: debit Depreciation Expense $40.
Credits increase contra assets: credit Accumulated Depreciation—Equipment $40.

Journal Entry

Oct. 31	Depreciation Expense	40	
	Accumulated Depreciation—Equipment		40
	(To record monthly depreciation)		

Posting

Equipment			157
Oct. 2	5,000		
Oct. 31	Bal. 5,000		

Accumulated Depreciation—Equipment			158
		Oct. 31	**Adj. 40**
		Oct. 31	Bal. 40

Depreciation Expense			711
Oct. 31	**Adj. 40**		
Oct. 31	Bal. 40		

Depreciation

Statement Presentation

- Accumulated Depreciation is a **contra asset account** (credit)
- **Offsets related asset account** on the balance sheet
- **Book value** is the difference between the cost of any depreciable asset and its accumulated depreciation

Equipment	$5,000
Less: Accumulated depreciation—equipment	40
Book value	**$4,960**

Prepaid Expenses

Accounting for Prepaid Expenses

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Insurance, supplies, advertising, rent, Depreciation	Prepaid expense originally recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets or Contra Assets

3.6 Unearned Revenues

Unearned Revenues

Receipt of cash that is recorded as a liability because the service has not been performed.

Cash receipt BEFORE revenue recorded

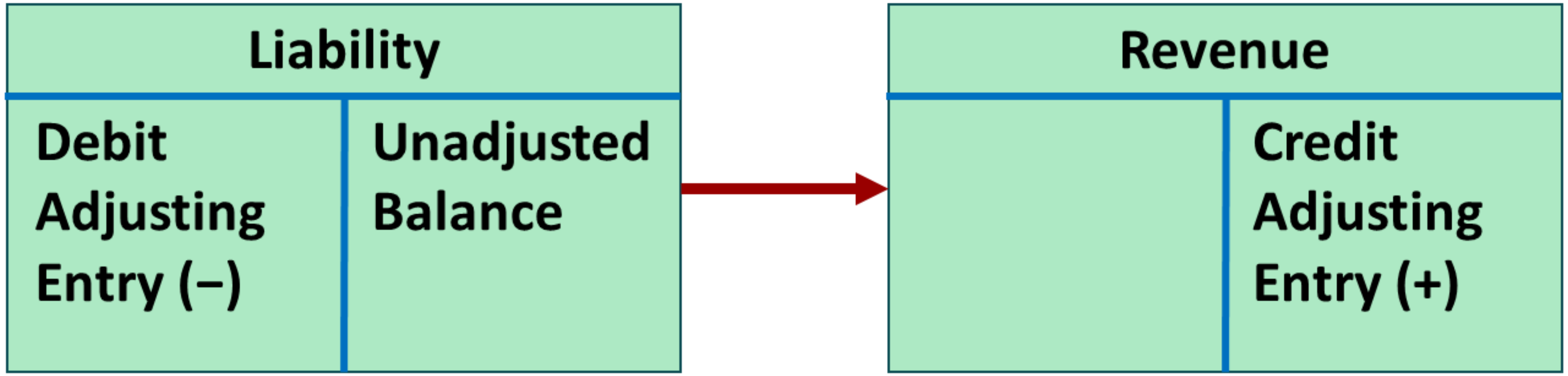
Unearned revenues often occur in regard to:

- Rent
- Airline tickets
- Magazine subscriptions
- Customer deposits

Unearned Revenues

Adjusting entry is made to **record the revenue** for services performed during the period and to show the liability that remains at the end of the period

Results in a **decrease** (debit) to a **liability account** and an **increase** (credit) to a **revenue account**



Unearned Revenues

Illustration: Pioneer Advertising received $1,200 on October 2 from R. Knox for advertising services expected to be completed by December 31. Unearned Service Revenue shows a balance of $1,200 in the October 31 trial balance. Analysis reveals that the company performed $400 of services in October.

Oct. 31	Unearned Service Revenue	400	
	Service Revenue		400

Adjustment for Unearned Revenues

Basic Analysis

The liability Unearned Service Revenue is decreased $400; the revenue Service Revenue is increased $400.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Unearned Service Revenue		Service Revenue
		−$400		+$400

Debit–Credit Analysis

Debits decrease liabilities: debit Unearned Service Revenue $400.
Credits increase revenues: credit Service Revenue $400.

Journal Entry

Oct. 31	Unearned Service Revenue	400	
	Service Revenue		400
	(To record revenue for services performed)		

Posting

Unearned Service Revenue 209			
Oct. 31	Adj. 400	Oct. 2	1,200
		Oct. 31	Bal. 800

Service Revenue 400			
		Oct. 3	10,000
		31	Adj. 400
		Oct. 31	Bal. 10,400

Unearned Revenues

Accounting for Unearned Revenue

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Rent, magazine subscriptions, customer deposits for future service	Unearned revenues recorded in liability accounts are now recognized as revenue for services performed.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues

Self Test Question 1: Adjusting Entries for Deferrals

The ledger of Hammond Company, on March 31, 2020, includes these selected accounts before adjusting entries are prepared.

Account Titles	Debit	Credit
Prepaid Insurance	$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated Depreciation—Equipment		$5,000
Unearned Service Revenue		9,200

An analysis of the accounts shows the following.

1. Insurance expires at the rate of $100 per month.
2. Supplies on hand total $800.
3. The equipment depreciates $200 a month.
4. During March, services were performed for $4,000 of the unearned service revenue reported.

Requirement: Prepare the adjusting entries for the month of March.

Answer to the Self Test Question 1: Adjusting Entries for Deferrals

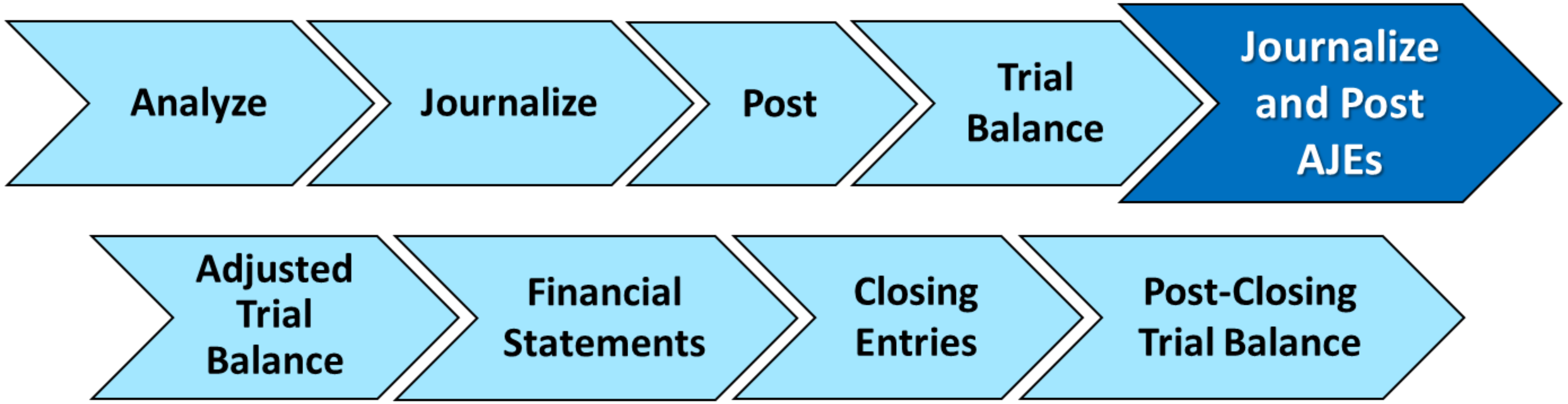
Prepare the adjusting entries or journals by yourself and match them with the answer provided in the ~~buX~~

3.7 Accrued Revenues

Adjusting Entries for Accruals

Accruals are made to record,

- **Revenues** for services performed but not yet recorded at the statement date
- **Expenses** incurred but not yet paid or recorded at the statement date



Accrued Revenues

Revenues for services performed but not yet received in cash or recorded.

Revenue recorded BEFORE cash receipt

Accrued revenues often occur in regard to:

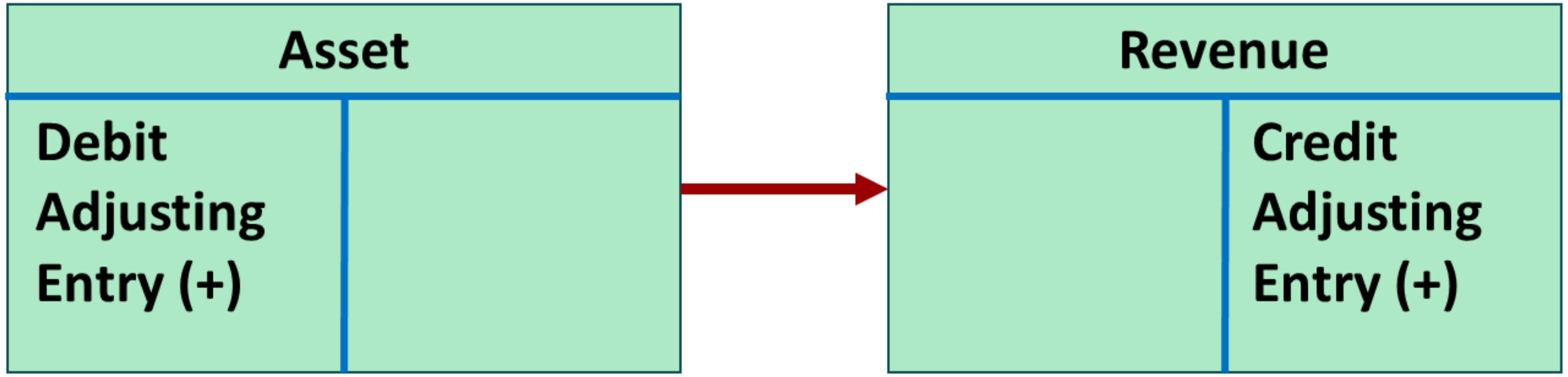
- Rent
- Interest
- Services

Accrued Revenues

Adjusting entry records the receivable that exists and records the revenues for services performed.

Adjusting entry:

- **Increases** (debits) an **asset account** and
- **Increases** (credits) a **revenue account**



Accrued Revenues

Illustration: In October Pioneer Advertising performed services worth $200 that were not billed to clients on or before October 31.

Oct. 31 **(Adjusting Entry)**

Accounts Receivable	200	
Service Revenue		
(To record revenue for services performed)		200

On November 10, Pioneer receives cash of $200 for the services performed. The journal entry on the 10th is:

Cash	200	
Accounts Receivable		
(To record cash collected on account)		200

Accrued Revenues

Revenue and receivable are recorded for unbilled services

Adjustment for Accrued Revenue

Basic Analysis

The asset Accounts Receivable is increased $200; the revenue Service Revenue is increased $200.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Accounts Receivable				Service Revenue
+$200				+$200

Debit–Credit Analysis

Debits increase assets: debit Accounts Receivable $200.
Credits increase revenues: credit Service Revenue $200.

Journal Entry

Oct. 31	Accounts Receivable	112	200	
	Service Revenue	400		200
	(To record revenue for services performed)			

Posting

Accounts Receivable			112
Oct. 31	Adj. 200		
Oct. 31	Bal. 200		

Service Revenue			400
		Oct. 31	10,000
		31	400
		31	Adj. 200
		Oct. 31	Bal. 10,600

Accrued Revenues

Accounting for Accrued Revenues

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, services	Services performed but not yet received In cash or recorded.	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues

3.8 Accrued Expenses

Accrued Expenses

Expenses incurred but not yet paid in cash or recorded.

Expense recorded BEFORE cash payment

Accrued expenses often occur in regard to:

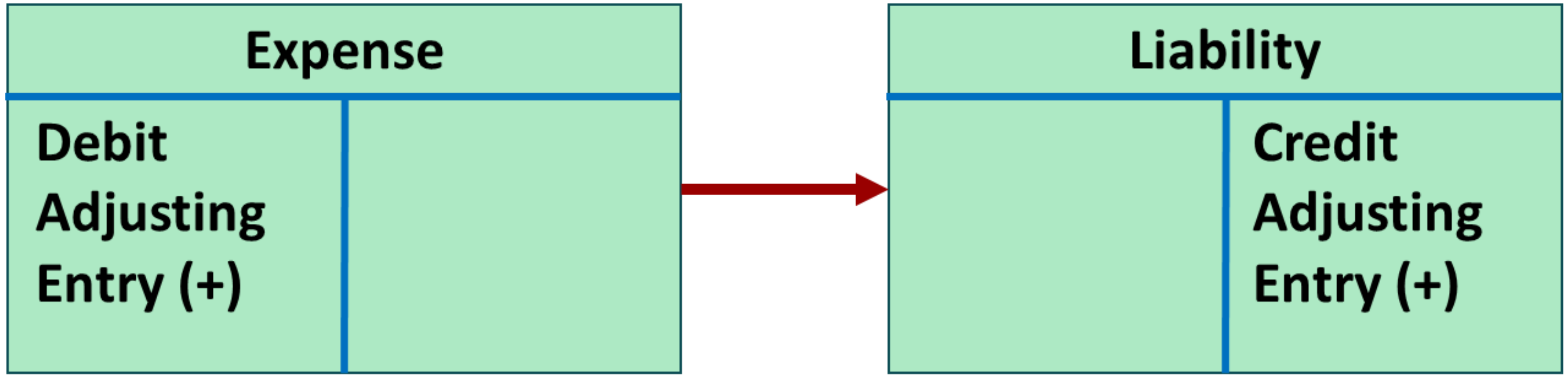
- Rent
- Interest
- Taxes
- Salaries

Adjusting Accrued Expenses

Adjusting entry records the obligation and recognizes the expense.

Adjusting entry:

- **Increase** (debit) an **expense account** and
- **Increase** (credit) a **liability account**



Accrued Expenses

Accrued Interest

Illustration: Pioneer Advertising signed a three-month note payable in the amount of $5,000 on October 1. The note requires Pioneer to pay interest at an annual rate of 12%.

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
$5,000	×	12%	×	$\frac{1}{12}$	=	$50

Oct. 31	Interest Expense	50	
	Interest Payable		50

Adjustment for Accrued Interest

Basic Analysis

The expense Interest Expense is increased $50; the liability Interest Payable is increased $50.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Interest Payable		Interest Expense
		+$50		−$50

Debit–Credit Analysis

Debits increase expenses: debit Interest Expense $50.
Credits increase liabilities: credit Interest Payable $50.

Journal Entry

Oct. 31	Interest Expense	50	
	Interest Payable		50
	(To record interest on notes payable)		

Posting

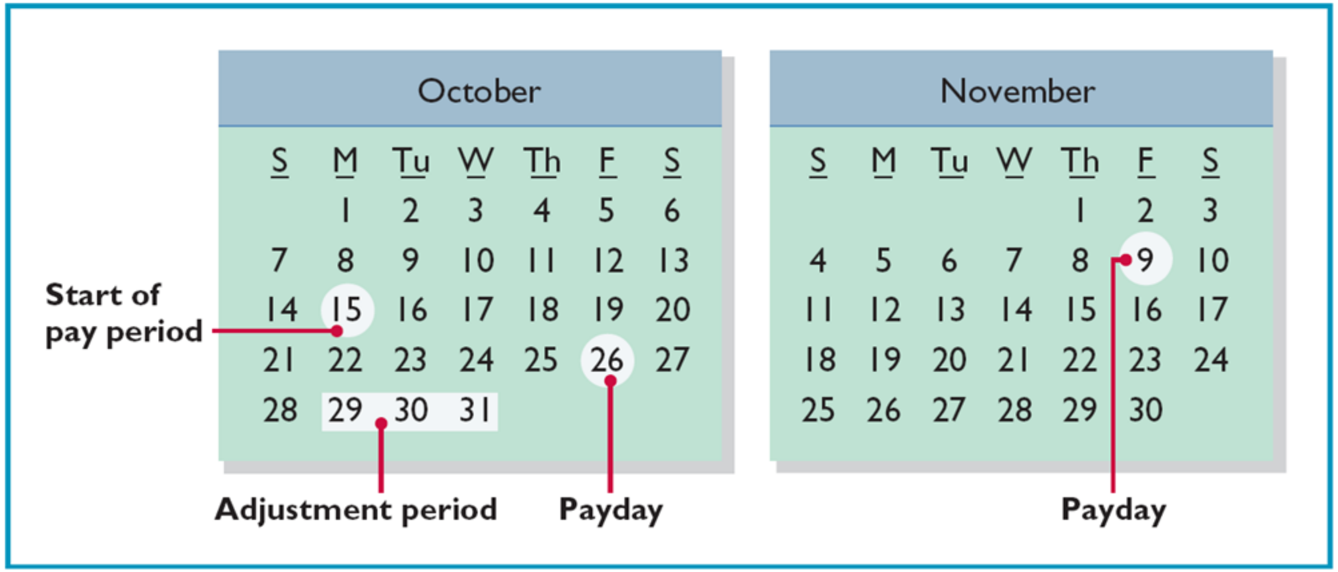
Interest Expense		905
Oct. 31	Adj. 50	
Oct. 31	Bal. 50	

Interest Payable		230
	Oct. 31	Adj. 50
	Oct. 31	Bal. 50

Accrued Expenses

Accrued Salaries and Wages

Illustration: Pioneer Advertising paid salaries and wages on October 26; the next payment of salaries will not occur until November 9. The employees receive total salaries of $2,000 for a five-day work week, or $400 per day.



On October 31,

the salaries and wages for three remaining working days (October 29 to 31) represent an accrued expense and a related liability.

Adjustment for Accrued Salaries

Basic Analysis

The expense Salaries and Wages Expense is increased $1,200; the liability account Salaries and Wages Payable is increased $1,200.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Salaries and Wages Payable		Salaries and Wages Expense
		+$1,200		−$1,200

Debit–Credit Analysis

Debits increase expenses: debit Salaries and Wages Expense $1,200.
Credits increase liabilities: credit Salaries and Wages Payable $1,200.

Journal Entry

Oct. 31	Salaries and Wages Expense	1,200	
	Salaries and Wages Payable		1,200
	(To record accrued salaries and wages)		

Posting

Salaries and Wages Expense 726				
Oct. 26		4,000		
31	Adj.	1,200		
Oct. 31	Bal.	5,200		

Salaries and Wages Payable 212				
		Oct. 31	Adj.	1,200
		Oct. 31	Bal.	1,200

Accrued Expenses

Accounting for Accrued Expenses

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Interest, rent, salaries	Expenses have been incurred but not yet paid in cash or recorded.	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities

3.9 Summary of Adjusting Entries and Adjusted Trial Balance

Summary of Basic Relationships

Type of Adjustment	Accounts Before Adjustment	Adjusting Entry
Prepaid expenses	Assets overstated. Expenses understated.	Dr. Expense Cr. Assets or Contra Assets
Unearned revenues	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities

Self Test Question 2: Adjusting Entries for Accruals

Micro Computer Services began operations on August 1, 2020. At the end of August 2020, management prepares monthly financial statements. The following information relates to August.

1. At August 31, the company owed its employees $800 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed $30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
3. Revenue for services performed but unrecorded for August totaled $1,100.

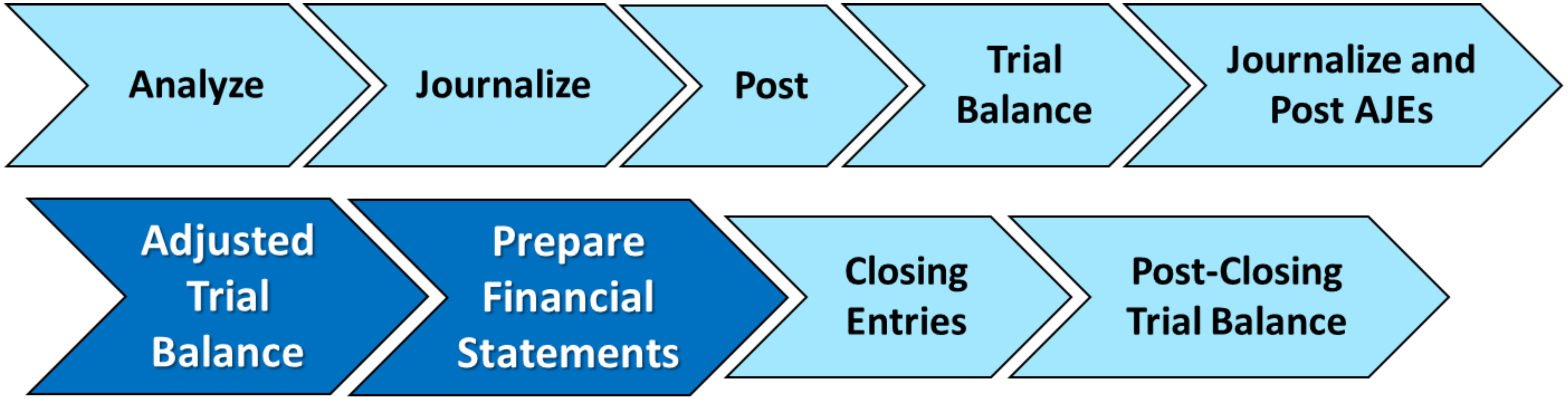
Required: Prepare the adjusting entries needed at August 31, 2020.

Answer to the Self Test Question 2: Adjusting Entries for Accruals

Prepare the adjusting entries or journals by yourself and match them with the answer provided in the ~~buX~~

Adjusted Trial Balance

- Prepared **after adjusting entries** are journalized and posted
- **Proves equality** of debit and credit balances
- **Basis for the preparation** of financial statements

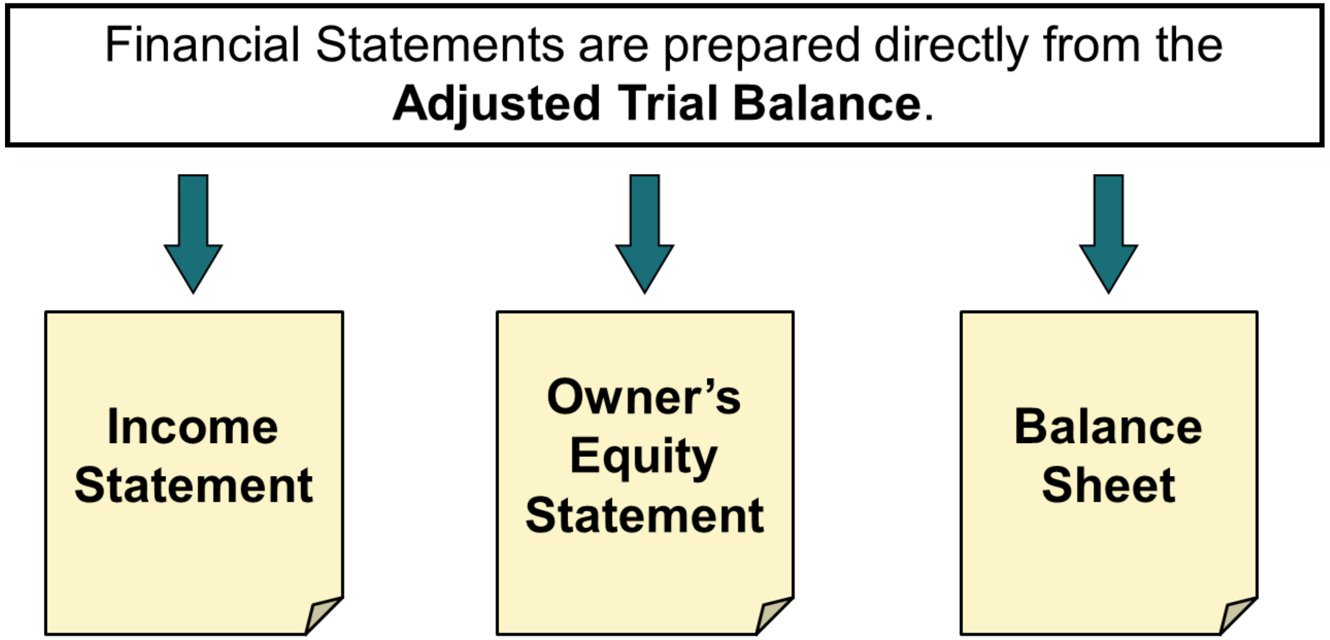


Adjusted Trial Balance

Pioneer Advertising
Adjusted Trial Balance
October 31, 2020

	Debit	Credit
Cash	$15,200	
Accounts Receivable	**200**	
Supplies	**1,000**	
Prepaid Insurance	**550**	
Equipment	5,000	
Accumulated Depreciation		**$ 40**
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		**800**
Salaries and Wages Payable		**1,200**
Interest Payable		**50**
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		**10,600**
Salaries and Wages Expense	**5,200**	
Supplies Expense	**1,500**	
Rent Expense	900	
Insurance Expense	**50**	
Interest Expense	**50**	
Depreciation Expense	**40**	
	$30,190	**$30,190**

Preparing Financial Statements



Preparing Financial Statements

PIONEER ADVERTISING
Adjusted Trial Balance
October 31, 2020

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING
Income Statement
For the Month Ended October 31, 2020

Revenues		
Service revenue		$10,600
Expenses		
Salaries and wages expense	$5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		$ 2,860

PIONEER ADVERTISING
Owner's Equity Statement
For the Month Ended October 31, 2020

Owner's capital, October 1	$ –0–
Add: Investments	10,000
	10,000
Net income	2,860
	12,860
Owner's drawings	500
Owner's capital, October 31	$12,360

To balance sheet

Preparing Financial Statements

PIONEER ADVERTISING
Adjusted Trial Balance
October 31, 2020

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING
Balance Sheet
October 31, 2020

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment	$5,000	
Less: Accumulated depreciation—equip.	40	4,960
Total assets		$21,910
Liabilities and Owner's Equity		
Liabilities		
Notes payable		$ 5,000
Accounts payable		2,500
Unearned service revenue		800
Salaries and wages payable		1,200
Interest payable		50
Total liabilities		9,550
Owner's equity		
Owner's capital		12,360
Total liabilities and owner's equity		$21,910

Capital balance at Oct. 31 from owner's equity statement in Illustration 3-26