Adjusting Accounts For Financial Statements

Chapter 3

Wild, Kwok, Venkatesh and Shaw

Fundamental Accounting Principles

3rd Edition

Debit and Credit Effects on Each Account Type

- A simple memory aid

WEA

Withdrawals

Expenses

Assets

Debit and Credit Rule

↑, Debit

↓, Credit

(normal Debit balance)

LOR

Liabilities

Owners' equity/capital

Revenue

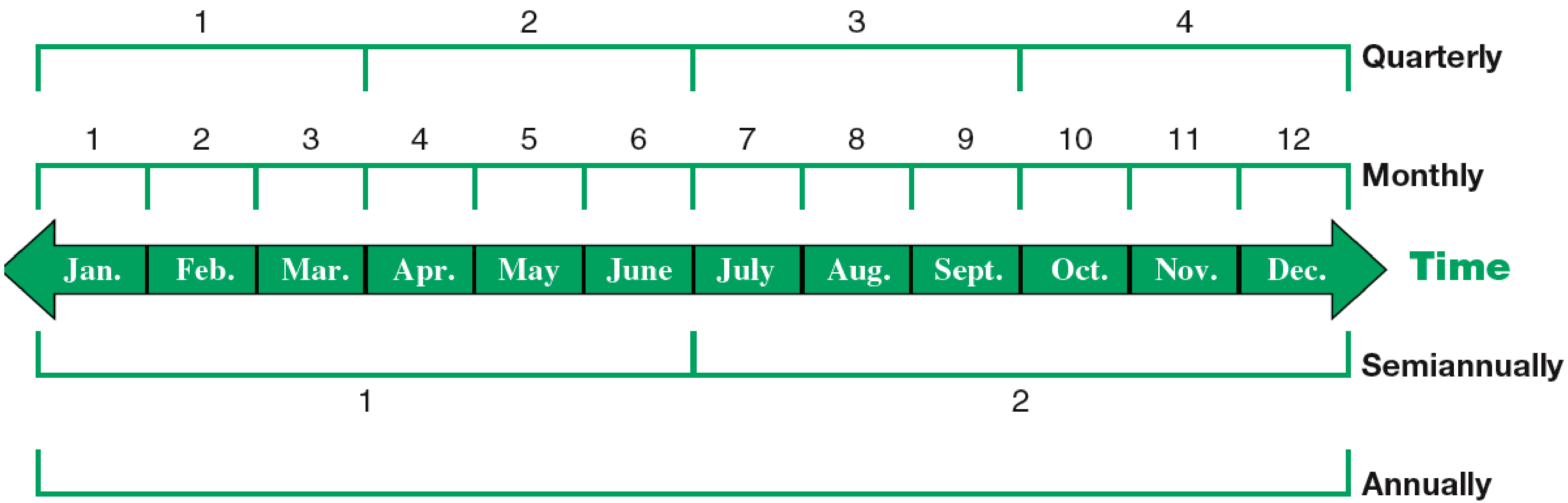
↓, Debit

↑, Credit

(normal Credit balance)

The Accounting Period

Exhibit 3.1



Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

Accrual Basis versus Cash Basis Definitions

Accrual Basis

Revenues are recorded when products or services are delivered, and records expenses when incurred.

Cash Basis

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

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

Accrual Basis versus Cash Basis
Accrual Basis Example

On the accrual basis, $100 of insurance expense is recognized in 2021, $1,200 in 2022, and $1,100 in 2023.

The expense is matched with the periods benefited by the insurance coverage.

Exhibit 3.2

Accrual Basis versus Cash Basis
Cash Basis Example

On December 1, 2021, FastForward paid $2,400 for 24 months of insurance coverage.
Using the cash basis, the entire $2,400 would be recognized as insurance expense in 2021. No insurance expense from this policy would be recognized in 2022 or 2023, periods covered by the policy.

Exhibit 3.3

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

Discussion Question

Q: What is the difference between the cash basis and the accrual basis of accounting?

Discussion Question

Q: What is the difference between the cash basis and the accrual basis of accounting?

Recognizing Revenues

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

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

Recognizing Expenses

The expense recognition (or matching) requires that expenses be recorded in the same accounting period as the revenues that are recognized as a result of those expenses.

Framework for Adjustments

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

Deferral of expense | Deferral of revenue | Accrued expense | Accrued revenue

Adjustments are 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 C1: Explain the importance of periodic reporting and the role of accrual accounting.

Learning Objective P1

Prepare and explain adjusting entries for deferral of expenses.

Discussion Question

Q: What is a prepaid expense and where is it reported in the financial statements?

Discussion Question

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Prepaid (Deferred) Expenses

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

Examples: Prepaid Insurance, Prepaid Rent, Supplies

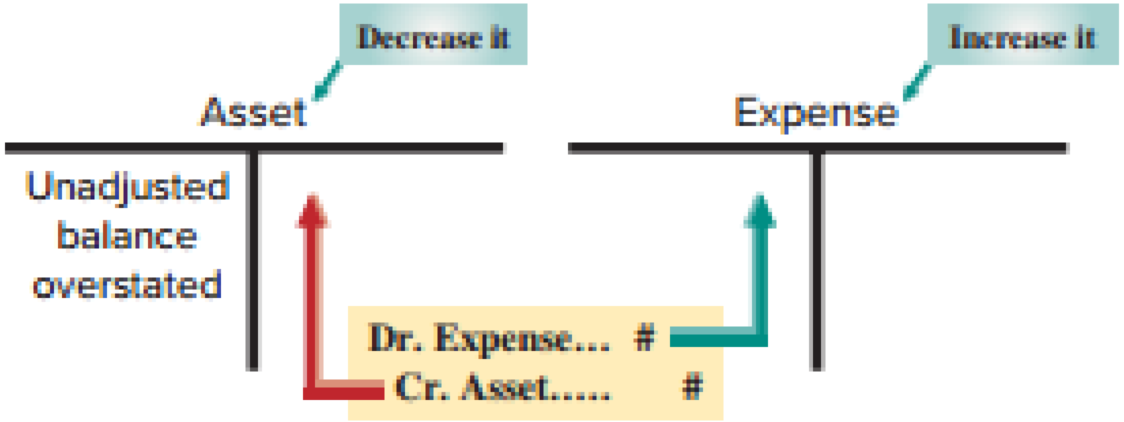


Exhibit 3.5

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Prepaid Insurance Step 1

Step 1: Determine current balance:

- FastForward paid $2,400 to cover insurance for 24 months that began on December 1 of 2021.
- FastForward recorded the expenditure as *Prepaid Insurance* on December 1.

24-month policy Beginning 12/01

PREPAID INSURANCE	
$2,400	

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Prepaid Insurance
Step 2

Step 2: Balance in balance in prepaid insurance should equal $2,300. On 12/31, one month’s worth of insurance has expired.

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Prepaid Insurance
Step 3

	Adjustment (*a*)		
Dec. 31	Insurance Expense	100	
	Prepaid Insurance.		100
	Record first month's expired insurance.		

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

Insurance Expense			637
Dec. 31	100		

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Supplies
Steps 1 and 2

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.

SUPPLIES

Purchases during December	
$9,720	

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Supplies Step 3

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

	Adjustment (*b*)		
Dec. 31	Supplies Expense	1,050	
	Supplies		1,050
	Record supplies used.		

Supplies			126
Dec. 2	2,500	Dec. 31	1,050
6	7,100		
26	120		
Balance	8,670		

Supplies Expense			652
Dec. 31	1,050		

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Depreciation

Instead of expensing the cost of a property, plant and equipment (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:

$$\text{Straight-Line Depreciation Expense} = \frac{\text{Asset Cost} - \text{Residual Value}}{\text{Useful Life}}$$

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Depreciation – Step 1

- Step 1: FastForward purchased equipment on Dec 1 for $26,000.
- It has an estimated useful live of 5 years.
- The equipment is expected to be worth about $8,000 at the end of five years.
- They purchased the equipment on Dec. 1 but it is now Dec. 31.

Because FastForward expects the equipment to be worth $8,000 when the five years are over, only $18,000 of the cost needs to be spread over the next 60 months.

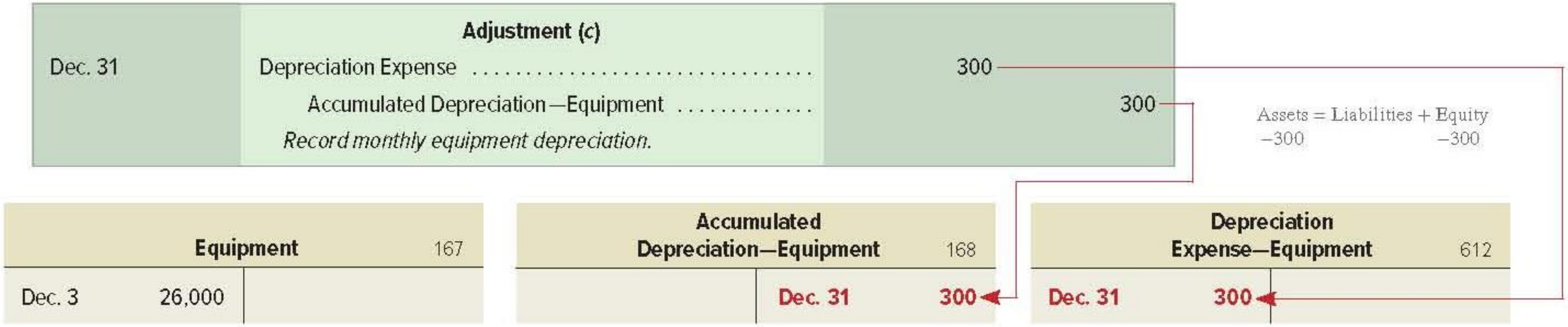
Adjusting for Depreciation– Step 2

- Step 2: Equipment has a 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.

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Adjusting for Depreciation – Step 3



- Step 3: Record adjusting entry for $300 for one month.
- The depreciation amount of $300 is credited to Accumulated Depreciation account instead of the asset account, **Equipment.**

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Depreciation – Balance Sheet

Exhibit 3.7

Assets (at February 28, 2022)		
Cash		$
⋮		
Equipment	**$26,000**	
Less accumulated depreciation	**900**	**25,100**
Total Assets		$

Commonly titled *Equipment, net*

Learning Objective P1: Prepare and explain adjusting entries for deferral of expenses.

Discussion Question

Q: What type of assets requires adjusting entries to record depreciation?

Discussion Question

Q: What type of assets requires adjusting entries to record depreciation?

Learning Objective P2

Prepare and explain adjusting entries for deferral of revenues.

Deferral of Revenue

Unearned revenue is cash received in advance of providing products or services.

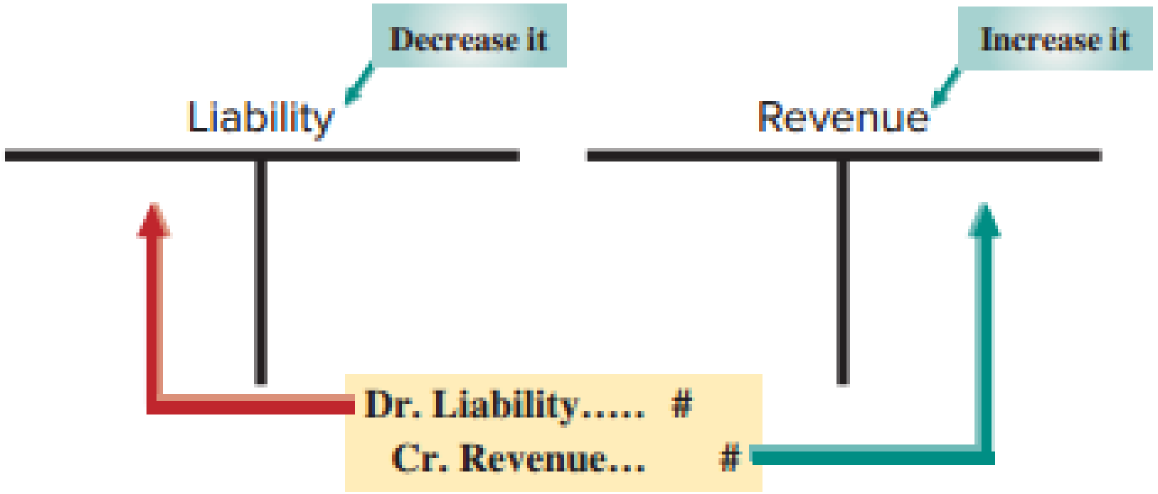


Exhibit 3.8

Learning Objective P2: Prepare and explain adjusting entries for deferral of revenues.

Adjusting for Unearned Revenues – Steps 1 and 2

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
	Received advance payment for services over the next 60 days.		

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

Learning Objective P2: Prepare and explain adjusting entries for deferral of revenues.

Adjusting for Unearned Revenue – Step 3

	Adjustment (*d*)		
Dec. 31	Unearned Consulting Revenue	250	
	Consulting Revenue		250
	Record earned revenue that was received in advance ($3,000 × 5/60).		

Unearned Consulting Revenue			236
Dec. 31	250	Dec. 26	3,000
		Balance	2,750

Consulting Revenue			403
		Dec. 5	4,200
		12	1,600
		31	250
		Balance	6,050

Learning Objective P2: Prepare and explain adjusting entries for deferral of revenues.

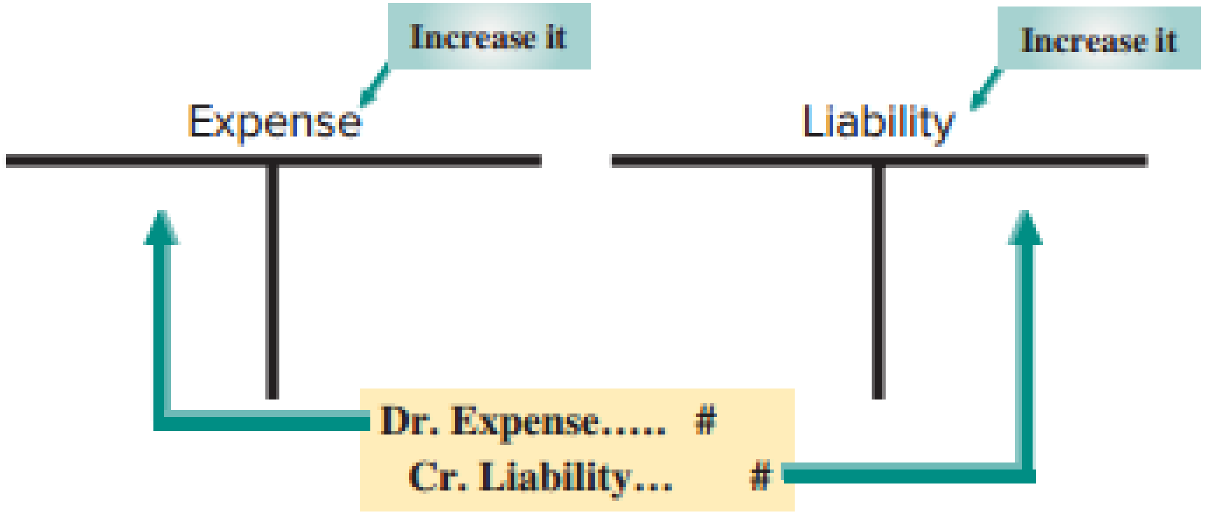
Learning Objective P3

Prepare and explain adjusting entries for accrued expenses.

Accrued Expense

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

Exhibit 3.9



Learning Objective P3: Prepare and explain adjusting entries for accrued expenses.

Adjusting for Accrued Salaries – Steps 1 and 2

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 x 3 = $210.

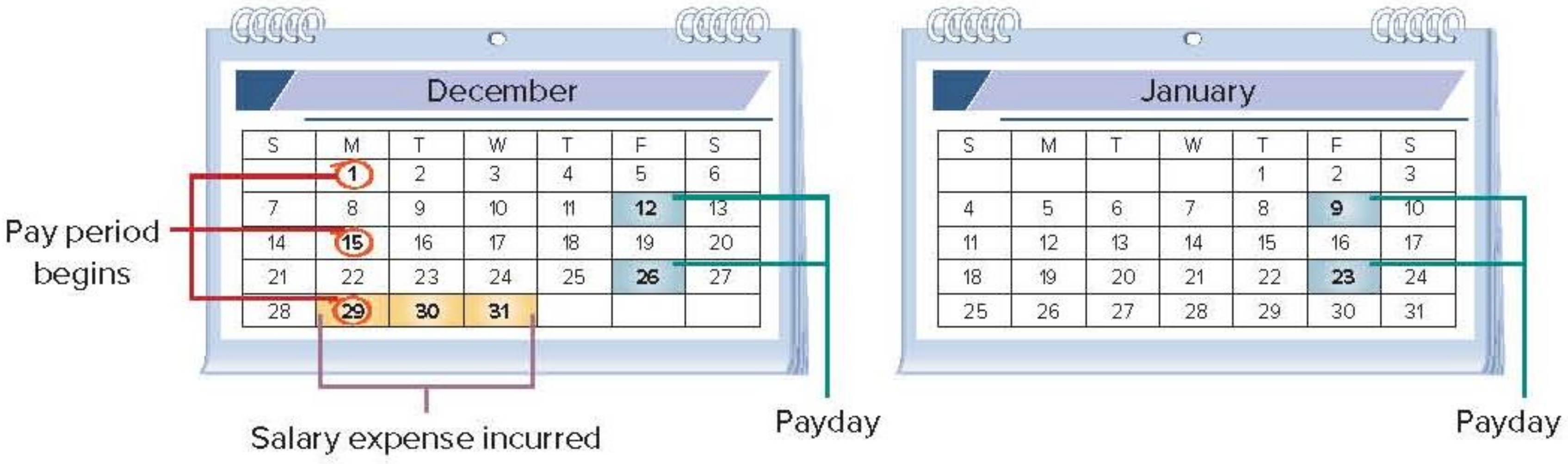


Exhibit 3.10

Learning Objective P3: Prepare and explain adjusting entries for accrued expenses.

Adjusting for Accrued Salaries – Step 3

	Adjustment (*e*)		
Dec. 31	Salaries Expense	210	
	Salaries Payable		210
	Record three days' accrued salary (3 × $70).		

Salaries Expense		622	
Dec. 12	700		
26	700		
31	**210**		
Balance	1,610		

Salaries Payable		209	
		Dec. 31	**210**

Learning Objective P3: Prepare and explain adjusting entries for accrued expenses.

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 days at $70 per day)	210	
	Salaries Expense (7 days at $70 per day)	490	
	Cash		700
	Pay two weeks' salary including three days accrued.		

Learning Objective P3: Prepare and explain adjusting entries for accrued expenses.

Learning Objective P4

Prepare and explain adjusting entries for accrued revenues.

Accrued Revenue

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

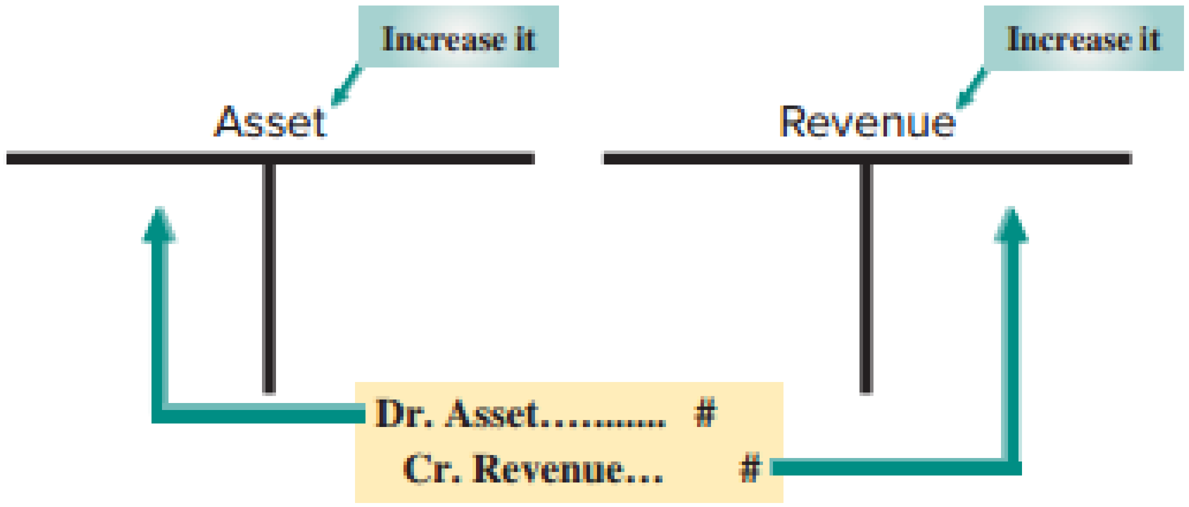


Exhibit 3.11

Learning Objective P4: Prepare and explain adjusting entries for accrued revenues.

Adjusting for Accrued Services Revenue – Steps 1 and 2

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 x 20/30 days).

Learning Objective P4: Prepare and explain adjusting entries for accrued revenues.

Adjusting for Accrued Services Revenue – Step 3

	Adjustment (*f*)		
Dec. 31	Accounts Receivable	1,800	
	Consulting Revenue		1,800
	Record 20 days' accrued revenue.		

Accounts Receivable 106

Dec. 12	1,900	Dec. 22	1,900
31	1,800		
Balance	1,800		

Consulting Revenue 403

		Dec. 5	4,200
		12	1,600
		31	250
		31	1,800
		Balance	7,850

Learning Objective P4: Prepare and explain adjusting entries for accrued revenues.

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 at $90 per day)		1,800
	Consulting Revenue (10 days at $90 per day)		900
	Receive cash for accrued asset and record earned consulting revenue for January.		

Learning Objective P4: Prepare and explain adjusting entries for accrued revenues.

Links to Financial Statements

EXHIBIT 3.12

Summary of Adjustments and Financial Statement Links

		Four Adjustments	Adjusting Entry	BEFORE Adjusting
Deferrals	Paid (or received) cash before expense (or revenue) recognized	Deferral of expense†	Dr. (increase) Expense Cr. (decrease) Asset*	← Expense understated ← Asset overstated
		Deferral of revenue†	Dr. (decrease) Liability Cr. (increase) Revenue	← Liability overstated ← Revenue understated
Accruals	Paid (or received) cash after expense (or revenue) recognized	Accrued expense	Dr. (increase) Expense Cr. (increase) Liability	← Expense understated ← Liability understated
		Accrued revenue	Dr. (increase) Asset Cr. (increase) Revenue	← Asset understated ← Revenue understated

*For depreciation, the credit is to Accumulated Depreciation (contra asset).
†Exhibit assumes that deferred expenses are initially recorded as assets and that deferred revenues are initially recorded as liabilities.

Learning Objective P4: Prepare and explain adjusting entries for accrued revenues.

Adjusted Trial Balance

Exhibit 3.13

FASTFORWARD
Trial Balances
December 31, 2021

Acct. No.	Account Title	Unadjusted Trial Balance Dr.	Unadjusted Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.
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		7,850
					(f) 1,800		
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 P5: Explain and prepare an adjusted trial balance.

Preparing Financial Statements from an Adjusted Trial Balance

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

Step 2—Prepare statement of changes in equity using capital and withdrawals from adjusted trial balance; and pull net profit from step 1.

Step 3—Prepare balance sheet using asset and liability account from adjusted 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).

Preparing Financial Statements from an Adjusted Trial Balance

Exhibit 3.14

FASTFORWARD
Adjusted Trial Balance
December 31, 2021

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	$47,610	$47,610

FASTFORWARD
Balance Sheet
December 31, 2021

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

Step 2 Prepare statement of changes in equity

FASTFORWARD
Statement of Changes in Equity
For Month Ended December 31, 2021

C. Taylor, Capital, December 1		$ 0
Plus: Investments by owner	$30,000	
Net profit	3,785	
		33,785
Less: Withdrawals by owner		200
C. Taylor, Capital, December 31		$33,585

Step 1 Prepare income statement

FASTFORWARD
Income Statement
For Month Ended December 31, 2021

Revenues		
Consulting revenue	$7,850	
Rental revenue	300	
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	305	
Total expenses		4,365
Net profit		$3,785

Steps to Prepare Financial Statements

Step 1	Prepare income statement using revenue and expense accounts from trial balance
Step 2	Prepare statement of changes in equity using capital and withdrawals accounts from trial balance; and pull net profit from step 1
Step 3	Prepare balance sheet using asset and liability accounts 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)

Learning Objective P6: Prepare financial statements from an adjusted trial balance.

Types of Adjusting Entries

Deferrals

(A) **Prepaid Expenses**—Assets paid for in advance of receiving their benefits. When these assets are used, those advance payments become expenses.

E.g. prepaid rent/supplies /depreciation for equipment

(L) **Unearned Revenues**—Receive cash in advance of providing products and services.

Accruals

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

Accrued Revenues—Revenues earned in a period that are both unrecorded and not yet received in cash (or other assets).

Dr. Prepaid Expense
  Cr. Cash
Dr. XX Expense
  Cr. Prepaid Expense

Dr. Cash
  Cr. Unearned Revenue
Dr. Unearned Revenue
  Cr. XX Revenue

Dr. XX Expense
  Cr. XX Payable

Dr. XX Receivable
  Cr. XX Revenue

E3–6: Prepare adjusting journal entries for the year ended (date of) Dec 31 for each of these separate situations.

a. Depreciation on the company's equipment for the year is computed to be $18,000.
b. The Prepaid Insurance account had a $6,000 debit balance at Dec 31 before adjusting for the costs of any expired coverage. An analysis of the company's insurance policies showed that $1,100 of unexpired insurance coverage remains.
c. The Supplies account had a $700 debit balance at the beginning of the year; and $3,480 of supplies were purchased during the year. Dec 31 physical count showed $300 of supplies available.
d. Two-thirds of the work related to $15,000 of cash received in advance was performed this period.
e. The Prepaid Rent account had a $6,800 debit balance at Dec 31 before adjusting for the costs of expired prepaid rent. An analysis of the rental agreement showed that $5,800 of the prepaid rent had expired.
f. Wage expenses of $3,200 have been incurred but are not paid as of Dec 31.

- Entries can draw from the following partial chart of accounts:

Cash; Accounts Receivable; Supplies; Prepaid Insurance; Prepaid Rent; Equipment; Accumulated Depreciation-Equipment; Wages Payable; Unearned Revenue; Revenue; Wages Expense; Supplies Expense; Insurance Expense; Rent Expense; Depreciation Expense-Equipment

a. Depreciation on the company’s equipment for the year is computed to be $18,000.

b. The Prepaid Insurance account had a $6,000 debit balance at Dec 31 before adjusting for the costs of any expired coverage. An analysis of the company's insurance policies showed that $1,100 of unexpired insurance coverage remains.

c. The Supplies account had a $700 debit balance at the beginning of the year; and $3,480 of supplies were purchased during the year. Dec 31 physical count showed $300 of supplies available.

d. Two-thirds of the work related to $15,000 of cash received in advance was performed this period.

e. The Prepaid Rent account had a $6,800 debit balance at Dec 31 before adjusting for the costs of expired prepaid rent. An analysis of the rental agreement showed that $5,800 of the prepaid rent had expired.

f. Wage expenses of $3,200 have been incurred but are not paid as of Dec 31.

End of Chapter 3