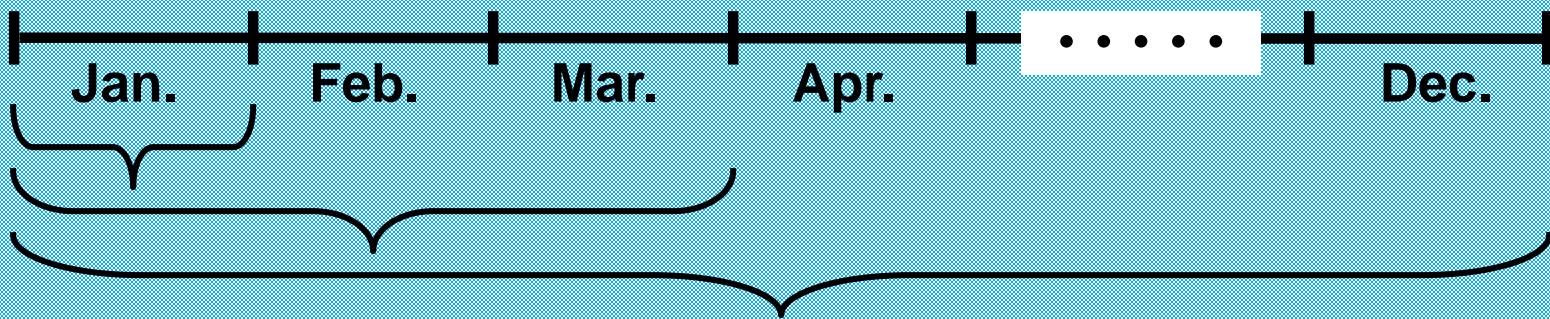


# Adjusting the Accounts

# Timing Issues

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



- Generally a **month**, a **quarter**, or a **year**.
- Fiscal year vs. calendar year
- Also known as the “Periodicity Assumption”

# Timing Issues

## Review

The time period assumption states that:

- a. revenue should be recognized in the accounting period in which it is earned.
- b. expenses should be matched with revenues.
- c. the economic life of a business can be divided into artificial time periods.
- d. the fiscal year should correspond with the calendar year.

## Accrual- vs. Cash-Basis Accounting

### Accrual-Basis Accounting

- Transactions recorded in the periods in which the events occur
- **Revenues** are recognized when earned, rather than when cash is received.
- **Expenses** are recognized when incurred, rather than when paid.

## Accrual- vs. Cash-Basis Accounting

### Cash-Basis Accounting

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

# Timing Issues

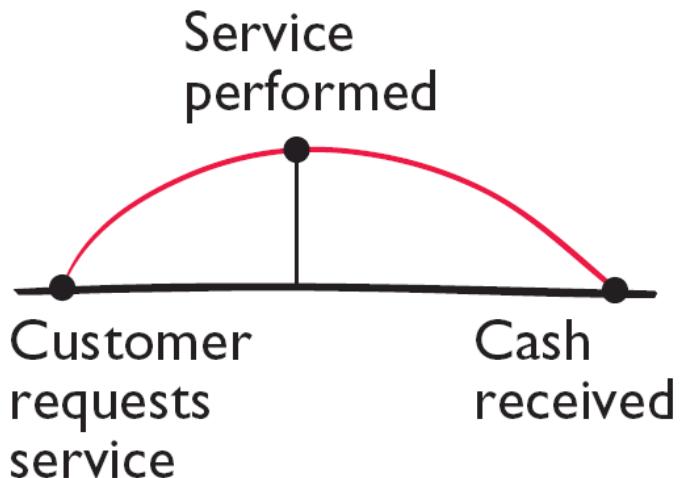
## Recognizing Revenues and Expenses

### Revenue Recognition Principle

Companies recognize revenue in the accounting period in which it is earned.

In a service enterprise, revenue is considered to be earned at the time the service is performed.

#### Revenue Recognition

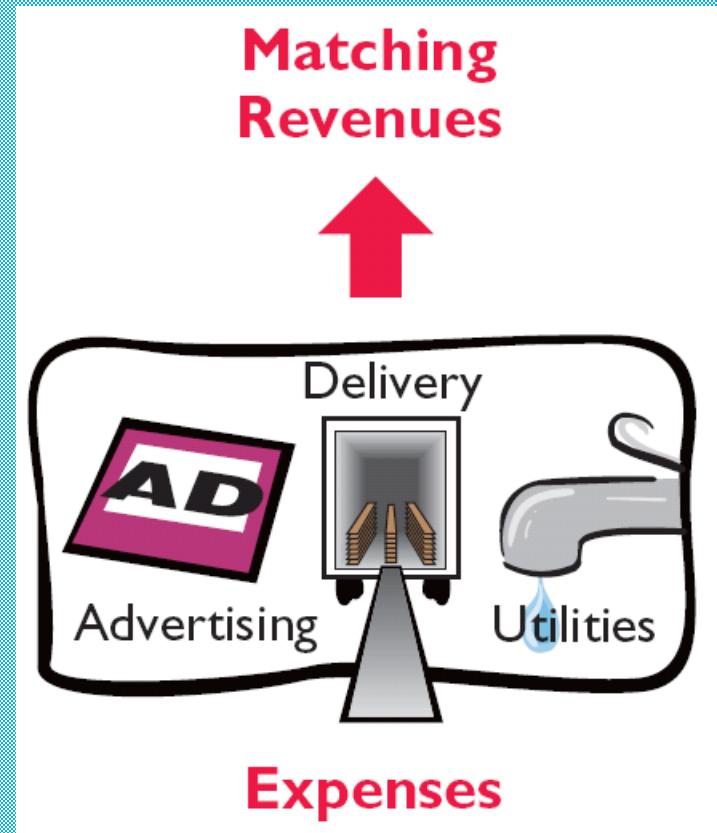


## Recognizing Revenues and Expenses

### Matching Principle

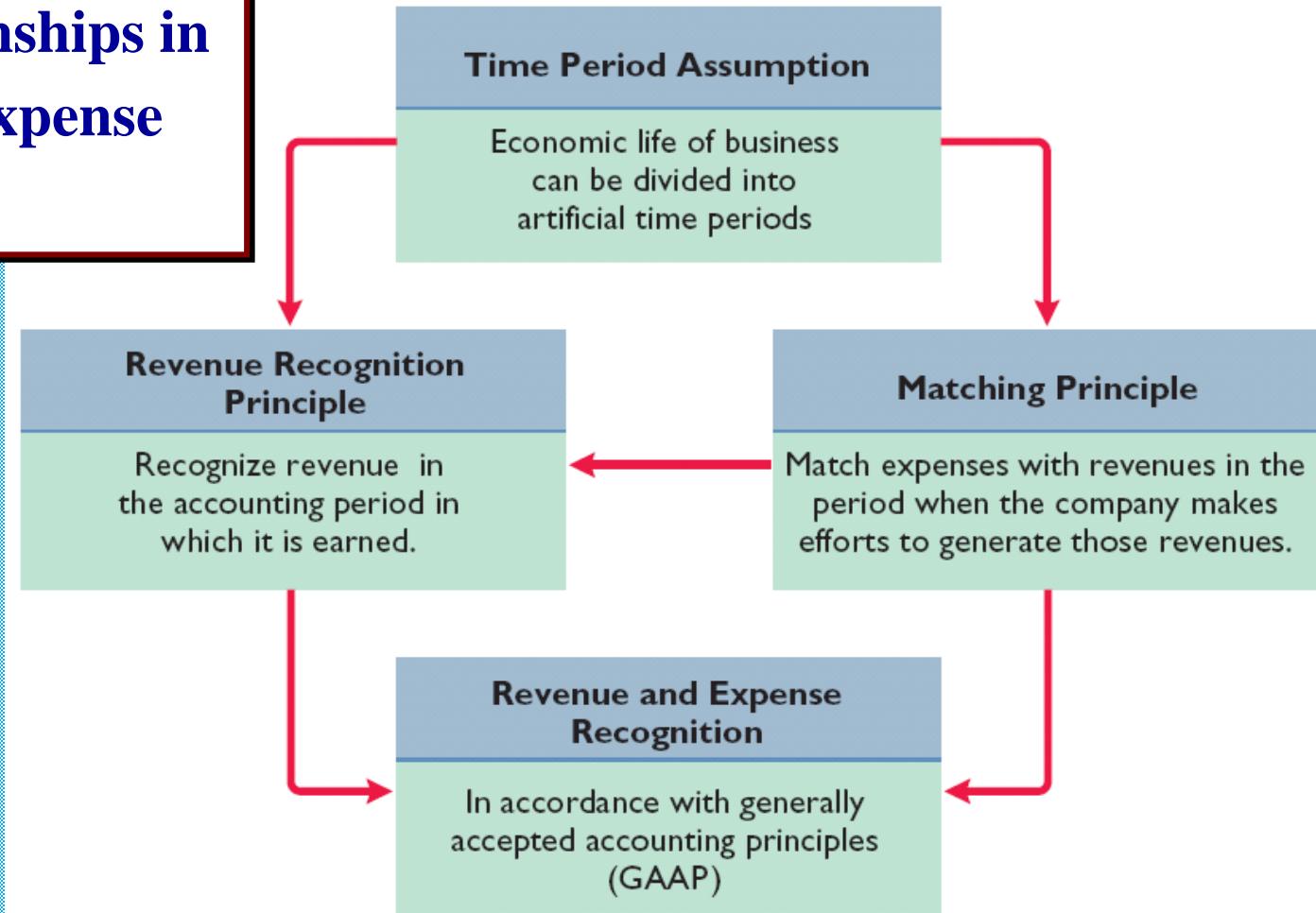
Match expenses with revenues in the period when the company makes efforts to generate those revenues.

**“Let the expenses follow the revenues.”**



# Timing Issues

## GAAP relationships in revenue and expense recognition



# Timing Issues

## Review

One of the following statements about the accrual basis of accounting is *false*. That statement is:

- a. Events that change a company's financial statements are recorded in the periods in which the events occur.
- b. Revenue is recognized in the period in which it is earned.
- c. The accrual basis of accounting is in accord with generally accepted accounting principles.
- d. Revenue is recorded only when cash is received, and expenses are recorded only when cash is paid.

# The Basics of Adjusting Entries

- Adjusting entries make it possible to report correct amounts on the **balance sheet** and on the **income statement**.
- A company must make adjusting entries every time it prepares financial statements.

# The Basics of Adjusting Entries

- **Revenues** - recorded in the period in which they are earned.
- **Expenses** - recognized in the period in which they are incurred.
- **Adjusting entries** - needed to ensure that the revenue recognition and matching principles are followed.

# Timing Issues

## Review

Adjusting entries are made to ensure that:

- a. expenses are recognized in the period in which they are incurred.
- b. revenues are recorded in the period in which they are earned.
- c. balance sheet and income statement accounts have correct balances at the end of an accounting period.
- d. all of the above.

# Types of Adjusting Entries

## Illustration 4-2

Categories of adjusting entries

### Deferrals

1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets before they are used or consumed.
  
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities before they are earned.

### Accruals

3. **Accrued Revenues.** Revenues earned but not yet received in cash or recorded.
  
4. **Accrued Expenses.** Expenses incurred but not yet paid in cash or recorded.

# Trial Balance

**Trial Balance** – Each account is analyzed to determine whether it is complete and up-to-date.

**Phoenix Consulting - Jan. 31st (before adjusting entries)**

Acct. No.	Account	Debit	Credit
100	Cash	\$ 50,000	
105	Accounts receivable	35,000	
110	Prepaid insurance	12,000	
120	Equipment	24,000	
130	Investments	300,000	
200	Accounts payable		\$ 20,000
210	Unearned rent revenue		24,000
220	Note payable		200,000
300	Austin, capital		40,000
400	Sales		137,000
		<u>\$ 421,000</u>	<u>\$ 421,000</u>

# Adjusting Entries for Deferrals

**Deferrals** are either:

- Prepaid expenses

*OR*

- Unearned revenues.

# Adjusting Entries for “Prepaid Expenses”

Payment of cash, that is recorded as an asset because service or benefit will be received in the future.

Cash Payment

**BEFORE**

Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- maintenance on equipment
- fixed assets (depreciation)

# Adjusting Entries for “Prepaid Expenses”

## Prepaid Expenses

- Costs that expire either with the passage of time or through use.
- Adjusting entries (1) to record the expenses that apply to the current accounting period, and (2) to show the unexpired costs in the asset accounts.

# Adjusting Entries for “Prepaid Expenses”

**Example (Insurance):** On Jan. 1<sup>st</sup>, Phoenix Consulting paid \$12,000 for 12 months of insurance coverage. Show the journal entry to record the payment on Jan. 1<sup>st</sup>.

Jan. 1	Prepaid Insurance	12,000
	Cash	12,000

Prepaid Insurance		Cash	
Debit	Credit	Debit	Credit
12,000			12,000

# Adjusting Entries for “Prepaid Expenses”

**Example (Insurance):** On Jan. 1<sup>st</sup>, Phoenix Consulting paid \$12,000 for 12 months of insurance coverage. Show the adjusting journal entry required at Jan. 31<sup>st</sup>.

Jan. 31	Insurance Expense	1,000
	Prepaid Insurance	1,000

Prepaid Insurance		Insurance Expense	
Debit	Credit	Debit	Credit
12,000	1,000	1,000	
11,000			

# Adjusting Entries for “Prepaid Expenses”

## Depreciation

- Buildings, equipment, and vehicles (long-lived assets) are recorded as assets, rather than an expense, in the year acquired.
- Companies report a portion of the cost of a long-lived asset as an expense (depreciation) during each period of the asset’s useful life (**Matching Principle**).

# Adjusting Entries for “Prepaid Expenses”

**Example (Depreciation):** On Jan. 1<sup>st</sup>, Phoenix Consulting paid \$24,000 for equipment that has an estimated useful life of 20 years. Show the journal entry to record the purchase of the equipment on Jan. 1<sup>st</sup>.

Jan. 1	Equipment	24,000
	Cash	24,000

Equipment		Cash	
Debit	Credit	Debit	Credit
24,000			24,000

# Adjusting Entries for “Prepaid Expenses”

**Example (Depreciation):** On Jan. 1<sup>st</sup>, Phoenix Consulting paid \$24,000 for equipment that has an estimated useful life of 20 years. Show the adjusting journal entry required at Jan. 31<sup>st</sup>.       $(\$24,000 / 20 \text{ yrs.} / 12 \text{ months} = \$100)$

Jan. 31	Depreciation Expense	100
	Accumulated Depreciation	100

Depreciation Expense		Accumulated Depreciation	
Debit	Credit	Debit	Credit
100			100

# Adjusting Entries for “Prepaid Expenses”

## Depreciation (Statement Presentation)

- Accumulated Depreciation is a contra asset account.
- Appears just after the account it offsets (Equipment) on the balance sheet.

Balance Sheet		Jan. 31
Assets		
Equipment		24,000
Accumulated Depreciation		(100)
Net Equipment		23,900

# Adjusting Entries for “Unearned Revenues”

Receipt of cash that is recorded as a liability because the revenue has not been earned.

Cash Receipt

**BEFORE**

Revenue Recorded

Unearned revenues often occur in regard to:

- rent
- airline tickets
- school tuition
- magazine subscriptions
- customer deposits

# Adjusting Entries for “Unearned Revenues”

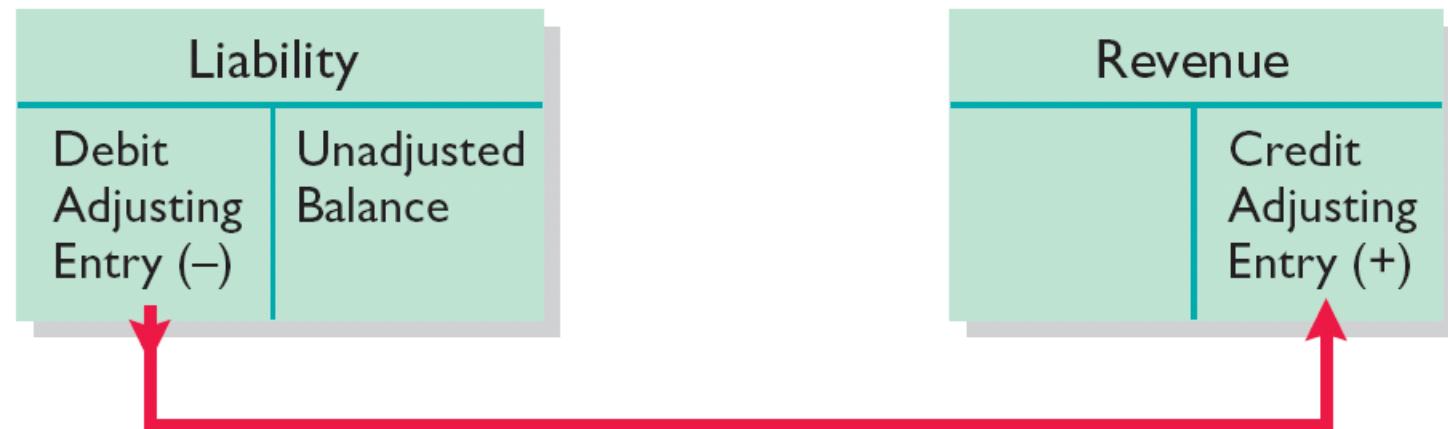
## Unearned Revenues

- Company makes an adjusting entry to record the revenue that has been earned and to show the liability that remains.
- The adjusting entry for unearned revenues results in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account.

# Adjusting Entries for “Unearned Revenues”

Adjusting entries for unearned revenues

## Unearned Revenues



- Decrease (a debit) to a liability account and
- Increase (a credit) to a revenue account.

# Adjusting Entries for “Unearned Revenues”

**Example:** On Jan. 1<sup>st</sup>, Phoenix Consulting received \$24,000 from Arcadia High School for 3 months rent in advance. Show the journal entry to record the receipt on Jan. 1<sup>st</sup>.

Jan. 1	Cash	24,000
	Unearned Rent Revenue	24,000

Cash		Unearned Rent Revenue	
Debit	Credit	Debit	Credit
24,000			24,000

# Adjusting Entries for “Unearned Revenues”

**Example:** On Jan. 1<sup>st</sup>, Phoenix Consulting received \$24,000 from Arcadia High School for 3 months rent in advance. Show the adjusting journal entry required on Jan. 31<sup>st</sup>.

Jan. 31	Unearned Rent Revenue	8,000
	Rent Revenue	8,000

Rent Revenue		Unearned Rent Revenue	
Debit	Credit	Debit	Credit
	8,000	8,000	24,000
		16,000	

# Adjusting Entries for Accruals

Made to record:

- Revenues earned and

*OR*

- Expenses incurred

in the current accounting period that have not been recognized through daily entries.

# Adjusting Entries for “Accrued Revenues”

Revenues earned but not yet received in cash or recorded.

Adjusting entry results in:

Revenue Recorded

**BEFORE**

Cash Receipt

Accrued revenues often occur in regard to:

- rent
- interest
- services performed

# Adjusting Entries for “Accrued Revenues”

## Accrued Revenues

An adjusting entry serves two purposes:

- (1) It shows the receivable that exists, and
- (2) It records the revenues earned.

# Adjusting Entries for “Accrued Revenues”

Adjusting entries for accrued revenues

## Accrued Revenues



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

# Adjusting Entries for “Accrued Revenues”

**Example:** On Jan. 1<sup>st</sup>, Phoenix Consulting invested \$300,000 in securities that return 5% interest per year. Show the journal entry to record the investment on Jan. 1<sup>st</sup>.

Jan. 1	Investments	300,000
	Cash	300,000

Investments		Cash	
Debit	Credit	Debit	Credit
300,000			300,000

# Adjusting Entries for “Accrued Revenues”

**Example:** On Jan. 1<sup>st</sup>, Phoenix Consulting invested \$300,000 in securities that return 5% interest per year. Show the adjusting journal entry required on Jan. 31<sup>st</sup>. ( $\$300,000 \times 5\% / 12 \text{ months} = \$1,250$ )

Jan. 31	Interest Receivable	1,250
	Interest Revenue	1,250

Interest Receivable		Interest Revenue	
Debit	Credit	Debit	Credit
1,250			1,250

# Adjusting Entries for “Accrued Expenses”

Expenses incurred but not yet paid in cash or recorded.

Adjusting entry results in:

Expense Recorded

**BEFORE**

Cash Payment

Accrued expenses often occur in regard to:

- rent
- interest
- taxes
- salaries

# Adjusting Entries for “Accrued Expenses”

## Accrued Expenses

An adjusting entry serves two purposes:

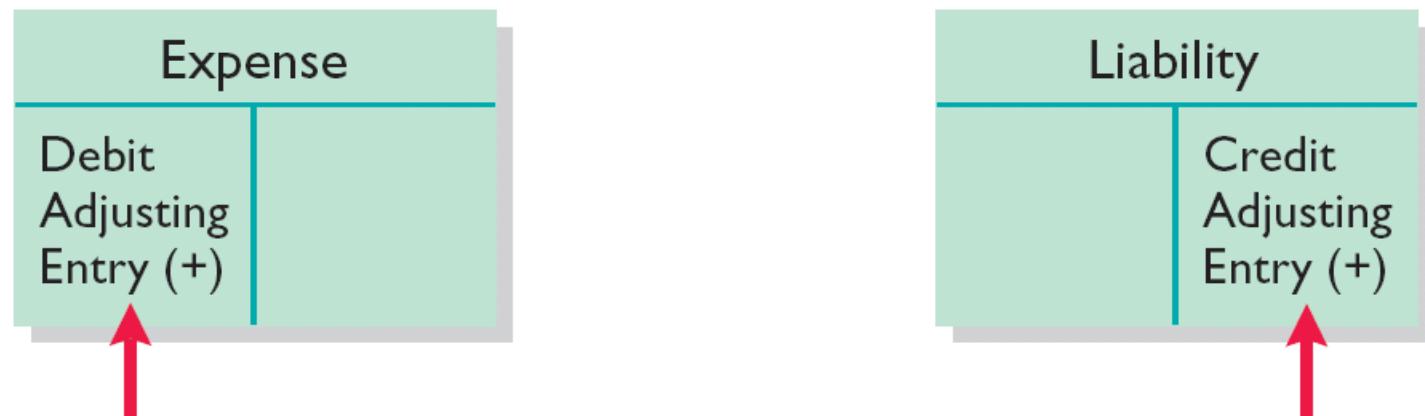
- (1) It records the obligations, and
- (2) It recognizes the expenses.

# Adjusting Entries for “Accrued Expenses”

## Illustration 3-16

Adjusting entries for accrued expenses

### Accrued Expenses



- Increases (debits) an expense account and
- Increases (credits) a liability account.

# Adjusting Entries for “Accrued Expenses”

**Example:** On Jan. 2<sup>nd</sup>, Phoenix Consulting borrowed \$200,000 at a rate of 9% per year. Interest is due on first of each month. Show the journal entry to record the borrowing on Jan. 2<sup>nd</sup>.

Jan. 2	Cash	200,000
	Notes Payable	200,000

Cash		Notes Payable	
Debit	Credit	Debit	Credit
200,000			200,000

# Adjusting Entries for “Accrued Expenses”

**Example:** On Jan. 2<sup>nd</sup>, Phoenix Consulting borrowed \$200,000 at a rate of 9% per year. Interest is due on first of each month. Show the adjusting journal entry required on Jan. 31<sup>st</sup>. ( $\$200,000 \times 9\% / 12 \text{ months} = \$1,500$ )

Jan. 31	Interest Expense	1,500
	Interest Payable	1,500

Interest Expense		Interest Payable	
Debit	Credit	Debit	Credit
1,500			1,500

# Adjusting Entries for “Accrued Expenses”

## Summary

### 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

# The Adjusted Trial Balance

After all adjusting entries are journalized and posted the company prepares another trial balance from the ledger accounts (**Adjusted Trial Balance**).

Its purpose is to prove the equality of debit balances and credit balances in the ledger.

# The Adjusted Trial Balance

## Review

Which of the following statements is *incorrect* concerning the adjusted trial balance?

- a. An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.
- b. The adjusted trial balance provides the primary basis for the preparation of financial statements.
- c. The adjusted trial balance lists the account balances segregated by assets and liabilities.
- d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.

# Preparing Financial Statements

Financial Statements are prepared directly from the Adjusted Trial Balance.

Balance  
Sheet

Income  
Statement

Owner's  
Equity  
Statement

# Preparing Financial Statements

<b>Adjusted Trial Balance</b>	<b>Debit</b>	<b>Credit</b>
Cash	\$ 50,000	
Accounts receivable	35,000	
Interest receivable	1,250	
Prepaid insurance	11,000	
Equipment	24,000	
Accumulated depreciation		\$ 100
Investments	300,000	
Accounts payable		20,000
Interest payable		1,500
Unearned revenue		16,000
Note payable		200,000
Austin, capital		40,000
Sales		137,000
Interest revenue		1,250
Rent revenue		8,000
Interest expense	1,500	
Depreciation expense	100	
Insurance expense	1,000	
	<b>\$ 423,850</b>	<b>\$ 423,850</b>

## Income Statement

### Income Statement

For the Month Ended Jan. 31, 2010

#### Revenues:

Sales	\$ 137,000
Interest revenue	1,250
Rent revenue	8,000
Total revenue	<u>146,250</u>

#### Expenses:

Interest expense	1,500
Depreciation expense	100
Insurance expense	1,000
Total expenses	<u>2,600</u>
<b>Net income</b>	<b>\$ 143,650</b>

# Preparing Financial Statements

<b>Adjusted Trial Balance</b>	<b>Debit</b>	<b>Credit</b>
Cash	\$ 50,000	
Accounts receivable	35,000	
Interest receivable	1,250	
Prepaid insurance	11,000	
Equipment	24,000	
Accumulated depreciation	\$ 100	
Investments	300,000	
Accounts payable		20,000
Interest payable		1,500
Unearned revenue		16,000
Note payable		200,000
Austin, capital		40,000
Sales		137,000
Interest revenue		1,250
Rent revenue		8,000
Interest expense	1,500	
Depreciation expense	100	
Insurance expense	1,000	
	<b>\$ 423,850</b>	<b>\$ 423,850</b>

## Statement of Owner's Equity

### Statement of Owner's Equity For the Month Ended Jan. 31, 2010

Austin, Capital, Jan. 1	\$ 40,000
+ Net income	143,650
- Drawings	0
<b>Austin, Capital, Jan. 31</b>	<b>\$ 183,650</b>

# Preparing Financial Statements

<b>Adjusted Trial Balance</b>	<b>Debit</b>	<b>Credit</b>
Cash	\$ 50,000	
Accounts receivable	35,000	
Interest receivable	1,250	
Prepaid insurance	11,000	
Equipment	24,000	
Accumulated depreciation		\$ 100
Investments	300,000	
Accounts payable		20,000
Interest payable		1,500
Unearned revenue		16,000
Note payable		200,000
Austin, capital		40,000
Sales		137,000
Interest revenue		1,250
Rent revenue		8,000
Interest expense	1,500	
Depreciation expense	100	
Insurance expense	1,000	
	<b>\$ 423,850</b>	<b>\$ 423,850</b>

<b>Balance Sheet</b>	<b>Jan. 31, 2010</b>
<b>Assets</b>	
Cash	\$ 50,000
Accounts receivable	35,000
Interest receivable	1,250
Prepaid insurance	11,000
Equipment	24,000
Accum. Depreciation	(100)
Investments	300,000
Total assets	<b>\$ 421,150</b>
<b>Liabilities &amp; Owner's Equity</b>	
Accounts payable	\$ 20,000
Interest payable	1,500
Unearned revenue	16,000
Note payable	200,000
Austin, capital	183,650
Total liab. & equity	<b>\$ 421,150</b>



Thank you!