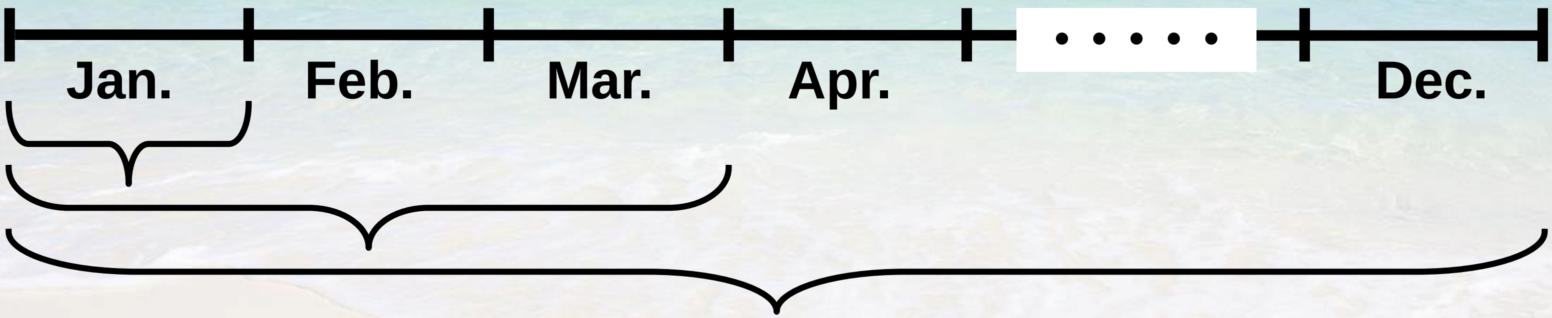
Adjusting the Accounts

DMH
4-1

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.

Timing Issues

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.

Timing Issues

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).

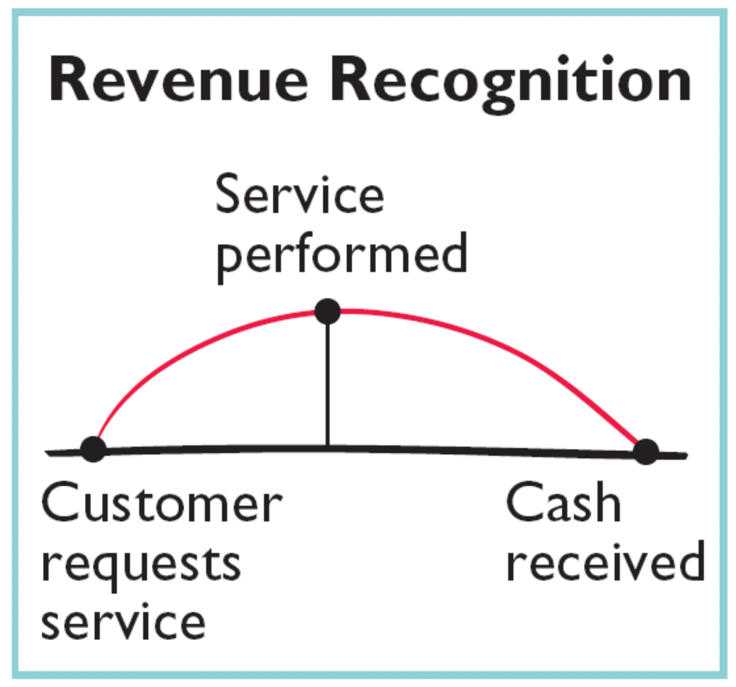
Timing Issues

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.



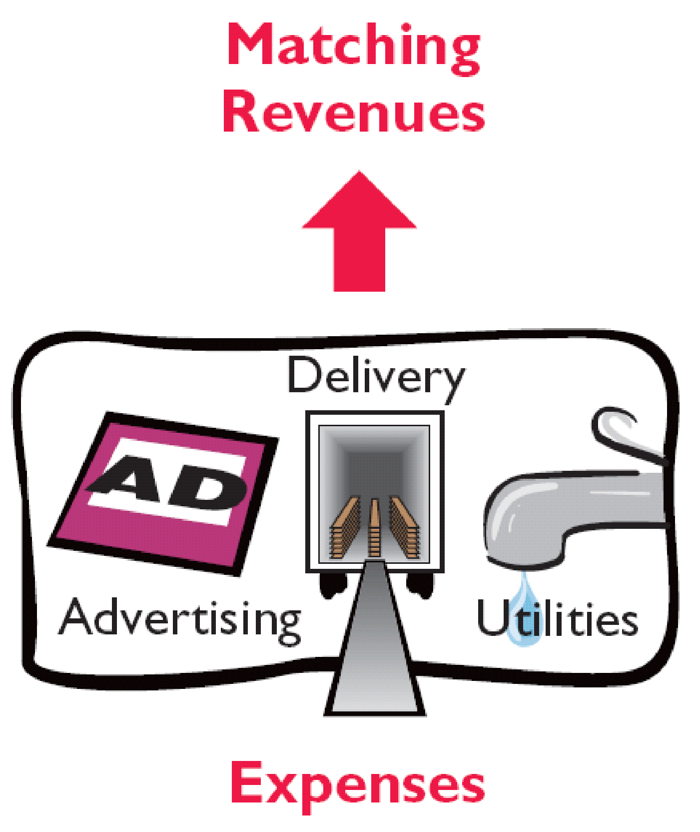
Timing Issues

Recognizing Revenues and Expenses

Matching Principle

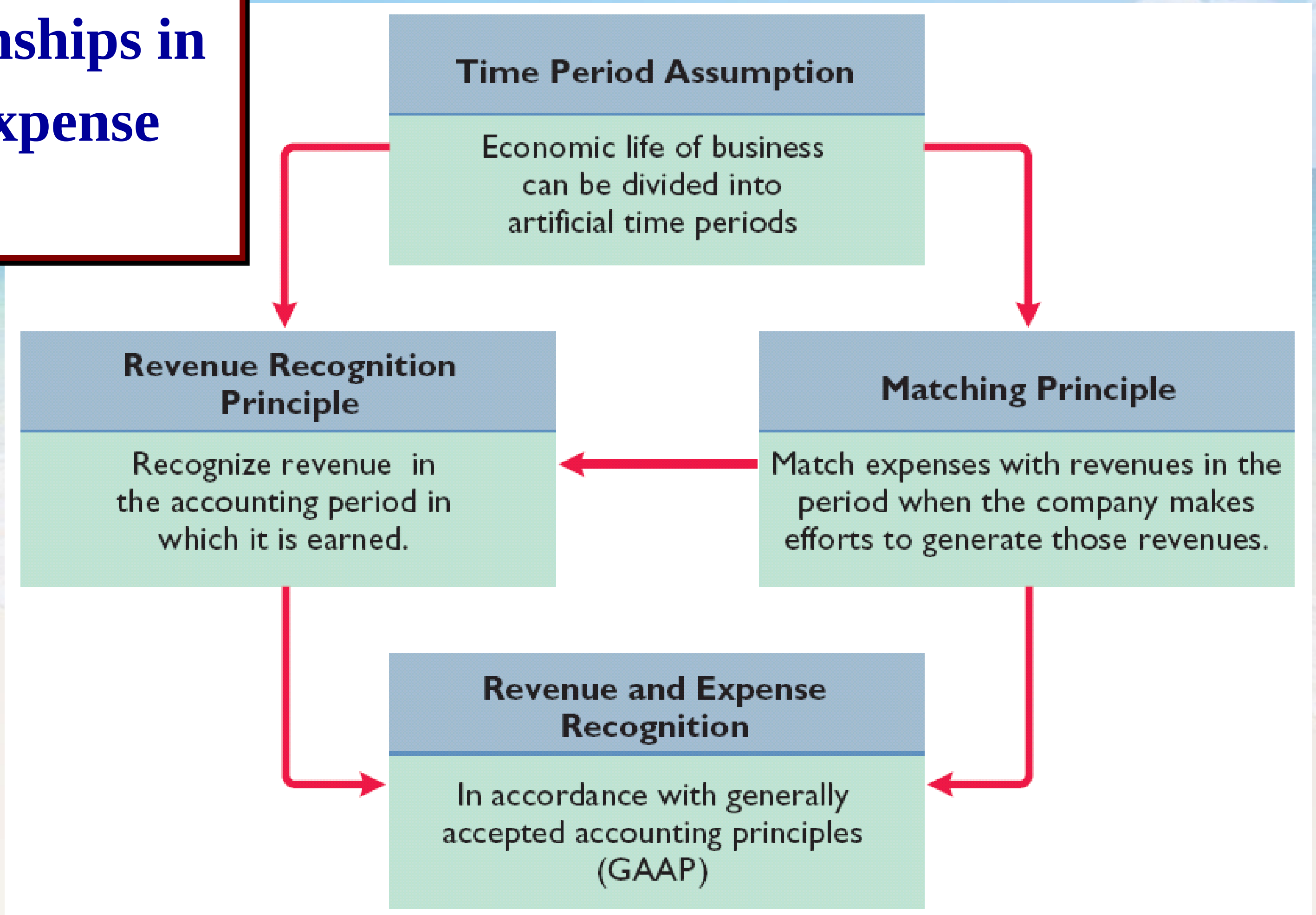
Match expenses with revenues in the period when the company makes efforts to generate those revenues.

“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	Accruals
1. **Prepaid Expenses.** Expenses paid in cash and recorded as assets before they are used or consumed.	3. **Accrued Revenues.** Revenues earned but not yet received in cash or recorded.
2. **Unearned Revenues.** Revenues received in cash and recorded as liabilities before they are earned.	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
		$ 421,000	$ 421,000

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. 1st, Phoenix Consulting paid $12,000 for 12 months of insurance coverage. Show the journal entry to record the payment on Jan. 1st.

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

Prepaid Insurance

Debit	Credit
12,000	

Cash

Debit	Credit
	12,000

Adjusting Entries for "Prepaid Expenses"

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

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

Prepaid Insurance

Debit	Credit
12,000	1,000
11,000	

Insurance Expense

Debit	Credit
1,000	

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. 1st, 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. 1st.

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. 1st, Phoenix Consulting paid $24,000 for equipment that has an estimated useful life of 20 years. Show the adjusting journal entry required at Jan. 31st. **($24,000 / 20 yrs. / 12 months = $100)**

Jan. 31	Depreciation Expense	100	
	Accumulated Depreciation		100

Depreciation Expense

Debit	Credit
100	

Accumulated Depreciation

Debit	Credit
	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

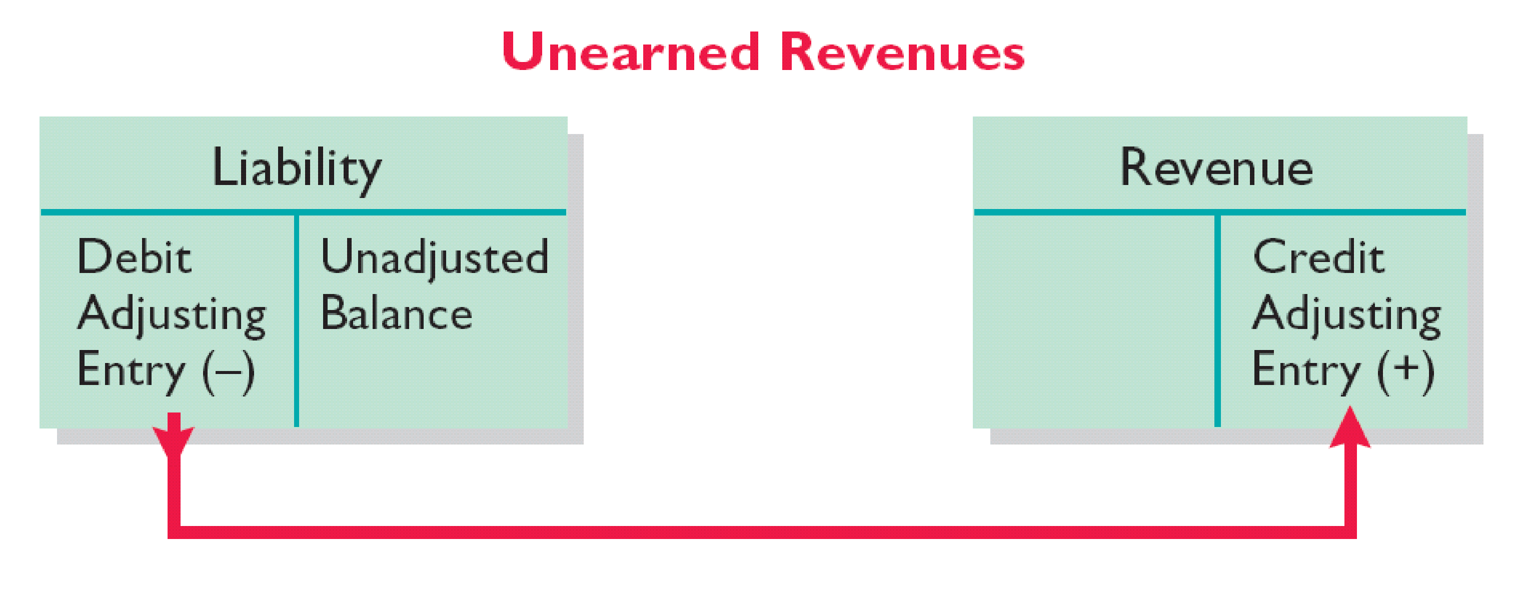
Adjusting Entries for "Unearned Revenues"

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



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

Adjusting Entries for "Unearned Revenues"

Example: On Jan. 1st, 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. 1st.

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

Cash

Debit	Credit
24,000	

Unearned Rent Revenue

Debit	Credit
	24,000

Adjusting Entries for "Unearned Revenues"

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

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

Rent Revenue

Debit	Credit
	8,000

Unearned Rent Revenue

Debit	Credit
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

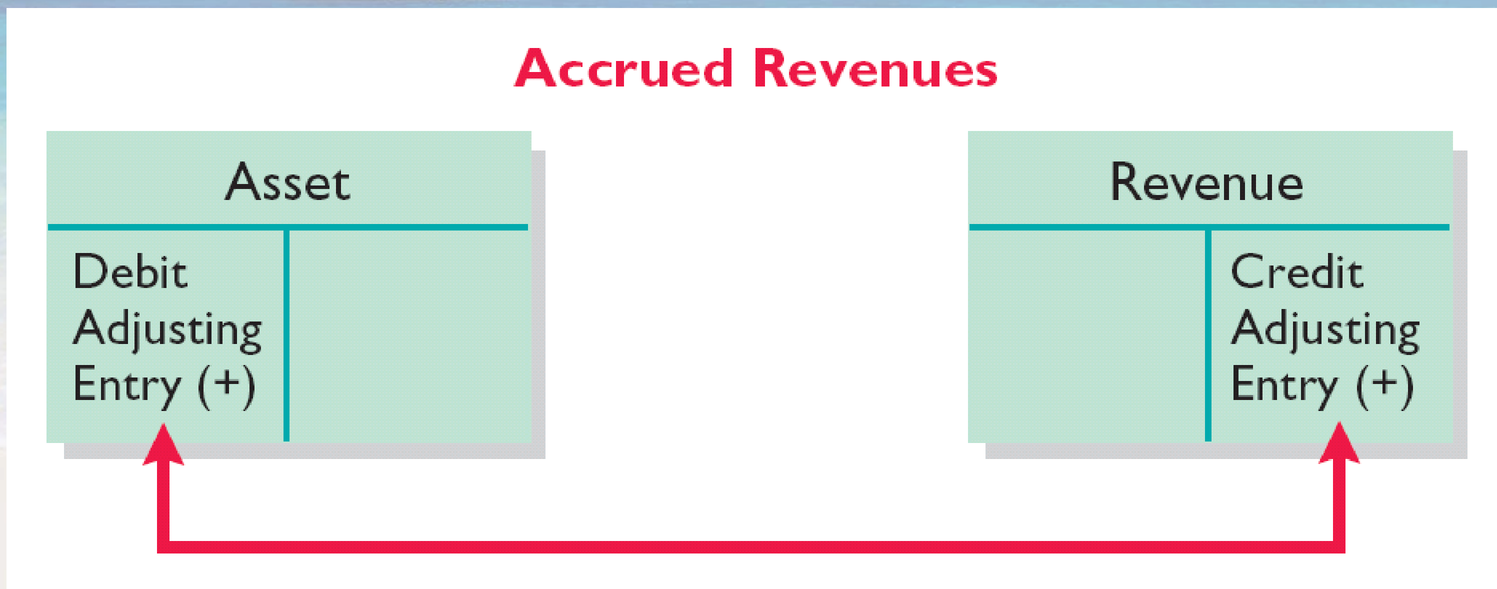
An adjusting entry serves two purposes:

(1) It shows the receivable that exists, and

(2) It records the revenues earned.

Adjusting Entries for "Accrued Revenues"

Adjusting entries for accrued revenues



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

Adjusting Entries for "Accrued Revenues"

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

Jan. 1	Investments	300,000	
	Cash		300,000

Investments

Debit	Credit
300,000	

Cash

Debit	Credit
	300,000

Adjusting Entries for "Accrued Revenues"

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

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

Interest Receivable

Debit	Credit
1,250	

Interest Revenue

Debit	Credit
	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:

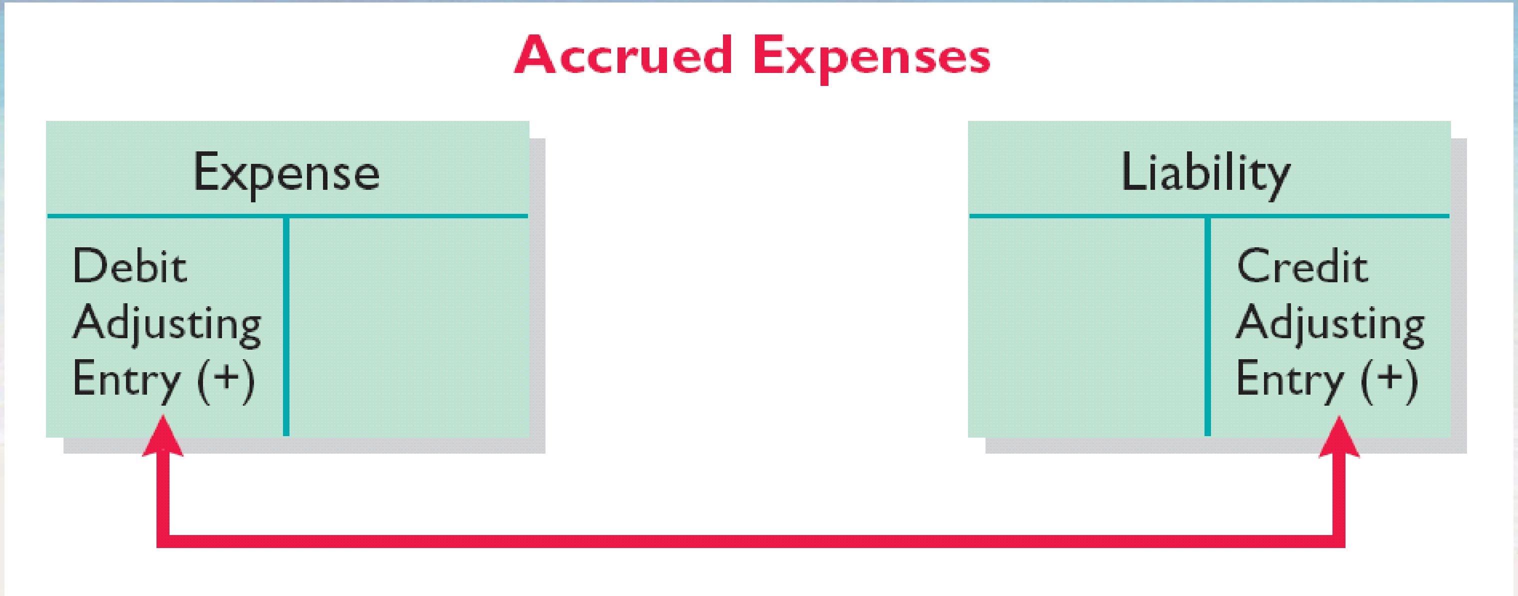
(1) It records the obligations, and

(2) It recognizes the expenses.

Adjusting Entries for "Accrued Expenses"

Illustration 3-16

Adjusting entries for accrued expenses



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

Adjusting Entries for "Accrued Expenses"

Example: On Jan. 2nd, 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. 2nd.

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

Cash

Debit	Credit
200,000	

Notes Payable

Debit	Credit
	200,000

Adjusting Entries for "Accrued Expenses"

Example: On Jan. 2nd, 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. 31st. **($200,000 x 9% / 12 months = $1,500)**

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

Interest Expense

Debit	Credit
1,500	

Interest Payable

Debit	Credit
	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

Adjusted Trial Balance	Debit	Credit
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	
	$ 423,850	$ 423,850

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	146,250
Expenses:	
Interest expense	1,500
Depreciation expense	100
Insurance expense	1,000
Total expenses	2,600
Net income	$ 143,650

Preparing Financial Statements

Adjusted Trial Balance	Debit	Credit
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	
	$ 423,850	$ 423,850

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
Austin, Capital, Jan. 31	$ 183,650

Preparing Financial Statements

Adjusted Trial Balance	Debit	Credit
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	
	$ 423,850	$ 423,850

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