**ADJUSTMENTS TO THE ACCOUNTS**

Managers of most companies understand the need to present financial information fairly so as not to mislead users. However, since **end-of-period adjustments are the most complex portion of the annual recordkeeping process**, they are prone to error. External auditors examine the company’s records on a test, or sample, basis. To maximize the chance of detecting any errors significant enough to affect users’ decisions, CPAs allocate more of their testing to transactions most likely to be in error. Several accounting research studies have documented the most error-prone transactions for medium-size manufacturing companies. End-of-period adjustment errors such as failure to provide adequate product warranty liability, failure to include items that should be expensed and end-of-period transactions recorded in the wrong period (called cut-off errors) are in the top category and thus receive a great deal of attention from the auditors. The table below describes the organization of this chapter.

1. **The accounting cycle**

The Exhibit above presents the basic steps in the **accounting cycle.** As initially discussed in class, the accounting cycle is the process followed by entities to analyze and record transactions, adjust the records at the end of the period, prepare financial statements, and prepare the records for the next cycle. **During** the accounting period, transactions that result in exchanges between the company and other external parties are analyzed and recorded in the general journal in chronological order (journal entries), and the related accounts are updated in the general ledger (T-accounts). In this chapter, we examine the **end-of-period** steps that focus primarily on adjustments to record revenues and expenses in the proper period and to update the statement of financial position accounts for reporting purposes.

**Unadjusted Trial Balance**

Before adjusting the accounting records, managers normally review an unadjusted trial balance. A **trial balance** is a spreadsheet that lists the names of the T-accounts in one column, usually in financial statement order, with their ending debit or credit balances in the next two columns. Debit balances are indicated in the left column and credit balances are indicated in the right column. Then the two columns are totaled to provide a check on the equality of the debits and credits. Errors in a generated trial balance may exist if wrong accounts and/or amounts are used in the journal entries. Once equality is established, the accounts on the trial balance can be reviewed to determine if there are any adjustments that need to be recorded.

Purpose of Adjustments

Accounting systems are designed to record most recurring daily transactions, particularly those involving cash. As cash is received or paid, it is recorded in the accounting system. In general, this focus on cash works well, especially when cash receipts and payments occur in the same period as the activities that produce revenues and expenses. However, cash is not always received in the period in which the company earns revenue; likewise, cash is not always paid in the period in which the company incurs an expense.

How does the accounting system record revenues and expenses when one transaction is needed to record a cash receipt or payment and another transaction is needed to record revenue when it is earned or an expense when it is incurred? The solution to the problem created by such differences in timing is to record **adjusting entries** at the end of every accounting period, so that

* Revenues are recorded when they are earned (the **revenue principle)**,
* Expenses are recorded when they are incurred to generate revenue (the **matching principle)**,
* **Assets** are reported at amounts that represent the probable future benefits remaining at the end of the period, and
* **Liabilities** are reported at amounts that represent the probable future sacrifices of assets or services owed at the end of the period.

Companies wait until the **end of the accounting period** to adjust their accounts in this way because adjusting the records daily would be very costly and time-consuming. Adjusting entries are required every time a company wants to prepare financial statements for external users.

Types of Adjustments

The Exhibit below describes the four types of adjustments (two in which cash was already received or paid and two in which cash will be received or paid). Each of these types of adjustments involves two entries:

**1.** One for the cash receipt or payment.

**2.** One for recording the revenue or expense in the proper period through the adjusting entry.

|  |  |
| --- | --- |
| **Adjusting entries that increase revenues** |  |
| Deferred revenues | Previously recorded as liabilities that were created when cash was received in advance; liabilities that must now be reduced for the amount of revenue actually earned during the period. |
| Accrued revenues | Revenues that have been earned but not yet recorded because cash will be received after the services are performed or goods delivered |
| **Adjusting entries that increase expenses** |  |
| Deferred expenses | Previously recorded assets such as prepaid rent, supplies and equipment that were created when cash was paid in advance and that must be reduced for the amount of the expense actually incurred during the period through the use of the asset. |
| Accrued expenses | Expenses that have been incurred but not yet recorded because cash will be paid after the goods or services are used. |

In practice, almost every account could require an adjustment. Rather than trying to memorize an endless list of specific examples, you should focus instead on learning the general types of adjustments that are needed and the process that is used to determine how to adjust the accounts.

Adjustment Process

In analyzing adjustments at the end of the period, there are three steps:

**Step 1**

**Ask: Was revenue earned or an expense incurred that is not yet recorded?** If the answer is YES, credit the revenue account or debit the expense account inthe adjusting entry.

**Step 2**

**Ask: Was the related cash received or paid in the past or will it be received or paid in the future?**

If cash **was received** in the past (creating a deferred revenue [liability] account in the past) → Reduce the liability account (usually Unearned Revenue) that was recorded when cash was received because some or all of the liability has been earned since then.

If cash **will be received** in the future → Increase the receivable account (such as Interest Receivable or Rent Receivable) to record what is owed by others to the company (creates accrued revenue).

If cash **was paid** in the past (creating a deferred expense account [asset] in the past) → Reduce the asset account (such as Supplies or Prepaid Expenses) that was recorded in the past because some or the entire asset has been used since then.

If cash **will be paid** in the future → Increase the payable account (such as Interest Payable or Wages Payable) to record what is owed by the company to others (creates an accrued expense).

**Step 3**

**Compute the amount of revenue earned or expense incurred.**

Sometimes the amount is given or known, sometimes it must be computed, and sometimes it must be estimated.

**A QUICK REVIEW**

Adjustments are necessary at the end of the accounting cycle to record all revenues and expenses in the proper period and to reflect the proper valuation for assets and liabilities.

• **Deferred revenues** (liabilities) have balances at the end of the period because cash was received before it was earned. If all or part of the liability has been satisfied by the end of the period, revenue needs to be recorded and the liability reduced.

• **Accrued revenue** adjustments are necessary when the company has earned revenue, but the cash will be received in the next period. Since nothing has yet been recorded, revenue needs to be recognized and an asset (a receivable) increased.

• **Deferred expenses** (assets) have balances at the end of the period because cash was paid in the past by the company for the assets. If all or part of the asset has been used to generate revenues in the period, an expense needs to be recorded and the asset reduced.

• **Accrued expense** adjustments are necessary when the company has incurred an expense but the cash will be paid in the next period. Since nothing has yet been recorded, an expense needs to be recognized and a liability (a payable) increased.

**EXERCISE**

For practice, complete the following adjustments using the three-step process outlined in the chapter: Determine if revenue was earned or an expense incurred; (2) determine if cash was received or paid in the past or will be received or paid in the future; and (3) compute the amount.

Mombasa Flippers, a scuba diving and instruction business, completed its first year of operations on December 31, 2010.

*AJE 1:* Mombasa Flippers received Ksh.6, 000 from customers on November 15, 2010, for diving trips to the Mombasa in December and January. The Ksh.6, 000 was recorded in Unearned Revenue on that date. By the end of December, one-third of the diving trips had been completed.

*AJE 2:* On December 31, 2010, Mombasa Flippers provided advanced diving instruction to 10 customers who will pay the business Ksh.800 in January. No entry was made when the instruction was provided.

*AJE 3:* On September 1, 2010, Mombasa Flippers paid Ksh.24, 000 for insurance for the 12 months beginning on September 1. The amount was recorded as Prepaid Insurance on September 1.

*AJE 4:* On March 1, 2010, Mombasa Flippers borrowed Ksh.300, 000 at 12 percent. Interest is payable each March 1 for three years.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Revenue earned or expense incurred | Cash received/ paid in the past or cash to be received/ paid in the future | Amount | Adjusting entry  Accounts | Debit | Credit |
| AJE1 |  |  |  |  |  |  |
| AJE2 |  |  |  |  |  |  |
| AJE3 |  |  |  |  |  |  |
| AJE4 |  |  |  |  |  |  |

PREPARING FINANCIAL STATEMENTS

Before we prepare a complete set of financial statements, we update the trial balance to reflect the adjustments and provide us with adjusted balances for the statements. In the original trial balance, four columns are added. Two are used to reflect the adjustments to each of the accounts. The other two are the updated balances, determined by adding (or subtracting) across each row.

Again, we note that the total debits equal the total credits in each of the columns. It is from these adjusted balances that we will prepare an income statement, a statement of stockholders’ equity (which includes a column for Retained Earnings), and The statement of financial position.

As we learned earlier, the financial statements are interrelated—that is, the numbers from one statement flow into the next statement. The Exhibit below illustrates the interconnections among the statements using the fundamental accounting equation. Starting on the bottom right, notice that

* Revenues minus expenses yield net income on the **Income Statement.**
* Net income (or net loss) and dividends to stockholders affect Retained Earnings and any additional issuances of stock during the period affect the balance in Contributed Capital, both on the **Statement of Changes in Equity.**
* Stockholders’ Equity is a component of the **statement of financial position.**

Thus, if a number on the income statement changes or is in error, it will impact the other statements. The Exhibit also includes special labels for the accounts. The statement of financial position accounts is considered **permanent,** indicating that they retain their balances from the end of one period to the beginning of the next. Revenue, expense, gain, and loss accounts are **temporary** accounts because their balances accumulate for a period, but start with a zero balance at the beginning of the next period.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets= | Liabilities + | Stockholders’ equity |  |  |
|  |  | Stockholders’ equity= | Contributed capital + | Retained earnings |
|  |  |  |  |  |
|  |  | Retained earnings= | Net Income/ loss - | Dividends paid |
|  |  |  | Net Income/ Loss= | Revenue - Expenses |
| Revenue/ Expenses and dividends paid are Temporary accounts. All others are permanent accounts | | | | |

**TRIAL BALANCE ADJUSTMENT**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | Adjustments | | Adjusted trial balance | |
| **Date** | **Description** | **DR** | **CR** | **DR** | **CR** | **DR** | **CR** |
|  |  | **Ksh.** | **Ksh.** | **Ksh.** | **Ksh.** | **Ksh.** | **Ksh.** |
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**ILLUSTRATION QUESTION: ADJUSTMENTS**

We take a look at the accounting activities of Terrific Lawn Maintenance Corporation by illustrating the activities at the end of the accounting cycle: the adjustment process, financial statement preparation, and the closing process. No adjustments had been made to the accounts to reflect all revenues earned and expenses incurred in April. The trial balance for Terrific Lawn on April 30, 2010, based on the unadjusted balances, is as follows:

|  |  |  |
| --- | --- | --- |
| TERRIFIC LAW MAINTENANCE CORPORATION  Unadjusted trial balance as at April 30, 2010 | | |
| Cash | 5032 |  |
| Accounts receivable | 1700 |  |
| Notes Receivable | 0 |  |
| Prepaid expenses | 300 |  |
| Equipment | 4600 |  |
| Accumulated depreciation |  | 0 |
| Land | 3750 |  |
| Accounts payable |  | 220 |
| Wages payable |  | 0 |
| Utilities payable |  | 0 |
| Notes payable |  | 3700 |
| Interest payable |  | 0 |
| Income tax payable |  | 0 |
| Unearned revenue |  | 1600 |
| Contributed capital |  | 9000 |
| Retained earnings |  | 0 |
| Mowing revenue |  | 5200 |
| Interest revenue |  | 12 |
| Wages expense | 3900 |  |
| Fuel expense | 410 |  |
| Insurance expense | 0 |  |
| Utilities expense | 0 |  |
| Depreciation expense | 0 |  |
| Interest expense | 40 |  |
| Income tax expense | 0 |  |
|  |  |  |
|  | 19,732 | 19,732 |

Additional information follows:

*a.* One-fourth of the Ksh.1, 600 cash received from the city at the beginning of April for future mowing service has been earned in April. The Ksh.1, 600 in Unearned Revenues represents four months of service (April through July).

*b.* Insurance costing Ksh.300 providing coverage for six months (April through September) paid by Terrific Lawn at the beginning of April has been partially used in April.

*c.* Mowers, edgers, rakes, and hand tools (equipment) have been used in April to generate revenues. The company estimates Ksh.300 in depreciation each year.

*d.* Wages have been paid through April 28. Employees worked the last two days of April and will be paid in May. Wages accrue at Ksh.200 per day.

*e.* An extra telephone line was installed in April at an estimated cost of Ksh.52, including hookup and usage charges. The bill will be received and paid in May.

*f.* Interest accrues on the outstanding notes payable at an annual rate of 12 percent. The Ksh.3, 700 in principal has been outstanding all month.

*g.* The estimated income tax rate for Terrific Lawn is 35 percent.

***Required:***

**1.** Using the three-step process outlined in this chapter, (1) determine if a revenue was earned or an expense incurred that needs to be recorded for the period, (2) determine whether cash was or will be received or paid, and (3) compute the amount. Prepare the adjusting journal entries for April.

**2.** Prepare an adjusted trial balance.

**3.** Prepare an income statement, statement of stockholders’ equity, and balance sheet from the amounts in the adjusted trial balance. Include earnings per share on the income statement. The company issued 1,500 shares.

**4.** Prepare the closing entry for April 30, 2010.

**5.** Compute the company’s net profit margin for the month.

NB: All figures are in thousands of Ksh.

NB: in doing adjustments, you will not always be given all the account titles (in this illustration, you have been given the favor of having the accounts with zero balances included). In that case, you are supposed to create the accounts yourself.

**Recording Seven Typical Adjusting Entries**

Dittman’s Variety Store is completing the accounting process for the year just ended, December 31,

2011. The transactions during 2011 have been journalized and posted. The following data with respect to adjusting entries are available:

*a.* Wages earned by employees during December 2011, unpaid and unrecorded at December 31, 2011,

amounted to Ksh.2,700. The last payroll was December 28; the next payroll will be January 6, 2012.

*b.* Office supplies on hand at January 1, 2011, totaled Ksh.450. Office supplies purchased and debited to Office Supplies during the year amounted to Ksh.500. The year-end count showed Ksh.275 of supplies on hand.

*c.* One-fourth of the basement space is rented to Heald’s Specialty Shop for Ksh.560 per month, payable

monthly. On December 31, 2011, the rent for November and December 2011 had not been collected

or recorded. Collection is expected January 10, 2012.

*d.* The store used delivery equipment that cost Ksh.60,500; Ksh.12,100 was the estimated depreciation for

2011.

*e.* On July 1, 2011, a two-year insurance premium amounting to Ksh.2,400 was paid in cash and debited in

full to Prepaid Insurance. Coverage began on July 1, 2011.

*f.* The remaining basement of the store is rented for Ksh.1,600 per month to another merchant, M. Carlos,

Inc. Carlos sells compatible, but not competitive, merchandise. On November 1, 2011, the store collected

six months’ rent in the amount of Ksh.9,600 in advance from Carlos; it was credited in full to

Unearned Rent Revenue when collected.

*g.* Dittman’s Variety Store operates a repair shop to meet its own needs. The shop also does repairs for

M. Carlos. At the end of December 31, 2011, Carlos had not paid Ksh.800 for completed repairs. This

amount has not yet been recorded as Repair Shop Revenue. Collection is expected during January

2012.

***Required:***

1. Identify each of these transactions as a deferred revenue, deferred expense, accrued revenue, or accrued expense.

2. Prepare the adjusting entries that should be recorded for Dittman’s Variety Store at December 31, 2011.

**Recording Seven Typical Adjusting Entries**

Cardon’s Boat Yard, Inc., repairs, stores, and cleans boats for customers. It is completing the accounting process for the year just ended, November 30, 2012. The transactions during 2012 have been journalized and posted. The following data with respect to adjusting entries are available:

*a.* Cardon’s winterized (cleaned and covered) three boats for customers at the end of November, but did

not record the service for Ksh.2,700.

*b.* On October 1, 2012, Cardon’s paid Ksh.1,200 to the local newspaper for an advertisement to run every

Thursday for 12 weeks. All ads have been run except for three Thursdays in December to complete the

12-week contract.

*c.* Cardon’s borrowed Ksh.250,000 at a 12 percent annual interest rate on April 1, 2012, to expand its boat

storage facility. The loan requires Cardon’s to pay the interest quarterly until the note is repaid in three

Years. Cardon’s paid quarterly interest on July 1 and October 1.

*d.* The Johnson family paid Cardon’s Ksh.4,500 on November 1, 2012, to store its sailboat for the

winter until May 1, 2013. Cardon’s credited the full amount to Unearned Storage Revenue on

November 1.

*e.* Cardon’s used boat-lifting equipment that cost Ksh.220,000; Ksh.22,000 was the estimated depreciation for

2012.

*f.* Boat repair supplies on hand at December 1, 2011, totaled Ksh.16, 500. Repair supplies purchased and

debited to Supplies during the year amounted to Ksh.46,000. The year-end count showed Ksh.12,400 of the supplies on hand.

*g.* Wages earned by employees during November 2012, unpaid and unrecorded at November 30, 2012,

amounted to Ksh.3,800. The next payroll date will be December 5, 2012.

***Required:***

**1.** Identify each of these transactions as a deferred revenue, deferred expense, accrued revenue, or

accrued expense.

1. Prepare the adjusting entries that should be recorded for Cardon’s at November 30, 2012.