CHAPTER 3

Adjusting the Accounts

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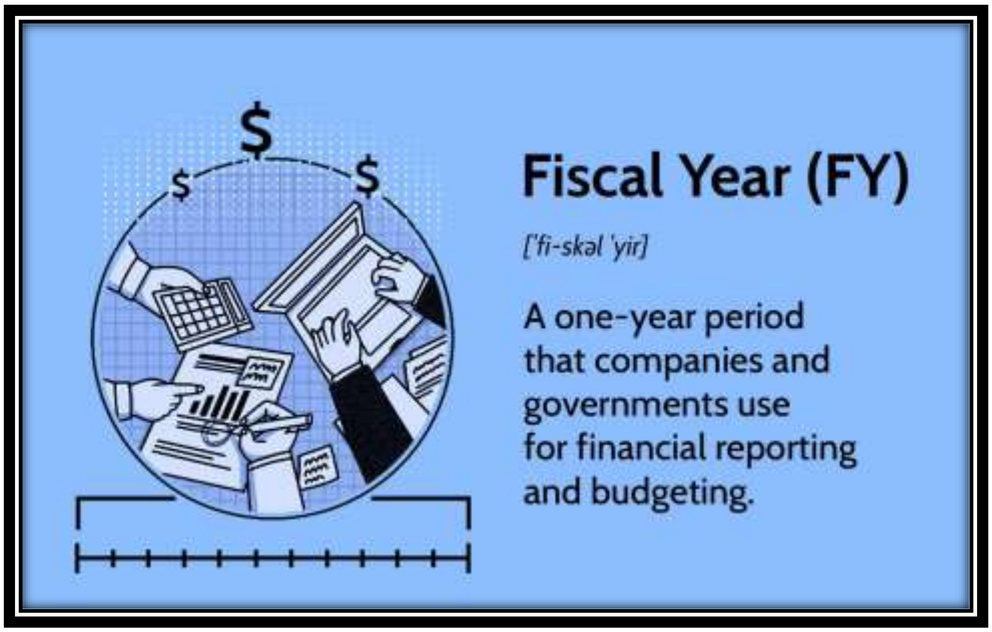
FISCAL YEAR & CALENDAR YEAR

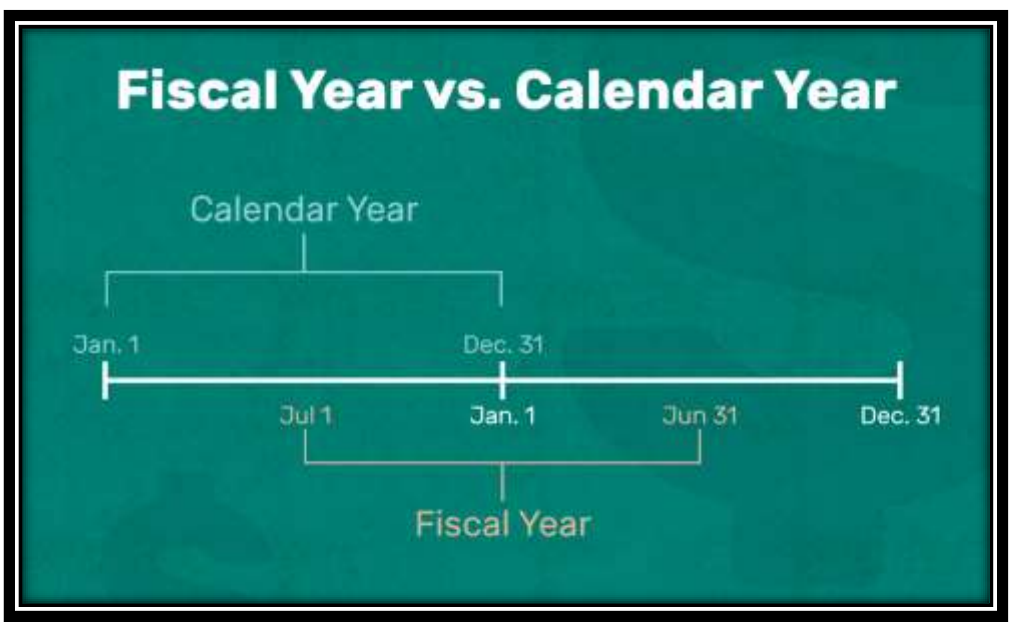
❖ Fiscal Year

An accounting time period that is one year in length is a **fiscal year**. A fiscal year usually begins with the first day of a month and ends 12 months later on the last day of a month.

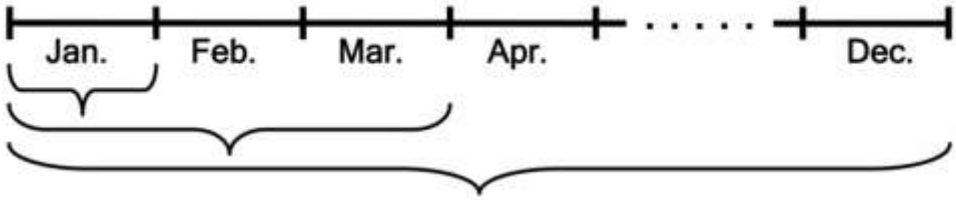
❖ Calendar Year

Many businesses use the **calendar year** (January 1 to December 31) as their accounting period.





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



Generally a

- **month**,
- **quarter**, or
- **year**.

> **Alternative Terminology**
> The time period assumption is also called the *periodicity assumption*.

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

ACCRUAL-BASIS VS CASH-BASIS ACCOUNTING

Accrual-Basis Accounting: An accounting system in which:

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

Cash-Basis Accounting

1. Revenues are recognized when cash is received
2. Expenses are recognized when cash is paid
3. Not in accordance with the generally accepted accounting principles (GAAP).

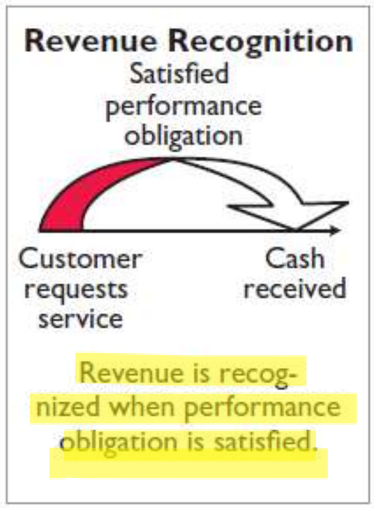
Question:

1. Why do accrual-basis financial statements provide more useful information than cash-basis statements?

RECOGNIZING REVENUES AND EXPENSES

❖ Revenue Recognition Principle

When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. When the company meets this performance obligation, it recognizes revenue. The **revenue recognition principle** therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. **In a nutshell**, revenue is recognized in the period in which when performance obligation satisfied.



Example 1:

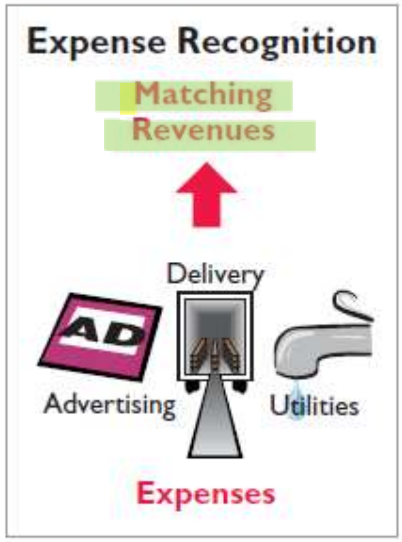
Assume that Dave's Dry Cleaning cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July. Dave's should record revenue in June when it performed the service (satisfied the performance obligation) rather than in July when it received the cash. At June 30, Dave's would report a receivable on its balance sheet and revenue in its income statement for the service performed.

Example 2:

Your business provides tax services for a client. Once their tax return has been completed, you forward a copy of your invoice to your client, who has agreed to pay the bill within the next 30 days. You **can recognize** the revenue **immediately**, since the **services have already been delivered**.

❖ Expense Recognition Principle

Accountants follow a simple rule in recognizing expenses: **"Let the expenses follow the revenues."** Thus, expense recognition is tied to revenue recognition. This practice of expense recognition is referred to as the **expense recognition principle** (often referred to as the **matching principle**).



Example 1:

A salesman earns a 5% commission on sales shipped and recorded in January. The commission of $5,000 is paid in February. You should record the commission expense in January, so that the expense is recognized in the same month as the associated sale.

Example 2:

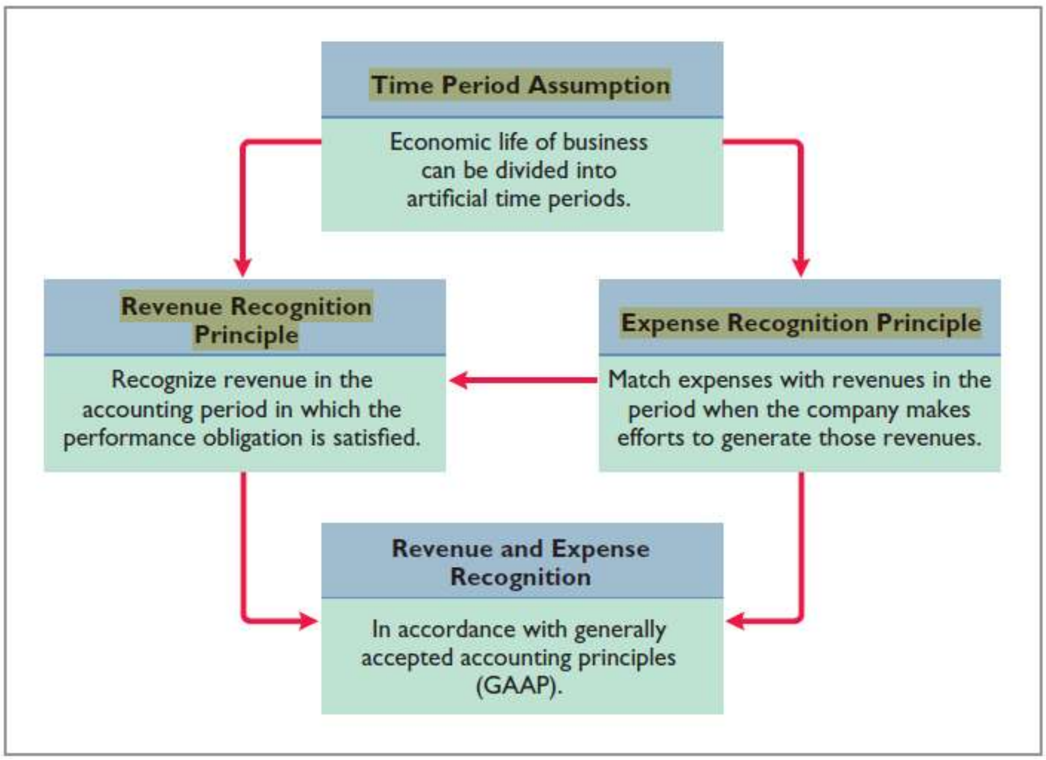
A company acquires production equipment for $100,000 that has a projected useful life of 10 years. It should charge the cost of the equipment to depreciation expense at the rate of $10,000 per year for ten years, so that the expense is recognized over the entirety of its useful life.

Example 3:

A company sells 50 units of a product for **$5,000**. The cost of the goods sold for these units is **$2,000**. The company should recognize the entire $2,000 cost as expense in the same reporting period as the sale, since the recognition of revenue and the cost of goods sold are tightly linked.

❖ Time Period Assumption

If we could wait to prepare financial statements until a company ended its operations, no adjustments would be needed. At that point, we could easily determine its final balance sheet and the amount of lifetime income it earned. However, most companies need immediate feedback about how well they are doing. For example, management usually wants monthly financial statements. The Internal Revenue Service requires all businesses to file annual tax returns. Therefore, accountants divide the economic life of a business into artificial time periods. This convenient assumption is referred to as the **time period assumption**.



ADJUSTING ENTRIES

❖ What is Adjusting Entry?

Adjusting entries are the entries made at the **end of an accounting period** to ensure that companies follow the **revenue recognition** and **expense recognition** principles.

❖ The Need for Adjusting Entries

1. Adjusting entries ensure that the **revenue recognition** and **expense recognition** principles are followed.
2. Adjusting entries are necessary because the **trial balance data** may not contain **up-to-date and complete data**.
3. Adjusting entries are required every time a company prepares financial statements. The company analyzes each account in the trial balance to determine whether it is complete and up-to-date for financial statement purposes. That means, **to comply with the time period assumption**, adjusting entries are necessary.

❖ Types of Adjusting Entries

Adjusting entries are classify ed as either **prepaids/deferrals** or **accruals**. Each of these classes has two subcategories.

❖ **Prepaids/Deferrals:** Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals to record the portion of the prepayment that represents the expense incurred or the revenue for services performed in the current accounting period.

1. Prepaid expenses: Expenses paid in cash before they are used or consumed.
2. Unearned revenues: Cash received before services are performed.

❖ **Accruals:** Accruals are either accrued revenues or accrued expenses. Companies make adjusting entries for accruals to record revenues for services performed and expenses incurred in the current accounting period that have not been recognized through daily entries.

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.

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

❖ How do the adjusting entries differ from other journal entries?

1. Adjusting entries are made only **at the end** of the period.
2. Adjusting entries never affect the Cash account.
3. All adjusting entries debit or credit
   - at least one **income statement** account (a revenue or an expense), and
   - at least one **balance sheet** account (an asset or a liability).

DO IT – 1

Adjusting Entries for Prepaids/Deferrals

The ledger of Hammond Company, on March 31, 2017, includes these selected accounts before adjusting entries are prepared.

	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 one-half of the unearned service revenue.

Required:

i. Prepare the adjusting entries for the month of March

Solution: The adjusting entries for the month of March 31, 2017 are shown below:

No.	Account Titles and Explanation	Debit	Credit
March 31 1	Insurance Expense Prepaid Insurance (To record insurance expired)	100	 100
2	Supplies Expense Supplies (To record supplies used)	2,000	 2,000
3	Depreciation Expense Accumulated Depreciation—**Equipment** (To record monthly depreciation)	200	 200
4	Unearned Service Revenue Service **Revenue** (To record revenue for services performed)	4,600	 4,600

DO IT - 2

Adjusting Entries for Accruals

Micro Computer Services began operations on August 1, 2017. At the **end of August** 2017, 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:

i. Prepare the **adjusting entries** needed at August 31, 2017.

Solution: The adjusting entries for the month of August 31, 2017 are shown below:

No.	Account Titles and Explanation	Debit	Credit
August 31 1	Salaries and Wages **Expense** Salaries and Wages **Payable** (To record accrued salaries)	800	800
2	Interest **Expense** Interest **Payable** (To record accrued interest) $30,000*10%*(1/2) = $250	250	250
3	Accounts Receivable Service **Revenue** (To record revenue for services performed)	1,100	1,100

Practice Exercise

Evan Watts, D.D.S., opened a dental practice on January 1, 2017. During the first month of operations, the following transactions occurred.

1. Watts performed services for patients totaling $2,400. These services have not yet been recorded.
2. Utility expenses incurred but not paid prior to January 31 totaled $400.
3. Purchased dental equipment on January 1 for $80,000, paying $20,000 in cash and signing a $60,000, 3-year note payable. The equipment depreciates $500 per month. Interest is $600 per month.
4. Purchased a one-year malpractice insurance policy on January 1 for $12,000.
5. Purchased $2,600 of dental supplies. On January 31, determined that $900 of supplies were on hand.

Instruction:

i. Prepare the adjusting entries on January 31.

Solution: The adjusting entries for the month of January 31, 2017 are shown below:

No.	Account Titles and Explanation	Debit	Credit
January 31	Accounts Receivable	2,400	
1	Service Revenue		2,400
	(To record revenue for services performed)		
2	Utilities **Expense**	400	
	Utilities **Payable**		400
	(To record accrued utilities)		
3	Depreciation **Expense**	500	
	Accumulated Depreciation—**Equipment**		500
	(To record monthly depreciation)		
	Interest **Expense**	600	
	Interest **Payable**		600
	(To record accrued interest)		
4	Insurance **Expense**	1,000	
	Prepaid Insurance		1,000
	(To record insurance expired) ($12,000/12)		
5	Supplies **Expense**	1,700	
	Supplies		1,700
	(To record supplies used) ($2,600-$900)		

Practice Problem

The Green Thumb Lawn Care Company began operations on **April 1**. **At April 30**, the trial balance shows the following balances for selected accounts.

Prepaid Insurance	$ 3,600
Equipment	28,000
Notes Payable	20,000
Unearned Service Revenue	4,200
Service Revenue	1,800

Analysis reveals the following additional data.

1. Prepaid insurance is the cost of a 2-year insurance policy, effective April 1.
2. Depreciation on the equipment is $500 per month.
3. The note payable is dated April 1. It is a 6-month, 12% note.
4. **Seven customers** paid for the company's 6-month lawn service package of $600 beginning in April. The company **performed services** for these customers in April.
5. Lawn services performed for other customers but not recorded at April 30 totaled $1,500.

Instruction:

i. Prepare the adjusting entries for the month of April. Show computations

Solution: The adjusting entries for the month of April 30 are shown below:

No.	Account Titles and Explanation	Debit	Credit
April 30 1	Insurance **Expense** Prepaid Insurance (To record insurance expired) $3,600/24 = $150 per month	150	150
2	Depreciation **Expense** Accumulated Depreciation—Equipment (To record monthly depreciation)	500	500
3	Interest **Expense** Interest Payable (To record interest on notes payable) $20,000*12%*(1/12) = $200	200	200
4	Unearned Service Revenue Service **Revenue** (To record revenue for services performed) $600/6 = $100 $100 per month * 7 = $700	700	700
5	Accounts Receivable Service Revenue (To record revenue for services performed)	1,500	1,500

Summary Problem 3-1

The trial balance of Super Employment Services, Inc., pertains to December 31, 2014, the end of Super's annual accounting period. Data needed for the adjusting entries include the following:

a. Supplies on hand at year-end, $200.
b. Depreciation on furniture, $2,000.
c. Depreciation on building, $1,000.
d. Salaries owed but not yet paid, $500.
e. Accrued service revenue, $1,300.
f. $3,000 of the unearned service revenue has been earned.

Requirement:

i. Journalize Super's adjusting entries at December 31, 2014.

Summary Problem 3-2

Cloud Break Consulting, Inc., has the following information at June 30, 2014:

CLOUD BREAK CONSULTING, INC.
Unadjusted Trial Balance
June 30, 2014

No	Account Title	Debit	Credit
1	Cash	$ 131,000	
2	Accounts receivable	104,000	
3	Supplies	4,000	
4	Prepaid rent	27,000	
5	Land	45,000	
6	Land	300,000	
7	Accumulated depreciation—building		155,000
8	Accounts payable		159,000
9	Unearned service revenue		40,000
10	Common stock		50,000
11	Retained earnings		52,000
12	Retained earnings	7,000	
13	Service revenue		450,000
14	Salary expense	255,000	
15	Rent expense	25,000	
16	Miscellaneous expense	8,000	
		906,000	**906,000**

Cloud Break must make adjusting entries for the following items:

a. Supplies on hand at year-end, $1,000.
b. Nine months of rent ($27,000) were paid in advance on April 1, 2014.
c. Depreciation expense on the building of $12,000 has not been recorded.
d. Employees work Monday through Friday. The weekly payroll is $5,000 and is paid every Friday. June 30, 2014, is a Monday.
e. Service revenue of $15,000 must be accrued.
f. Cloud Break received $40,000 in advance for consulting services to be provided evenly from January 1, 2014, through August 31, 2014. None of the revenue from this client has been recorded.

Requirement:

i. Journalize Cloud Break's adjusting entries at June 30, 2014