Adjusting the Accounts

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## Accrual vs Cash-Basis Accounting

Everything that we have been doing so far falls into the category of **Accrual-Basis Accounting**. This states that companies should record revenues and expenses in the period in which they occur. For example, if we perform a service, we should record the revenue for that service in the time period in which the service was performed, even if the payment for the service has not been received. In this case, accounts receivable will be debited.

This is opposed to **Cash-Basis Accounting**, which states that companies should only record revenues and expenses when the actual cash is received or paid out. Unfortunately, Cash-Basis Accounting produces misleading financial statements. Essentially, it fails to record accounts receivable and accounts payable. Thus, Cash-Basis Accounting is not in accordance with Generally Accepted Accounting Principles (GAAP). For all these reasons, Cash-Basis Accounting is only ever used in small scale companies, not larger ones.

## Recognizing Revenues and Expenses

### Revenue Recognition Principle

The **Revenue Recognition Principle** essentially restates the basis of Accrual-Basis Accounting. Revenues should be recorded in the accounting period in which they were earned.

### Matching Principle

Every revenue also has some expenses attached to it. The **Matching Principle** states that expenses should be reported in the same period in which they were incurred. For example, if we earn service revenue in an accounting period, we should record the salaries expense for those services in the same accounting period, regardless of whether or not we actually paid the expenses.

## Adjusting Entries

Sometimes, we have revenues and expenses that are not directly recorded in the accounting period in which they occur. For example, if we pay for 12 months of insurance at the start of the year, we have a prepaid insurance. However, the actually monthly insurance needs to be recorded. If we do not record this, we would be breaking the matching principle in this case.

To avoid breaking the revenue recognition and matching principles, accountants use **adjusting entries**. Essentially, we can bring our accounts up-to-date using these adjusting entries.

Adjusting entries are of two types:

1. **Deferrels** – These are of two types, Prepaid Expenses and Unearned Revenues
2. **Accruals** – These are also of two types, Accrued Revenue and Accrued Expenses.

We have already seen **Prepaid Expenses**, which are assets, and **Unearned Revenues**, which are liabilities. **Accrued Revenues** are assets, since they are revenues for which payment has not yet been received. **Accrued Expenses** are liabilities, since they are expenses that have been incurred but have not yet been paid.

### Supplies

Consider that we bought supplies worth but only used worth of supplies in this accounting period. If we show the entire amount as our expense in a single accounting period (the period in which we bought the supplies), the amount of expenses for the month would be misleading. At the same time, we have used up some of our supplies, so the assets being reported is also inaccurate. To deal with this, we make an adjusting entry to show the actual expense.

Thus, the supplies that were bought were essentially the company paying a prepaid expense.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Supplies | | Dr. | 2,500 |  |
|  | Cash | Cr. |  | 2,500 |

For the entry above, the adjusting entry would be like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Supplies Expense | | Dr. | 1,500 |  |
|  | Supplies | Cr. |  | 1,500 |

### Insurance

We have actually seen Prepaid Insurance and its adjusting entry before. It follows the same logic as the one provided for supplies. It is also a prepaid expense.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Prepaid Insurance | | Dr. | 600 |  |
|  | Cash | Cr. |  | 600 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Insurance Expense | | Dr. | 50 |  |
|  | Prepaid Insurance | Cr. |  | 50 |

### Depreciation

**Depreciation** is the allocation of the cost of an asset over the lifetime of the asset. Essentially, we do not show the expense of some assets at the time they are bought. Instead, we show smaller expenses over the time for which the asset is used.

Depreciation can be done in many ways, the simplest of which is the **straight-line** method, which just means the expense shown per month is the same.

If we buy a piece of furniture for and intend to use it for years, then the yearly depreciation is .

We also have to take the **salvage value** into account. This is the value remaining for the asset at the end of its usable life. For example, say we have decided that we will sell a piece of furniture at the end of a 10-year period. Thus, the value at which we will be able to sell it at that time is the salvage value.

The **accumulated depreciation** is the total decrease in the value of the asset due to depreciation. The remaining value is the **Book Value**. This entry is made in the balance sheet.

|  |  |  |  |
| --- | --- | --- | --- |
| Office Equipment | | 5,000 |  |
| Less: Accumulated Depreciation  – Office Equipment | | 40 |  |
|  | Book Value  – Office Equipment |  | 4,960 |

If we can sell something for more than its booking value, we are at a profit.

Depreciation is a **non-cash expense**, and is thus a debit. Accumulated depreciation is a **contra-asset**, meaning it decrease the value of an asset, and is thus a credit.

Depreciation is a prepaid expense. The adjusting entry for depreciation is given below.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Depreciation Expense | | Dr. | 40 |  |
|  | Accumulated Depreciation  - Office Equipment | Cr. |  | 40 |

### Unearned Revenue

We have also seen the adjusting entry for unearned revenue before. Not adjusting it would cause us to have an incorrect liability and revenue amount.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cash | | Dr. | 400 |  |
|  | Unearned Revenue | Cr. |  | 400 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unearned Revenue | | Dr. | 400 |  |
|  | Service Revenue | Cr. |  | 400 |

### Accrued Revenues

Accrued revenues must be adjusted when the payment is made. Otherwise, the accounts receivable and the cash amounts will be incorrect.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Accounts Receivable | | Dr. | 200 |  |
|  | Service Revenue | Cr. |  | 200 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cash | | Dr. | 200 |  |
|  | Accounts Receivable | Cr. |  | 200 |

### Accrued Interest

Accrued interest occurs when the total interest amount is paid at the end of the contract. For example, if we have a note payable for $5000 at 12% interest for 3 months, we should be paying $50 per month, since the interest rate is for 1 year (this is always the case for interest). We should show this expense monthly, even if we pay it together at the end of the period. At the end, we should make an adjustING entry when the accrued expense is actually paid.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Oct 31 | Interest Expense | | Dr. | 50 |  |
|  |  | Interest Payable | Cr. |  | 50 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Nov 30 | Interest Expense | | Dr. | 50 |  |
|  |  | Interest Payable | Cr. |  | 50 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Dec 31 | Interest Expense | | Dr. | 50 |  |
|  | Interest Payable | | Dr. | 100 |  |
|  | Note Payable | | Dr. | 5000 |  |
|  |  | Cash | Cr. |  | 5150 |

### Accrued Salaries

Accrued Salaries are a form of Accrued Expense that piles up because salaries are not paid at the moment that the work is done. For example, suppose we have made one payment on October 26. On October 31, we have to create our journal. Say there were 3 working days between October 26 and October 31. If we pay $400 dollars per day, then the adjusting entry on October 31 will be like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Salaries Expense | | Dr. | 1,200 |  |
|  | Salaries Payable | Cr. |  | 1,200 |

Suppose the next payday is November 09. On that day, we pay the salaries payable as well as the extra expenses for the rest of the working days. Suppose there were 9 working days between October 31 and November 09.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Salaries Payable | | Dr. | 1,200 |  |
| Salaries Expense | | Dr. | 2,800 |  |
|  | Cash | Cr. |  | 4,000 |

Example

Adjusting entries are made in the same format as a journal. Note that all adjusting entries are made on the last day of the accounting period. For complicated calculations, we also have to show the calculation directly below the corresponding journal entry.

1. $900 of supplies have been used during the month.
2. Travel expense incurred but not pain on May 31, 2010, $250
3. The insurance policy is for 2 years.
4. $400 of the balance in the unearned service revenue account remains unearned at the end of the month.
5. May 31 is a Wednesday, and employees are paid on Fridays. Hambone Consulting has two employees, paid $800 each for a 5-day work week.
6. The office furniture has a 5-year life with no salvage value. It is being depreciated at $170 per month for 60 months.
7. Invoices representing $1,200 of services performed during the month have no been recorded as of May 31.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Hambone Consulting | | | | | | |
| Adjusting Entries | | | | | | |
| Date | Accounts Title | | | Ref. | Debit ($) | Credit ($) |
| 2010 |  |  |  |  |  |  |
| May 31 | Supplies Expense | | Dr. |  | 1400 |  |
|  |  | Supplies | Cr. |  |  | 1400 |
| May 31 | Utilities Expense | | Dr. |  | 150 |  |
|  |  | Utilities Payable | Cr. |  |  | 150 |
| May 31 | Insurance Expense | | Dr. |  | 250 |  |
|  |  | Prepaid Insurance | Cr. |  |  | 250 |
|  |  | | |  |  |  |
| May 31 | Unearned Service Revenue | | Dr. |  | 2500 |  |
|  |  | Service Revenue | Cr. |  |  | 2500 |
| May 31 | Salaries Expense | | Dr. |  | 2000 |  |
|  |  | Salaries Payable | Cr. |  |  | 2000 |
| May 31 | Depreciation Expense | | Dr. |  | 250 |  |
|  |  | Accumulated Depreciation - Office Equipment | Cr. |  |  | 250 |
| May 31 | Accounts Receivable | | Dr. |  | 1000 |  |
|  |  | Service Revenue | Cr. |  |  | 1000 |

## Adjusted Trial Balance

After we have made the adjusting entries in the journal, we also need to modify the original trial balance and create an **adjusted trial balance**.

|  |  |  |
| --- | --- | --- |
| Hambone Consulting | | |
| Trial Balance | | |
| May 31, 2010 | | |
| Account Title | Debit ($) | Credit ($) |
| Cash | 5700 |  |
| Accounts Receivable | 6000 |  |
| Supplies | 1900 |  |
| Prepaid Insurance | 3600 |  |
| Office Furniture | 10200 |  |
| Accounts Payable |  | 4500 |
| Unearned Service Revenue |  | 2000 |
| K. Ham, Capital |  | 17700 |
| Service Revenue |  | 7500 |
| Salaries Expense | 3400 |  |
| Rent Expense | 900 |  |
|  | 31700 | 31700 |

|  |  |  |
| --- | --- | --- |
| Hambone Consulting | | |
| Trial Balance | | |
| May 31, 2010 | | |
| Account Title | Debit ($) | Credit ($) |
| Cash | 5700 |  |
| Accounts Receivable | 7200 |  |
| Supplies | 1000 |  |
| Prepaid Insurance | 3450 |  |
| Office Furniture | 10200 |  |
| Accumulated Depreciation - Office Furniture |  | 170 |
| Accounts Payable |  | 4500 |
| Unearned Service Revenue |  | 400 |
| Salaries Payable |  | 960 |
| Travel Payable |  | 250 |
| K. Ham, Capital |  | 17700 |
| Service Revenue |  | 10300 |
| Salaries Expense | 4360 |  |
| Rent Expense | 900 |  |
| Supplies Expense | 900 |  |
| Depreciation Expense | 170 |  |
| Insurance Expense | 150 |  |
| Travel Expense | 250 |  |
|  | 34280 | 34280 |