Completing the Accounting Cycle

Chapter 8

Agenda

The Adjustment Process

- It is critical for F/S to be ***accurate***, ***current***, and ***consistent*** from year to year.
- Responsibility for F/S rests entirely with the company's accountants
- Accountants must ensure that:
  - All accounts are brought up to date
  - Late transactions are taken into account
  - Calculations are correct
  - Accounting principles/standards are followed

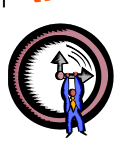
The Adjustment Process

- So accountants must adjust the accounts
  - Done through adjusting journal entries
  - Journal entries assign an amount of ***Revenue*** or ***Expense*** to the appropriate accounting period
  - This brings the accounts up to date
  - Ensures that accounting principles are followed



Time Period Concept

- The time period concept assumes that the economic life of a business can be divided into artificial time periods — generally a month, a quarter, or a year.
- The accounting time period of one year in length is usually known as a fiscal year.
- So accounts must be adjusted at the end of each fiscal period.

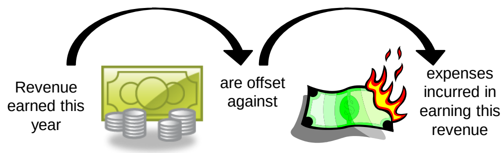



Revenue Recognition Principle

- The revenue recognition principle states that revenue should be recognized in the accounting period in which it is earned not when payment is received.
- In a service business, revenue is usually considered to be earned at the time the service is performed.
- Most customers/clients will pay later
- Some customers/clients pay in advance


Matching Principle

- The practice of expense recognition is referred to as the matching principle.
- The matching principle dictates that **expenses** are to be recognized in the same fiscal period as the **revenue** that they help earn.



Accrual Basis of Accounting

- It means to record Revenue & Expense when they happen
- Revenue is **recorded when earned**, not necessarily when payment is received.

- Expense is recorded when **services or goods are used** in the generation of revenue, not necessarily when payment is made.
- Adheres to the
  - Revenue recognition principle
  - Matching principle

  } GAAP

- Adjusting Entries make these principles HAPPEN!
- Adjusting Entries convert a company's accounting record to accrual basis of accounting.

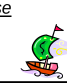
Adjusting Entries

- Adjusting entries are required each time financial statements are prepared**.**

- 5 types of adjusting entries:
  1. Supplies
  2. Prepaid expenses
  3. Unearned revenue
  4. Late arriving purchase invoices
  5. Amortization

Types of Adjusting Entries

1. **Supplies –** you have used supplies but the usage has not been recorded.
2. **Prepaid expenses** — Expenses pre-paid in cash and originally recorded as assets before they are used.
3. **Unearned revenues** — Revenues pre-received in cash and originally recorded as liabilities before they are earned.
4. **Late arriving purchasing invoices** — Expenses incurred but their invoices arrive late and they have not yet been paid.
5. **Amortization** — Allocation of the cost of long-term assets to expense over their useful lives. It's about how to *expense fixed assets* over time.



Supplies

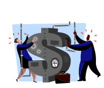
- You buy supplies throughout the year and then take a count at the end of the year to see how much is left. If you bought supplies worth $10,000 and there is $3,000 left, then $7,000 has been used. So supplies account has to be adjusted.

DR Supplies
    CR Cash

ORIGINAL ENTRY

DR **Supplies Expense**
    CR **Supplies**

ADJUSTING ENTRY



Moving a part of asset (supplies) to expense (supplies expense)

Adjusting Entries for Supplies

Starting Supplies = $5,000
ADD Purchases <u>+ $7,000</u>
Total supplies = $12,000
Amount left at end of month <u>= $4,000</u>
THEREFORE, amount used = $8,000

Prepaid Expenses

- Prepaid expenses are assets *(to be used in the future)*
- Prepaid expense adjusting entries are required to record the portion of the prepayment that represents the expense incurred during the period.
- Prepaid expenses expire with the passage of time or through their use.
- Examples of prepaid expenses include rent, insurance, & property tax.

DR Prepaid Rent/Insurance (Asset)
CR Cash — **ORIGINAL ENTRY**

DR **Rent/Insurance Expense** (expense)
CR **Prepaid Rent/Insurance** (Asset) — **ADJUSTING ENTRY**

Moving a part of asset (prepaid rent/insurance) to expense (rent/insurance)

Note: *In a way, all assets are prepaid expenses that are expensed overtime through adjusting entries*.

Unearned Revenue

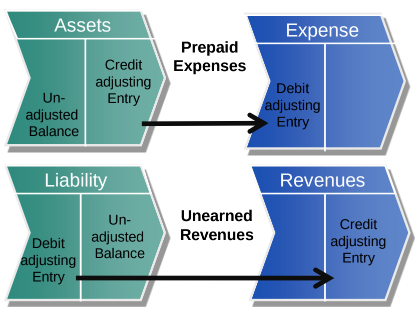
- **Unearned revenues** are revenues received and recorded as liabilities before they are earned. These are payments customers/clients make in advance.
- Unearned revenues are subsequently earned by performing a service or providing a good to a customer.
- Examples of unearned revenues include rent, magazine subscriptions, airplane tickets, and tuition.

DR Cash
CR Unearned Revenue (liability) — **ORIGINAL ENTRY**

DR **Unearned Revenue** (liability)
CR **Revenue** (revenue) — **ADJUSTING ENTRY**

Moving a part of liability (unearned revenue) to revenue

Adjusting Entries Prepayments



Late Arriving Purchase Invoices

- Accrued expenses are expenses **incurred but not yet paid**.
- Some purchase invoices arrive late.

DR **Expense**
CR **Cash** or **A/P** — **ADJUSTING ENTRY**

Ensures that all expenses are recorded

Amortization

- The process of allocating the cost of a long-term asset to expense, over its useful life in a rational and systematic manner.
- Rule: **<u>expense a portion of the value of an</u> asset** in *every accounting period*. This process is used to recover the cost of long-term assets.
- Amortization attempts to **match** the *<u>cost</u>* of a long-term asset to the *<u>revenue</u>* it generates in each period.
- Amortization is an *estimate* rather than a factual amount of the cost of long-term asset for that period.

Reason for Amortization

- **<u>Matching principle</u>** states that **expenses** are to be recognized in the same fiscal period as the **revenue** that they help earn.
- Long lasting **assets**, therefore, must be **expensed** over *a longer period of time* to reflect the matching principle.

Amortization

❖ Two methods:

1. Straight-line: record decrease in value of fixed asset evenly

   Amortization = **Cost – Salvage Value** / **Years** (of useful life)

2. Declining Balance: accelerated decrease in value in early years where greater use

   Amortization= Book value x CCA allowance %

Net Book value = Cost – Accumulated Amortization

CCA = Capital Cost % allowed by government, e.g., Autos 30%, Equipment 20%, Buildings (brick 5%), Buildings (wood) 10%, etc.

Amortization

ADJUSTING ENTRY

DR Amortization Expense – Name of Asset
CR Accumulated Amortization – Name of Asset

- Accumulated Amortization is a **contra asset** a/c:
  - It has a CR balance.
  - It is subtracted from the asset account on B/S.

Note: *Assets help generate revenue and amortization is used to move a portion of asset value to the expenses section.*

Amortization
Straight Line

❖ Automobile *cost* $**20,000**, *salvage* (residual) value $**4,000**, **8** useful *years*

❖ Calculate first year's depreciation and adjusting entry:

Dr. **Amortization Expense**, Auto	**2000**
Cr. **Accumulated Amortization**, Auto	**2000**
(20,000-4,000)/8	

Amortization

Balance Sheet Presentation

Office equipment	**$5,000**
Less: *Accumulated amortization*	**83**
Net Book Value	**$4,917**

Estimate

NBV = **Cost of an Asset** – **AA**

Amortization

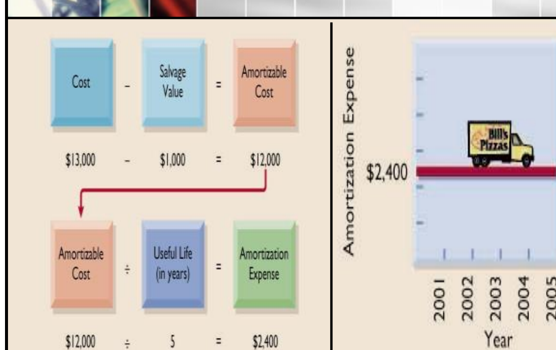
❖ Cost of Long Term Asset: the amount paid for the asset.

❖ Useful Life: an estimate of expected life of the asset in number of years.

❖ Salvage Value: estimate of the asset's value at the end of its useful life.

❖ Use straight line method to calculate amortization expense for the year.

Straight Line Method



Amortization: An Example

- Purchased furniture for $10,000. Useful life is 4 years. Salvage value is $0.

DR Furniture 10,000
CR Cash 10,000

Amortization calculation using the straight-line method:
($10,000 - $0) / 4 years = $2,500 per year

DR Amortization Expense, Furniture 2,500
CR A/A, Furniture 2,500

Amortization on B/S and I/S

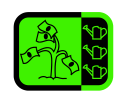
Balance Sheet		Income Statement	
Furniture	**$10,000**	Rent Expense	**2,000**
Less: AA	**2,500**	Amortization Expense	**2,500**
Net Book Value	**$ 7,500**		**$ 4,500**

Summary of Adjusting Entries

Type of Adjustment	Account Relationship	Accounts Before Adjustment	ADJUSTING ENTRY
Supplies	Assets & Expenses	Assets Overstated Expenses Understated	DR Supplies Exp CR Supplies
Prepaid Expenses	Assets & Expenses	Assets overstated Expenses understated	DR Expense CR Prepaid Asset
Unearned Revenues	Liabilities & Revenues	Liabilities overstated Revenues understated	DR Unearned Rev CR Revenue
Late Arriving Purchase Invoices	Expenses & Assets/Liabilities	Liabilities Understated Expenses Understated	DR Expense CR Cash or A/P
Amortization	Expense & Contra Asset	Expenses Understated Assets Overstated	DR Amort Exp CR A/A

Adjusted Trial Balance

- An Adjusted TB is prepared after all adjusting entries have been journalized and posted.
- Financial statements can be prepared directly from the adjusted trial balance.

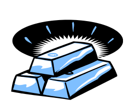


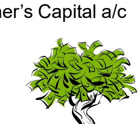
Closing Entries

- B/S accounts are permanent and I/S accounts are temporary
- All temporary accounts must be closed
- Updates the owner's capital account in the ledger by transferring net income (loss) and owner's drawings to owner's capital.
- Closes the temporary accounts (revenue, expense, drawings) for next year's transactions by reducing their current balances to '0'.

Temporary VS Permanent Accounts

TEMPORARY	PERMANENT
These accounts **are closed** to the Balance Sheet accounts	These accounts **are not closed** to the Balance Sheet accounts
All Revenue Accounts	All Asset Accounts
All Expense Accounts	All Liability Accounts
Owner's Drawings a/c	Owner's Capital a/c





Closing Entries STEPS

1. DR revenue account for its balance, and CR the owner's capital account for total revenue

   DR Revenue

   CR Owner's Capital

2. DR owner's capital account for total expenses, & CR each expense account for its balance

   DR Owner's Capital

   CR Expense Accounts

3. DR owner's capital for the balance in the owner's drawings account & CR owner's drawings for the same amount.

   DR Owner's Capital

   CR Owner's Drawings

DR & CR the opposite to close each temporary account.

Note: *These procedures may also apply to HST. The end of HST reporting period may also be the end of fiscal period. In this case, remove all reported amounts from your HST Payable and HST Recoverable accounts to prepare them for the next reporting period.*

Accounting Cycle Steps