CHAPTER

3

ADJUSTING THE ACCOUNTS

TIME PERIOD ASSUMPTION

- The time period (or periodicity) assumption assumes that the economic life of a business can be divided into artificial time periods — generally a month, a quarter, or a year.
- Periods of less than one year are called interim periods.
- The accounting time period of one year in length is usually known as a fiscal year.

REVENUE RECOGNITION PRINCIPLE

- The revenue recognition principle states that revenue should be recognized in the accounting period in which it is earned.
- In a service business, revenue is usually considered to be earned at the time the service is performed.
- In a merchandising business, revenue is usually earned at the time the goods are delivered.

THE MATCHING PRINCIPLE

- The practice of expense recognition is referred to as the matching principle.
- The matching principle dictates that efforts (expenses) be matched with accomplishments (revenues).

ACCRUAL BASIS OF ACCOUNTING

- Adheres to the
  - Revenue recognition principle
  - Matching principle
- Revenue recorded when earned, not only when cash received.
- Expense recorded when services or goods are used or consumed in the generation of revenue, not only when cash paid.

GAAP

CASH BASIS OF ACCOUNTING

- Revenue recorded only when cash received.
- Expense recorded only when cash paid.

ADJUSTING ENTRIES

- Adjusting entries make the revenue recognition and matching principles

HAPPEN!

ILLUSTRATION 3-3
TRIAL BALANCE

Pioneer Advertising Agency
Trial Balance
October 31, 2002

	Debit	Credit
Cash	$ 15,200	
Advertising Supplies	2,500	
Prepaid Insurance	600	
Office Equipment	5,000	
Notes Payable		$ 5,000
Accounts Payable		2,500
Unearned Revenue		1,200
C.R. Byrd, Capital		10,000
C.R. Byrd, Drawings	500	
Service Revenue		10,000
Salaries Expense	4,000	
Rent Expense	900	
	$ 28,700	$ 28,700

The Trial Balance is analysed to determine the need for adjusting entries.

ADJUSTING ENTRIES

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

- Adjusting entries can be classified as

  1. prepayments (*prepaid expenses* or *unearned revenues*),
  2. accruals (*accrued revenues* or *accrued expenses*), or
  3. estimates (*amortization*).

TYPES OF ADJUSTING ENTRIES

Prepayments

1. **Prepaid Expenses** — Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned Revenues** — Revenues received in cash and recorded as liabilities before they are earned.

TYPES OF ADJUSTING ENTRIES

Accruals

1. **Accrued Revenues** — Revenues earned but not yet received in cash or recorded.
2. **Accrued Expenses** — Expenses incurred but not yet paid in cash or recorded.

TYPES OF ADJUSTING ENTRIES

Estimates

1. **Amortization —** Allocation of the cost of capital assets to expense over their useful lives.

PREPAYMENTS

- Prepayments are either prepaid expenses or unearned revenues.
- Adjusting entries for prepayments are required to record the portion of the prepayment that represents

  1. the expense incurred or,

  2. the revenue earned in the current accounting period.

PREPAID EXPENSES

- Prepaid expenses are expenses paid in cash and recorded as assets before they are used or consumed.
- Prepaid expenses expire with the passage of time or through use and consumption.
- An *asset-expense* account relationship exists with prepaid expenses.

PREPAID EXPENSES

- Prior to adjustment, assets are overstated and expenses are understated.
- The adjusting entry results in a debit to an expense account and a credit to an asset account.
- Examples of prepaid expenses include supplies, rent, insurance, and property tax.

UNEARNED REVENUES

- Unearned revenues are revenues received and recorded as liabilities before they are earned.
- Unearned revenues are subsequently earned by performing a service or providing a good to a customer.
- A *liability-revenue* account relationship exists with unearned revenues.

UNEARNED REVENUES

- Prior to adjustment, liabilities are overstated and revenues are understated.
- The adjusting entry results in a debit to a liability account and a credit to a revenue account.
- Examples of unearned revenues include rent, magazine subscriptions, airplane tickets, and tuition.

ACCRUALS

- A different type of adjusting entry is accruals.
- Adjusting entries for accruals are required to record revenues earned and expenses incurred in the current period.
- The adjusting entry for accruals will increase both a balance sheet and an income statement account.

ACCRUED REVENUES

- Accrued revenues may accumulate with the passing of time or through services performed but not billed or collected.
- An *asset-revenue* account relationship exists with accrued revenues.
- Prior to adjustment, assets and revenues are understated.
- The adjusting entry requires a debit to an asset account and a credit to a revenue account.
- Examples of accrued revenues include accounts receivable, rent receivable, and interest receivable.

ACCRUED EXPENSES

- Accrued expenses are expenses incurred but not yet paid.
- A *liability-expense* account relationship exists.
- Prior to adjustment, liabilities and expenses are understated.
- The adjusting entry results in a debit to an expense account and a credit to a liability account.
- Examples of accrued expenses include accounts payable, rent payable, salaries payable, and interest payable.

ILLUSTRATION 3-6
FORMULA TO CALCULATE INTEREST

Face Value of Note	x	Annual Interest Rate	x	Time (in Terms of One Year)	=	Interest
$5,000	x	6%	x	1/12	=	$25

AMORTIZATION

- Amortization is the process of allocating the cost of certain capital assets to expense over their useful life in a rational and systematic manner.
- Amortization attempts to match the *cost* of a long-term, capital asset to the *revenue* it generates each period.

AMORTIZATION

- Amortization is an *estimate* rather than a factual measurement of the cost that has expired.

We're not attempting to reflect the

actual change in value of an asset!

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AMORTIZATION

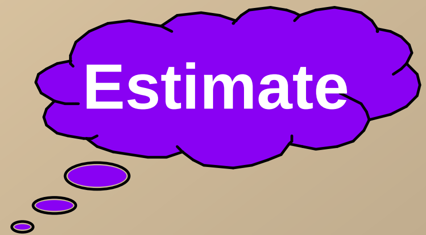
- **In recording amortization, Amortization Expense is debited and a contra asset account, Accumulated Amortization, is credited.**
- **The difference between the cost of the asset and its related accumulated amortization is referred to as the net book value of the asset.**

Amortization Expense		Accumulated Amortization	
XXX			XXX

AMORTIZATION

Balance Sheet Presentation

Office equipment	**$5,000**
Less: Accumulated amortization	**<u>83</u>**
Net book value	**<u>$4,917</u>**



SUMMARY OF ADJUSTING ENTRIES

Type of Adjustment	Account Relationship	Accounts before Adjustment	Adjusting Entry
1. Prepaid expenses	Assets and expenses	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
2. Unearned revenues	Liabilities and revenues	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
3. Accrued revenues	Assets and revenues	Assets understated Revenues understated	Dr. Assets Cr. Revenues
4. Accrued expenses	Expenses and liabilities	Expenses understated Liabilities understated	Dr. Expenses Cr. Liabilities
5. Amortization Exp	Expense and contra asset	Expenses understated Assets overstated	Dr. Amort. Cr. Accum. Amortization

ADJUSTED TRIAL BALANCE

- An Adjusted Trial Balance is prepared after all adjusting entries have been journalized and posted.
- It shows the balances of all accounts at the end of the accounting period and the effects of all financial events that have occurred during the period.
- It proves the equality of the total debit and credit balances in the ledger after all adjustments have been made.
- Financial statements can be prepared directly from the adjusted trial balance.

TRIAL BALANCE AND ADJUSTED TRIAL BALANCE COMPARED

Pioneer Advertising Agency
Trial Balance
October 31, 2002

	Before Adjustment		After Adjustment	
	Debit	Credit	Debit	Credit
Cash	$ 15,200		$ 15,200	
Accounts Receivable			**200**	
Advertising Supplies	2,500		**1,000**	
Prepaid Insurance	600		**550**	
Office Equipment	5,000		5,000	
Accumulated Amort'n.				**$ 83**
Notes Payable		$ 5,000		5,000
Accounts Payable		2,500		2,500
Unearned Revenue		1,200		**800**
Salaries Payable				**1,200**
Interest Payable				**25**
C.R. Byrd, Capital		10,000		10,000
C.R. Byrd, Drawings	500		500	
Service Revenue		10,000		**10,600**
Adv. Supplies Expense			**1,500**	
Amortization Expense			**83**	
Insurance Expense			**50**	
Salaries Expense	4,000		**5,200**	
Rent Expense	900		**900**	
Interest Expense			**25**	
	$ 28,700	$ 28,700	$ 30,208	$ 30,208

PREPARING FINANCIAL STATEMENTS

Financial statements can be prepared directly from an adjusted trial balance.

1. The ***income statement*** is prepared from the revenue and expense accounts.

2. The ***statement of owner's equity*** is derived from the owner's capital and drawings accounts and the net income (or net loss) shown in the *income statement*.

3. The ***balance sheet*** is then prepared from the asset and liability accounts and the ending owner's capital balance as reported in the *statement of owner's equity*.

PREPARATION OF THE INCOME STATEMENT AND THE STATEMENT OF OWNER'S EQUITY FROM THE ADJUSTED TRIAL BALANCE

Pioneer Advertising Agency
Adjusted Trial Balance
October 31, 2002

	Debit	Credit
Cash	$ 15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Amort'n.		$ 83
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		25
C.R. Byrd, Capital		**10,000**
C.R. Byrd, Drawings	**500**	
Service Revenue		**10,600**
Adv. Supplies Expense	**1,500**	
Amortization Expense	**83**	
Insurance Expense	**50**	
Salaries Expense	**5,200**	
Rent Expense	**900**	
Interest Expense	**25**	
	$ 30,208	$ 30,208

Pioneer Advertising Agency
Income Statement
For the Month Ended October 31, 2002

Revenues		
Service Revenue		**$ 10,600**
Expenses		
Adv. Supplies Expense	**$ 1,500**	
Amortization Expense	**83**	
Insurance Expense	**50**	
Salaries Expense	**5,200**	
Rent Expense	**900**	
Interest Expense	**25**	
Total Expenses		**7,758**
Net Income		**$ 2,842**

Pioneer Advertising Agency
Statement of Owner's Equity
For the Month Ended October 31, 2002

C.R. Byrd, Capital, October 1	$ -
Add: Investments	**10,000**
Net income	**2,842**
	12,842
Less: Drawings	**500**
C.R. Byrd, Capital, October 31	$ 12,342

ILLUSTRATION 3-13

PREPARATION OF THE BALANCE SHEET FROM THE ADJUSTED TRIAL BALANCE

Pioneer Advertising Agency
Adjusted Trial Balance
October 31, 2002

	Debit	Credit
Cash	$ 15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Amort'n.		$ 83
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		25
C.R. Byrd, Capital		10,000
C.R. Byrd, Drawings	500	
Service Revenue		10,600
Adv. Supplies Expense	1,500	
Amortization Expense	83	
Insurance Expense	50	
Salaries Expense	5,200	
Rent Expense	900	
Interest Expense	25	
	$ 30,208	$ 30,208

Pioneer Advertising Agency
Balance Sheet
October 31, 2002

Assets

Cash		$ 15,200
Accounts Receivable		200
Advertising Supplies		1,000
Prepaid Insurance		550
Office Equipment	$ 5,000	
Less: Accumulated Amortization	83	4,917
Total Assets		$ 21,867

Liabilities and Owner's Equity

Liabilities	
Notes Payable	$ 5,000
Accounts Payable	2,500
Unearned Revenue	800
Salaries Payable	1,200
Interest Payable	25
Total Liabilities	$ 9,525
Owner's Equity	
C.R. Byrd, Capital	12,342
Total Liabilities and Owner's Equity	$ 21,867

From Statement of Owner's Equity

STEPS IN THE ACCOUNTING CYCLE

1. Analyse transactions

2. Journalize the transactions

3. Post to ledger accounts

4. Prepare a trial balance

5. Journalize and post adjusting entries

6. Prepare adjusted trial balance

7. Prepare financial statements

8. Coming next chapter

9. Coming next chapter