Chapter 3 – Adjusting Accounts for Financial Statements
MGMT 1A

A. The Accounting Cycle – the steps in preparing financial statements. Done every period, over and over. *Financial statements generally prepared monthly, quarterly (Form 10Q for Public Companies) and annual/yearly (Form 10K for Public Companies)*

1. Adjusting Entries – Adjust accounts that are not correct at period end.

   We use an "A" to indicate an adjusting entry (this is something we do just in our accounting courses to help us learn)

Assume a calendar (12/31) year-end:

a. On ___*8/1*_____ we paid one year of advertising expense in advance, _*$12,000*_______.

What is the journal entry?

8/1/ DR: Prepaid Advertising $12,000
CR: Cash $12,000
(To record pre-payment of 1-year advertising)

Prepaid Advertising	
12,000	
	5,000
7,000	

On ___*12/31*____ this account needs to be _*adjusted*__________.

Monthly expense = $12,000 / 12 months = $1,000

A: 12/31 Advertising Expense $5,000
Prepaid Advertising $5,000
(To adjust prepaid advertising at year-end)
*($1,000 per month * 5 months)*

Advertising Expense	
5,000	
5,000	

PRACTICE COUNTING MONTHS!
(All of August (1), September (2), October (3), November (4), December (5) – from 8/1 to 12/31)

b. On ___11/1___ we received __6__ months of rent in advance, _$12,000_____.

What is the journal entry?

11/1	*Cash*	*$12,000*	
	Unearned Rent		*$12,000*
	(To record collection of rent in advance)		

Unearned Rent	
	12,000
4,000	
	*8,000^*

*** Unearned rent = Liability account. Company owes the service of renting the property*

On _12/31_____ this account needs to be _adjusted____________.

$12,000 / 6 months = $2,000 monthly rental revenue

A: 12/31	*Unearned Rent*	*$4,000*		*← $2,000 / month * 2 months (11/1 – 12/31)*
	Rent Revenue		*$4,000*	
	(To record rent earned for 2 months of the year)			

^ The remaining $8,000 of rent will be earned by 4/30/Y2 (1/1/Y2 – 4/30/Y2 = 4 months)

c. On __6/27__ we purchased some supplies for _$800______ cash. At the end of the year,

_$96_______ of supplies remained. What is the journal entry?

Supplies	
800	
	????? *704*
96	

6/27	*Supplies*	*$800*	
	Cash		*$800*
	(To record purchase of supplies)		

We don't record a journal entry to reduce supplies every time an employee grabs a pen, highlighter, post-it, etc.

We count the supplies at the end of the year, and record one adjusting journal entry to correct the account balance.

On 12/31 does this account need to be adjusted? *Yes*

A: 12/31	*Supplies Expense*	*$704*		
	Supplies		*$704*	*← We call this a "Plug": What amount do we need to DR/CR the account to make it balance at a DR = $96? CR $704*

d. We pay workers ___*$100*___________ per day. Every Friday is pay day.

Monday	Tuesday	Wednesday	Thursday	Friday
$100	*$100*	*$100*	*$100*	*$100*

What journal entry would normally be made every Friday?

Salary Expense $500
Cash $500
(To record payment of weekly salaries)

Assume 12/31 is a ___*Tuesday*___________. What is wrong with making the above entry on Friday? *Puts all the Expense in Y2, when part of the expense belongs in Y1.*

12/30/Y1	*12/31/Y1*	*1/1/Y2*	*1/2/Y2*	*1/3/Y2*
Monday	Tuesday	Wednesday	Thursday	Friday
$100	*$100*	*$100*	*$100*	*$100*
$100 + $100 = $200 (Y1)		*$100 + $100 + $100 = $300 (Y2)*		

We need to get $200 of Payroll Expense into Y1; We need to get $300 of Payroll Expense into Y2.

Prepare the appropriate adjusting entry on December 31 (Called an__*accrual*______ entry):

A: 12/31 Payroll Expense $200

Salary Payable (or Accrued Payroll) $200

(To accrue 2 days worth of Payroll and related expense in Y1)

A*ccrual*_____________ = expense now, pay later.

Prepare the appropriate journal entry on January _*3*___: *(Friday is still payday – we don't pay employees early on Tuesday, just because it is the end of the year)*

1/3/Y2 Salary Expense $300
Salary Payable $200 ← Use up accrual (liability now has $0 balance)
Cash $500
(To record Y1 & Y2 salaries paid on Friday)

e. On 1/1, we purchased equipment for __*$10,000*_________. We will use the equipment for

_*5*_____ years.

Equipment $10,000
Cash $10,000
(To record purchase of equipment)

D*epreciate*_______: systematically allocate cost of an asset to the year(s) it will benefit.
Depreciation is an application of the Matching Principle – The equipment is used to generate revenue, the cost (expense) of using the equipment must be matched to the same period

1. Contra-Accounts *– Accumulated Depreciation (A/D)*
   a. They are usually attached to some other account *(A/D is attached to PPE)*
   b. They have the opposite of normal balance *(A/D has a normal CR Balance; PPE has a normal DR balance)*
   c. In preparation of financial statements, they reduce the account to which they are attached *(See below table)*
      i. Balance Sheet Presentation (all 3 parts should be presented):

Balance Sheet – As of December 31, *Year 1*		**YEAR 5**
Equipment	*$10,000*	*$10,000*
Less: Accumulated Depreciation	*($2,000)*	*($10,000)*
Property, Plant & Equipment – Net	*$8,000*	*0* *("fully depreciated")*

f. On _*12/31*______ the equipment needs to be _*depreciated*____________.

A: 12/31 Depreciation Expense $2,000

Accumulated Depreciation $2,000

(To record straight-line depreciation of equipment)

Straight-line depreciation = Cost / Useful Life in years

Straight-line depreciation = $10,000 / 5 years = $2,000 per year

We DO NOT CR: Equipment: (1) Equipment is not smart enough to know it is wearing out (2) Equipment is not worth less, just because we have used part of it up.

Book Value = Accounting Convention (Cost – Accumulated Depreciation) does NOT necessarily reflect what the equipment is worth in the open market.

g. On _*1/15/Y2*_ we receive a utility bill from the city for _*$500*______ for the month of

_*December (Y1)*____________.

Payment is due on _*2/15/Y2*__. Does an adjusting entry need to be recorded *at 12/31/Y1*?
Yes
Even though we don't receive the bill until Y2, the expense relates to Y1 (December) and so we need to record an adjusting entry. Otherwise Y1 expense will be understated. Called an "unrecorded liability".

A: 12/31/Y1	*Utilities Expense*	*$500*	
	Accounts Payable		*$500*
	(To record utilities for December)		

What type of adjusting entry is this? ____*Accrual (Expense now, Pay Later)*_________

2. Adjusting Entries – what do you notice? *Never DR/CR Cash*

   We DR/CR Cash when transactions occur.
   Adjusting entries are not recorded when transactions occur; they are recorded at the end of the accounting period to correct account balances.

   REVIEW:

DEA = LER

D = Dividends (Contra-Equity/Retained Earnings)

E = Expenses

A = Assets

These accounts have a normal DR Balance (go up w/ DR; go down w/CR)

L = Liabilities

E = Equity (Contributions & Retained Earnings)

R = Revenues

These accounts have a normal CR Balance (go up w/CR; go down w/ DR)

Dividends are a distribution of the Company's income to its owners/stockholders. Net Income closes to Retained Earnings, then Retained Earnings are used to distribute dividends. This is also why "dividends" is a component of the Statement of Retained Earnings.

B. Worksheets – Used to help companies prepare financial statements

1. Trial balance – listing of accounts and their balances. Make sure DR = CR

2. Adjusting entries
   a. Journalized and posted on the last day of the period
   b. Entered into the worksheet and the general ledger
   c. Practice using the worksheet:

i. There are ___*$555*_____________ of supplies remaining at December 31.

Supplies	
2,175	*???*
	1,620
555	

What was the balance of supplies in the unadjusted TB? →

A: 12/31 Supplies Expense 1,620
Supplies 1,620
(To record supplies used up)
Then post the entry to the Worksheet (in the Adjustments Column)

ii. On _*12/1*_____ we purchased 3 months of rent in advance.

What was the balance of prepaid rent in the unadjusted TB? $2,250
$2,250 / 3 months = $750 one month's rent expense
A: 12/31 Rent Expense $750
Prepaid Rent $750
(To record December rent expense)
Then post the entry to the Worksheet (in the Adjustments Column)

iii. On _*1/2*_____ we purchased printing equipment we estimate will last us for _*10*_ years.

What was the balance of printing equipment in the unadjusted TB? $20,000
$20,000 / 10 years = $2,000 one year's depreciation expense
A: 12/31 Depreciation Expense $2,000
Accumulated Depreciation $2,000
(To record one year's depreciation expense)
Then post the entry to the Worksheet (in the Adjustments Column)

iv. We pay our employees ____*$40*____ per day. Pay day is on Friday.

The end of the year is on a ____*Tuesday*___________________. *($40 * 2 days)*

A: 12/31 Salary Expense $80
Salaries Payable $80
(To accrue 2 days salaries)

3. Financial Statements

a. Income Statement: Expenses are usually listed from largest to smallest

Bruin Printing, Inc.		
Income Statement		
For the Year Ended 12/31		
Service Revenue		*$8,900*
Operating Expenses		
Depreciation Expense		*$2,000*
Supplies Expense		*$1,620*
Salary Expense		*$880*
Rent Expense		*$750*
Miscellaneous Expense		*$365*
Net Income		*$3,285*

b. Statement of Changes in Retained Earnings

Bruin Printing, Inc.		
Statement of Changes in Retained Earnings		
For the Year Ended 12/31		
Beginning R/E		*$350*
Net Income		*$3,285*
Dividends		*(2,000)*
Ending R/E		*$1,635*

c. Balance Sheet

i. Current Asset: An asset that will be used up or will turn to cash within one year

ii. Assets are usually listed in order of liquidity

iii. Liquidity: how quickly an asset can be converted to cash

iv. Property, Plant & Equipment: cost, less accumulated depreciation = book value. Sometimes called “Plant Assets” or “Fixed Assets”

v. Current Liability: A liability that will be satisfied within a year

vi. Classified Balance Sheet: Groups together current assets, non-current assets, current liabilities, non-current liabilities

Bruin Printing, Inc.			
Balance Sheet			
As of 12/31			
Assets			
Current Assets			
Cash		*5,010*	
Accounts Receivable		*2,050*	
Prepaid Rent		*1,500*	
Supplies		*555*	
Total Current Assets			*9,115*
Property Plant & Equipment			
Printing Equipment		*20,000*	
(Less: Accumulated Depreciation)		*(2,000)*	
Book Value			*18,000*
Total Assets			*27,115*
Liabilities			
Current Liabilities			
Accounts Payable		*1,400*	
Salary Payable		*80*	
Total Current Liabilities			*1,480*
Common Stock		*24,000*	
Retained Earnings		*1,635*	
Total Equity			*25,635*
Total Liabilities and Owners Equity			*27,115*

4. Reversing Entries – optional entries recorded in response to accrual entries
   a. DR and CR are the exact opposite of the accrual:

      A: 12/31 DR: Salary Expense $200
      CR: Salary Payable $200

      R: 1/1 *DR: Salary Payable $200*
      CR: Salary Expense $200

      (I do not see reversing entries used in practice, and we will not use them in our class.)

   b. Advantages: Simplifies entries to be made on pay day:

      1/3 *DR: Salary Expense $500*
      CR: Cash $500

      (Record 1 week salary expense paid on Friday)

   c. Disadvantages: Account starts with an abnormal CREDIT balance

5. Closing Process: Types of Accounts
   a. Permanent Accounts: A balance sheet account. Balance carried forward to the next period.
      i. Assets
      ii. Liabilities
      iii. Retained Earnings

   b. Temporary Accounts: *Accounts are closed out (zeroed out) at the end of each period*
      i. Revenues
      ii. Expenses
      iii. Dividends

   c. Close out all revenue accounts (temporary accounts with CR balances) to Income Summary
   d. Close out all expense accounts (temporary accounts with DR balances) to Income Summary
   e. Close out Income Summary to Retained Earnings
   f. Close out Dividends to Retained Earnings

Closing Entries:

DR: Service Revenue	*$8,900*	
CR: Income Summary		*$8,900*
DR: Income Summary	*$2,000*	
CR: Depreciation Expense		*$2,000*
DR: Income Summary	*$1,620*	
CR: Supplies Expense		*$1,620*
DR: Income Summary	*$880*	
CR: Salary Expense		*$880*
DR: Income Summary	*$750*	
CR: Rent Expense		*$750*
DR: Income Summary	*$365*	
CR: Misc. Expense		*$365*
DR: Income Summary	*$3,285*	
CR: Retained Earnings		*$3,285*
DR: Retained Earnings	*$2,000*	
CR: Dividends		*$2,000*

Service Revenue

	8,900
8,900	
	0

Depreciation Expense

2,000	
	2,000
0	

Supplies Expense

1,620	
	1,620
0	

Salary Expense

880	
	880
0	

Rent Expense

750	
	750
0	

Miscellaneous Expense

365	
	365
0	

Dividends

2,000	
	2,000
0	

Income Summary

	8,900
2,000	
1,620	
880	
750	
365	
2,000	
	3,285
3,285	
	0

Retained Earnings

	350
	3,285
2,000	
	1,635

6. Financial Analysis
   a. Profit Margin – useful measure of a company's operating results
      (reflects the percent of profit in each $ of sales)

      $$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

   b. Current Ratio – assess a Company's ability to pay its' debts in the near-term

      $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

      2:1 is a good target, sign of a healthy company
      Too high (i.e., 9:1) means that the Company is not putting its $ to work to grow the company

Summary: What have we done so far this quarter?

- *Journalized (i.e. moved from journal to ledger = posting) transactions*
- *Prepared a trial balance to make sure DR = CR*
- *Prepared adjusting entries*
- *Prepared financial statements*
- *Prepared closing entries*