

# The Adjusting Process

Chapter 3

## Learning Objective 1

Differentiate between accrual and cash-basis accounting

### Accrual Basis vs. Cash Basis

#### Accrual Basis

Revenues are recognized when earned and expenses are recognized when incurred.

#### Cash Basis

~~Revenues are recognized when cash is received and expenses recorded when cash is paid.~~

**Not GAAP**

### Accrual vs. Cash-Basis: Revenue



Accrual – Revenue recognized when services provided



Cash – Revenue recognized when cash is received

### Accrual vs. Cash-Basis: Expenses

Accrual – Expense recognized when incurred

Cash – Expense recognized when cash is paid

## Learning Objective 2

Define and apply the accounting period concept, revenue, and matching principles

## Accounting Period

- ▶ Businesses prepare financial statements for specific periods to evaluate performance
- ▶ Basic accounting period = one year
  - Calendar year
  - Fiscal year
- ▶ Interim periods
  - Financial statements of less than one year

## Revenue Principle

- ▶ When to record revenue?
  - When it is **earned**
- ▶ What amount of revenue should be recorded?
  - Value of item or service transferred to customer

## The Matching Principle

- ▶ Measure all expenses incurred during the accounting period
- ▶ Match the expenses against the revenues earned during the *same* period

## The Time Period Concept

- ▶ Requires that accounting information be reported at regular intervals
- ▶ Accounts are updated at the end of each accounting period

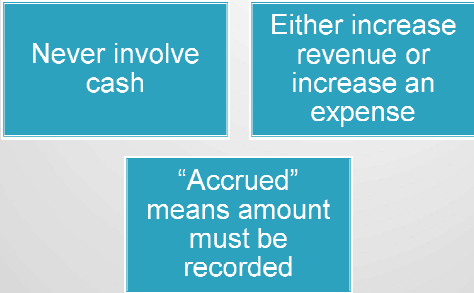
## Learning Objective 3

Explain why adjusting entries are needed

## Adjusting Entries

- ▶ Prepared at end of an accounting period
- ▶ Assign:
  - Revenues to the period when earned
  - Expenses to the period when incurred
- ▶ Update asset and liability accounts
- ▶ Need to properly measure:
  - Net Income
  - Assets & Liabilities

## Adjusting Entry Rules



## Learning Objective 4

Journalize and post adjusting entries

## Types of Adjusting Entries



## Prepaid Expenses

- ▶ Advance payments of expenses
- ▶ Recorded as an asset
- ▶ Adjusting entry records amount used as an expense

## Short Exercise 3-6

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Apr 1	Prepaid rent		4,800	
	Cash			4,800
	<i>Prepaid rent for 6 months</i>			

Prepaid rent	
4/1	4,800

## Short Exercise 3-6 (continued)

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Apr 30	Rent expense		800	
	Prepaid rent			800
	<i>To record rent expired in April</i>			

Prepaid rent		Rent expense	
4/1	4,800	4/30	800
Bal	4,000	4/30	800

## Depreciation

- ▶ Plant assets
  - Long-lived tangible assets used in business operations
- ▶ Depreciation
  - Allocation of a plant asset's cost to expense over its useful life
  - Land is not depreciated

## Depreciation Entry

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
12 31	Depreciation expense		\$\$\$\$	
	Accumulated depreciation			\$\$\$\$

Contra-asset account

Amount calculated based on depreciation method

## Accumulated Depreciation

- ▶ Contra asset
  - Normal credit balance
  - Always paired with related account
- ▶ Holds sum of all depreciation recorded on a plant asset
- ▶ Book value:
  - Cost minus accumulated depreciation

## Accrued Expenses

- ▶ Expenses incurred before payment is made
- ▶ Opposite of a prepaid expense

## Accrued Expense Entries

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Dec 31	Interest expense		\$\$\$\$	
	Interest payable			\$\$\$\$\$
	<i>To record accrued interest</i>			

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Dec 31	Salaries expense		\$\$\$\$	
	Salaries payable			\$\$\$\$
	<i>To record accrued salaries</i>			

## Accrued Revenues

- ▶ Revenue earned before cash is received
- ▶ Results in a receivable

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Dec 31	Accounts receivable		\$\$\$\$	
	Service revenue			\$\$\$\$
	<i>To record accrued revenues</i>			

## Unearned Revenue

- ▶ Cash is collected before revenue is earned
- ▶ Also called deferred revenue

## Unearned Revenue Entries

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Dec 1	Cash		\$\$\$\$\$	
	Unearned revenue			\$\$\$\$\$
	<i>To record cash received before service is provided</i>			

GENERAL JOURNAL				
DATE	DESCRIPTION	REF	DEBIT	CREDIT
Dec 31	Unearned revenue		\$\$\$\$	
	Service revenue			\$\$\$\$
	<i>To record earned portion of unearned revenue</i>			

## Summary of Adjusting Entries

- ▶ To properly measure net income on the income statement
- ▶ To update the balance sheet

## Summary of Adjusting Entries

Category of Adjusting Entry	Debit	Credit
Prepaid expense	Expense	Asset
Depreciation	Expense	Contra asset
Accrued expense	Expense	Liability
Accrued revenue	Asset	Revenue
Unearned revenue	Liability	Revenue

## Learning Objective 5

Explain the purpose of and prepare an adjusted trial balance

## Adjusted Trial Balance

- ▶ Prepared after adjusting entries are posted
- ▶ Useful step in preparing financial statements

Any Company Worksheet December 31, 2010						
Account Title	Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	5,400				5,400	
Supplies	700			a. 500	200	
Equipment	17,000				17,000	
Accum. depr. - Equip.		1,000		b. 1,000		2,000
Accounts payable		200				200
Interest payable				c. 100		100
Note payable		9,000				9,000
Josie Smith, Capital		6,000				6,000
Josie Smith, W/D	1,000				1,000	
Service revenue		12,000				12,000
Rent expense	4,000		a. 500		4,000	
Supplies expense				b. 1,000	500	
Depreciation expense				c. 100	1,000	
Interest expense	100				200	
Totals	27,200	27,200	1,600	1,600	28,300	28,300

## Learning Objective 6

Prepare the financial statements from the adjusted trial balance

## The Financial Statements

Income statement

Statement of owner's equity

Balance sheet

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Any Company Worksheet December 31, 2010		
Account Title	Adjusted Trial Balance	
	Dr.	Cr.
Cash	5,400	
Supplies	200	
Equipment	17,000	
Accum. depr. - Equip.		2,000
Accounts payable		200
Interest payable		100
Note payable		9,000
Josie Smith, Capital		6,000
Josie Smith, W/D	1,000	
Service revenue		12,000
Rent expense	4,000	
Supplies expense	500	
Depreciation expense	1,000	
Interest expense	200	
Totals	28,300	28,300

Balance sheet

Income statement

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## Income Statement

Any Company Income Statement Year ended December 31, 2010	
<b>Revenue:</b>	
Service revenue	\$ 12,000
<b>Expenses:</b>	
Rent expense	\$ 4,000
Depreciation expense	1,000
Supplies expense	500
Interest expense	200
Total expenses	5,700
Net income	\$ 6,300

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## Statement of Owner's Equity

Any Company Statement of Owner's Equity Year ended December 31, 2010	
Josie Smith, Capital, January 1, 2010	\$ 5,000
Add: Net income	6,300
Josie Smith, Capital, December 31, 2010	\$11,300

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Any Company Balance Sheet December 31, 2010	
<b>Assets</b>	
Cash	\$ 5,400
Supplies	200
Equipment	17,000
Less: Accumulated depreciation	<u>(2,000)</u> 15,000
<b>Total assets</b>	<b>\$ 20,600</b>
<b>Liabilities</b>	
Accounts payable	200
Interest payable	100
Notes payable	<u>9,000</u>
<b>Total liabilities</b>	<b>9,300</b>
<b>Owner's equity</b>	
Josie Smith, Capital	<u>11,300</u>
<b>Total liabilities &amp; owner's equity</b>	<b>\$ 20,600</b>

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End of Chapter 3