Chapter 3: The Adjusting Process

Accrual v Cash-basis Accounting

- Two types of accounting:
    - **Accrual accounting:** records the effect of *each transaction as it occurs*. Most businesses use accrual basis.
    - **Cash-basis accounting:** records only cash receipts and cash payments. It ignores receivables, payables and other items. Only very small businesses use the cash-basis accounting.
- Accrual accounting provides more complete information than a cash-basis accounting system. The difference is more complete data.

Why we adjust the accounts

- The trial balance is unadjusted because it omits various transactions.
- Adjusting entries assign revenues to the period when they are earned and expenses to the period when they are incurred.
- Adjustments are needed to properly measure two things:
    - Profit (loss) in the income, and
    - Assets and liabilities in the balance sheet
- The end-of-period process is called *making the adjustments, adjusting the books* or *balance day adjustments.* Remember the following:
        - Adjusting entries never involve the cash account
        - Adjusting entries either:
            - Increase revenue earned (Revenue *credit*), or
            - Increase an expense (Expense *debit*).
        - When information is provided about an adjustment to an account and the information is worded as ‘accrued’ or ‘prepaid’ an amount for a particular account, you journalise the stated amount to the stated account in your adjusting entry.

Two categories of adjusting entries

- Two basic categories:
    - **Prepayments**: in a prepaid adjustment, the cash payment occurs before an expense is recorded or the cash receipt occurs before the revenue is earned.
    - **Accruals**: an accrual records an expense before the cash payment or records the revenue before the cash is received.
- Adjusting entries fall into five types:
    - Prepaid expenses
    - Depreciation of non-current assets
    - Accrued expenses

- Accrued revenues
- Unearned revenues

Prepaid expenses

- **Prepaid expenses** are advance payments of expenses. E.g. rent, insurance and supplies.
- Is considered an asset.
- An asset which is expired is considered an *expense*.

Prepaid Rent

- Some landlords require tenant to pay rent in advance.
- Suppose a company has to pay three months' office rent in advance of $3000 on 1 June 2016. The entry would be:

June 1	Dr		Prepaid rent ($1000 x 3)	3000	
		Cr	Cash		3000

- At **30 June** prepaid rent account is not the same. Because throughout the three months, the prepaid rent should decrease for what is used up (1000 per month).
- The adjusting entry is:

June 30	Dr		Rent Expense ($3000 x 1/3)	1000	
		Cr	Prepaid rent		1000

Depreciation

- Property, plant and equipment assets are long-lived, non-current, tangible assets used in the operation of a business.
- As a business uses non-current assets, their value and usefulness decline.
- The allocation of non-current asset's value to expense is called depreciation.
- A way to calculate depreciation is to divide the cost of the asset (x) by its expected useful life (y). So the depreciation for each month is $\frac{\frac{x}{y}}{12}$.
- Deprecation expense is recorded by the following adjusting entry:

	Dr		Depreciation Expense	xxx	
		Cr	Accumulated Depreciation		xxx

Accumulated Depreciation

- When adjusting entries for depreciation, the original asset account remains constant and a contra asset, accumulated depreciation, is used to show the sum of all the depreciation recorded for the asset.
    - Keeping the original asset cost aids decision making.
- A **contra account** has two main characteristics:
    - It is paired with and follows its related account.
    - It's normal balance (debit or credit) is the opposite of the balance of the related account e.g. Furniture account has a debit balance, therefore Accumulated depreciation would have a credit balance.

Carrying Value (book value)

- Accumulated depreciation is subtracted from its paired main asset. The resulting net amount of a non-current asset is called its **carrying amount**, or sometimes its **book value**.

Carrying value of furniture assets:	
Furniture	*xxx*
Less: Accumulated depreciation – furniture	*yyy*
Carrying amount of the furniture	*zzz*

Accrued Expenses

- Businesses often incur expenses before paying them, this is known as accrued expenses.
- E.g. employees work and accrue a salary. Salary is an expense to the business, however, pays often fortnightly or weekly.

Accruing Salary Expense

- Suppose a company pays salaries on the 17th of the month, and on the 1st of the next month.
    - The entry on the 17th of June would be:

17th June	Dr		Salary Expense	xxx	
		Cr	Cash		xxx

- The trial balance on the 30th June would be:

30th June	Dr		Salary Expense	xxx	
		Cr	Salary Payable		xxx

The second expense will incur on 1st July, however, the expense was incurred in June, so the expense must be recorded in June.

Accrued Revenues

- **Accrued revenue** is a revenue that has been earned but for which the cash hasn't yet been collected.
- The journal entry for accrued revenue earned would be:

Dr		Accounts Receivable	xxx	
	Cr	Service Revenue		xxx

Unearned Revenues

- Receiving cash before earning it creates a liability to perform work in the future, called **unearned revenue**.
    - The business owns a product or a service to the customer, or it owes the customer his or her money back.

Dr		Cash	xxx	
	Cr	Unearned service revenue		xxx

- Unearned service revenue is a liability because the business owes a service to a client in the future.
- Once a business earns the service revenue by completing the task the following entry is made as an adjusting entry:

Dr		Unearned service revenue	xxx	
	Cr	Service revenue		xxx

The Financial Statements

- Financial statements are prepared form the adjusted trial balance.
    - Income Statement → revenues and expenses
    - Statement of Changes in Equity → why capital changed during the period
    - Balance Sheet → assets, liabilities and owners' equity

Preparing Statements

- Financial statements should be prepared in the following order:
  1) Income statement – determine profit or loss
  2) Statement of changes in equity – needs profit or loss from the income statement to calculate ending capital (retained earnings).
  3) Balance sheet – needs ending capital to achieve its balancing feature.

Relationships between the financial statements

- Profit increases capital, a loss decreases capital.
- Transferring ending capital from statement of changes in equity balances the accounting equation in the balance sheet.