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 cashbasis 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:
 - o 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 xx	хх
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.
 - o 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	ууу
Carrying amount of the furniture	<u>zzz</u>

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.
 - o The entry on the 17th of June would be:

17 th June	Dr		Salary Expense	xxx
		Cr	Cash	xxx

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

30th June Dr	Cr	Salary Expense Salary Payable	xxx	xxx
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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:

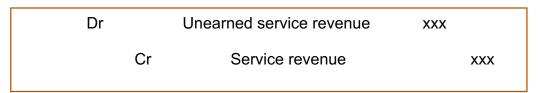


Unearned Revenues

- 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.



- 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:



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.