Accounting: The Adjusting Process

Accounting Methods:

- **Cash Basis Accounting** - revenues and expenses are not recorded until cash is either received or paid.
- **Accrual Basis Accounting** - revenues and expenses are recorded when revenue is earned or when expenses are incurred whether or not cash is received or paid.

Accrual Accounting Principles and Concepts

Time Period Concept. Report the financial results of its activities over a standard time period, which is usually monthly, quarterly, or annually.

Matching Principle. Recording of all expenses in the same period as the revenues these expenses generated. If the future benefit of a cost cannot be determined, it should be charged to expense immediately.

Revenue Recognition Principle. Recording revenue when an entity has substantially completed a revenue generation process. Revenue when it has been earned and not when it has been paid. If an entity receives payment in advance from a customer, then the entity records this payment as a liability, not as revenue. Only after it has completed all work under the arrangement with the customer can it recognize the payment as revenue.

Adjusting Entries

The main purpose of adjusting entries update the accounts to conform with the accrual concept. At the end of the accounting period, some income and expenses may have not been recorded, taken up or updated. Adjusting entries can be divided into five categories:

1. **Prepaid (Deferred) Expenses.** Expenditures paid for in one accounting period, but which will not be used and expensed until a future period. Prepaid expenses are carried on the balance sheet as currents asset until they are expensed (matched with revenues they produced).
2. **Depreciation of Assets.** A method of allocating the cost of a tangible asset over its useful life. This is an example of the matching principle. Businesses depreciate long-term assets for both tax and accounting purposes.
3. **Accrued Expenses.** An accounting expense recognized in the books before it is paid for. It is a liability, and is usually current. Accrued expenses are the opposite of prepaid expenses. Firms will typically incur periodic expenses such as wages, interest and taxes. Even though they are to be paid at some future date, they are indicated on the firm's balance sheet from when the firm can reasonably expect their payment, until the time they are paid.
4. **Accrued Revenues.** An asset class for goods or services that have been sold or completed, but the associated revenue that has not yet been billed to the customer. Accrued revenue is treated as an asset the balance sheet. Accrued revenue must have been earned due to a sale that has occurred and is finalized. When not yet billed/invoiced, accrued revenue must still be reported under generally accepted accounting principles (GAAP).
5. **Unearned (Deferred) Revenues.** Money received by an individual or company for a service or product that has yet to be fulfilled. Unearned revenue can be thought of as a "prepayment" for goods or services that a person or company is expected to produce for the purchaser. As a result of this prepayment, the seller has a liability equal to the revenue earned until delivery of the good or service.

Questions to ask yourself when doing adjusting entries:

1. What is the current balance?
2. What should the balance be?
3. How much is the adjustment?

Deferred (Prepaid) Expenses: Include miscellaneous assets that are paid for in advance and then expire or get used up in the near future: *Debit an expense account and credit the prepaid asset account.* Examples include Rent, Insurance, and Supplies.

Adjusting Journal entry:

____(Any)____ Expense________________________$xxx

____(Any)____ Prepaid Asset___________________$xxx

The value of the prepaid that was used up

Depreciation of Plant Assets represent allocating an asset's cost to an expense account as it is used over its useful life. *Debit an expense account and credit a contra-asset account*.

Why Accumulated Depreciation Instead of Crediting the Original Asset Account?

1. If the original asset account was used then the original cost of the asset would not be reflected in any of the asset accounts.
2. The original cost is needed when assets are sold or disposed
3. The original cost of the asset must be reported on the income tax return of the company

Adjusting Journal entry:

Depreciation Expense, ________________________$xxx

Accumulated Depreciation, ____________________$xxx

Accrued Expenses: Expenses that a business incurs before they are payed: *Debit an expense account and credit a liability account.* Examples include Wages and Interest

Adjusting Journal Entry

____(Any)____ Expense________________________$xxx for the amount

____(Any)____ Payable________________________$xxx ÷ owed

Accrued Revenues: Revenues that a business has earned but are not yet received payment for: *Debit an asset account and credit a revenue account*. Examples include Interest

Adjusting Journal Entry

____(Any)____ Receivable______________________$xxx

____(Any)____ Revenue_______________________$xxx

Deferred (Unearned) Revenues: Cash collected from customers before work is done by the business. The business has a liability to provide a product or service to the customer. Debit a liability account and credit a revenue account.

Adjusting Journal Entry

Unearned Revenue____________________________$xxx for the value of services

Revenue____________________________________$xxx ÷ or products provided

Adjusted Trial Balance:_a list of all ledger accounts with their adjusted balances. These amounts are used in creating the financial statements.

