Transcript: The Adjustment Process – Overview

https://youtu.be/bqU3iSALmAo

This is the first part of kind of a two-parter on the adjustment process. We are learning in this book accrual accounting, and in accrual accounting revenues are reported when they are earned and not necessarily when the cash changes hands. We defined expenses as costs used to earn revenue, so in accrual accounting, expenses are recorded in the period they are consumed or used up to earn revenues. This is in contrast to the cash basis of accounting where the only time we would record anything is if the cash changes hands.

Two basic concepts that are part of generally accepted accounting principles that help explain why we use accrual accounting and why the adjustment process is part of the accounting cycle. The first one is the accounting period concept and it requires accounting data to be recorded and summarized for a period of time and the other is the matching concept. We want to report the revenues earned for the period in which the expenses occurred in generating the revenue, and so, for this reason, when we take a deposit, a business does, for services to be provided in the future, before we provided the service or delivered the product we have, in essence, collected deferred revenue.

Let's say we take, if we take a deposit, what really happens on our books? Well, our cash increases, so we have to record it, right? So we're going to record cash is coming in, and the offset to that is going to be to the account unearned fees. Unearned fees is a liability account, because we haven't earned it yet. If we don't ever provide the service we have to, we would return the money to the customer because we owe our customer when we've collected money in advance, so here again is another, this is a new account, unearned fees.

Another thing that's different about this is that it is a liability account that does not end in the word payable. Now on the other side if we pay an expense on account before we have used the service or consumed the product, we have what's called a deferred expense, and deferred expenses are classified as assets until we use them up.

They're an asset because if we don't use them, you know we might return them and get a refund. We're trying to match it to the period that it belongs to, the accounting period. One very common expense that businesses pay for in advance is insurance. We might pay for it six years in advance. We might pay an annual premium and usually a policy is at least six months.

When we pay insurance in advance, well, we're decreasing our cash, aren't we? But, we're increasing this account called prepaid whatever it is, whatever it might be, in this case prepaid insurance. Prepaid insurance again, is an asset. Okay, so we're going to get into the actual adjustment process. I was just trying to give you some background on things that cause us to have to look at our books to see what we did.

Adjustment Process – Overview in Accrual Accounting

- Revenues are recorded when earned and not necessarily when the cash changes hands.

- Expenses are recorded in the period they are consumed or used up to earn revenue.

- In contrast to the cash basis of accounting when the transactions are recorded only when the cash changes hands.

There are two basic accounting concepts that are part of GAAP that help explain why we use accrual accounting and why the adjustment process is part of the accounting cycle.

1. The accounting period concept – requires data to be recorded and summarized for a period of time.

2. The matching concept – We want to report the revenues earned for the period in which the expenses are incurred in generating the revenue.