**Chapter 3 – The Adjusting Process**

Heretofore, we learned about preparing journal entries from outside sources such as bills, invoices, bank statements, etc. Now we will learn about the accrual process—matching revenue with expenses to properly state how much it costs a business to earn its revenues. Most of this matching process takes place internally within a company and in order to properly match the expenses associated with revenues, internal journal entries are required—these are called “Adjusting Journal Entries.” They are different from journal entries which proceed from external sources.

The requirement to use the matching principle (matching expenses to revenues) comes as a result of preparing financial statements in accordance with GAAP. The financial statements must be correct for a particular period of time (I/S and SOE) and a particular point in time (B/S). Financials statements are normally prepared on a monthly basis (sometimes quarterly and rarely yearly). The business operations continue as normal each day, but the general ledger accounts must be brought up to date as of the date of the financial statements. This artificial deadline is imposed in order to provide the owners and company managers with timely information on how the business is performing.

If the business does not have a GAAP requirement, it may prepare financial statements on a cash basis which recognizes revenue when received and expenses when paid. Accrual accounting (using the matching principle) requires a company to match the expenses to the revenue it earned. Accrual accounting also requires use of the revenue recognition principle which means companies recognize revenue when they have satisfied their performance obligation in relation to the services the company provides. Once hair is cut, dry cleaning done, a product delivered, grass cut, etc. the company has performed its obligation in relation to the revenue irrespective of the date when paid. So once the obligation performance has been met, the company recognizes the revenue even though the funds may not be received from the customer or the customer’s credit card right away.

The same holds true if the company received the cash before you perform the services such as paying for tickets in advance or prepaying for insurance or rent. Since the company has not yet performed the services related to the cash they received, they must report a liability. However, revenue may have been earned as of the financial statement date. The company will then record the revenue earned.

Revenue recognition precedes expense recognition (matching principle). For example, if you have a hair salon, you would match the utility expense, rent expense, supplies expense, salary expense, etc. to the revenue generated for the month. But for these expenses, you could not have earned the revenue.

Adjusting journal entries are necessary to bring the unadjusted trial balance up to date. Once the adjusting journal entries have been made, the trial balance will be updated. It is now termed the “adjusted trial balance.” The hallmark of an adjusting journal entry is that the entry will affect one income statement account and one balance sheet account but never ever cash.

We will learn about six types of adjusting journal entries in this chapter.

1. Prepaid Expenses such as insurance and rent--In a company-to-company transaction, one company will have prepaid expenses and the other company will have unearned revenue.
2. Supplies
3. Depreciation – We will learn about a new account entitled “accumulated depreciation.”
4. Unearned Revenues—In a company-to-company transaction, one company will have unearned revenue and the other company will have prepaid expenses.
5. Accrued Expenses
6. Accrued Revenues

**Prepaid Expenses – Example insurance**

Often insurance is paid in advance. (Think of your own car insurance.) The journal entry would be either:

Prepaid Insurance 2,400 Prepaid Insurance 2,400

Cash 2,400 Accounts Payable 2,400

Accounts Payable 2,400

Cash 2,400

An example: Insurance policy is for 24 months.

An asset prepaid insurance is debited (It is an asset because it benefits future periods. If it had benefited the current period only, it would have been an expense). Cash is reduced with a credit. Or it is purchased on credit (accounts payable) and subsequently paid in cash.

The asset prepaid insurance will become an expense as each month expires to match the expense of the insurance to the revenue it helped to generate for the month. This will be done for each of the 24 months for the policy in our example. To calculate the adjusting journal entry, you must determine the amount of time that has passed to determine the AJE. If one month has passed, then 1/24th of the insurance has changed from an asset to an expense. The AJE would be:

Insurance expense 100

Prepaid insurance 100

Notice both an asset (B/S) and an expense (I/S) account were affected. The general ledger balance of the prepaid insurance account is now reduced by $100.



If the company were to change insurance carriers, they would request a refund but would only receive $2,300 because one month has expired.

If the example were to be prepaid rent, the same dynamics would hold.

**Supplies**

When companies buy several months of supplies at a time, the purchase is considered an asset because it will benefit future periods. (If the supplies are for the current month, it would be considered an expense).

The journal entry would be either:

Supplies 9,720 Supplies 9,720

Cash 9,720 Accounts Payable 9,720

Accounts Payable 9,720

Cash 9,720

When F/S are prepared, the amount of supplies used must be determined in order to match this expense to the revenue it helped to generate. The process to determine the AJE is to count the supplies still on hand and compare the count to the amount in the general ledger to figure out how much must have been used. This is more efficient than requiring someone to sign for each miscellaneous supply they take from the storeroom.

For example, if supplies in the general ledger total $9,720, and the supply count is 8,670 at the end of the month, then (9,720 minus 8,670) $1,050 must have been used by the business during the month.



The AJE would be:

Supplies Expense (I/S) 1,050

Supplies 1,050

The adjusted general ledger amount will be 8,670 which makes sense because it equals the current count of supplies.



**Depreciation**

Companies purchase equipment to produce income. These assets benefit an extended period of time with reference to future periods, and the cost of the asset must be rationally and systematically expensed against future revenues. The rational and systematic allocation of the cost of equipment to expense is called depreciation. It is not a determination of value or impairment of the asset but an allocation of expense.

Depreciation expense is found on the Income Stmt and is the debit in the AJE. The corresponding Balance Sheet account credited is not the asset. Assets are shown on the B/S at the purchase price amount to provide readers of the Financial Stmt with information on the amount spent by the company on its infrastructure. No, rather an account called “Accumulated Depreciation” is credited. Accumulated depreciation is associated with each class of asset and is considered a “contra asset” account. It is contra to the asset (has a normal balance opposite of the normal balance of the account is associated with) and is shown on the balance sheet along with the asset.



This presentation helps financial statement reader know how long an asset has been in service. For example, the book value is the same for both of these companies but which has the newer assets:



Book value of an asset is the historical cost of the asset minus accumulated depreciation.

The AJE for depreciation is determined by several factors:

1. Cost of the asset
2. Salvage value of the asset
3. Useful life of the asset

To calculate depreciation (We will only learn straight line depreciation in this chapter. Later in the semester, we will learn other depreciation methods), let’s look at an example:



We will always use monthly depreciation because the calculation can accommodate monthly, yearly and partial year calculations. The trick is to look at the time period to determine how many months of depreciation expense is warranted. If one month, the AJE:

Depreciation Expense (I/S) 375

Accumulated Depreciation (B/S) 375

**Unearned Revenues**

Many times companies receive money in advance of earning the revenue associated with the money. If the performance obligation has not yet been met by the company, it cannot recognize the revenue. Consider the New Orleans Saints. They are paid in March for games that will not be played until August.

Let’s use an example of a company that is paid in advance for a 60-day contract in the amount of $3,000. The journal entry would be either:

Cash 3,000 Accounts Receivable 3,000

Unearned Revenue 3,000 Unearned Revenue 3,000

Cash 3,000

Accounts Receivable 3,000

Unearned revenue is credited because the company has received either the cash or a promise to pay. They are in possession of the money but have not performed the obligation required to recognize the money as revenue. Instead, they have a liability they must pay back if they do not earn the money. Once a portion of the contract has been fulfilled (or in the case of the Saints, have played a game), the company can recognize the portion it has earned.

In our example, the company has worked on the contracted job for five days when the financial stmts are to be prepared. Thus, the company has earned a portion of the money and can recognize it as revenue and no longer has to show this portion as an obligation.

To calculate:



The AJE would be:

Unearned Revenue 250

Revenue 250



Now, the company will show an obligation of $2,750 related to the contract since it has earned $250.

**Accrued Expenses**

These are expenses the business has incurred but must be internally recognized or “accrued” by the business to property state expenses and liabilities. These expenses have occurred but are not yet paid as of the date of the financial stmts.

**Interest**

Companies borrow from banks to expand their business by buying high dollar value items such as equipment. Interest on loans accumulates daily. The interest on a loan must be recognized in order for all expenses associated with earning revenue is recorded as of the F/S date. Interest is calculated as follows:



The journal entry would be:

Interest Expense (I/S) 50

Interest Payable (B/S) 50

(We will not calculating interest yet but the example includes it to familiarize you with interest calculations).

**Salaries and Wages**

A company must recognize the amount of salaries and wages used to generate revenue but not yet paid as of the date of the F/S.

The calculation is to determine the daily amount of salaries and wages and multiply this amount by the number of days between the last pay day and the date the F/S will be prepared.

Example: Salaries and Wages are $70 per day and there are three days between the last paycheck and the date of the F/S. Thus, the company must recognize salary expense of $210 and salaries payable of $210. The AJE would be:

Salary Expense (I/S) 210

Salaries Payable (B/S) 210

Salary expense is usually the largest expense a company incurs monthly. Some companies who produce monthly GAAP F/S have opted to pay their employees on the 15th and the last day of the month to avoid the headache of calculating accrued salaries and wages especially if there are a large number of employees.

**Accrued Revenues**

These are revenues that have been earned but not billed by month end. An example, a company is working on a consulting job which is not yet completed and billed but has worked on the job for 20 days. Even if the customer were to cancel the job, they would still owe for the 20 days. If the company were to be paid $90 per day, then the company would accrue $1,800 for the 20 days.

Accounts Receivable (B/S) 1,800

Consulting Revenue 1,800

**Adjusted Trial Balance**

Once all of the AJE’s have been prepared and posted to the general ledger, the adjusted trial balance is ready to be prepared. The use of the term “adjusted” indicates to internal managers, the AJE’s have been entered. Upper management will look at the Adjusted Trial Balance to look for normal balances and to determine the amounts are what were anticipated. Now is the time to investigate anything that looks incorrect before the books are closed for the month.

**GAAP Theory Review**

Now that we have learned more about the F/S, let’s review the underlying framework, enhancing qualities, assumptions and principles of GAAP.

1. Framework: Information for F/S readers must be useful. Usefulness implies the following two concepts:
   1. Relevance – The information provided makes a difference to the readers of the F/S and would influence their decisions regarding the company. It must be material (large enough in value related to the company’s financial information. $5,000 may be material for a hair salon but would be immaterial to Apple). The information can be used to form expectations for the company—it has predictive value. It also must have confirmatory value – it will confirm or correct prior expectations.
   2. Faithful representation – The information presented in the F/S and in the notes to the F/S must be accurate, complete, neutral (not biased) and materially error free.
2. Enhancing qualities: Information should be
   1. Comparable to other companies. Everyone is following the same rules of the road.
   2. Consistent – the company uses the same accounting principles and methods from year to year unless otherwise stated.
   3. Verifiable – others following the same principles and methods would achieve the same results.
   4. Timely – F/S should be prepared with sufficient regularity so that information is not too old or stale and therefore useless to decision makers.
   5. Understandable – information should be easily understood and concise.
3. Assumptions
   1. Monetary unit – Only those items that can be expressed in dollars should be included in the F/S.
   2. Economic entity – Only the information related to the company should be included – not personal transactions or other company transactions.
   3. Time period – The company’s accounting system can respond to the need to prepare F/S based on artificial deadlines such as month end, quarter end and year end. Effective F/S can be prepared based on these deadlines.
   4. Going Concern – If the company’s F/S do not state otherwise, the company is assumed to be a viable entity that will continue into the foreseeable future.
4. Principles
   1. Historical Cost – Assets are recorded based on amount paid. Discussed in Chapter 1
   2. Fair Value – For certain assets and liabilities which are traded on the open market, current value may be more useful to decision makers – Discussed in Chapter 1
   3. Revenue Recognition – discussed earlier in this chapter.
   4. Expense Recognition or Matching principle – discussed earlier in this chapter.
   5. Full Disclosure – All relevant information to decision makers that is material should be included in the F/S and its notes.
   6. Cost Constraint – If the cost of providing information is balanced against the benefit to be derived to the readers of the F/S.