Introduction to Business Accounting

Chapter 6 - Adjusting Process

WORKBOOK

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The Purpose of the Adjusting Process

If you recall, the Revenue Recognition Principle requires that all revenue be recorded when it is earned.

The Matching Principle requires all expenses to be properly matched with revenue.

The adjusting process allows bookkeepers to make adjustments to the accounts to ensure all revenue and the applicable expenses are recorded in the period.

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The Adjusting Process

Thus, the adjusting process is the review and updating of accounts at the end of the accounting period before financial statements are prepared to ensure proper revenue and expenses are recorded.

And adjusting entries are the journal entries required to bring accounts up to date at the end of the accounting period

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Cash vs. Accrual Basis

The Cash Basis of accounting states that revenues and expenses are reported on the income statement in the period in which cash is received for revenue or paid for expenses. This IS NOT GAAP!

The Accrual Basis of accounting states that revenues are reported on the income statement in the period in which they are earned and expenses when they are incurred regardless of when cash is received or paid. This IS GAAP!

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Adjusting Process - Defined

The adjusting process occurs for several reasons including:

- Some events are not recorded daily. Examples include the consumption of supplies and employees wages.
- Some revenues and expenses are incurred as time passes rather than as separate transactions.
- Some revenues and expenses may be unrecorded but we do not yet have the bills.

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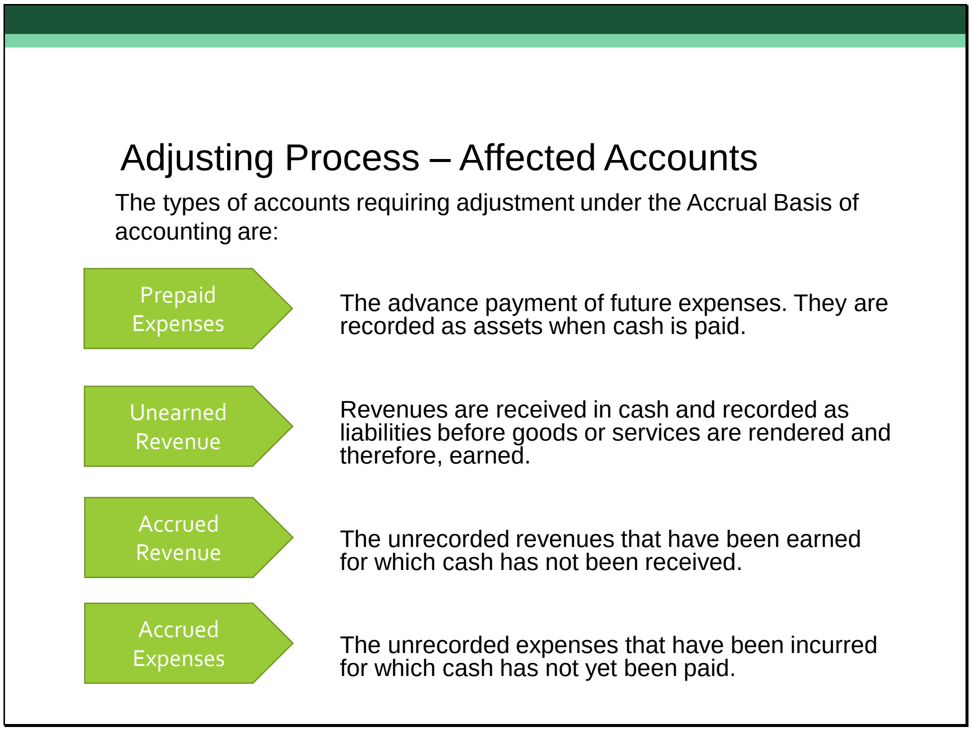
Adjusting Process – Affected Accounts
The types of accounts requiring adjustment under the Accrual Basis of accounting are:
Prepaid Expenses
The advance payment of future expenses. They are recorded as assets when cash is paid.
Unearned Revenue
Revenues are received in cash and recorded as liabilities before goods or services are rendered and therefore, earned.
Accrued Revenue
The unrecorded revenues that have been earned for which cash has not been received.
Accrued Expenses
The unrecorded expenses that have been incurred for which cash has not yet been paid.

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Type of Adjustment	Account Relationship	Adjusting Entry
1 Prepaid Expense	Assets and expenses	Debit Expenses Credit Assets
2 Unearned Revenue	Liabilities and revenues	Debit Liabilities Credit Revenues
3 Accrued Revenue	Assets and revenues	Debit Assets Credit Revenues
4 Accrued Expense	Expenses and liabilities	Debit Expenses Credit Liabilities

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Adjusting Process – Affected Accounts

Fixed assets are the physical land, buildings, equipment and furniture that are owned and used by a business that either have a long useful life or have permanent usefulness. These are also sometimes called Plant Assets.

- All fixed assets, Except Land, lose their usefulness over time; they are said to Depreciate.

- The Depreciation Expense account is used to record the loss in value of a fixed asset due to depreciation.

The most common form of depreciating an asset is straight-line. Equal amounts of depreciation are recorded monthly over the assets useful life.

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Depreciation Adjustment

Straight Line depreciation – An Example

Equipment costing $45,000 is purchased and is said to have a life of 15 years. Depreciation is calculated as follows:

$45,000/15 = $3,000 per year

$3,000 per year/12 months = $250 per month

Note: Useful lives are set by GAAP and tax laws. They are not arbitrary and you cannot extend the life of an asset once set using these guidelines.

Questions

and

Answers

Review Questions:

1. Which of the following types of accounts need adjusting at the end of a period?
    A. Accrued expenses
    B. Unearned revenue
    C. Accrued revenue
    D. All of the above

2. True or False: The useful life of a fixed asset is determined by the Bookkeeper.
    A. True
    B. False

3. True or False: The most common method of depreciation is straight line over the useful life of the asset.
    A. True
    B. False

4. True or False: We make adjusting entries because we use the cash basis of accounting.
    A. True
    B. False

5. Bookkeepers make adjusting entries for which of the following reasons:
    A. Some events are not recorded daily
    B. Some revenues are expensed
    C. Accrued revenue is needed to maximize profit
    D. All of the above

Answer Key:

1. D
   Accrued expenses, unearned revenue, and accrued revenue all need adjusting at the end of a period.

2. B
   False. The useful life of a fixed asset is determined by GAAP and the IRS.

3. A
   True. The most common method of depreciation is straight line over the useful life of the asset.

4. B
   False. We make adjusting entries because we use the accrual basis of accounting.

5. A
   Bookkeepers make adjusting entries because revenue or expenses may have been earned or incurred and have gone unrecorded, as well as the fact that some events are not recorded daily.