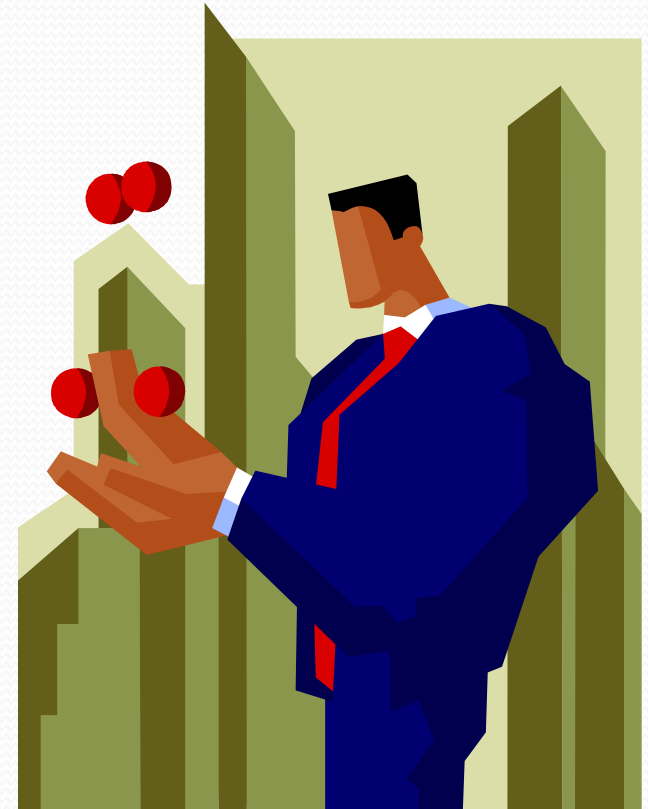


Chapter

4

THE ACCOUNTING CYCLE: Accruals and Deferrals

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At the end of the period, we need to make **adjusting entries** to get the accounts up to date for the financial statements.



Adjusting Entries

Adjusting entries are needed whenever revenue or expenses affect **more than one accounting period.**

Every adjusting entry involves a change in either a **revenue or expense** and an **asset or liability.**

Types of Adjusting Entries

① Converting assets to expenses

② Converting liabilities to revenue

③ Accruing unpaid expenses

④ Accruing uncollected revenues



Converting Assets to Expenses

End of Current Period

Prior Periods

Current Period

Future Periods



Transaction

Paid future expenses in advance (creates an asset).

Adjusting Entry

- ① Recognize portion of asset consumed as expense, and
- ② Reduce balance of asset account.

Converting Assets to Expenses

Examples Include:

Depreciation

Supplies

Expiring Insurance Policies

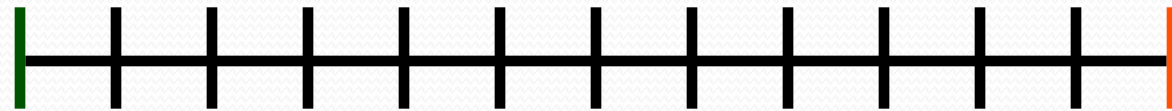


Converting Assets to Expenses

**\$2,400 Insurance Policy
Coverage for 12 Months**



\$200 Monthly Insurance Expense



Jan. 1

Dec. 31

On January 1, Webb Co. purchased a one-year insurance policy for \$2,400.

Converting Assets to Expenses

Initially, costs that benefit more than one accounting period are recorded as **assets**.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Jan.	1	Unexpired Insurance	2,400	
		Cash		2,400
		Purchase a one-year insurance policy.		

Converting Assets to Expenses

The costs are **expensed** as they are used to generate revenue.

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
	Monthly Adjusting Entry for Insurance		
Jan. 31	Insurance Expense	200	
	Unexpired Insurance		200
	Insurance expense for January.		

Converting Assets to Expenses

Balance Sheet

Cost of assets
that benefit
future periods.



Unexpired Insurance

1/1	2,400	1/31	200
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Bal.	2,200		
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Income Statement

Cost of assets
used this period to
generate revenue.

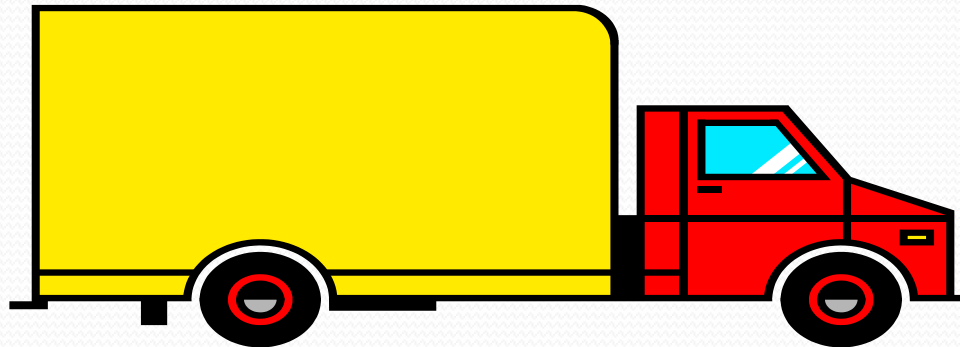


Insurance Expense

1/31	200		
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The Concept of Depreciation

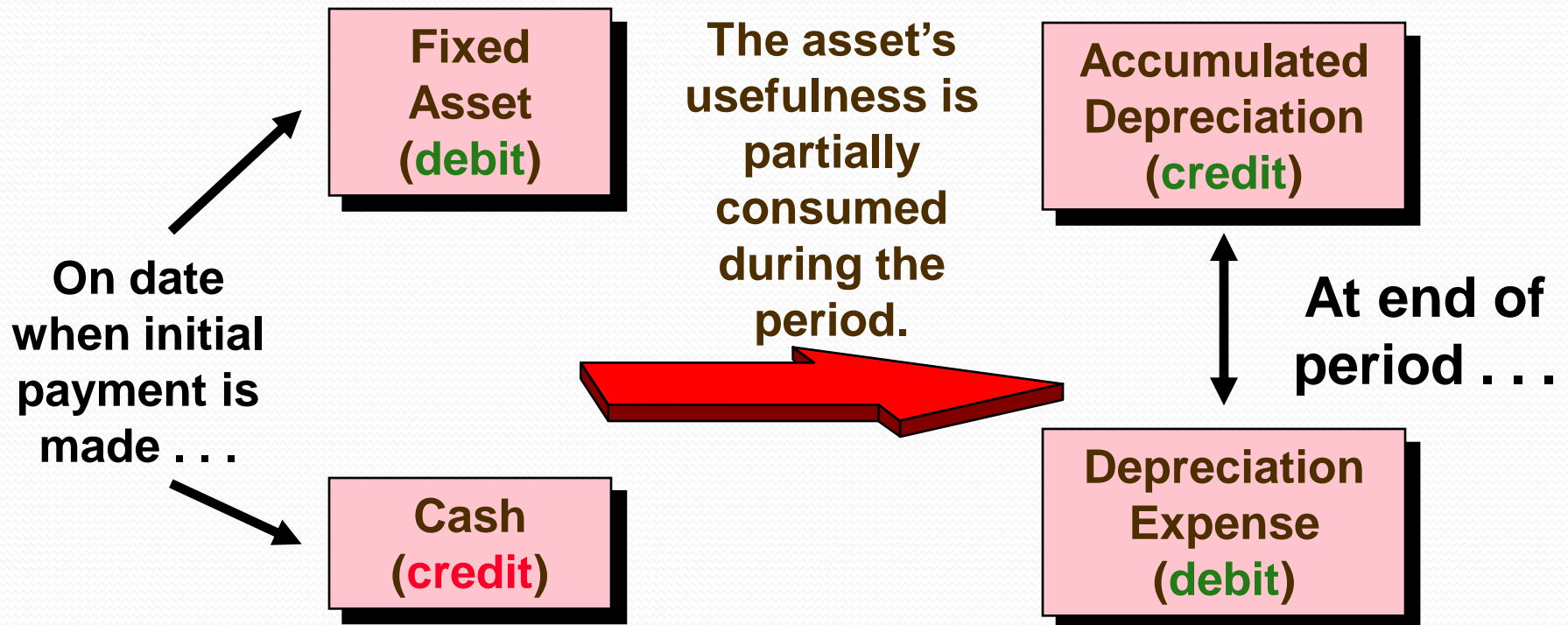
Depreciable assets are **physical objects** that retain their size and shape but lose their economic usefulness over time.



Depreciation is the systematic allocation of the cost of a depreciable asset to expense.

The Concept of Depreciation

The portion of an asset's utility that is used up must be expensed in the period used.



Depreciation Is Only an Estimate

On May 2, 2003, JJ's Lawn Care Service purchased a lawn mower with a useful life of 50 months for \$2,500 cash.

Using the straight-line method, calculate the monthly depreciation expense.

$$\text{Depreciation expense (per period)} = \frac{\text{Cost of the asset}}{\text{Estimated useful life}}$$

$$\text{\$50} = \frac{\text{\$2,500}}{50}$$



Depreciation Is Only an Estimate

JJ's Lawn Care Service would make the following adjusting entry.



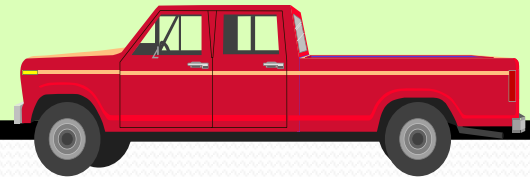
GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
May	31	Depreciation Expense: Tools & Eq.	50	
		Accumulated Depreciation: Tools & Eq.		50
		To record one month's depreciation.		

Contra-asset

Depreciation Is Only an Estimate

JJ's \$15,000 truck is depreciated over 60 months as follows:



GENERAL JOURNAL

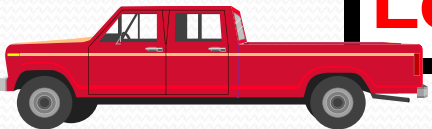
Date	Account Titles and Explanation	Debit	Credit
May 31	Depreciation Expense: Truck	250	
	Accumulated Depreciation: Truck		250
	To record one month's depreciation.		

$\$15,000 \div 60 \text{ months} = \250 per month

Accumulated depreciation would appear on the balance sheet as follows:



Tools & equipment	\$ 2,650	
Less: Accum. depr.	50	2,600
	<hr/>	
Truck	\$ 15,000	
Less: Accum. depr.	250	14,750
	<hr/>	



Converting Liabilities to Revenue

End of Current Period

Prior Periods

Current Period

Future Periods



Transaction

Collected from customers in advance (creates a liability).

Adjusting Entry

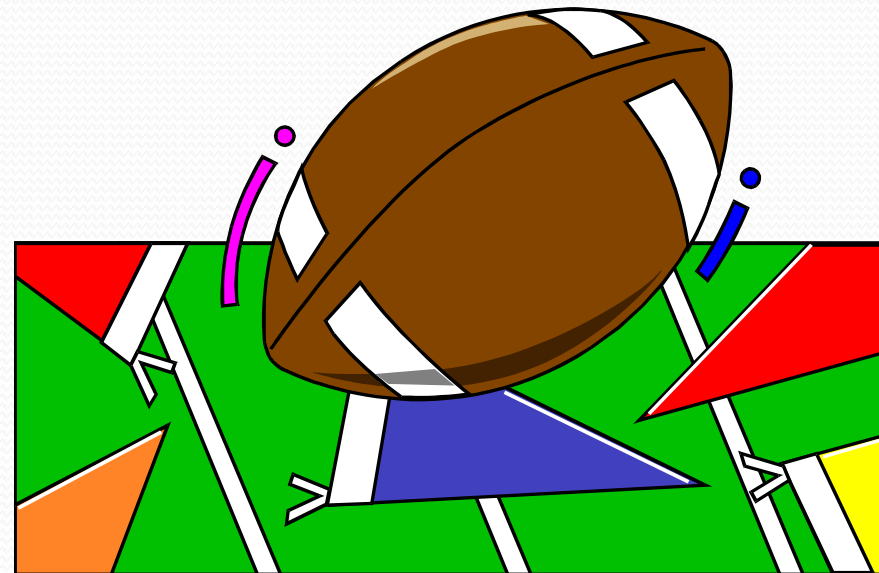
- ① Recognize portion earned as revenue, and
- ② Reduce balance of liability account.

Converting Liabilities to Revenue

Examples Include:

Airline Ticket Sales

**Sports Teams' Sales of
Season Tickets**

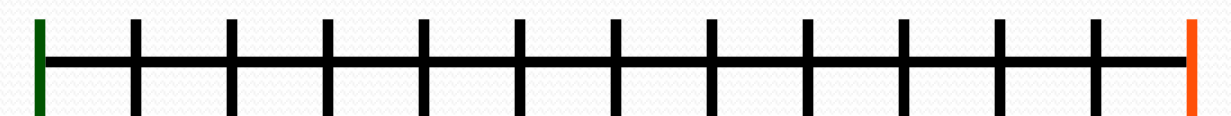


Converting Liabilities to Revenue

**\$6,000 Rental Contract
Coverage for 12 Months**



\$500 Monthly Rental Revenue



Jan. 1

Dec. 31

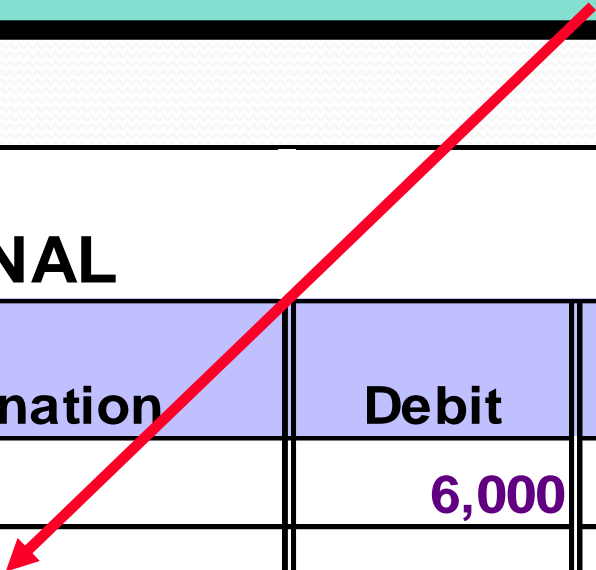
On January 1, Webb Co. received \$6,000 in advance for a one-year rental contract.

Converting Liabilities to Revenue

Initially, revenues that benefit more than one accounting period are recorded as **liabilities**.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Jan.	1	Cash	6,000	
		Unearned Rental Revenue		6,000
		Collected \$6,000 in advance for rent.		



Converting Liabilities to Revenue

Over time, the revenue is recognized as it is **earned.**

GENERAL JOURNAL

Date	Account Titles and Explanation	Debit	Credit
	Monthly Adjusting Entry for Rent Revenue		
Jan. 31	Unearned Rental Revenue	500	
	Rental Revenue		500
	Rental revenue for January.		

Converting Liabilities to Revenue

Balance Sheet

**Liability for
future periods.**



Unearned Rental Revenue

1/31	500	1/1	6,000
		Bal.	5,500

Income Statement

**Revenue earned
this period.**



Rental Revenue

	1/31	500
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Accruing Unpaid Expenses

End of Current Period

Prior Periods

Current Period

Future Periods



Adjusting Entry

- ① Recognize expense incurred, and
- ② Record liability for future payment.

Transaction

Liability will be paid.

Accruing Unpaid Expenses

Examples Include:

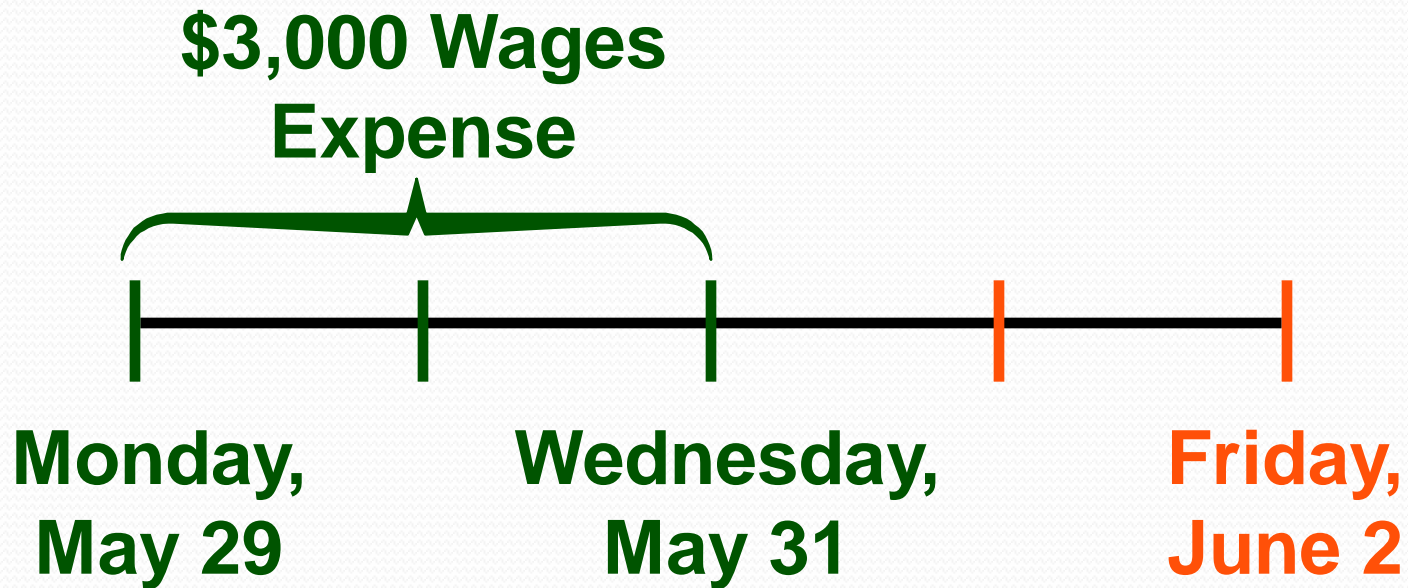
Interest

Wages and Salaries

Property Taxes



Accruing Unpaid Expenses



**On May 31, Webb Co. owes wages of \$3,000.
Pay day is Friday, June 2.**

Accruing Unpaid Expenses

Initially, an expense and a liability are recorded.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
May	31	Wages Expense	3,000	
		Wages Payable		3,000
		To accrue wages owed to employees.		

Accruing Unpaid Expenses

Balance Sheet

Liability to be paid in a future period.



Wages Payable

	5/31	3,000
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Income Statement

Cost incurred this period to generate revenue.

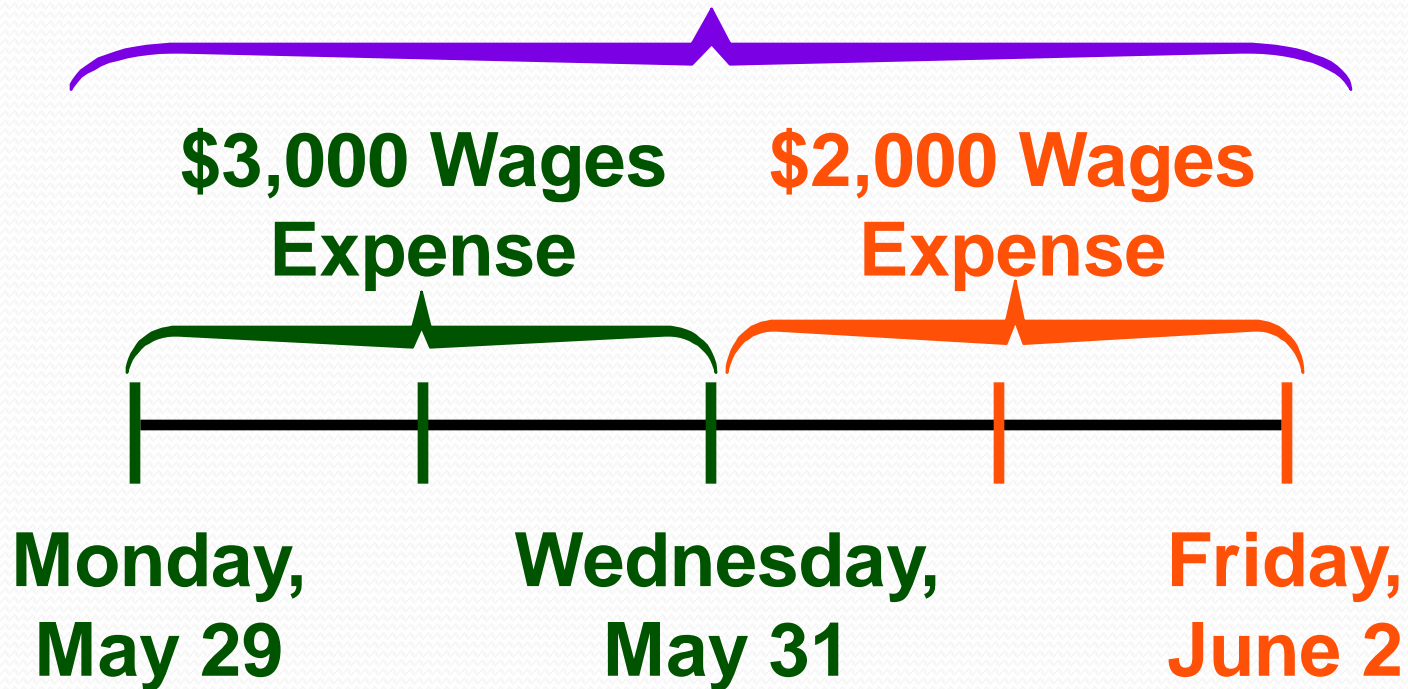


Wages Expense

5/31	3,000	
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Accruing Unpaid Expenses

\$5,000 Weekly Wages



Let's look at the entry for June 2.

Accruing Unpaid Expenses

The liability is extinguished when the debt is paid.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
June	2	Wages Expense (for June)	2,000	
		Wages Payable (accrued in May)	3,000	
		Cash		5,000
		Weekly payroll for May 29-June 2.		

Accruing Uncollected Revenue



Adjusting Entry

- ① Recognize revenue earned but not yet recorded, and
- ② Record receivable.

Transaction

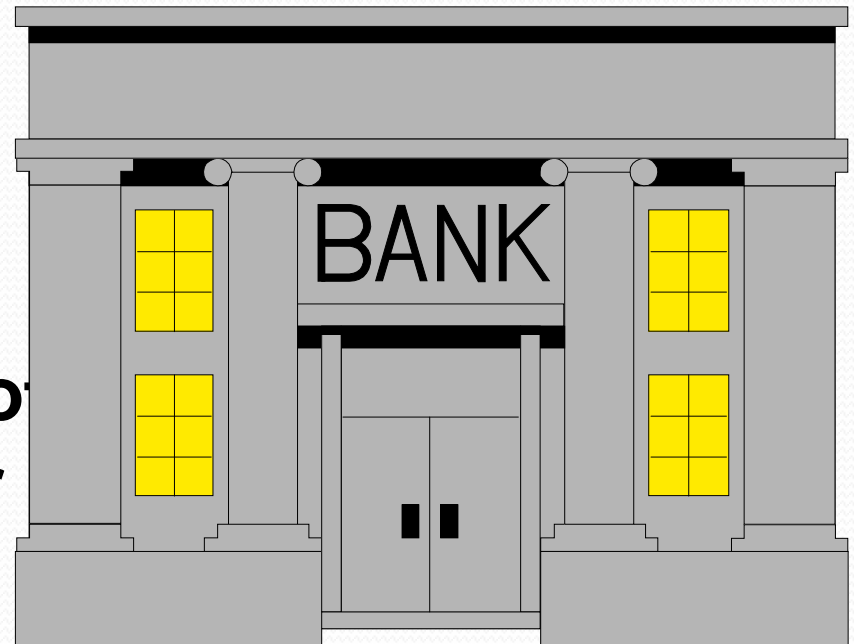
Receivable will be collected.

Accruing Uncollected Revenue

Examples Include:

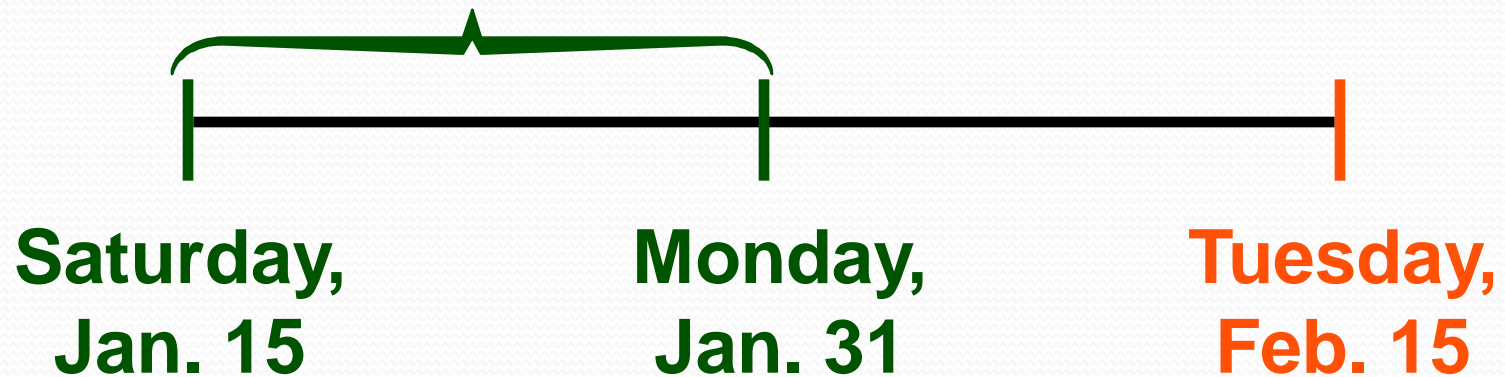
Interest Earned

**Work Completed But Not
Yet Billed to Customer**



Accruing Uncollected Revenue

**\$170 Interest
Revenue**



On Jan. 31, the bank owes Webb Co. interest of \$170. Interest is paid on the 15th day of each month.

Accruing Uncollected Revenue

Initially, the revenue is recognized and a receivable is created.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Jan.	31	Interest Receivable	170	
		Interest Revenue		170
		To recognize interest revenue.		

Accruing Uncollected Revenue

Balance Sheet

Receivable to be collected in a future period.



Interest Receivable

1/31	170	
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Income Statement

Revenue earned this period.

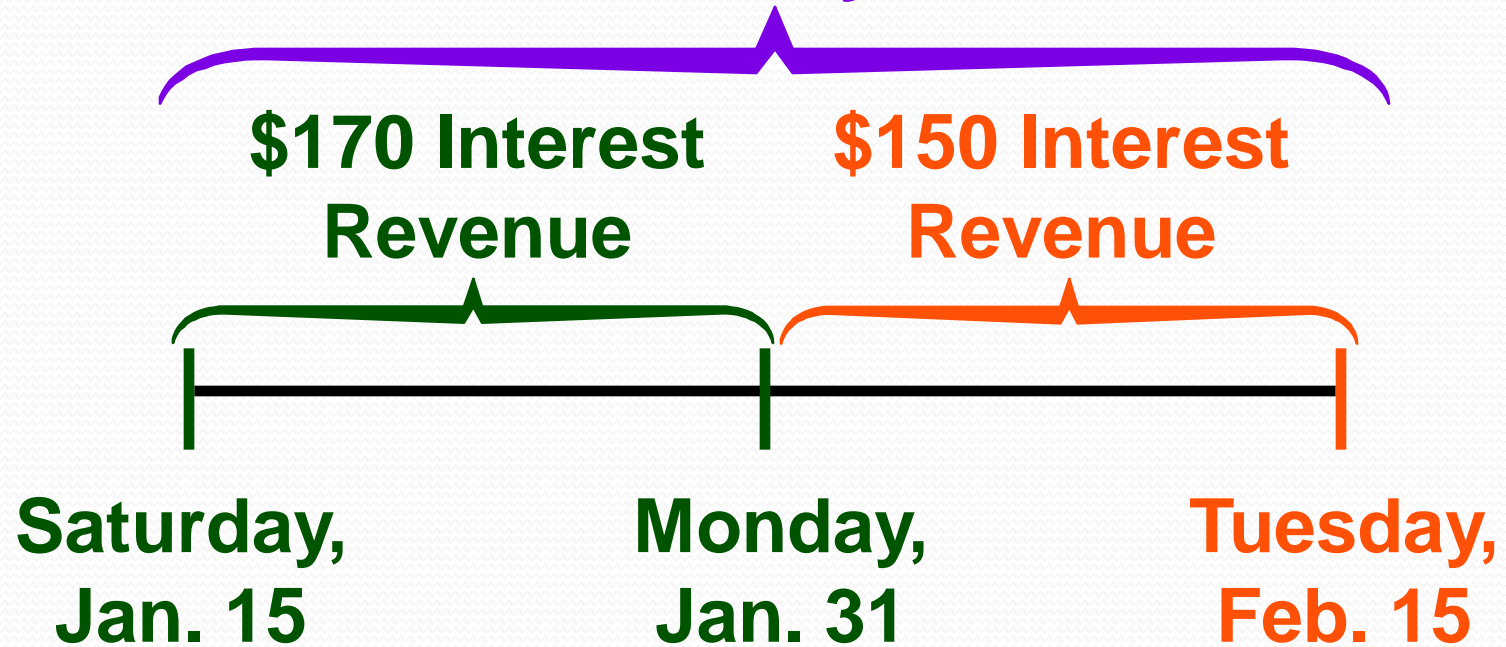


Interest Revenue

	1/31	170
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Accruing Uncollected Revenue

\$320 Monthly Interest



Let's look at the entry for February 15.

Accruing Uncollected Revenue

The receivable is collected in a future period.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Feb.	15	Cash	320	
		Interest Revenue (for February)		150
		Interest Receivable (accrued Jan. 31)		170
		To record interest received.		

Accruing Income Taxes Expense: The Final Adjusting Entry

As a corporation earns taxable income, it incurs income taxes expense, and also a liability to governmental tax authorities.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec.	31	Income Taxes Expense	780	
		Income Taxes Payable		780
		Estimated income taxes applicable to taxable income earned in December.		

Adjusting Entries and Accounting Principles

Costs are **matched with revenue
in two ways:**

**① Direct association of costs
with specific revenue
transactions.**

**② Systematic allocation of costs
over the “useful life” of the
expenditure.**

The Concept of Materiality

An item is “material” if knowledge of the item might reasonably **influence the decisions** of users of financial statements.

Many companies immediately charge the cost of immaterial items to expense.



Supplies

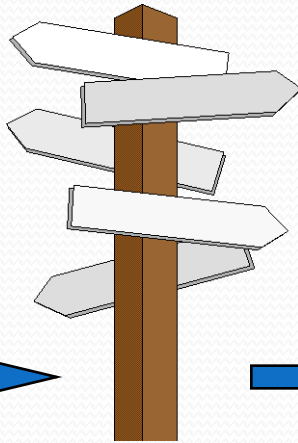


Lightbulbs

Effects of the Adjusting Entries



Journalize transactions.



Post entries to the ledger accounts.



Prepare trial balance.



Make end-of-year adjustments.

Recall from the accounting cycle discussed in Chapter 3, that after the adjusting entries are made, an **adjusted trial balance** is prepared.



Prepare adjusted trial balance.

Reference

Williams et al. 2011. *Financial and Managerial Accounting: The Basis for Business Decision 16 ed.* New York: McGraw-Hill.