CH 3: ADJUSTING ACCOUNTS AND PREPARING FINANCIAL STATEMENTS

I. The Accounting Period

<u>Time period principle</u> – assumes that an organization's life can be divided into specific time periods

- Annual financial statements – cover a one-year period
  - Calendar year – accounting period ending December 31
  - Fiscal year – accounting period consisting of any twelve consecutive months (e.g., ending March 31, ending November 30, etc.)
- Interim financial statements – cover less than one year

II. The Matching Concept

<u>Revenue recognition principle</u> – requires that revenues be recorded when earned – when services are rendered or ownership over goods is transferred

<u>Matching concept</u> – requires that expenses are recorded in the same accounting period as the revenues that are earned as a result of these expenses

III. Accrual basis versus Cash basis

<u>Accrual basis accounting</u> - uses the adjusting process to recognize revenues when earned and to match expenses with revenues

<u>Cash basis accounting</u> – recognizes revenues when cash is received and records expenses when cash is paid

IV. Adjusting Entries

a. Deferred Expenses (Prepaid Expenses)

- Items paid for in advance of receiving their benefits
- Initially recorded as assets; become expenses when used

- **Prepaid insurance**

  Example: On 1 Nov. 2006, White Company paid P2,160 cash for 12 months of insurance through October 31 of the next year

11/1/06	Prepaid insurance	2,160	
	Cash		2,160
12/31/06	Insurance expense	360	
	Prepaid insurance		360
	(2,160 x 2/12 = 360)		

- **Supplies**
  Example: On 3 February 2006, Brown Company bought P5,000 worth of supplies in cash. A year-end count showed that only P1,240 worth of supplies remain.

2/03/06	Supplies	5,000	
	Cash		5,000
12/31/06	Supplies expense	3,760	
	Supplies		3,760
	(5,000 – 1,240 = 3,760)		

b. Deferred Revenue (Unearned Revenue)

- Refers to cash received in advance of providing products and services
- Initially recorded as liability; become earned revenues as products or services are provided

- **Example:** On 1 October 2006, Blue Company received P8,600 cash for a five-month subscription to Blue magazine.

10/01/06	Cash	8,600	
	Unearned revenue		8,600
12/31/06	Unearned revenue	5,160	
	Subscription revenue		5,160
	(8,600 3/5 = 5,160)		

c. Accrued Expenses (Accrued Liabilities)

- Refer to costs tat are incurred in a period but are both unpaid and unrecorded
- Increase expenses and liabilities (payables)

- **Accrued salaries expense**
  Example: Green Company has ten employees who are paid weekly. As of the end of the year, three days' wages have accrued at the rate of P400 per day.

12/31/06	Salaries expense	12,000	
	Salaries payable		12,000
	(P400 x 3 x 10)		

- **Accrued interest expense**
  Example: On 30 June 2006, Yellow Company obtained a P100,000 bank loan, 8% p.a., payable in 3 years. Interest is payable at maturity of the loan.

12/31/06	Interest expense	4,000	
	Interest payable		4,000
	(P100,000 x 8% x 6/12 = 4,000)		

d. **Accrued Revenues (Accrued Assets)**

- Refer to revenue earned in a period that are both unrecorded and not yet received in cash (or other assets)
- Increase assets (receivables) and revenue
- **Example:** Pink Company rendered P56,800 advertising services to Serf Laundry on 14 December 2006. Pink Company allowed a 30-day credit to Serf.

12/14/06	Accounts receivable	56,800	
	Service revenue		56,800

e. **Fixed Assets (Accumulated Depreciation)**

- Plant assets – refer to long-term tangible assets used in the operations of the business (e.g., buildings, computers, machines, etc.)
- Depreciation – process of allocating the costs of plant assets over their expected useful lives
- Accumulated depreciation – a contra account of the asset account

- **Example:** Black Company purchased a sewing machine for P85,400 on March 1. Black estimated that the machine has a useful life of four years with salvage value of P5,000. Black uses straight-line method.

12/31/06	Depreciation expense	16,750	
	Accumulated depreciation		16,750

Cost	85,400
Salvage value	(5,000)
Depreciable cost	80,400
Divide by: Useful life	4
Depreciation per year	20,100
Depreciation (Mar-Dec)	
20,100 x 10/12	16,750

V. Summary of Adjustment Process (Adjusted trial balance)