

The Accounting Cycle: Accruals and Deferrals

Chapter 4



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

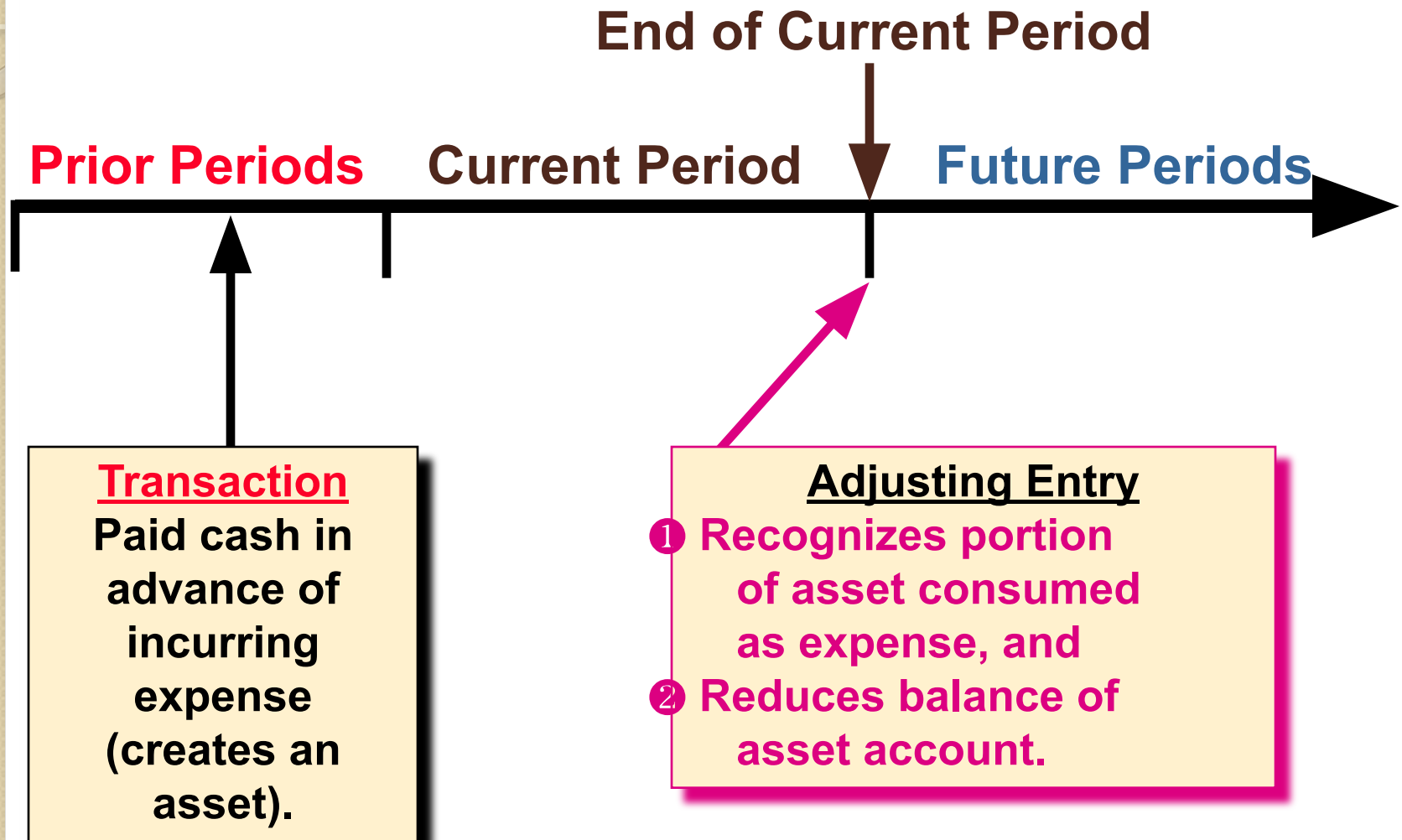
② Converting liabilities to revenue

③ Accruing unpaid expenses

④ Accruing uncollected revenue



Converting Assets to Expenses

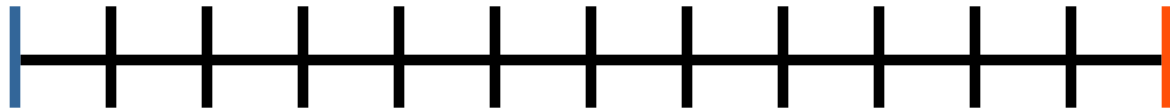


Converting Assets to Expenses

**\$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
Bal.	2,200		

Income Statement

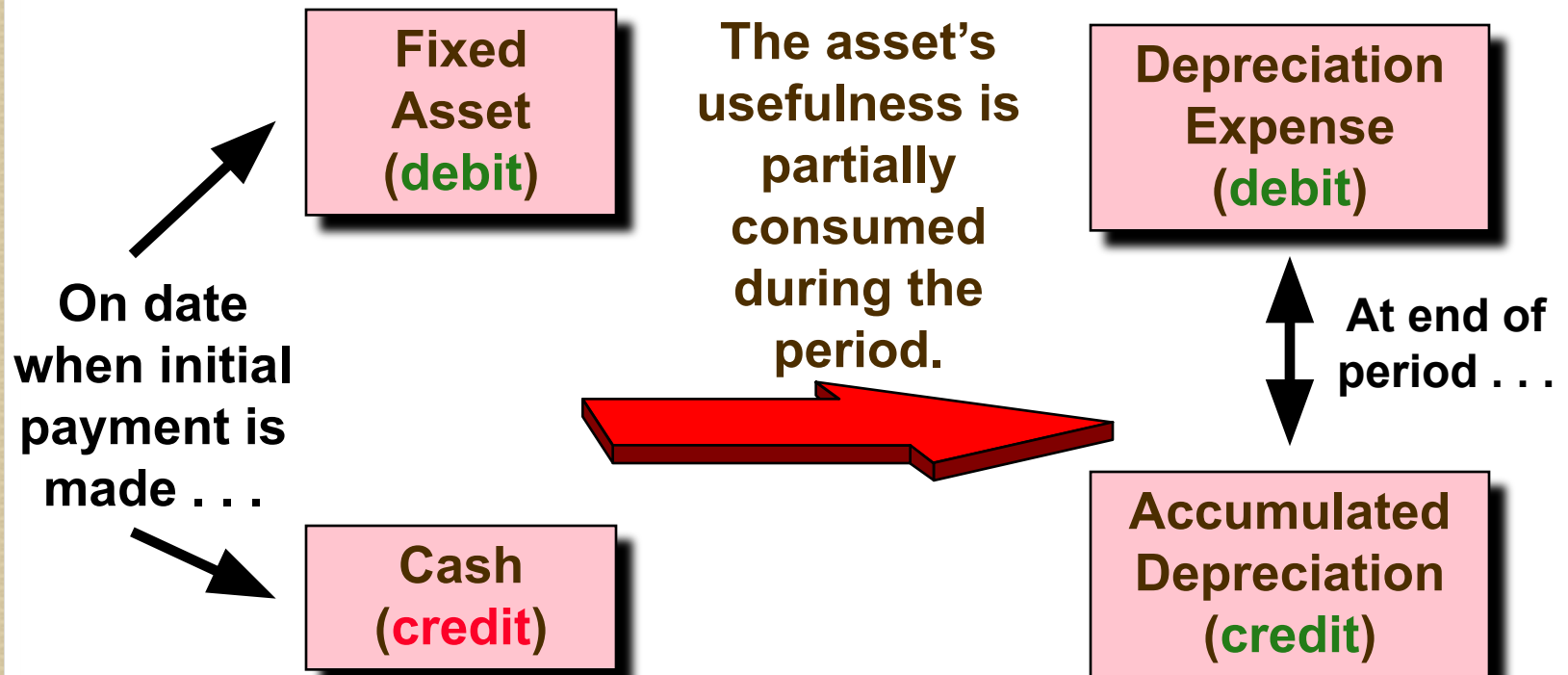
Cost of assets
used this period to
generate revenue.



Insurance Expense			
1/31	200		

The Concept of Depreciation

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



Depreciation Is Only an Estimate

On May 2, 2009, 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.

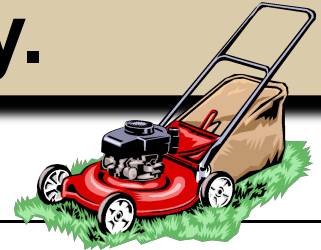
Depreciation expense (per period) = $\frac{\text{Cost of the asset}}{\text{Estimated useful life}}$

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



Depreciation Is Only an Estimate

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



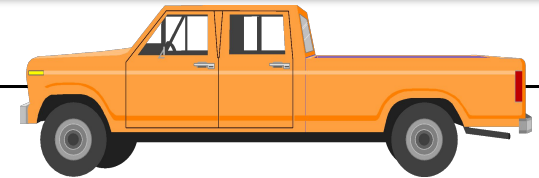
GENERAL JOURNAL

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

Contra-asset

Depreciation Is Only an Estimate

JJ's \$15,000 truck is depreciated over 60 months. Calculate monthly depreciation and make the journal entry.



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.		

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

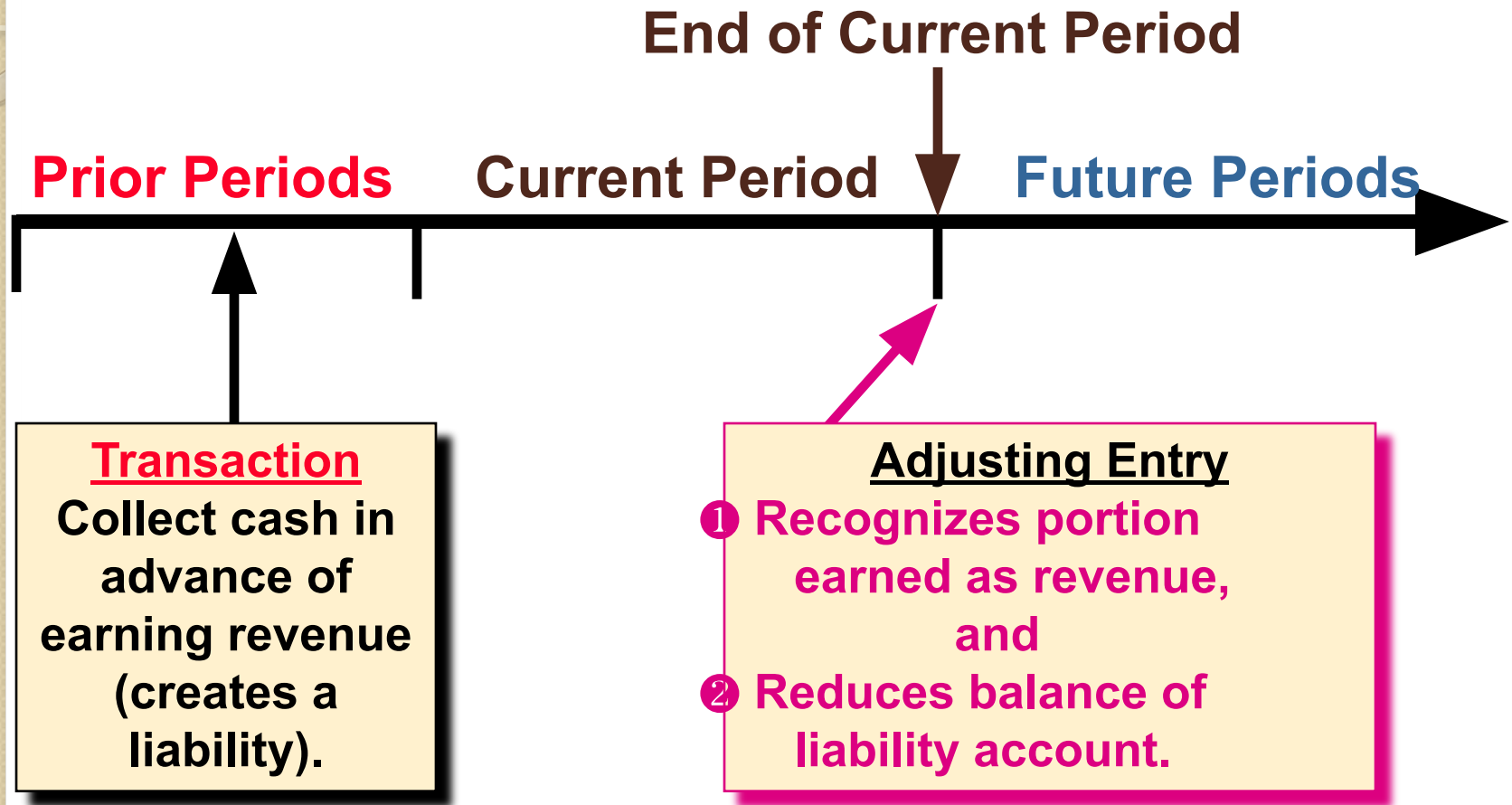
Depreciation Is Only an Estimate

Accumulated depreciation would appear on the balance sheet as follows:

Equipment	\$ 2,500	
Less: Accum. depr.	50	2,450
	<hr/>	
Truck	\$ 15,000	
Less: Accum. depr.	250	14,750
	<hr/>	

Cost - Accumulated Depreciation = Book Value

Converting Liabilities to Revenue

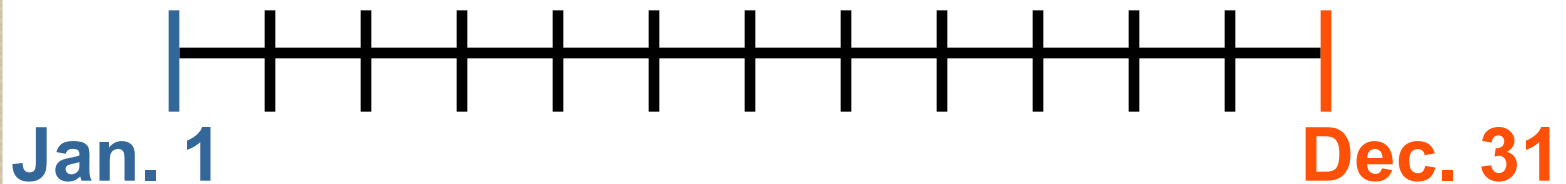


Converting Liabilities to Revenue

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



\$500 Monthly Rental Revenue

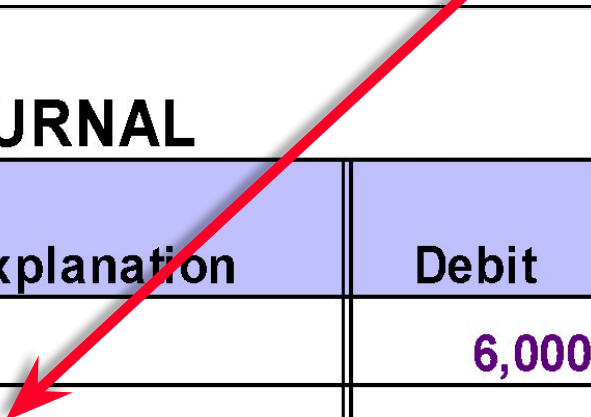


On January 1, Webb Co. received \$6,000 in advance for a one-year rental contract.

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 Rent 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 Rent Revenue		500	
	Rental Revenue			500
	Rental revenue for January.			

Converting Liabilities to Revenue

Balance Sheet
Liability for
future periods.



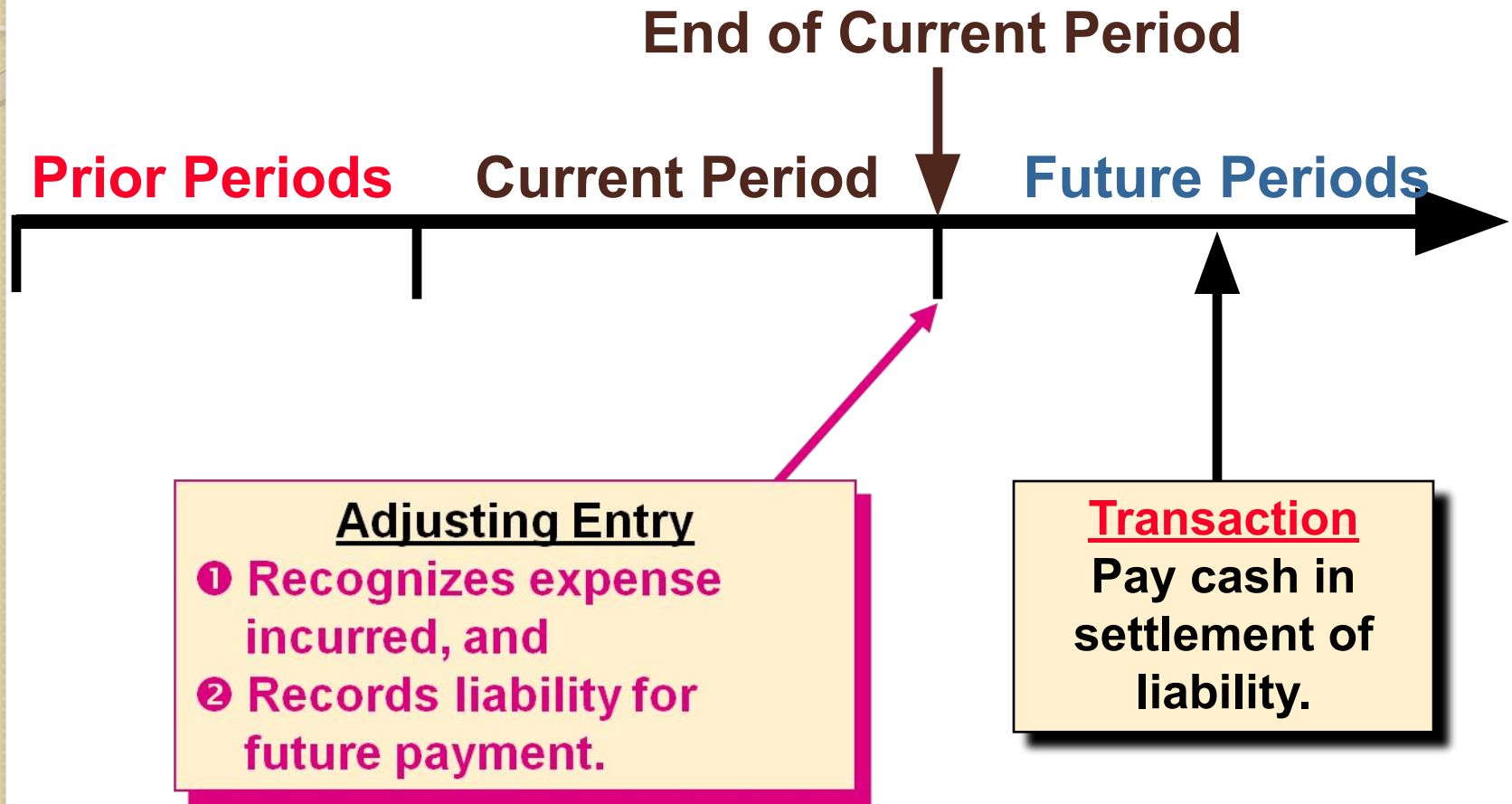
Unearned Rental Revenue			
1/31	500	1/1	6,000
		Bal.	5,500

Income Statement
Revenue earned
this period.

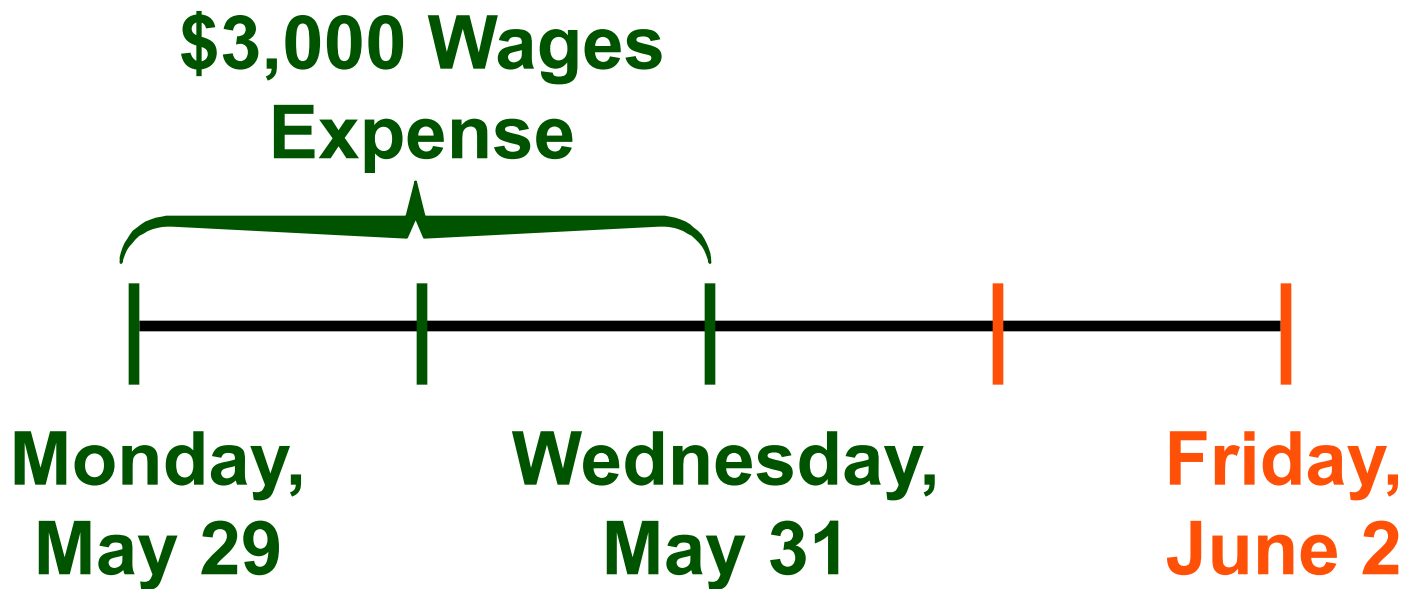


Rental Revenue		
	1/31	500

Accruing Unpaid Expenses



Accruing Unpaid Expenses



On May 31, Webb Co. owes wages of \$3,000. Payday 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

Income Statement

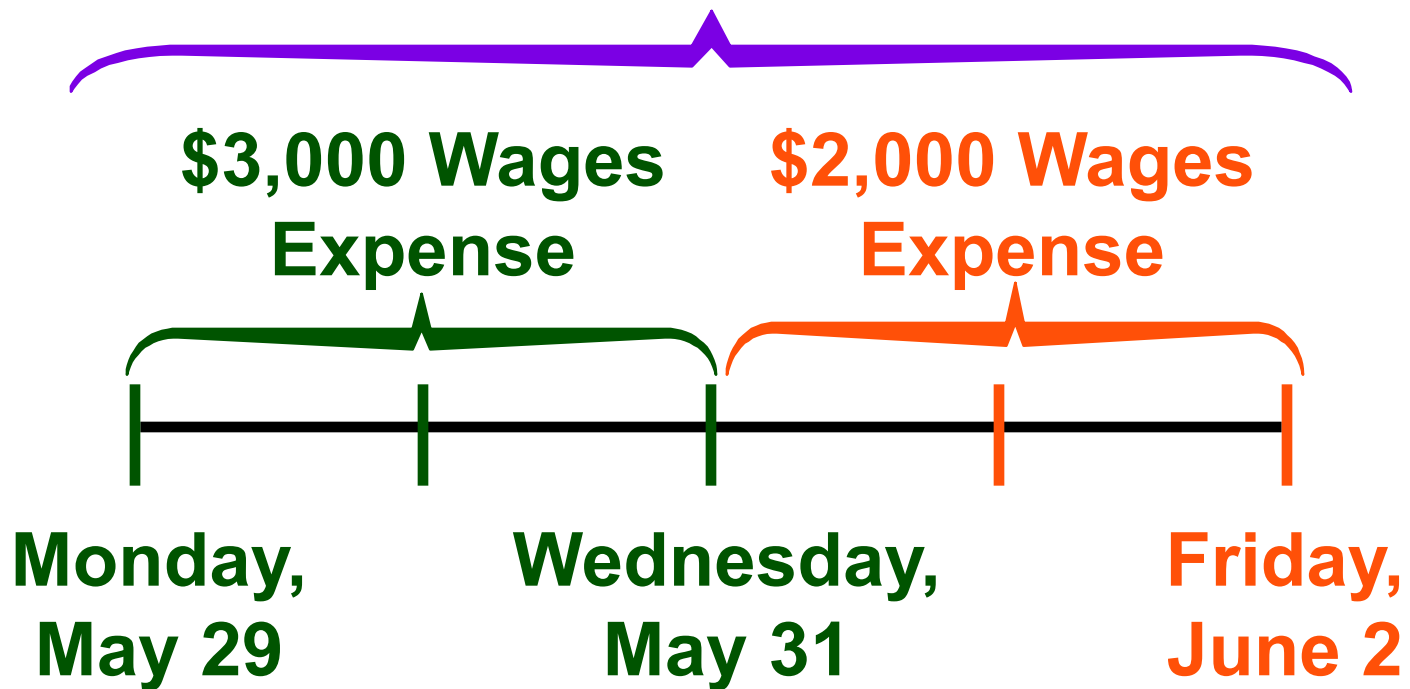
Cost incurred this period to generate revenue.



Wages Expense	
5/31	3,000

Accruing Unpaid Expenses

\$5,000 Weekly Wages



Let's look at the entry for June 2.

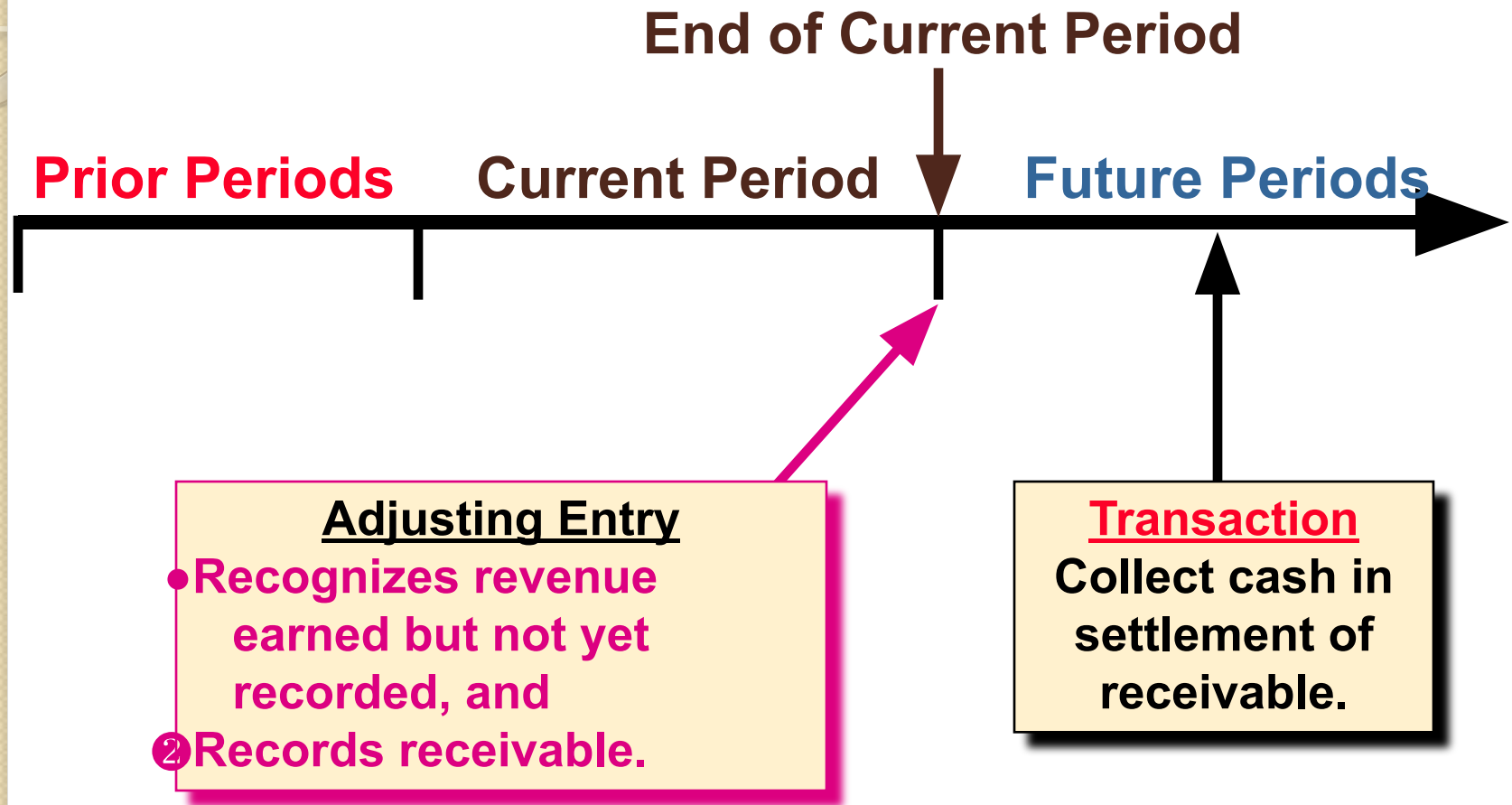
Accruing Unpaid Expenses

The liability is extinguished when the debt is paid.

GENERAL JOURNAL

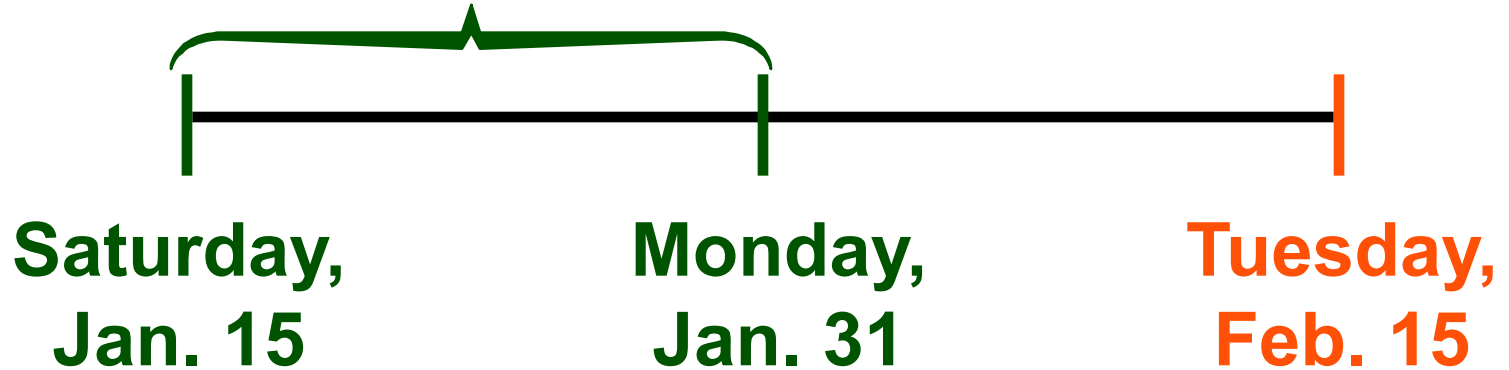
Date		Account Titles and Explanation	Debit	Credit
June	2	Wages Expense (for June)	2,000	
		Wages Payable (accrued in May)	3,000	
		Cash		5,000
		Weekly payroll for May 29-June 2.		

Accruing Uncollected Revenue



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

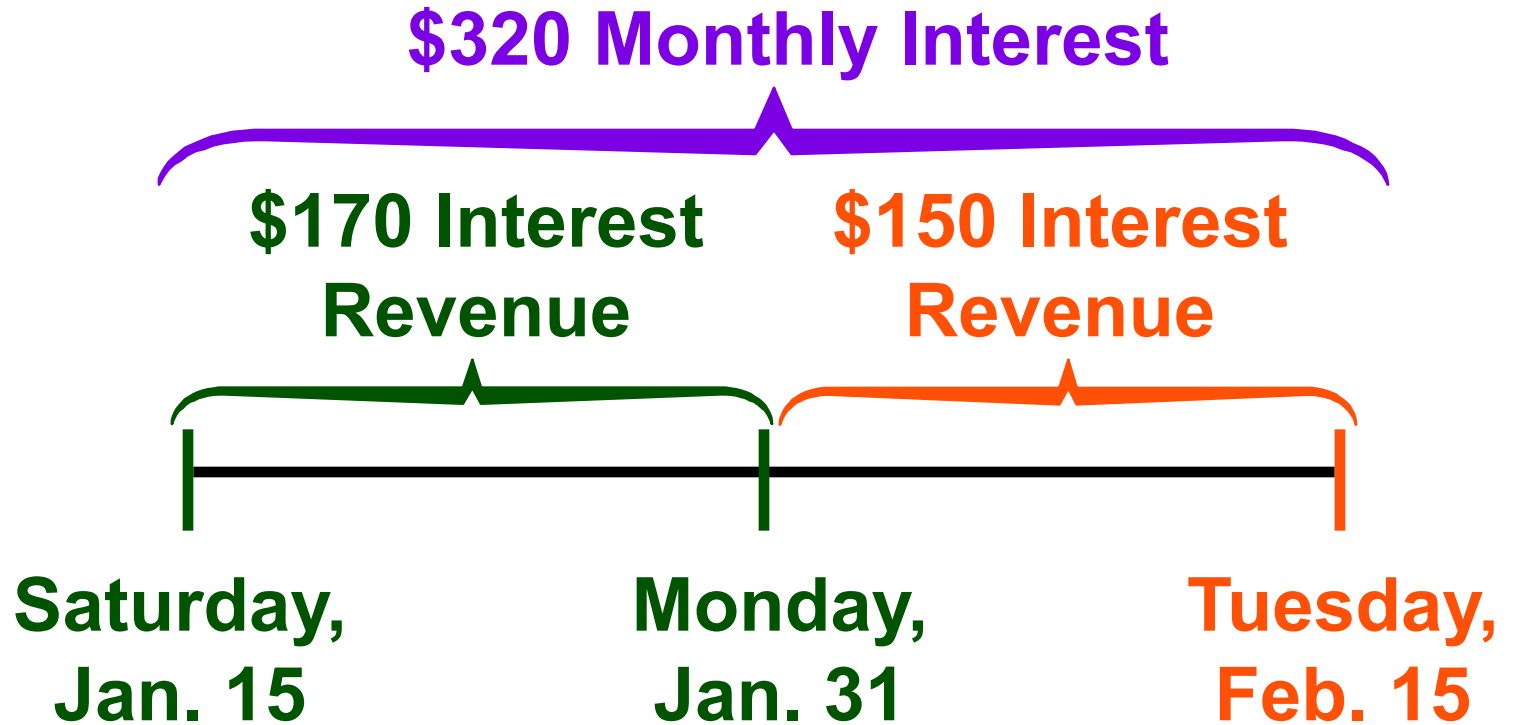
Income Statement

Revenue earned this period.



Interest Revenue	
	1/31 170

Accruing Uncollected Revenue



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:

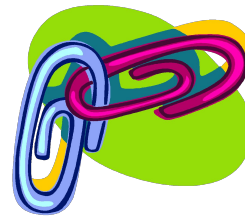
- **Direct association of costs with specific revenue transactions.**

- 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



Light bulbs

Effects of the Adjusting Entries

Adjustment	Income Statement			Balance Sheet		
	Revenue	Expenses	Net Income	Assets	Liabilities	Owners' Equity
Type I						
Converting Assets to Expenses	No effect	Increase	Decrease	Decrease	No effect	Decrease
Type II						
Converting Liabilities to Revenue	Increase	No effect	Increase	No effect	Decrease	Increase
Type III						
Accruing Unpaid Expenses	No effect	Increase	Decrease	No effect	Increase	Decrease
Type IV						
Accruing Uncollected Revenue	Increase	No effect	Increase	Increase	No effect	Increase



Adjusted Trial Balance

JJ's Lawn Care Service Adjusted Trial Balance May 31, 2009			
Cash	\$	3,925	
Accounts receivable		75	
Tools & equipment		2,650	
Accum. depreciation: tools & eq.			\$ 50
Truck		15,000	
Accum. depreciation: truck			250
Notes payable			13,000
Accounts payable			150
Capital stock			8,000
Dividends		200	
Sales revenue			750
Gasoline expense		50	
Depreciation exp.: tools & eq.		50	
Depreciation exp.: truck		250	
Total	\$	22,200	\$ 22,200

All balances are taken from the ledger accounts on May 31 after preparing the two depreciation adjusting entries.

End of Chapter 4

