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Chapter F:3

The Adjusting Process

Chapter F:3: Overview

The chapter introduces the student to the adjusting process so that the amounts for the account balances are reported accurately. Cash basis accounting and accrual basis accounting are illustrated and differentiated. The time period concept, the revenue recognition principle, and the matching principle are explained. Adjusting entries are defined. The four categories of adjusting entries—deferred expenses, deferred revenues, accrued expenses, and accrued revenues—are illustrated and described in detail. The text provides examples of adjusting entries for prepaid rent, supplies, depreciation of furniture and building, unearned revenue, accrued salaries expense, accrued interest expense, and accrued service revenue. Accumulated depreciation, contra accounts, and book value are explained. A comparison of the timing of deferrals and accruals and a summary of the adjusting process concludes the discussion of adjusting entries.

The last part of the chapter focuses on the adjusted trial balance and the worksheet. Students learn how to prepare an adjusted trial balance. The impact of the adjusting entries on the financial statements is emphasized. The purpose of a worksheet and how a worksheet is used to prepare adjusting entries and the adjusted trial balance is explained. An appendix covers the use of the worksheet to prepare adjusting entries and the adjusted trial balance.

A Tying It All Together feature provides an example of how to report advance payments related to a client contract. An Ethics feature provides students insight into real-world ethical dilemmas in accrual accounting, addressing the issue of when accrued expenses should be recorded. The Review section includes Things You Should Know, which highlights the information students should have acquired from the chapter. A Check Your Understanding Problem reviews the adjusting process, including adjusting entries, the adjusted trial balance, and preparation of a partial worksheet. A list of Key Terms is provided. A Quick Check gives students a chance to assess their knowledge of the chapter learning objectives.

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Chapter F:3: Learning Objectives

LO 1. Differentiate between cash basis accounting and accrual basis accounting

LO 2. Define and apply the time period concept, revenue recognition, and matching principles

LO 3. Explain the purpose of and journalize and post adjusting entries for deferrals

LO 4. Explain the purpose of and journalize and post adjusting entries for accruals

LO 5. Explain the purpose of and prepare an adjusted trial balance

LO 6. Identify the impact of adjusting entries on the financial statements

LO 7. Describe the accounting cycle

LO 8. Explain the purpose of a worksheet and use it to prepare adjusting entries and the adjusted trial balance (Appendix 3A)

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Chapter F:3: Teaching Outline with Lecture Notes

LO 1. Differentiate between cash basis accounting and accrual basis accounting

a) Cash basis accounting

b) Accrual basis accounting

Lecture Notes: To indicate why the accrual method is the more "correct" method, you can provide a simple example of a company with two (or more) transactions, one with cash revenue and one with accrued expense, for example, and ask students to compute net income under the cash basis and accrual basis. Note the differences and ask students which computation provides a more accurate picture of the company's operations.

LO 2. Define and apply the time period concept, revenue recognition, and matching principles

a) The time period concept

i. Fiscal year

b) The revenue recognition principle

i. Step 1: Identify the contract with the customer.

ii. Step 2: Identify the performance obligations in the contract.

iii. Step 3: Determine the transaction price.

iv. Step 4: Allocate the transaction price to the performance obligations in the contract.

v. Step 5: Recognize revenue when (or as) the entity satisfies each performance obligation.

c) The matching principle

Lecture Notes: It helps to explain to students that accountants have several accounting principles or concepts that guide them in recording financial information. These principles include the time period concept, the revenue recognition principle, and the matching principle. These three concepts are important for their understanding of adjusting entries. Relating the revenue recognition principle to the payment of rent to a landlord and the five-step process to determine when the landlord may record rent revenue under the lease contract may aid their understanding as many students rent apartments or rooms on campus. Reinforce the interrelationship of revenues and expenses (net income) and why it is important to match expenses incurred against the revenues earned in the same period.

Suggested In-Class Exercise: E-F:3-18

LO 3. Explain the purpose of and journalize and post adjusting entries for deferrals

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a) Exhibit F:3-1: Unadjusted Trial Balance

b) Journalize and post adjusting entries

i. Deferred expenses

- Adjusting entry: Increase an expense with a debit and decrease an asset with a credit
  - Prepaid rent
  - Supplies
  - Depreciation
    - Explain the following terms:
      - Property, plant, and equipment (plant assets)
      - Depreciation
      - Residual value
      - Straight-line method
      - Accumulated depreciation
      - Contra account
      - Book value
    - Exhibit F:3-2: Property, Plant, and Equipment on the Balance Sheet of Smart Touch Learning

Lecture Notes: Just as the adjusting entries for Prepaid Expenses and Supplies reduce an asset and increase the related expense, so does the adjusting entry for depreciation. However, because the asset values are considered more significant and therefore more important, the integrity of the original asset acquisition value is maintained in the primary plant asset account, and the reduction of the asset value in the adjusting entry is entered into the related contra asset for accumulated depreciation. Highlight the cost principle when explaining this concept.

ii. Deferred revenues

- Adjusting entry: Decrease a liability (Unearned Revenue) with a debit and increase a revenue with a credit

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LO 4. Explain the purpose of and journalize and post adjusting entries for accruals

i. Accrued expenses

- Adjusting entry: Increase an expense with a debit and increase a liability with a credit
  - Accrued salaries expense
  - Accrued interest expense

ii. Accrued revenues

- Adjusting entry: Increase an asset (Receivable) with a debit and increase a revenue with a credit

Lecture Notes: Emphasize that adjusting entries are simply a kind of journal entry and *must* balance: Debits equal credits. Adjusting entries are always dated as of the last day of the accounting period.

Point out that adjusting entries *never* affect the cash account. This is because cash has already changed hands or will change hands at a later date. Deferral entries are related to cash that has been paid in advance, with the revenue earned or the expense incurred at a later date. Accrual entries are related to revenue that has been earned or expense that has been incurred, with the related cash payment occurring at a later date. Adjusting entries *always* involve one income statement account and one balance sheet account. It may be helpful to provide several adjusting entry examples and ask students which account affects the balance sheet and which affects the income statement.

Some students have difficulty with adjusting the Unearned Revenue account. Explain that the purpose of the adjusting entry is to record the revenue that was earned *during* the period by completing work for the client, not the amount related to work to be performed in the future. However, when adjusted correctly, the ending balance in Unearned Revenue equals the amount related to work to be performed in the future.

Suggested In-Class Exercise: E-F:3-24

LO 5. Explain the purpose of and prepare an adjusted trial balance

i. Exhibit F:3-3: Summary of Deferral and Accrual Adjustments

ii. Exhibit F:3-4: Journalizing and Posting the Adjusting Entries of Smart Touch Learning

iii. Adjusted trial balance

iv. Exhibit F:3-5: Adjusted Trial Balance

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Lecture Notes: Explain that the adjusted trial balance is used to ensure that total debits equal total credits after the adjusting entries have been made, although this equality does not necessarily ensure accuracy.

Suggested In-Class Exercise: E-F:3-25

LO 6. Identify the impact of adjusting entries on the financial statements

i. Exhibit F:3-6: Impact of Adjusting Entries on Financial Statements

Lecture Notes: Financial statements are created using the adjusted trial balance. Emphasize the impact on the financial statements if adjusting entries are not made. For example, if the adjusting entry for a deferred expense is not made to increase an expense and decrease the related asset, then Total Assets is overstated on the balance sheet and Net Income is overstated on the income statement (because Total Expense is understated).

Suggested In-Class Exercise: E-F:3-27

LO 7. Describe the accounting cycle

i. Accounting cycle steps 1-6

ii. Exhibit F:3-7: The Accounting Cycle: Steps 1 Through 6

Lecture Notes: In the previous chapter, we introduced the first four steps of the accounting cycle for Smart Touch Learning. Remember, the accounting cycle is the process by which companies produce their financial statements for a specific period of time. It is the steps that companies follow throughout the time period. In this chapter, we discuss the next two steps of the accounting cycle: Step 5: Journalize and post adjusting entries. At the end of the accounting period, companies journalize and post adjusting entries to record revenues to the period in which they are earned and the expenses to the period in which they occur. Step 6: Prepare the adjusted trial balance. An adjusted trial balance is prepared to summarize the account balances as reported in the ledger.

LO 8. Explain the purpose of a worksheet and use it to prepare adjusting entries and the adjusted trial balance (Appendix 3A)

i. Worksheet

ii. First four sections of a worksheet

iii. Exhibit F:3A-1: Partially Completed Worksheet

Lecture Notes: Remind students to be careful when calculating adjusted trial balance totals. Not every adjustment is an addition or subtraction; it depends on the account type. For example, debits are added to debits but are subtracted from credits. Calculations on the worksheet are completed just as they would be in a T-account.

Suggested In-Class Exercise: E-F:3A-29

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Chapter F:3: Handout for Student Notes

LO 1. What is the difference between cash basis accounting and accrual basis accounting?

LO 2. What concepts and principles apply to accrual basis accounting?

- The time period concept
- The revenue recognition principle
- The matching principle

LO 3. What are the adjusting entries for deferrals, and how do we record them?

- Deferred expenses:
  - Prepaid Rent
  - Supplies
  - Depreciation
- Deferred revenues

LO 4. What are the adjusting entries for accruals and how do we record them?

- Accrued expenses:

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- Accrued Salaries Expense
- Accrued Interest Expense

  - Accrued revenues

LO 5. What is the purpose of the adjusted trial balance, and how do we prepare it?

LO 6. What is the impact of adjusting entries on the financial statements?

LO 7. Describe the first six steps of the accounting cycle.

LO 8. How could a worksheet help in preparing adjusting entries and the adjusted trial balance?

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Chapter F:3: Student Chapter Summary

LO 1. Differentiate between cash basis accounting and accrual basis accounting

For cash basis accounting, revenue is recorded only when cash is received, and expenses are recorded only when cash is paid. This method is not permitted by Generally Accepted Accounting Principles (GAAP), although it is often used by small businesses. For accrual basis accounting, revenue is recorded when earned, and expenses are recorded when incurred, which may occur before or after cash is received or paid.

LO 2. Define and apply the time period concept, revenue recognition, and matching principles

The time period concept assumes that a business's activities can be sliced into small time segments and that the financial statements can be prepared for specific periods, such as a month, quarter, or year.

The revenue recognition principle tells accountants when to record revenue and requires companies to follow a five-step process:

Step 1. Identify the contract with the customer. A contract is an agreement between two or more parties that creates enforceable rights and obligations.

Step 2. Identify the performance obligations in the contract. A performance obligation is a contractual promise with a customer to transfer a distinct good or service. A contract might have multiple performance obligations.

Step 3. Determine the transaction price. The transaction price is the amount that the entity expects to be entitled to as a result of transferring goods or services to the customer.

Step 4. Allocate the transaction price to the performance obligations in the contract. If the transaction has multiple performance obligations, the transaction price needs to be allocated among the different performance obligations.

Step 5. Recognize revenue when (or as) the entity satisfies each performance obligation. The business recognizes revenue when (or as) it satisfies each performance obligation by transferring a good or service to a customer. A good or service is considered transferred when the customer obtains control of the good or service. The amount of revenue recognized is the amount allocated to the satisfied performance obligation.

The matching principle guides accounting for expenses and ensures that all expenses are recorded when they are incurred during the period. It then matches those expenses against the revenues of the period.

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LO 3. Explain the purpose of and journalize and post adjusting entries for deferrals

Adjusting entries are completed at the end of the accounting period and record revenues to the period in which they are earned and expenses to the period in which they are incurred. Adjusting entries also update the asset and liability accounts. The first two types of adjusting entries are for deferred expenses and revenues:

- Deferred expenses: In the related sequence of events, cash has previously been paid to acquire an asset, such as prepaid rent, supplies, or a plant asset. The accounting entry to record that transaction increases the asset with a debit and decreases cash with a credit. Later, at the end of the accounting period, the adjusting entry recognizes that the asset has been all or partially used up during the current accounting period by increasing the related expense with a debit and decreasing the asset with a credit. Depreciation is a special case of a deferred expense. Because plant asset values are considered more significant and, therefore, more important, the integrity of the original asset acquisition value is maintained in the primary plant asset account, and the reduction of the asset value in the adjusting entry is entered into the related contra asset for accumulated depreciation.

- Deferred revenues: In the related sequence of events, cash has previously been received for goods or services to be provided to the customer at some time in the future. The accounting entry to record that transaction increases cash with a debit and increases the liability account Unearned Revenue with a credit. Later, at the end of the accounting period, the adjusting entry recognizes that some or all of the revenues have been earned for goods or services that have since been provided to the customer by decreasing the liability Unearned Revenue with a debit and increasing the corresponding revenue with a credit.

LO 4. Explain the purpose of and journalize and post adjusting entries for accruals

The second two types of adjusting entries are for accrued expenses and revenues:

- Accrued expenses: In the related sequence of events, the adjusting entry first records that an expense (such as Salaries Expense or Interest Expense) has been incurred but not paid by increasing the expense with a debit and increasing the related liability with a credit. Later, when the cash payment transaction occurs in the following accounting period, the liability is decreased with a debit, and cash is decreased with a credit.

- Accrued revenues: In the related sequence of events, the adjusting entry first records revenues that have been earned but not collected by increasing an asset, such as Accounts Receivable, with a debit and increasing the related revenue with a credit. Later, when the cash collection transaction occurs in the following period, Cash is increased with a debit, and the asset is decreased with a credit.

LO 5. Explain the purpose of and prepare an adjusted trial balance

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An adjusted trial balance is a list of all the accounts with their adjusted balances. It ensures that total debits equal total credits. Be careful when calculating adjusted trial balance totals. Not every adjustment is an addition or a subtraction; it depends on the account balance. For example, debits are added to debits but subtracted from credits.

LO 6. Identify the impact of adjusting entries on the financial statements

If adjusting entries are not recorded, the balance sheet and income statement accounts will either be overstated or understated. Overstating or understating accounts causes the financial statements to be incorrect.

LO 7. Describe the accounting cycle

- Step 1: Start with the beginning account balances
- Step 2: Analyze and journalize transactions in the journal
- Step 3: Post journal entries to the accounts in the ledger
- Step 4: Prepare the unadjusted trial balance
- Step 5: Journalize and post adjusting entries
- Step 6: Prepare the adjusted trial balance

LO 8. Explain the purpose of a worksheet and use it to prepare adjusting entries and the adjusted trial balance

A worksheet is an internal document that helps identify the accounts that need adjustments. In addition, a worksheet helps summarize data for the preparation of the financial statements.

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Chapter F:3: Assignment Grid and Other Materials

	LO 1	LO 2	LO 3	LO 4	LO 5	LO 6	LO 7	LO 8
S-F:3-1	X							
S-F:3-2	X							
S-F:3-3		X						
S-F:3-4		X						
S-F:3-5			X					
S-F:3-6			X					
S-F:3-7			X					
S-F:3-8			X					
S-F:3-9			X					
S-F:3-10				X				
S-F:3-11				X				
S-F:3-12				X				
S-F:3-13					X			
S-F:3-14						X		
S-F:3-15							X	
S-F:3A-16								X
E-F:3-17	X	X						
E-F:3-18	X	X						
E-F:3-19			X					
E-F:3-20			X					
E-F:3-21				X				
E-F:3-22			X	X				
E-F:3-23			X	X				
E-F:3-24			X	X				
E-F:3-25					X			
E-F:3-26			X	X		X		
E-F:3-27			X	X		X		
E-F:3A-28			X	X				X
E-F:3A-29					X			X
P-F:3-30A, P-F:3-35B			X	X				
P-F:3-36B			X	X		X		
P-F:3-32A, P-F:3-37B			X	X	X		X	
P-F:3-33A, P-F:3-38B			X	X	X		X	
P-F:3-34A, P-F:3-38B			X	X	X		X	X

S – Short Exercises (*Easy)*
E – Exercises (*Moderate)*
P – Problems (*Difficult)*

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