

THE ACCRUAL BASIS OF ACCOUNTING VS. THE CASH BASIS OF ACCOUNTING

- ☞ **Cash Basis:** In the cash basis of accounting revenues and expenses are only recognized when cash is received or paid, therefore there are no accounts receivable or accounts payable accounts.
- ☞ **Accrual Basis:** In the accrual basis of accounting revenues are recognized (recorded) when earned, and expenses are recognized when incurred regardless of whether cash been received or paid.

NATURE OF THE ADJUSTING PROCESS

A lot of revenues and expenses are recorded during the period as they occur, but a lot of accounts are not. For these accounts the accountant must determine when to recognize these accounts, and adjust them at the end of the accounting period in order to bring them up to date. When dealing with the timing of revenue and expense recognition there are two terms that must be understood, **Accrued** and **Deferred**.

ACCRUED

Revenues or Expenses

☞ **Accrued revenues**, sometimes referred to as accrued assets, are revenues that have been earned but have not been recorded in the accounts.

Fees Earned, Accounting Revenue, Sales...

☞ **Accrued expenses**, sometimes referred to as accrued liabilities, are expenses that have been incurred but have not been recorded in the accounts.

Wages, Legal services. Fees for paper usage in a copier machine...

To remember what accrued means think of your car, if you don't wash it for 2 weeks, it's okay. But after 4 weeks people start writing "wash me" on your window—Accrued builds up over time and the revenue or expense is recognized at the end of the accounting period!

DEFERRED

Revenues or Expenses

☞ **Prepaid expenses:** sometimes referred to as deferred expenses, are items that have been initially recorded as assets but are expected to become expenses over time or through the normal Operations of business.

Building, Automobile—(Accumulated Depreciation), Supplies, and Rent paid in advance...

☞ **Unearned revenues:** (deferred revenue) are items that have been initially recorded as liabilities but are expected to become revenues over time or through the normal operations of the business.

Unearned Gift Card Revenue, Subscription Revenue, Rent money received in advance...

To remember what deferred means think of "Rooms to Go" you get a room full of furniture today and you don't have to pay until 2014—Deferred moves the revenue or expense recognition to a future accounting period.

Accumulated depreciation is a contra - asset, used to record the reduction in value of the asset account.

Accrued Revenue

You have worked all month on the bookkeeping for John Smith, now at the end of the month (May 31, 2014) you bill him for \$2,500. You have accrued (earned) the revenue since you have completed the work.

Accrued Expense

Your employees have worked 4 days this week and earned \$400 the month ends on Thursday, but they will not be paid until payday.

Deferred Expense

At the beginning of the year, you purchased insurance (prepaid Insurance) for the next 12 months for \$1,200. At the end of month one you have used up \$100 worth.

Deferred Revenue

You received \$120 on January 1 for magazine subscription. (Unearned Subscription Revenue) Now you have sent the first magazine and have earned one month's revenue.

JOURNALIZING ADJUSTING ENTRIES
Adjustments must be recorded in the General Journal.

General Journal				Page 1
Date	Description	Post Ref	Debit	Credit
	Adjusting Entries			
May 31	Accounts Receivable		2,500	
	Fees Earned			2,500
	<i>Completed Accounting Work for May, \$2,500</i>			
May 31	Wages Expense		400	
	* Wages Payable			400
	<i>Incurred wages for 4 days, amount owed \$400</i>			
May 31	* Insurance Expense		100	
	Prepaid Insurance			100
	<i>Used up 1 months insurance policy (1200÷12)</i>			
May 31	Unearned Subscription Revenue		10	
	* Subscription Revenue			10
	<i>Mailed first issue (100-10)</i>			

* Indicates a new account created to do the adjustment.

POSTING THE ADJUSTMENTS TO THE LEDGERS

Starting on page 120 of the textbook is a good example that walks you through the entire adjusting process, from journalizing, posting to the ledgers, and then the creation of the adjusted trial balance.

ADJUSTED TRIAL BALANCE

After the adjusting entries have been recorded in the journal and posted to the ledgers we create an adjusted trial balance. Adjusting entries generate new accounts that have may not been used before and these accounts must be integrated into the adjusted trial balance along with all the accounts on the trial balance before adjustments.

John Smith Company Trial Balance May 31, 2013		
Cash	2,700	
Accounts Receivable	850	
Prepaid Insurance	1,200	
Accounts Payable		150
Unearned Subscription Revenue		120
John Smith, Capital		3,000
John Smith, Drawing	420	
Fees Earned		4,000
Advertising Expense	600	
Rent Expense	475	
Wages Expense	1025	
	7,270	7,270

John Smith Company Adjusted Trial Balance May 31, 2013		
Cash	2,700	
Accounts Receivable	(850+2500)	3,350
Prepaid Insurance	(1200 - 100)	1,100
Accounts Payable		150
Wages Payable	(0+400)	400
Unearned Subscription Revenue	(120-10)	110
John Smith, Capital		3,000
John Smith, Drawing	420	
Fees Earned	(4000+2500)	6,500
Subscription Revenue	(0+10)	10
Advertising Expense		600
Rent Expense		475
Wages Expense	(1025+400)	1,425
Insurance Expense	(1200÷12)	100
	10,170	10170

VERTICAL ANALYSIS

By stating each income statement account as a percentage of Revenue and the balance sheet accounts as a percentage of Total Assets, companies are able to see trends over time, and compare to other companies and to industry averages.