

Adjusting and Closing Process

Accounting Cycle – Basic steps

- 1. Record transactions in the journal
- 2. Post from the journal to the ledger
- 3. Prepare an unadjusted trial balance
- 4. Record past year end adjusting entries
- 5. Prepare an adjusted trial balance
- 6. From the adjusted trial balance prepare financial statements

Accrual Accounting

- Revenues recorded when earned
- Expenses are recorded in the same period they help to earn revenues
 - Realization principle
 - Matching concept
- Adjusting entries are needed to ensure that the realization principle and matching concept are followed
 - 1. Revenues are recorded in the period earned
 - 2. Expenses are recognized in the period incurred
 - Regardless as to when cash is received or paid
- Adjusting entries – journal entries made at the end of the accounting period to update account balances
 - These are required because of accrual accounting and are required each time financial statements are prepared
- Two main categories of adjustment:
 - 1. Deferral – transaction where cash has been received or paid while the related revenue or expense has not been recorded
 - 2. Accruals – transactions for which cash has not yet been received or paid, but the related revenue or expense has been earned or incurred and thus must be recorded
- Deferred expense – company pays for expense item in advanced
 - Recorded as an asset
 - Becomes an expense when asset is used up
 - Ex. Prepaid insurance, prepaid rent, supplies
- Adjusting entries for deferred (prepaid) expenses are required to the recorded the portion of the prepayment representing the expense incurred which is the amount of the asset used up
 - The Adjusting entry results in a debit to an expense account and a credit to an asset account

- Problem #1
- Deferred revenue – company receives cash in advance for services to be performed or delivered later
 - This cash received is a liability
 - Becomes a revenue when service is performed or good is delivered
- Accruals – transactions for which cash has not been received or paid
 - Accrued revenue and expense
 - Ex. Salary
- Adjusting entries for accruals are required to record revenues earned and expenses incurred in the current period, but not yet received or paid in cash
 - Accrued Revenue – debit is an asset and credit is a revenue
 - Accrued expense – debit an expense and credit liability
- Depreciation – systematic allocation of the cost of a plant asset to expense over useful life
 - The using up of P-P-E
 - AJE is needed every year
 - *Depreciation has nothing to do with value of an asset, we don't depreciate an asset because its value is decreasing*
 - Matching concept
 - Record expense when asset used up
 - Debit – depreciation expense
 - Credit – accumulated depreciation
- Depreciation expenses:
 - Classified as an expense
 - Found on income statement
 - Reduces net income
 - Represents the amount of the building or equipment used up in the current year
- Accumulated Depreciation:
 - Causes decreases in assets
 - Classified as a contra asset
 - Normal balance is a credit
 - Found on the balance sheet directly underneath the asset being depreciated
 - Represents the total amount of the building or equipment used up since it was acquired
- Interest – comes about either when a company borrows money and must repay it with interest or when a company lends money to someone and is repaid with interest

- o Interest = principal*rate*time
- 4 Key Points
 - o 1. The rate is always expressed as an annual rate
 - o 2. Time is always a fraction and is always over 12, numerator = # of months used up
 - o 3. Interest can be computed for any time period less than or equal to one year, but never for a period of more than one year
 - o 4. For now we will assume all interest is paid at the end of the loan rather than have monthly payments that include interest
- An adjusted trial balance – prepared after all AJE's have been journalized and posted
 - o Its purpose is to prove the equality of the total debit and credit balances in the ledger after all adjustments have been made
 - o It is the same thing as the unadjusted trial balance except it includes the effects of adjusting entries
 - o Financial statements can be prepared directly from the adjusted trial balance
- Nominal (temporary account) – are closed to a zero balance at the end of every year
 - o Ex. – revenues, expenses, dividends
- Permanent (real) account – are never closed to zero as part of the year and closing process
 - o Assets, liabilities, equity
- The purpose of the closing entries is to transfer a net income or net loss and dividends to retained earnings

3 Closing Entries

- 1. Close revenue into retained earnings
- 2. Close expenses into retained earnings
- 3. Close dividends into retained earnings
- Debit each revenue and credit retained earnings for total revenue
 - o Debit retained earnings and credit expense for total expense
 - o Debit retained earning and credit dividends for dividends account
- Example #2
- After closing entries have been posted:
 - 1. All temporary accounts have a zero balance
 - 2. Balance in retained earnings represents the accumulated and undistributed earnings at the and of the accounting period
 - o The balance in retained earning represents net income for dividends