Adjusting the Accounts and Preparing the Statements

The accounting process involves

(1) analyzing the economic events of an organization and recording the effects of those events;
(2) classifying and summarizing the recorded effects in reports or financial statements.

The accounting process is based on a **time period principle**. In other words, the activities of a business are identified as occurring during specific time periods such as months or a year. The financial reports that show the results of operations are prepared for each period. Since this division of the life of the business into time periods is done for accounting purposes, the time periods are called accounting periods. The primary accounting period used is one year. However, businesses also prepare interim financial reports. Any 12-month period is called a fiscal year. A natural business year is the 12-month period that ends when the activities of a business are at their lowest point.

Some of the account balances that result from recording business transactions must be adjusted (changed) at the end of a time period. These transactions are not evidenced by source documents.

Need for Adjustments at the End of an Accounting Period

Some balances must be updated for statement purposes because internal economic events have occurred and have not yet been recorded.

The Adjustment Process

The adjustment process is based on two accounting principles: the **revenue recognition principle** and the **matching principle**. The revenue recognition principle states that revenue should be reported when it is earned and not before. The matching principle requires reporting expenses on the income statement in the same accounting period as the revenues that were earned as a result of the expenses.

When the adjustment process is used to assign revenues to the periods in which they are earned and to match expenses with revenues, the accounting system is described as **accrual basis accounting**. The alternative, **cash basis of accounting**, is a system in which revenues are reported on the income statement when cash is received and expenses are reported when cash is paid.

One important benefit of accrual accounting is that it makes the information on the accounting statements *comparable* from period to period.

Adjusting the Accounts

Prepaid Expenses--a prepaid expense is an economic benefit that has been paid for in advance of its use. An asset is an economic resource that will provide future benefits. When it is used, the benefit decreases and the portion used becomes an expense. Debit Expense; Credit asset

Examples include Prepaid Rent, Prepaid Insurance, and Supplies.

Depreciation -- represents the expiration of a plant asset's *usefulness*, not value. The amount of depreciation used is an estimate of the decline in usefulness. Debit depreciation expense, Asset; Credit Accumulated Depreciation, Asset.

Accumulated Depreciation is a contra account. Contra accounts allow balance sheet readers to observe both the original cost of the asset and the estimated amount of depreciation that has been charged to expense.

Unearned Revenue -- Payment for goods or services received in advance of delivering the goods. Debit Unearned Revenue; Credit Revenue Earned.

Accrued Revenue -- Earned revenue that is unrecorded because payment has not yet been received. Debit Accounts Receivable; Credit Revenue.

Accrued Expense -- Expense incurred during an accounting period that remains unrecorded because payment is not yet due. Debit an Expense; Credit a Liability.

Updating Accrued Revenue or Accrued Expense in the new accounting period

Accrued Expenses -- Debit Payable, Debit Expense; Credit Cash

Accrued Revenues -- Debit Cash; Credit Accounts Receivable, Credit Revenue

Business Entity Principle

The business should be accounted for separate from its owner(s).

Going-Concern Principle

It should be assumed that the business will continue to operate forever.

Objectivity Principle

The accounting records should provide a fair and unbiased report of how and what a business is doing.

Consistency Principle

Accounting procedures should remain the same from period to period whenever possible.

Conservatism Principle

When given a choice of alternatives, the choice least optimistic should be taken.

Monetary Unit Principle

All transactions should be reported using a single type of currency.

Time Period Principle

Business activities should be divided into separate time periods for reporting purposes.

Materiality Principle

The business need only report information that would make a difference to decision makers.

Cost Principle

All purchases should be recorded and maintained at their original cost regardless of their current market value.

Revenue Recognition Principle

Revenue should be recorded in the time period in which it was earned regardless of when the cash is received.

Matching Principle

Revenues earned should be matched in the same time period as the expenses used to generate them.