CHAPTER 7
A SECOND RUN THROUGH THE ACCOUNTING CYCLE

✓Topic 1 - Adjusting for Prepaid Expenses
Topic 2 - Adjusting for Depreciation Expense
Topic 3 - Expanding the Six-Column Worksheet to Ten Columns

In previous chapters you learned the eight steps in the accounting cycle and the purpose of each.

1. originating information through source documents
2. journalizing
3. posting
4. preparing the trial balance
5. preparing the worksheet
6. preparing financial statements (income statement and balance sh eet)
7. closing the books
8. preparing the postclosing trial balance

We all learned that once a cycle is complete, another can be started by using information in the postclosing trial balance.

In earlier chapters, we assumed **all** revenue and **all** expenses are recorded during an accounting period.

We also learned that it is very important that revenues were matched with related expenses to report a fair net income or loss for the accounting period.

In practice, not all revenues and expenses are recorded during the accounting period.

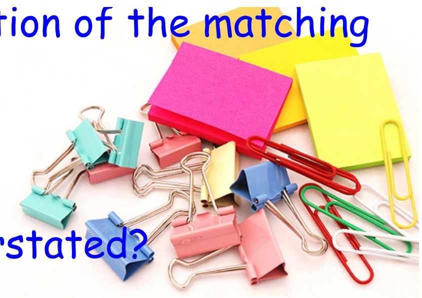
For example:

- A business may acquire office supplies costing $1000 at the beginning of the accounting period.
- Assume the cost is recorded in a current asset account Office Supplies on Hand.
- During the accounting period $800 of these supplies are used to support revenue making activities.
- Therefore at the end of the accounting period only 200 of the original supplies are on hand.

Jan 1	Office Supplies Purchased	**$1000**
	Less: Supplies Used to Support Revenue-Making Activities	**800**
Jan 31	Supplies on Hand	**$ 200**

How would this situation be recorded in the accounts?

- in the General Ledger there is an Office Supplies on Hand account (current asset) showing $1000
- however only $200 in Office Supplies are actually on hand at this time
- in addition no expense has been recorded for the $800 of office supplies that were used during the accounting period.
- because the expense has not been recorded the net income is overstated.
- also the current asset Office Supplies on Hand is overstated



Accounting Theory requires the correct application of the matching principle.

How can we resolve the fact that we have an unrecorded expense and an asset that is overstated?

An adjustment must be made to record the expense and decrease the asset.

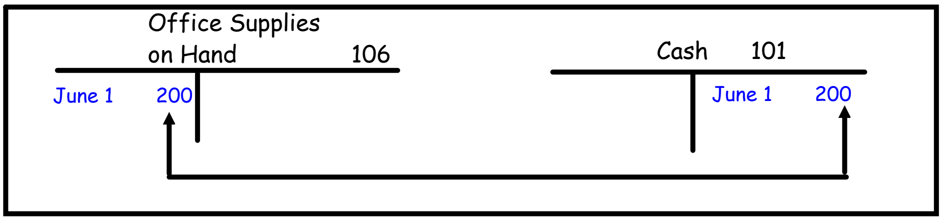
In the language of accounting, the mismatches are corrected through adjusting entries.

In practice, adjustments may be required for recorded and unrecorded revenues or expenses. We will only be dealing with unrecorded expenses

Topic 1 - ADJUSTING FOR PREPAID EXPENSES

Example:

June 1 Delta Real Estate issues a cheque for $200 to purchase enough office supplies to last several months. The cost is recorded in the asset account Office Supplies on Hand.



The supplies are expected to last more than accounting period therefore more than one accounting period will benefit from the expenditure, this asset is known as a prepaid expense.

Prepaid expense is a current asset because its cost will be used up or will expire usually within one year of the date of the balance sheet.

At the end of each period, the portion of the cost that has expired must be determined, and an adjustment made to transfer the expired portion from the asset account to the appropriate expense account.

expired cost → is an expense.
unexpired cost → is an asset.

Prepaid Expense: an expense payment made in advance to benefit more than one accounting period; hence a current asset whose cost will be used up in the very near future

June 30 In preparation for month-end financial statements, Delta Real Estate takes a physical count of office supplies and discovers $125 of unused supplies

Office Supplies Count	
June 1	$200
Less: Office Supplies count, June 30	125
Supplies Used	$ 75

The office supplies account must be adjusted to reflect this remaining cost.

Office Supplies Count	
June 1	$200
Less: Office Supplies count, June 30	125
Supplies Used	$ 75

Journal Entry:

June 30	Office Supplies Expense	75.00	
	Office Supplies on Hand		75.00
	To adjust the Office Supplies on Hand account for the month ended June 30th.		

Office Supplies Expense 520	
June 30 75	

Office Supplies on Hand 106	
June 1 200	June 30 75

Analysis:

- Credit the asset account Office Supplies on Hand for $75 (supplies used)
- Debit the expense account Office Supplies Expense. This records the dollar amount of office supplies used during the month.

Journal Entry:

June 30	Office Supplies Expense	75.00	
	Office Supplies on Hand		75.00
To adjust the Office Supplies on Hand account for the month ended June 30th.			

Why make the adjustment ??

- to correct the cost of the asset so that it reflects the unused or unexpired costs of supplies in the current asset section of the balance sheet
- the amount used - the expired cost - will be reported in the expense section of the income statement
- the adjustment updates both accounts, and the expense for the period is matched with the revenue for the period.

What would happen if the adjustment was not made?

- Revenue and expenses would be mismatched.
- Expenses would be understated by $75, because the used portion of office supplies is not recorded
- Net income would be overstated by $75
- Owner's equity, specifically capital, would be overstated by $75
- The asset section of the balance sheet would be overstated by $75, because the unused portion of the asset account would not have been reduced by the amount used during June.

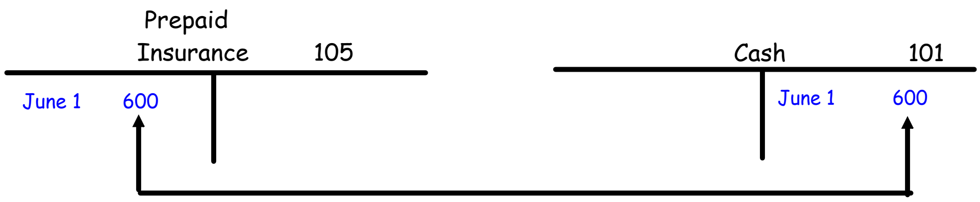
Prepaid Insurance - another type of prepaid expense

- Insurance is purchased on assets (such as equipment, automobiles, building and inventory) to ensure against loss due to theft, fire and flood etc.
- Insurance premiums are paid in advance, usually on a yearly basis and in a lump sum.
- When Insurance is purchased, the asset Prepaid Insurance is debited.
- The asset applies to the entire year, and if the accounting period is only one month, then only one-twelfth is used up.
- Therefore, this account should be adjusted periodically

June 1 Delta Real Estate issues a cheque for $600 for insurance on the automobile of the business.

What journal entry will you record?

June 1	Prepaid Insurance	600.00	
	Cash		600.00
	To pay for a one year insurance policy		



June 1 Delta Real Estate issues a cheque for $600 for insurance on the automobile of the business.

ANALYSIS:

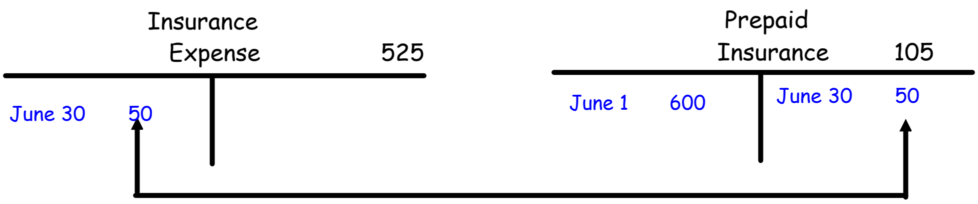
- The company bought 12 months of insurance for $600 ($50 per month). $\$600 \div 12 = \$50.^{00}$
- The business now owns insurance coverage for one year with an unexpired cost on June 1 of $600.
- Since the cheque was issued, Cash is credited.

June 30 At the end of June, one month of the insurance coverage or cost has expired,.... or we could say one-twelfth (1/12) of the insurance coverage has been used.

The Prepaid Insurance account must be adjusted and the expired portion (1/12 of $600 or $50) of the premium is debited to the expense account Insurance Expense.

What journal entry will you record?

June 30	Insurance Expense	50.00	
	Prepaid Insurance		50.00
	To record the expired cost of one month of insurance		



- The company now owns 11 months of insurance coverage. The unexpired portion is $550.
- The current asset account Prepaid Insurance refelects this amount, due to the adjustment

Other Prepaid Expenses - rent and advertising

- any time an expense is paid in advance and can be applied to more than one accounting period, it may be recorded as a prepaid expense.

What about rent that is paid monthly?

REDEFINING CURRENT ASSETS

- In Chapter 6 we defined current assets as assets that can be converted into cash within one year of the date of the balance sheet
- We must now expand this definition because of prepaid expenses

Current Assets: consists of cash and other economic resources that reasonably expected to be realized in cash, sold or consumed during the normal operating cycle of the business.

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Two distinct types of assets are included in this definition.
(1) assets, such as accounts receivable , that are intended to be converted into cash during the normal operating cycle of the business.

Operating cycle is the average time period between the performance of a service on account and the collection of cash from the accounts receivable. Most often this period is one year(or less) from the date of the balance sheet.

(2) asset to be consumed during the operating cycle of the business. These are identified as prepaid expenses - expenses which are unexpired costs (current assets) when they are acquired. They are expected to be consumed - or their costs to expire - within one year of the balance sheet.
**Remember the expired cost of such prepaid expenses must be transferred to expense accounts through adjusting entries

Current Asset Section of the Balance Sheet
- place the assets that are to be realized in cash before assets that will expire their costs while being used to support revenue-making activities
- prepaid expenses may be listed separately or grouped under a subheading.

Delta Real Estate
Partial Balance Sheet
As at June 20, 19 -

Current Assets:		
Cash		$8 796.00
Accounts Receivable		5 400.00
Prepaid Expenses:		
Supplies on Hand	$125.00	
Prepaid Insurance	550.00	675.00
Total Current Assets		$ 14 871.00

Finish 7-1, 7-2, 7-3

7-1 a)

		Debit	Credit
December 31	Supplies Expense	575	
	Supplies On Hand		575
	To adjust the supplies on hand account for the year		