Adjusting Entries

Canada's Winterland is gearing up for a new season of fun and excitement for families. To prepare for this year's grand opening, the amusement park must undergo its annual maintenance and start selling tickets for the big day. It's currently November 30th, and they are opening their doors on January 1st, giving them one whole month to get everything in order. With a long list of maintenance and operations on their to-do list, they've asked you to help them out with their books.

When keeping records, we must make sure that those records are understandable and useful later on. This is where **accrual- and cash-basis accounting** comes into play. Accrual-basis accounting is required by **GAAP,** where companies record transactions **when they occur**. This means that companies record journal entries when services are performed, goods are sold, or expenses are incurred, without regard to whether cash has changed hands. This also means that a company can record revenue if they've sold a product on account, despite not having received cash from a customer. This is also known as the **revenue recognition principle.** The alternative is cash-basis accounting, where companies record transactions when cash changes hands. On a cash basis, a company would only record revenue for a product sold on account only when a customer hands them cash for it. Although cash-basis accounting may be the simpler option, it's harder to capture the "substance" behind transactions. This is because in modern times, cash usually changes hands on a completely different schedule than when transactions are happening. Just think about your daily transactions, every time you pay with your credit card, the seller doesn't necessarily get cash from you right away. Thus, accounting standards and most businesses opt for a focus on accrual-based accounting, and provide a cash flow statement instead. However, cash-basis accounting can still be used internally or in smaller businesses which are not publicly listed.

Types of Adjustments

Because cash receipts are out of sync with the rest of our transaction records, we must use additional adjusting journal entries in accrual-based accounting to adjust for this. The types of adjustments we make in accrual-basis accounting will fall under **deferrals or accruals.** To help you remember, associate **deferrals with withholdings,** and **accruals with buildups**. **Deferrals** are when the money is exchanged first, then the delivery of goods or services occurs later. So, a firm receives **deferred revenue** when they receive cash for future goods or services that they still have to deliver, like the sale of a plane ticket. When this happens, the firm makes an initial journal entry to record the cash exchange taking place, as well as an adjusting journal entry later to recognize the transaction taking place. The firm **does not credit the revenue account** at this time because they have yet to fulfill the actual delivery of goods or services. Instead, the firm credits a temporary "unearned revenue" account to balance the debit to its cash account.

When they finally provide the goods or services, an adjusting entry is made. Recall the revenue recognition principle: revenues are recognized when they are earned. Now that the firm has provided a service or delivered a good to the customer, they have earned their revenue. This is the point at which the cash from before can be **recognized as revenue** to the firm, so we debit to zero-out our temporary "Unearned Revenue" account from before, and credit the **revenue account** that will contribute to the firm's net income.

Note that after the adjusting entry is made, the net effect is a debit to the cash account and credit to the revenue account. Why couldn't we have just done this in one entry?

Well, remembering back to the definition of accrual-basis accounting, companies must record transactions when they occur. This means recording an entry **at the time they promise to perform a service or sell a product to a customer.** However, the cash isn't necessarily paid at that moment, and the goods or services aren't necessarily provided at that moment either. Therefore, the temporary "Unearned Revenue" account provides a way for us to record both when **the cash changed hands** and when **the actual service was delivered.**

This was only one example of the adjusting entries we could make. We mentioned deferrals as a class of adjustments a firm might have to make. And seeing that we have a deferred revenue adjustment, we must surely have a deferred expense adjustment as well.

Deferred expense means cash was paid now in anticipation of future expenses on goods or services the firm will receive, like prepaid rent. First, an entry is made when the firm pays cash for the promise of a good or service that they will receive in the future.

Then the adjusting entry is made when the firm actually receives that good or service.

In accounting, we represent the things that a company gives up in exchange for revenues with expenses. Just like revenues, we have a principle regarding the recognition of expenses. **The matching principle**, also known as the **expense recognition principle**, states that **expenses need to be matched to the revenues that they helped earn**.

Thus, if there is a cash outflow for an expense in one period, but the expense is associated with a revenue in another period, **the expense must be recognized in the other period, and not the period in which there was a cash outflow**. For example, this is what we do with the Cost of Goods Sold, to avoid matching the money we spent this month, to purchase next month's inventory, with the revenue we earned this month, by selling this month's inventory, which we purchased last month. In the case of prepaid rent, we can match each month's operating revenue to a portion of our prepaid rent because that portion of rent expense contributes to that month's operating revenue.

Now that we've covered deferral adjustments, where the cash transaction happens first and the delivery of goods and services follows, we'll take a look at **accrual adjustments**. Accrual adjustments are the opposite of deferral adjustments, when the delivery happens first, then the cash transaction follows.

Accrued revenues are situations where the revenue is earned, but we haven't received cash for it yet. This includes things like services performed on account, or goods sold on account. When the service is performed or the goods are sold, the company can record the credit to revenue as they have earned it by doing their part. However, they debit accounts receivable instead of cash, because they haven't gotten any cash for it. Accounts receivable is an asset account, with a debit normal balance. In this case, accounts receivable is our temporary account.

When the firm receives the cash for the sale of a good or service at a later date, they debit cash with the cash received, and credit accounts receivable, which represents the customer paying off their debt. Thus, this is an accrued revenue, because we've built up revenue with a transaction on credit, and we got the cash for it later.

Lastly, an accrued expense is an expense incurred in the current period but not paid for until the future. They can appear as wage expenses owed to employees, as employees are often paid once every two weeks, for example. When the initial expense is incurred, the company records the accrued expense with a debit and credits their accounts payable for the amount owed. They are incurring current expenses that they will pay for in the future, but right now they're essentially paying for it on credit.

And when it comes time to pay for those expenses, they pay off the amount they owe with cash. Thus, they credit cash for the amount paid, and debit accounts payable to remove the amount owed.

To sum up, we've just covered **deferred revenues** and **expenses**, as well as **accrued revenues** and **expenses**. Deferred means cash exchanged now for future goods or services, and accrual means goods or services exchanged now and payment to come in the future.

In both cases, the event occurs at a different time from the cash exchange, and will require an adjusting entry to settle the temporary accounts from the first event. So, when approaching these questions, make sure you ask yourself: What is the order of events? What accounts are impacted by those events? And most importantly, after all the adjustments, does the **net balance** of the remaining accounts make sense?

Let's take what we just learned, and apply it to Canada's Winterland's books. In the month leading up to the grand opening, Canada's Winterland has the following activities scheduled:

The park's general manager tells you that they pay for all expenses with their corporate card, and settles those payments on the last day of each month. He's asked you to prepare the journal entries for the activities in accordance to accrual-basis accounting. Please include any journal entries required to settle amounts outstanding between January and March. Pause the video here to try it for yourself, and come back when you're ready for the solution.

Here is the solution.

A mechanic performs maintenance on the carousel for $4000 on December 2nd. Because the maintenance was performed and paid for with the corporate card, the maintenance expense is an accrued expense for Canada's Winterland.

The renewal of annual insurance for $24000 demonstrates both an **accrued expense** and **deferred expense** scenario. Because insurance for the year is charged to the corporate card on December 14th, that amount is accrued until the end of the month, where it is paid off with cash. However, the insurance is a prepaid expense for the year, so from December 31st it becomes a deferred expense.

The prepaid expense is the deferred expense, and the adjustment is made across each period in the season, as the **matching principle** states that we cannot recognize the prepaid expense until it can be matched to revenue each month. This means that our adjustment for the deferred insurance expense will stretch across twelve months, for $2000 per month.

Popular food vendor, Ottertails, rents out a food stand for the season for $12600. For Canada's Winterland, the rent revenue is both an accrued revenue and a deferred revenue. It is an accrued revenue on December 20th, even though Canada's Winterland and Ottertails already have a rental agreement, because the actual rental is not yet in effect. Therefore, Canada's Winterland has unearned rent revenue for the season rental amount which they will receive on December 31st. After December 31st, they will have received the cash for the next three months, but will only be able to recognize a portion of that amount as the earned rent revenue over each of the three months that Ottertails will operate the food stand for.

Canada's Winterland sells $10000 worth of season passes for guests to purchase. The revenue from the sale of season passes is an example of a deferred revenue, where Canada's Winterland will receive cash upfront for their guests' future visits. However, they will not be able to recognize this as sales revenue until guests have redeemed it.

To summarize, we just covered four different types of adjustments. Deferred revenue, deferred expense, accrued revenue, accrued expense. Remember that **deferrals** mean that the transaction has been paid for but the actual revenue or expense has not yet been made, **Accruals,** on the other hand, mean that the revenue or expense was made but the cash transaction hasn't happened yet.

In both cases, cash changes hands at a different time from when the company earns revenue or incurs an expense. Therefore, we make one journal entry to document the first financial activity using temporary accounts, and make a second adjusting entry to document the second financial activity happening at a later date. After the adjustment, the net balance of the temporary account should be zero, with debits equal to credits.

That concludes the basics of adjusting entries. Now you're ready to try out some problems by yourself! Although deferred and accrued adjustments may seem daunting at first glance, you can break the problems down by considering these questions: What is the order of events? What accounts are impacted by those events? And most importantly, after all the adjustments, does the net balance of the remaining accounts make sense?