Accruals, Deferrals, and the Worksheet

Section 1: Calculating and Recording Adjustments

Section Objectives

1. Determine the adjustment for merchandise inventory, and enter the adjustment on the worksheet.
2. Compute adjustments for accrued and prepaid expense items, and enter the adjustments on the worksheet.
3. Compute adjustments for accrued and deferred income items, and enter the adjustments on the worksheet.
The Accrual Basis of Accounting
The accrual basis is a system of accounting by which all revenues and expenses are matched and reported on financial statements for the applicable period.
Financial statements usually are prepared using the accrual basis of accounting because it most nearly attains the goal of matching expenses and revenue in an accounting period.
Revenue is recognized when earned, not necessarily when the cash is received.

- Revenue is recognized when the sale is complete.
- A sale is complete when title to the goods passes to the customer or when the service is provided.
- For sales on account, revenue is recognized when the sale occurs even though the cash is not collected immediately.
Expenses are recognized when incurred or used, not necessarily when cash is paid.

- Each expense is assigned to the accounting period in which it helped to earn revenue for the business, even if cash is not paid at that time.

- This is often referred to as matching revenues and expenses.
Adjustment for Merchandise Inventory
Objective 1

Determine the adjustment for merchandise inventory, and enter the adjustment on the worksheet.
• An asset account for merchandise inventory is maintained in the general ledger.
  
  \[ \text{Inventory} \]
  
  \[ \text{Purchases} \]
  
  \[ \text{Sales} \]
  
• All purchases of merchandise are debited to the Purchases account.

• All sales of merchandise are credited to the revenue account Sales.
Notice that no entries are made directly to the Merchandise Inventory account during the accounting period.

Consequently, when the trial balance is prepared at the end of the period, the Merchandise Inventory account still shows the beginning inventory for the period.
Adjustment for Merchandise Inventory

- At the end of each period a business determines the ending balance of the Merchandise Inventory account.

- The first step in determining the ending inventory is to count the number of units of each type of item on hand.

- As the merchandise is counted, the quantity on hand is entered on an inventory sheet.
An inventory sheet is a form used to list the quantity and type of goods a firm has in stock.
Based on a count taken on December 31, merchandise inventory for Simpson Antiques totaled $47,000.

Simpson Antiques needs to adjust the Merchandise Inventory account to reflect the balance at the end of the year.

The adjustment is made in two steps.

Each step needs two general ledger accounts:

- Merchandise Inventory
- Income Summary
The first step is to remove beginning inventory from the books. Simpson Antiques began the year with $52,000 in inventory.

**QUESTION:**

What is the amount of the first inventory adjustment?

**ANSWER:**

Beginning Inventory

$52,000
<table>
<thead>
<tr>
<th>Which account is debited?</th>
<th>Which account is credited?</th>
</tr>
</thead>
<tbody>
<tr>
<td>For what amount?</td>
<td>For what amount?</td>
</tr>
</tbody>
</table>

Adjustment for Beginning Inventory
<table>
<thead>
<tr>
<th>Income Summary</th>
<th>Merchandise Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>52,000</td>
<td>Bal. 52,000</td>
</tr>
<tr>
<td></td>
<td>52,000</td>
</tr>
</tbody>
</table>
The next step is to place ending inventory on the books. Simpson Antiques ended the year with $47,000 in inventory.

QUESTION:
What is the amount of the next inventory adjustment?

ANSWER:
$47,000
Adjustment for Ending Inventory

Which account is debited?  
For what amount?

Which account is credited?  
For what amount?
## Adjustment for Ending Inventory

<table>
<thead>
<tr>
<th>Merchandise Inventory</th>
<th>Income Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>47,000</td>
<td>47,000</td>
</tr>
</tbody>
</table>
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