

Unit 11 - Adjusting the Books

It is not enough that the debits equal the credits and that the statements be mathematically correct. They must also be **accurate**

The **matching principle** requires that the revenue of a particular accounting period be matched with the expenses of the same accounting period.

The purpose of adjusting the books is to ensure that the account balances and the financial statements are **accurate**

The balance sheet must show, as accurately as possible, the value of all of the assets, liabilities, and equity accounts at the end of the fiscal period.

The income statement must accurately present the revenue and expenses for the fiscal period it covers.

see page 242 example of Adjusting the books

Prepaid Expenses

Expenses-costs of items used up in operating a business.

Payments made in advance for items such as rent, insurance, and supplies are called **prepaid expenses**.

Prepaid expenses are items of value and are current assets

At the end of an accounting period, entries are made to record the conversion of prepaid assets to expenses in order to correct the **account balances for the balance sheet** and to record the **appropriate expenses for the income statement**

see page 243- prepaid rent, supplies, and prepaid insurance-
examples

Depreciation

Equipment is used up in operating the business, it does in some way contribute to the expenses of the business.

example - Equipment purchases for \$12, 000 and will be used for 5 years (life of equipment)

$$12000/5 \text{ years} = 2400 \text{ dollars a year}$$

The cost of the equipment should be assigned or allocated as an expense to each year's operation. Each year, part of the equipment cost should become an expense.

see page 246 for example of recording depreciation

Depreciation is a method of **spreading the cost of a fixed asset over the life of the asset**. It is a process of converting the cost of fixed assets into expenses over the time the asset will make a contribution to the business

There is a separate Depreciation Expense account and a separate Accumulated Depreciation account for each group of fixed assets.

example-**Building, Equipment, Delivery Truck, and Machinery**

Why not simply credit Equipment to show the decrease in value?

The use of the Accumulated Depreciation account as well as the asset account, Equipment, provides two types of information. One is the original cost of the equipment. The other is the total amount of depreciation recorded over the years.

Valuation or Contra Accounts

The Accumulated Depreciation account is sometimes called a **valuation account** because it is used to arrive at the value of an asset.

It is also known as a **contra asset account** because it has a credit balance rather than the normal debit balance found in most asset accounts.

Contra accounts provide information to the reader of the financial report.

see page 248 for example

Methods of Calculating Depreciation

Two methods of calculating depreciation

- Straight-line method
- Declining-balance method, fixed percentage

Straight-Line Method

Cost of the equipment divided by the number of years used

$$\$12,000.00 / 5 \text{ years use} = \$2,400.00 \text{ a year depreciation}$$

Allocates equal amount of depreciation to each fiscal year

see chart pg. 249

Declining-Balance Method, Fixed Percentage

Depreciation is greatest in the first few years of an asset's life
ex. Automobile

A greater amount of depreciation is allocated to the first years when the declining-balance method is used.

See page 230 for example

	20%		
12,000	2400	-	9600.00
9600	1920	-	7680.00
7680	1536	-	6144.00
6144	1228.80		4915.20
4915.20	983.04		3932.16

Depreciation and Income Tax

For income tax purposes in Canada, the declining-balance method must be used. This method is called **capital cost allowance** under the **Income Tax Act**.

Assets are grouped into classes and maximum percentages of depreciation allowed for income tax purposes is set for each class.

see page 251 for chart examples

Land is not depreciable. For income tax purposes, a business may not claim depreciation expense on land. see page 251

Two Sets of Books!!!

see page 252