

ADJUSTMENT ENTRIES (II)

Review of Deferred and Accrual Adjustment

<i>Type of Adjustment</i>	<i>Accounts Before Adjustment</i>	<i>Adjusting Entry</i>
Prepaid expenses	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
Unearned revenues	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated Revenues understated	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated Liabilities understated	Dr. Expenses Cr. Liabilities

19.1 Depreciation Expenses

- ◆ The third category of adjusting entries is related to other adjustments
- ◆ It includes depreciation and Accounting for bad debts
- ◆ Depreciation is the process of allocating the cost of tangible fixed assets over its estimated life
- ◆ Initially the cost of the assets including installation cost is debited to the particular assets
- ◆ In each accounting year/period a portion of the cost expires and needs adjustment for showing correct profit for the period and correct value of the asset

Example # 19.1: On January 1, 2015, Company acquired machinery (a depreciable asset) at a total cost of Rs. 152,000. The estimated salvage value of the asset is Rs. 2,000 and its estimated useful life is five years. Record yearly depreciation

Case 1: Cost Method

Adjusting Entry

Date		Account Title and Explanations	Ref	Amount (Rs)	
				Debit	Credit
Dec	31				

Case 2: Written Down Method

Adjusting Entry

Date	Account Title and Explanations	Ref	Amount (Rs)	
			Debit	Credit
Dec 31				

19.2 Accounting for Bad Debts

- ❖ For achieving the maximum sales, goods are often sold to known customers on credit
- ❖ Since of these customers fails to pay their debts due to insolvency or any other factor
- ❖ These debts which cannot be recovered are called bad debts. It is a loss/expense to the business so, an adjustment is needed
- ❖ Determining the amount of accounts receivable to report is difficult because some receivables will become uncollectible
- ❖ It should be noted here that no adjustment is required for any bad debt which is appearing already in the Trial Balance. The bad debt appearing in the trial balance shows as expense in the income statement only
- ❖ Two methods are used in accounting for uncollectible accounts are Direct Write-off Method and Allowance Method

19.2.1 Direct Write-off Method

- When a specific account is determined to be uncollectible, the loss is charged to Bad Debts Expense
- Bad debts expense will show only actual losses from uncollectible
- Using the direct write-off method, entries to record write-offs are often made in a period following sales rather than in the period in which the sales were made. Therefore, there is no matching of expenses with the revenue
- Use of the direct write-off method can reduce the usefulness of both the income statement and balance sheet
- Unless bad debt losses are insignificant, the direct write-off method is not acceptable for financial reporting purposes

Example # 19.2: Based on an analysis the bad debts expense adjustment for the year 2016 is Rs. 1,000 for Ali and Sons

Adjusting Entry

Date	Account Title and Explanations	Ref	Amount (Rs)	
			Debit	Credit

19.2.2 Allowance or Provision Method

- The allowance method of accounting for bad debts involves estimating uncollectible accounts at the end of each period
- It provides better matching of expenses and revenues on the income statement and ensures that receivables are stated at their cash (net) realizable value on the balance sheet
- Cash (net) realizable value is the net amount of cash expected to be received. It excludes amounts that the company estimates it will not collect
- Receivables are therefore reduced by estimated uncollectible amounts on the balance sheet through use of the allowance method
- The allowance method is required for financial reporting purposes when bad debts are material
- Three essential features of the allowance method are:
 - Companies estimated uncollectible accounts receivable and match them against revenues in the same accounting period in which the revenues are recorded
 - Company are record estimated uncollectible as an increase (a debit) to Bad Debts Expense and an increase (a credit) to Allowance for Doubtful Accounts (a contra asset account) through an adjusting entry at the end of each period
 - Companies debit actual uncollectible to Allowance for Doubtful Accounts and credit them to Accounts Receivable at the time the specific account is written off as uncollectible

19.2.2.1 Recording Estimated Uncollectible:

- Allowance for Doubtful Accounts shows the estimated amount of claims on customers that are expected to become uncollectible in the future
- The credit balance in the allowance account will absorb the specific write-offs when they occur
- Allowance for Doubtful Accounts is not closed at the end of the fiscal year
- Bad Debts Expense is reported in the income statement as an operating expense (usually a selling expense)

19.2.2.2 Recording the Write-Off

- Each write-off should be approved in writing by authorized management personnel
- Under the allowance method, every bad debt write-off is debited to the allowance account (not to Bad Debt Expense) and credited to the appropriate Account Receivable
- A write-off affects only balance sheet accounts. Cash realizable value in the balance sheet, therefore, remains the same

19.2.2.3 Recovery of an Uncollectible Account

- When a customer pays after the account has been written off, two entries are required:
 - (1) The entry made in writing off the account is reversed to reinstate the customer's account
 - (2) The collection is journalized in the usual manner
- The recovery of a bad debt, like the write-off of a bad debt, affects only balance sheet accounts

Example # 19.3: Assume Abbottabad Furniture has credit sales of Rs. 1,200,000 in 2011, of which Rs. 200,000 remains uncollected at December 31st 2016. The credit manager estimates that Rs. 12,000 of these sales will prove uncollectible. Pass the adjusting entry to record the estimated uncollectible

Estimation of Uncollectable

Date	Account Title and Explanations	Ref	Amount	
			Debit	Credit
2016				
Dec 31				

Assume that the vice-president of finance on March 1, 2017, authorizes a write-off of Rs. 500 balance owed by R. A. Sons. Pass the adjusting entry to record the write-off

Bad Debts Write-Off

Date	Account Title and Explanations	Ref	Amount	
			Debit	Credit
2017				
March 1				

When R. A. Sons pays Rs. 500, two journal entries are required to record the collection:

Recovery of Bad Debts

Date	Account Title and Explanations	Ref	Amount	
			Debit	Credit

- ◆ Frequently the allowance is estimated as a percentage of the outstanding receivables
 - Management establishes a percentage relationship between the amount of receivables and expected losses from uncollectible accounts
 - Companies often prepare a schedule in which customer balances are classified by the length of time they have been unpaid
 - Because of its emphasis on time, this schedule is often called an aging schedule and the analysis of it is often called aging the accounts receivable

SUMMARY OF ADJUSTING ENTRIES

Adjusting Entry	Account to be DEBITED	Account to be CREDITED
PREPAID EXPENSES:		
Asset Method	Expense	Prepaid expense
Expense method	Prepaid expense	Expense
UNEARNED REVENUES:		
Liability Method	Unearned Revenue	Revenue
Revenue method	Revenue	Unearned Revenue
ACCRUED EXPENSES		
	Expense	Payable
ACCRUED REVENUES		
	Receivable	Revenue
DEPRECIATION		
	Depreciation Expense	Accumulated depreciation
DOUBTFUL ACCOUNTS		
	Bad debts Expense	Allowance for Bad Debts

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Example # 19.4: For each of the following cases, prepare the adjusting entries at the end of December, 2011

- a. One-third of the fee related to Rs. 60,000 cash received in advance is performed this period
- b. Wages of Rs. 9,000 are earned by workers but not paid as of December 31, 2011
- c. The prepaid Insurance account had a Rs. 5,000 balance on December 31, 2011. An analysis of insurance policies shows that Rs. 2,200 of unexpired insurance benefits remains at December 31, 2012
- d. The company has earned (but not recorded) Rs. 750 of interest from investments in CDs for the year ended December 31, 2011. The interest revenue will be received on January 10, 2012
- e. The company has a bank loan and has incurred (but not recorded) interest expenses of Rs. 3,500 for the year ended December 31, 2011. The company must pay the interest on January 2, 2012
- f. Record the bad debt expense for December that estimates total uncollectible accounts at Rs. 1,400
- g. Depreciation on the company's equipment is Rs. 3,000 by WDM

Adjusting Entries

Date	Account Title and Explanations	Ref	Amount (Rs)	
			Debit	Credit
2011				
<i>Dec</i>	(a)			
	(b)			
	(c)			
	(d)			
	(e)			
	(f)			
	(g)			
Total				

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