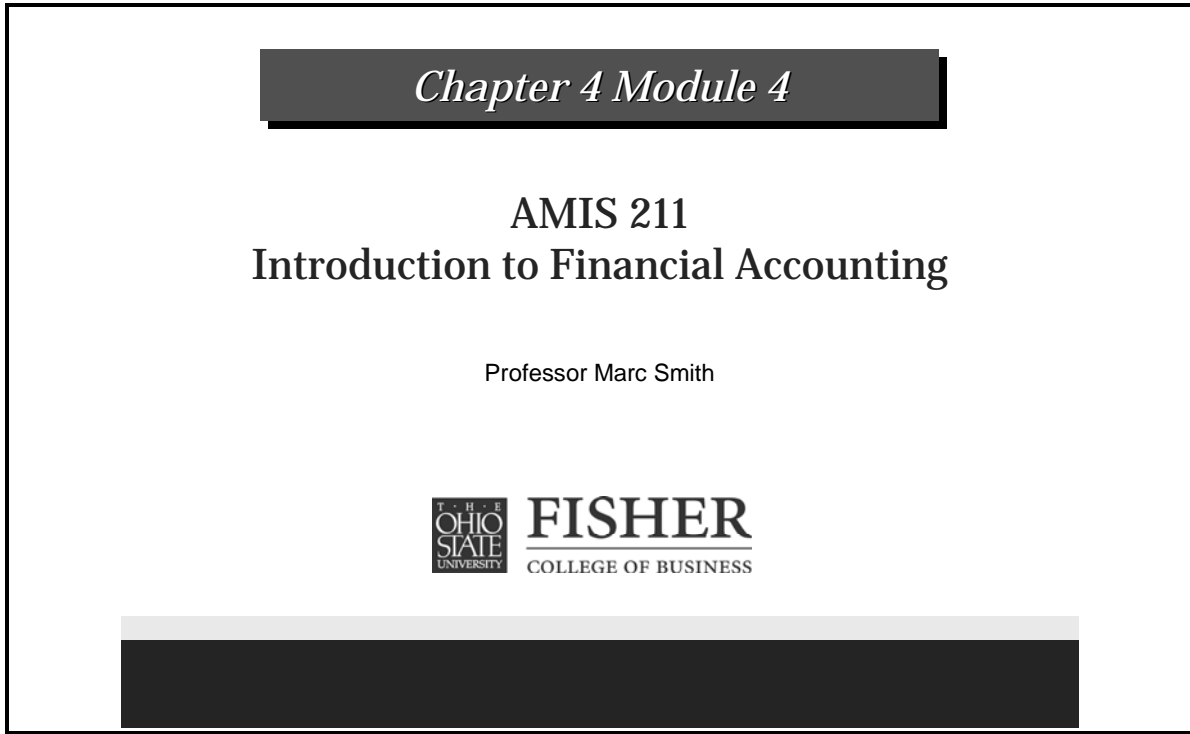


Chapter 4, Module 4


Slide 1

A rectangular box with a black border containing the slide content. At the top, a dark grey horizontal bar contains the text "Chapter 4 Module 4" in white italicized font. Below this, the text "AMIS 211" and "Introduction to Financial Accounting" is centered in a serif font. Underneath, "Professor Marc Smith" is centered in a smaller serif font. The Fisher College of Business logo is centered below that, featuring a square with "T H B OHIO STATE UNIVERSITY" and the word "FISHER" in large letters above "COLLEGE OF BUSINESS". At the bottom of the box, there are two horizontal bars: a light grey one on top and a dark grey one below it.

Chapter 4 Module 4

AMIS 211
Introduction to Financial Accounting

Professor Marc Smith

 **FISHER**
COLLEGE OF BUSINESS

Hi everyone. Welcome back.

Let's just continue our discussion of Adjusting Entries (AJEs), specifically Deferrals.

And, let's move to the next slide together.

Slide 2

Chapter 4 Module 4: Deferred Revenues

Deferrals

**transactions for which cash has been received or paid while the related revenue or expense has not been recorded
(exchange of cash has occurred before the action)**

Deferred Revenues (Unearned Revenue)

Company receives cash in advance for services to be performed or goods to be delivered later.

This cash received is recorded as a *liability*.

It only becomes a revenue when it is earned ...
when the company actually performs
the service or delivers the good

And, here is a definition we are used to seeing now.

A Deferral, one more time:

It is a transaction where the exchange of cash—either getting or paying cash—occurs before recording the Revenue or Expense. Exchange of cash happens first—the action happens later.

In this module, let's talk about a Deferred Revenue.

We have already talked about Deferred Expenses. So, let's talk about a Deferred Revenue—also called Unearned Revenues.

Now, with our Unearned Revenues—what is going on here is: the company receives cash. So, we are actually getting the money. The company receives cash for services to be performed or goods to be delivered at a future point in time.

We get cash first; we do the service or sell the good later.

The key point here is: the cash that we receive in advance is not considered a Revenue. The cash that we receive in advance is considered a Liability.

Why?

Because: when you take somebody's money, you now owe them that service or you owe them that good.

So, as soon as you take the money, you owe them the service or good. This money you get in advance—this Unearned Revenue—is treated as a Liability. It only becomes a Revenue when it is earned.

And, when is it earned?

This is one you should be able to answer for me.

According to the Realization Principle, it is earned when we actually perform the service or deliver the good—when we do our end of the bargain.

So, to summarize:

An Unearned Revenue or Deferred Revenue is when the company receives cash in advance for services to be performed at a future point in time. This receipt of cash in advance is treated as a Liability. It only becomes a Revenue when we actually perform the service. And, that, in a nutshell, is the Realization Principle.

Let's go to the next slide.

Slide 3

Chapter 4 Module 4: Deferred Revenues

Adjusting entries for deferred (unearned) revenues are required to record the portion of the liability that represents the revenue earned in the current period.

The adjusting entry results in a debit to a liability account and a credit to a revenue account.

Liability		Revenue	
Debit Adjusting Entry (↓)	Unadjusted Balance		Credit Adjusting Entry (↑)
		→	

And on the next slide (Slide 3) you can see the necessary adjustments for Unearned Revenues.

Remember: Unearned Revenue—cash received in advance—is treated as a Liability.

We need an adjustment to recognize the portion of the Liability that has been earned as of the end of the accounting period.

So, the Adjusting Entry (AJE) will always consist of a debit to the Liability account—reflecting the fact that we no longer have the Liability. We have done the work. We do not owe that service anymore.

So, you will always have a debit to the Liability and a credit to the Revenue to reflect the fact that it has now been earned.

And, you can see there (on Slide 3) in the T-Accounts how this would work.

You have the Liability with its unadjusted balance—the normal side of credit.

When it gets adjusted, you need a debit to the Liability to reduce it. And, you are moving it into a Revenue account. You have now performed the service and earned it. So you have a credit to the Revenue to increase it.

Those past couple of slides is crucial to your understanding of Unearned or Deferred Revenues.

Let's go to the next slide.

Slide 4

Chapter 4 Module 4: Example #1

Case D:
November 1, 1999 (receipt of advance payment)

Cash 20,000
Unearned Revenue 20,000

Cash = Asset
Unearned Revenue = Liability

Rev	-	Exp	=	NI	A	=	L	+	E
NE		NE		NE	↑20,000		↑20,000		NE

And, let's go back to our Web site problem. And, let's do an example of Unearned Revenue.

Here is what Case D says:

“On November 1st of 1999, XYZ Company received a \$20,000 advance payment for delivery services to be performed later. By the end of 1999, XYZ Company had performed 80% of these services.”

Now, before we worry about the necessary adjustment, let's just record the regular old Journal Entry at November 1st to reflect the fact that we have now received cash and we owe these delivery services.

The regular old Entry would be: a debit to cash—increase to Cash because you now have it—it is in your hands. And, credit the Liability: Unearned Revenue. You now owe this company this service. You now owe this customer these delivery services.

We know that Cash is an Asset.

And, we should know Unearned Revenue is a Liability. It reflects services we still owe.

So, to determine the effects of this transaction—getting cash in advance:

We can figure out there is No Effect (NE) on the Income Statement. There are no Revenues or Expenses.

There is an effect on the Balance Sheet. Our Assets—Cash, specifically—have increased and our Liabilities—Unearned Revenue, specifically—has increased.

And, of course, the Balance Sheet balances.

That is the regular Entry to record the receipt of Cash in advance.

Go to the next slide and let's answer a question.

Slide 5

Chapter 4 Module 4: Example #1

Case D:

Question: Do we need an adjusting entry at December 31, 1999 related to the unearned revenue?

Answer: Yes

Question: Why?

Answer: Because some of the services have been performed. Thus, we must reduce the liability and record the revenue earned.

And, the question is this:

Do we need an Adjusting Entry (AJE) at December 31st of 1999 relating to the Unearned Revenue?

My guess is you are all going to say: “Yes! Of course! It is in the Adjusting Entries chapter!”

So, of course, I am going to say: “Well, why?”

Yes, we do need an Adjusting Entry. How come?

The reason is: we have done some of the work. We have performed 80% of these services. We need an Adjusting Entry to reduce our Liability and record the Revenue earned—to reflect the fact that we have now performed some of the services that we owed.

Let’s go to the next slide.

Slide 6

Chapter 4 Module 4: Example #1**Case D:****December 31, 1999 (AJE)**

Unearned Revenue 16,000
Service Revenue 16,000

Unearned Revenue = Liability
Service Revenue = Revenue

Rev	-	Exp	=	NI	A	=	L	+	E
↑16,000		NE		↑16,000	NE		↓16,000		↑16,000

And, let's look at what Adjusting Entry (AJE) needs to be recorded.

To record the earning of Unearned Revenue: we will debit the Unearned Revenue account and credit the Service Revenue account.

And, if you go back to the slide with the T-Accounts on it (Slide 3), I think you will see it told you: always debit a Liability. So, we know Unearned Revenue is a Liability. And, always credit a Revenue account. And, we should know that Service Revenue is a Revenue account.

The effects on the financial statements of this Adjusting Entry (AJE):

We now have earned revenue. So, our Revenues go up, which, of course, causes Net Income to go up, which, of course, causes Equity—specifically Retained Earnings—to go up.

The other part of this transaction—the Unearned Revenue—the Liability is decreasing. We do not owe these services any more; we have performed them. So, while our Equity increases; our Liability decreases.

This allows our Balance Sheet to balance.

There is No Effect (NE) on the Asset side.

And, overall, there is No Effect (NE) on the Liabilities plus (+) Equity side; because you have one going up and one going down, this “nets” to No Effect (NE).

So, we are still in balance.

Please go to the next slide with me.

Slide 7

<i>Chapter 4 Module 4: Example #1</i>	
Case D:	
Question:	What would be the amount of unearned revenue appearing on the December 31, 1999 balance sheet?
Answer:	\$4,000 [20,000 – 16,000] The unearned revenue represents the amount of services still to be performed (i.e., still owed). It is a liability.

And, answer this question:

What amount would appear as the Liability: Unearned Revenue on the December 31st, 1999 Balance Sheet?

The answer is: \$4,000.

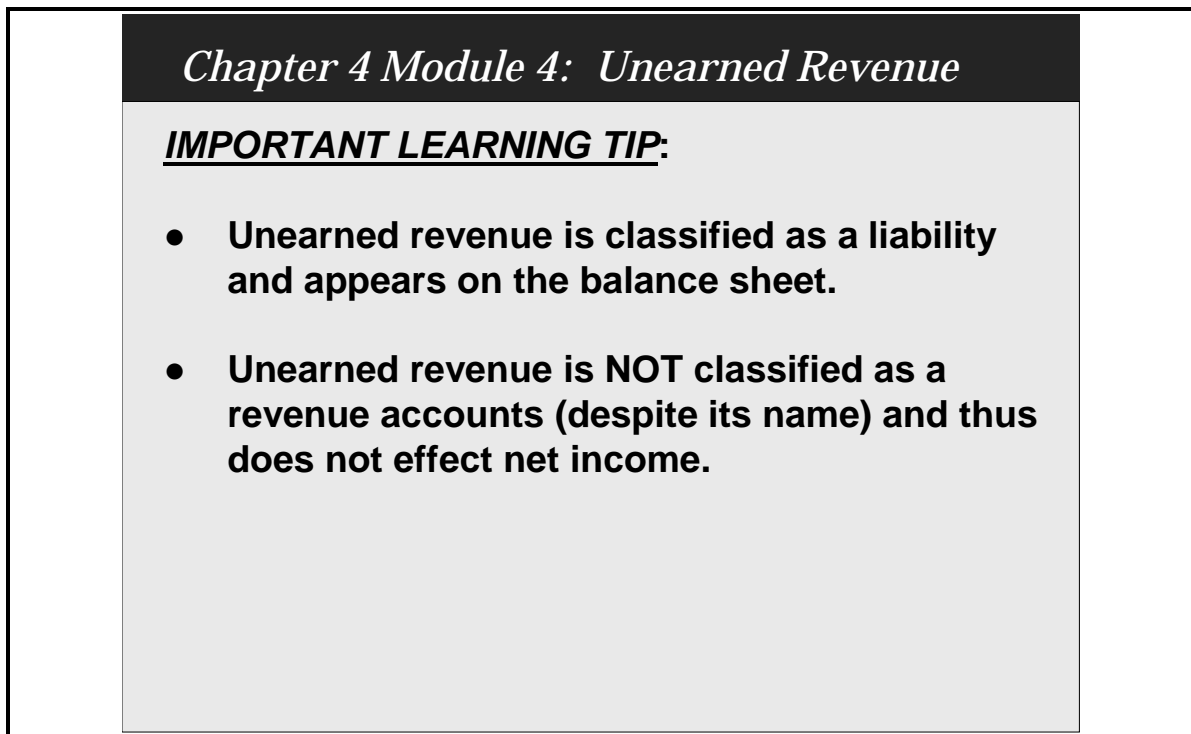
We started with \$20,000 of Unearned Revenue. We then performed 80% of the services. So, we reduced our Liability on the previous slide by \$16,000.

What we still have left—what is still owed—is: the \$4,000.

The Unearned Revenue represents the services we still owe—even though we have been paid for it already—we still have to perform these services. We still have to perform \$4,000 of the services that we have been paid for already.

Go to the next slide with me.

Slide 8

A rectangular box with a black border containing text. The top part is a dark grey header with white text. Below it is a light grey area with black text. The text includes a chapter title and two bullet points under a 'TIP' heading.

Chapter 4 Module 4: Unearned Revenue

IMPORTANT LEARNING TIP:

- **Unearned revenue is classified as a liability and appears on the balance sheet.**
- **Unearned revenue is NOT classified as a revenue accounts (despite its name) and thus does not effect net income.**

And, let's go over a couple of important learning tips relating to Unearned Revenue.

The first one: 1): Unearned Revenue is a Liability. It appears on the Balance Sheet.

It might be a little counterintuitive.

Despite the name, Unearned Revenue is a Liability that appears on the Balance Sheet.

2): Unearned Revenue is NOT classified as a Revenue account.

It has No Effect on the Income Statement. It does not affect Revenues. It does not affect Net Income.

It is simply a Liability. It simply reflects services or goods that we owe because we have already been paid for them.