Chapter 3

Adjusting the Accounts

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Explain the time period assumption.
- **2** Explain the accrual basis of accounting.
- **3** Explain the reasons for adjusting entries.
- 4 Identify the major types of adjusting entries.
- 5 Prepare adjusting entries for deferrals.
- 6 Prepare adjusting entries for accruals.
- 7 Describe the nature and purpose of an adjusted trial balance. The Navigator

The Navigator
Scan Study Objectives
Read Feature Story
Read Preview
Read text and answer Before You Go On p. 97 p. 104 p. 109 p. 114
Work Demonstration Problem
Review Summary of Study Objectives
Answer Self-Study Questions
Complete Assignments

Feature Story

WHAT WAS YOUR PROFIT?

The accuracy of the financial reporting system depends on answers to a few fundamental questions: At what point has revenue been earned? At what point is the earnings process complete? When have expenses really been incurred?

During the 1990s' boom in the stock prices of dot-com companies, many dot-coms earned most of their revenue from selling advertising space on their websites. To boost reported revenue, some dot-coms began swapping website ad space. Company A would put an ad for its website on company B's website, and company B would put an ad for its website on company A's website. No money changed hands, but each company recorded revenue (for the value of the space that it gave the other company on its site). This practice did little to boost net income, and it resulted in no additional cash flow—but it did boost reported revenue. Regulators eventually put an end to this misleading practice.

Another type of transgression results from companies recording revenues or expenses in the wrong year. In fact, shifting revenues and expenses is one of the most common abuses of financial accounting. Xerox, for example, admitted reporting billions of dollars of lease revenue in periods earlier than it should have been reported. And WorldCom stunned the financial markets with its admission that it had boosted net income by billions of dollars by delaying the recognition of expenses until later years.



Unfortunately, revelations such as these have become all too common in the corporate world. It is no wonder that a U.S. Trust survey of affluent Americans reported that 85% of respondents believed that there should be tighter regulation of financial disclosures; 66% said they did not trust the management of publicly traded companies.

Why did so many companies violate basic financial reporting rules and sound ethics? Many speculate that as stock prices climbed, executives were under increasing pressure to meet higher and higher earnings expectations. If actual results weren't as good as hoped for, some gave in to temptation and "adjusted" their numbers to meet market expectations.



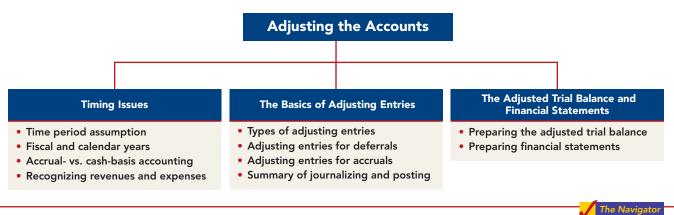
Inside Chapter 3

- How Long Will "The Force" Be with Us? (p. 96)
- Companies Change Advertising Treatment (p. 100)
- Turning Gift Cards into Revenue (p. 104)
- All About You: Is Your Old Computer a Liability? (p. 115)

Preview of Chapter 3

In Chapter 1 you learned a neat little formula: Net income = Revenues - Expenses. In Chapter 2 you learned some rules for recording revenue and expense transactions. Guess what? Things are not really that nice and neat. In fact, it is often difficult for companies to determine in what time period they should report some revenues and expenses. In other words, in measuring net income, timing is everything.

The content and organization of Chapter 3 are as follows.





TIMING ISSUES

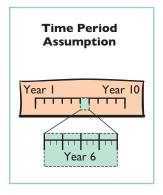
STUDY OBJECTIVE 1

Explain the time period assumption.

We would need no adjustments if we could wait to prepare financial statements until a company ended its operations. At that point, we could easily determine its final balance sheet and the amount of lifetime income it earned. The following story illustrates one way to compute lifetime income.

A grocery store owner from the "old country" kept his accounts payable on a spindle, accounts receivable on a note pad, and cash in a cigar box. His daughter, having just passed the CPA exam, chided the father: "I don't understand how you can run your business this way. How do you know what your profits are?"

"Well," the father replied, "when I got off the boat 40 years ago, I had nothing but the pants I was wearing. Today your brother is a doctor, your sister is a college professor, and you are a CPA. Your mother and I have a nice car, a well-furnished house, and a lake home. We have a good business, and everything is paid for. So, you add all that together, subtract the pants, and there's your profit."



ALTERNATIVE TERMINOLOGY

The time period assumption is also called the periodicity assumption.

Selecting an Accounting Time Period

Although the old grocer may be correct in his evaluation, it is impractical to wait so long for the results of operations. All companies find it desirable to report the results of their activities on a frequent basis. For example, management usually wants monthly financial statements, and the Internal Revenue Service requires all businesses to file annual tax returns. Therefore, **accountants divide the economic life of a business into artificial time periods**. This convenient assumption is referred to as the **time period assumption**.

Many business transactions affect more than one of these arbitrary time periods. For example, the airplanes purchased by Northwest Air Lines five years ago are still in use today. We must determine the relevance of each business transaction to specific accounting periods. (How much of the cost of an airplane contributed to operations this year?)

Fiscal and Calendar Years

Both small and large companies prepare financial statements periodically in order to assess their financial condition and results of operations. Accounting time periods are generally a month, a quarter, or a year. Monthly and quarterly time periods are called interim periods. Most large companies must prepare both quarterly and annual financial statements.

An accounting time period that is one year in length is a **fiscal year**. A fiscal year usually begins with the first day of a month and ends twelve months later on the last day of a month. Most businesses use the **calendar year** (January 1 to December 31) as their accounting period. Some do not. Companies whose fiscal year differs from the calendar year include **Delta Air Lines**, June 30, and **Walt Disney Productions**, September 30. Sometimes a company's year-end will vary from year to year. For example, **PepsiCo**'s fiscal year ends on the Friday closest to December 31, which was December 25 in 2004 and December 30 in 2005.

Accrual- vs. Cash-Basis Accounting

What you will learn in this chapter is accrual-basis accounting. Under the accrual basis, companies record transactions in the periods in which the events occur. For example, using the accrual basis to determine net income means companies recognize revenues when earned (rather than when they receive cash). It also means recognizing expenses when incurred (rather than

An alternative to the accrual basis is the cash basis. Under **cash-basis accounting**, companies record revenue when they receive cash. They record an expense when they pay out cash. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails to record revenue that a company has earned but for which it has not received the cash. Also, it does not match expenses with earned revenues. **Cash-basis accounting is not in accordance with generally accepted accounting principles (GAAP).**

Individuals and some small companies do use cash-basis accounting. The cash basis is justified for small businesses because they often have few receivables and payables. Medium and large companies use accrual-basis accounting.

Recognizing Revenues and Expenses

It can be difficult to determine the amount of revenues and expenses to report in a given accounting period. Two principles help in this task: the revenue recognition principle and the matching principle.

REVENUE RECOGNITION PRINCIPLE

The **revenue recognition principle** dictates that companies recognize revenue in the accounting period in which it is earned. In a service enterprise, revenue is considered to be earned at the time the service is performed. To illustrate, assume that Dave's Dry Cleaning, Inc. cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July. Under the revenue recognition principle, Dave's earns revenue in June when it performed the service, rather than in July when it received the cash. At June 30, Dave's would report a receivable on its balance sheet and revenue in its income statement for the service performed.

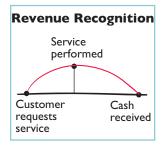
MATCHING PRINCIPLE

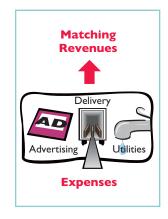
when paid).

Accountants follow a simple rule in recognizing expenses: "Let the expenses follow the revenues." That is, expense recognition is tied to revenue recognition. In the dry cleaning example, this principle means that Dave's should report the salary

STUDY OBJECTIVE 2

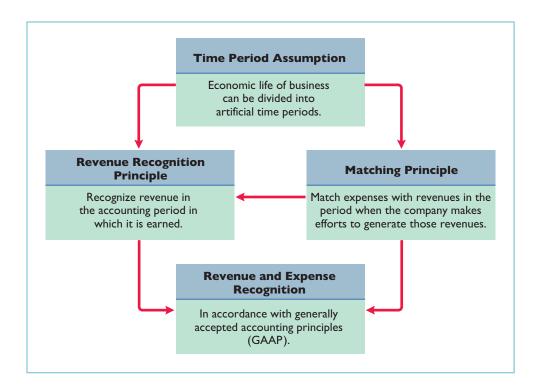
Explain the accrual basis of accounting





This practice of expense recognition is referred to as the **matching principle**. It dictates that efforts (expenses) be matched with accomplishments (revenues). Illustration 3-1 summarizes the revenue and expense recognition principles.

Illustration 3-1 GAAP relationships in revenue and expense recognition



ACCOUNTING ACROSS THE ORGANIZATION



How Long Will "The Force" Be with Us?

mestic revenues total over \$500 million for Star Wars and continue to grow.

Suppose you are filmmaker George Lucas and you spent \$11 million to produce Twentieth Century Fox's film Star Wars. Over what period should the studio expense the cost?

Yes, it should expense the cost over the economic life of the film. But what *is* its economic life? You must estimate how much revenue you will earn from box office sales, video sales, television, and games and toys—a period that could be less than a year or more than 20 years, as is the case for *Star Wars*. Originally released in 1977, and rereleased in 1997, do-

What accounting principle does this example illustrate? How will financial results be affected if the expenses are recognized over a period that is *less than* that used for revenues? What if the expenses are recognized over a period that is *longer than* that used for revenues?

Before You Go On...

REVIEW IT

- 1. What is the relevance of the time period assumption to accounting?
- 2. What are the revenue recognition and matching principles?



THE BASICS OF ADJUSTING ENTRIES

In order for revenues and expenses to be reported in the correct period, companies make adjusting entries at the end of the accounting period. Adjusting entries ensure that the revenue recognition and matching principles are followed. Adjusting entries make it possible to report correct amounts on the balance sheet and on the income statement.

STUDY OBJECTIVE 3

Explain the reasons for adjusting entries.

The trial balance—the first summarization of the transaction data—may not contain up-to-date and complete data. This is true for several reasons:

1. Some events are not recorded daily because it is not efficient to do so. For example, companies do not record the daily use of supplies or the earning of wages by employees.



2. Some costs are not recorded during the accounting period because they expire with the passage of time rather than as a result of daily transactions. Examples are rent, insurance, and charges related to the use of equipment.

Accounting Cycle Tutorial— Making Adjusting Entries

3. Some items may be unrecorded. An example is a utility bill that the company will not receive until the next accounting period.

A company must make adjusting entries every time it prepares financial statements. It analyzes each account in the trial balance to determine whether it is complete and up-to-date. For example, the company may need to make inventory counts of supplies. It may also need to prepare supporting schedules of insurance policies, rental agreements, and other contractual commitments. Because the adjusting and closing process can be time-consuming, companies often prepare adjusting entries after the balance sheet date, but date them as of the balance sheet date.

HELPFUL HINT

Adjusting entries are needed to enable financial statements to conform to GAAP.

Types of Adjusting Entries

Adjusting entries are classified as either **deferrals** or **accruals**. As Illustration 3-2 shows, each of these classes has two subcategories.

STUDY OBJECTIVE 4

Identify the major types of adjusting entries.

Deferrals

- 1. Prepaid Expenses. Expenses paid in cash and recorded as assets before they are used or consumed.
- 2. Unearned Revenues. Cash received and recorded as liabilities before revenue is earned.

Accruals

- **1. Accrued Revenues.** Revenues earned but not yet received in cash or recorded.
- **2.** Accrued Expenses. Expenses incurred but not yet paid in cash or recorded.

Illustration 3-2
Categories of adjusting entries

The following pages explain each type of adjustment and show examples. Each example is based on the October 31 trial balance of Pioneer Advertising Agency Inc. from Chapter 2 and reproduced in Illustration 3-3.

Illustration 3-3 Trial balance

PIONEER ADVERTIS Trial Ba October	alance	
Cash Advertising Supplies Prepaid Insurance Office Equipment Notes Payable Accounts Payable Unearned Revenue Common Stock Retained Earnings Dividends Service Revenue Salaries Expense Rent Expense	Debit \$15,200 2,500 600 5,000 500 4,000 900 \$28,700	\$ 5,000 2,500 1,200 10,000 -0- 10,000

We assume that Pioneer Advertising uses an accounting period of one month, and thus it makes monthly adjusting entries. The entries are dated October 31.

Adjusting Entries for Deferrals

STUDY OBJECTIVE 5

Prepare adjusting entries for deferrals.

Deferrals are either prepaid expenses or unearned revenues. Companies make adjustments for deferrals to record the portion of the deferral that represents the **expense incurred or the revenue earned** in the current period.

PREPAID EXPENSES

Companies record payments of expenses that will benefit more than one accounting period as assets called **prepaid expenses** or **prepayments**. When expenses are prepaid, an asset account is increased (debited) to show the service or benefit that the company will receive in the future. Examples of common prepayments are insurance, supplies, advertising, and rent. In addition, companies make prepayments when they purchase buildings and equipment.

Prepaid expenses are costs that expire either with the passage of time (e.g., rent and insurance) **or through use** (e.g., supplies). The expiration of these costs does not require daily journal entries. Companies postpone recognizing these costs until they prepare financial statements. At each statement date, they make adjusting entries: (1) to record the expenses that apply to the current accounting period, and (2) to show the unexpired costs in the asset accounts.

Prior to adjustment for prepaid expenses, assets are overstated and expenses are understated. As shown in Illustration 3-4, an adjusting entry for prepaid expense increases (debits) an expense account and a decreases (credits) an asset account.

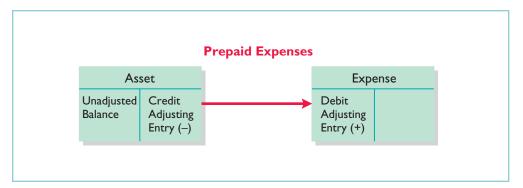


Illustration 3-4Adjusting entries for prepaid expenses

On the next few pages, we will look in more detail at some specific types of prepaid expenses, beginning with supplies.

Supplies. Businesses use various types of supplies such as paper, envelopes, and printer cartridges. Companies generally debit supplies to an asset account when they acquire them. In the course of operations, supplies are used, but companies postpone recognizing their use until the adjustment process. At the end of the accounting period, a company counts the remaining supplies. The difference between the balance in the Supplies (asset) account and the supplies on hand represents the supplies used (an expense) for the period.

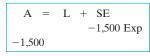
Pioneer Advertising Agency Inc. purchased advertising supplies costing \$2,500 on October 5. Pioneer recorded that transaction by increasing (debiting) the asset Advertising Supplies. This account shows a balance of \$2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that \$1,000 of supplies are still on hand. Thus, the cost of supplies used is \$1,500 (\$2,500 - \$1,000). Pioneer makes the following adjusting entry.

After the adjusting entry is posted, the two supplies accounts show:

Advertising Supplies				Adver	tising Su	pplies Expense	
10/5	2,500	10/31 Ad	j. 1,500	10/31	Adj.	1,500	
10/31 Bal.	1,000						

The asset account Advertising Supplies now shows a balance of \$1,000, which is equal to the cost of supplies on hand at the statement date. In addition, Advertising Supplies Expense shows a balance of \$1,500, which equals the cost of supplies used in October. If Pioneer does not make the adjusting entry, October expenses will be understated and net income overstated by \$1,500. Also, both assets and owner's equity will be overstated by \$1,500 on the October 31 balance sheet.

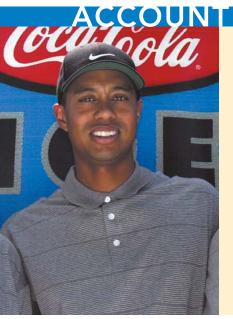




Cash Flows no effect

Equation analyses summarize the effects of the transaction on the elements of the accounting equation.

Illustration 3-5 Supplies accounts after adjustment



Companies Change Advertising Treatment

NG ACROSS THE ORGANIZATION

The method of accounting for advertising costs affects sales and marketing executives. In the past, companies sometimes recorded as assets the costs of media advertising for burgers, bleaches, athletic shoes, and other products. They then expensed those costs in subsequent periods as sales took place. The reasoning behind this treatment was that long ad campaigns provided benefits over multiple accounting periods. Today the accounting profession no longer allows this treatment because it decided that the benefits were too difficult to measure.

Instead, companies now must expense advertising costs when the advertising takes place. The issue is important because the outlays for advertising can be substantial. Recent big spenders: The Coca-Cola Company spent \$2.2 billion, PepsiCo., Inc. \$1.7 billion, Nike, Inc. \$1,378 million, and Limited Brands \$484 million.



Why might the new accounting method cause companies sometimes to spend less on advertising?

Insurance

Oct. 4
Insurance purchased;
record asset

Insurance Policy						
Oct	Nov	Dec	Jan			
\$50	\$50	\$50	\$50			
Feb	March	April	May			
\$50	\$50	\$50	\$50			
June	July	Aug	Sept			
\$50	\$50	\$50	\$50			
	LYFAR \$600					

Oct. 31 Insurance expired; record insurance expense

A = L + SE -50 Exp

Cash Flows

no effect

Illustration 3-6 Insurance accounts after adjustment **Insurance.** Companies purchase insurance to protect themselves from losses due to fire, theft, and other unforeseen events. Insurance must be paid in advance. Insurance premiums (payments) normally are recorded as an increase (a debit) to the asset account Prepaid Insurance. At the financial statement date companies increase (debit) Insurance Expense and decrease (credit) Prepaid Insurance for the cost that has expired during the period.

On October 4, Pioneer Advertising Agency Inc. paid \$600 for a one-year fire insurance policy. Coverage began on October 1. Pioneer recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of \$600 in the October 31 trial balance. Insurance of \$50 (\$600 \div 12) expires each month. Thus, Pioneer makes the following adjusting entry.

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50
	(To record insurance expired)		

After Pioneer posts the adjusting entry, the accounts show:

Prepaid Insurance				In	surance	Expense
10/4	600	10/31 Adj.	50	10/31 Adj.	50	
10/31 Bal.	550					

The asset Prepaid Insurance shows a balance of \$550. This amount represents the unexpired cost for the remaining 11 months of coverage. The \$50 balance in Insurance Expense equals the insurance cost that has expired in October. If Pioneer does not make this adjustment, October expenses will be understated and net income overstated by \$50. Also, both assets and stockholders' equity will be overstated by \$50 on the October 31 balance sheet.

Depreciation. Companies typically own buildings, equipment, and vehicles. These long-lived assets provide service for a number of years. Thus, each is recorded as an asset, rather than an expense, in the year it is acquired. As explained in Chapter 1, companies record such assets **at cost**, as required by the cost principle. The term of service is referred to as the **useful life**.

According to the matching principle, companies then report a portion of the cost of a long-lived asset as an expense during each period of the asset's useful life. **Depreciation** is the process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner.

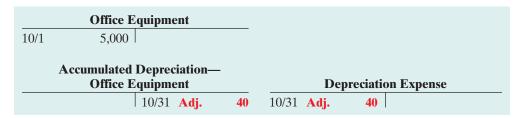
Need for Depreciation Adjustment. From an accounting standpoint, acquiring long-lived assets is essentially a long-term prepayment for services. Companies need to make periodic adjusting entries for depreciation, just as they do for other prepaid expenses. These entries recognize the cost that has been used (an expense) during the period and report the unexpired cost (an asset) at the end of the period.

When a company acquires a long-lived asset, it does not know its exact useful life. The asset may be useful for a longer or shorter time than expected, depending on various factors. Thus, **depreciation is an estimate** rather than a factual measurement of expired cost. A common procedure in computing depreciation expense is to divide the cost of the asset by its useful life. For example, if cost is \$10,000 and useful life is expected to be 10 years, annual depreciation is \$1,000.

Pioneer Advertising estimates depreciation on the office equipment to be \$480 a year, or \$40 per month. Thus, Pioneer makes the following adjusting entry to record depreciation for October.



After the adjusting entry is posted, the accounts show:



The balance in the accumulated depreciation account will increase \$40 each month. After journalizing and posting the adjusting entry at November 30, the balance will be \$80; at December 31, \$120; and so on.

Statement Presentation. Accumulated Depreciation—Office Equipment is a **contra asset account**. That means that it is offset against an asset account on the balance sheet. This accumulated depreciation account appears just after the account it offsets (in this case, Office Equipment) on the balance sheet. Its normal balance is a credit.

An alternative to using a contra asset account would be to decrease (credit) the asset account (e.g., Office Equipment) directly for the depreciation each month. But use of the contra account is preferable for a simple reason: it discloses *both* the original cost of the equipment *and* the total cost that has expired to date.





Cash Flows

Illustration 3-7Accounts after adjustment for depreciation

HELPFUL HINT

All contra accounts have increases, decreases, and normal balances opposite to the account to which they relate.

¹Chapter 10 addresses the computation of depreciation expense in detail.

In the balance sheet, Pioneer deducts Accumulated Depreciation—Office Equipment from the related asset account, as follows.

Illustration 3-8

Balance sheet presentation of accumulated depreciation

Office equipment	\$5,000		
Less: Accumulated depreciation—office equipment	40	\$4,960	

ALTERNATIVE TERMINOLOGY

Book value is sometimes referred to as carrying value or unexpired cost.

The difference between the cost of any depreciable asset and its related accumulated depreciation is its **book value**. In Illustration 3-8, the book value of the equipment at the balance sheet date is \$4,960. The book value of an asset generally differs from its **market value**—the price at which the asset could be sold in the marketplace. Remember that depreciation is a means of cost allocation, not a matter of market valuation.

Depreciation expense identifies that portion of the asset's cost that has expired during the period (in this case, in October). As for other prepaid adjustments, the omission of this adjusting entry would cause total assets, total owner's equity, and net income to be overstated and depreciation expense to be understated.

If the company owns additional long-lived assets, such as store equipment or buildings, it records depreciation expense on each of those items. It also establishes related accumulated depreciation accounts, such as: Accumulated Depreciation—Store Equipment; and Accumulated Depreciation—Buildings.

Illustration 3-9 summarizes the accounting for prepaid expenses.

Illustration 3-9
Accounting for prepaid expenses

ACCOUNTING FOR PREPAID EXPENSES						
Reason for Accounts Before Adjusting Examples Adjustment Adjustment Entry						
Insurance, supplies, advertising, rent, depreciation.	Prepaid expenses recorded in asset accounts have been used.	Assets over- stated. Expenses understated.	Dr. Expenses Cr. Assets			

Oct. 2 Thank you in advance for your work I will finish by Dec. 31

Cash is received in advance; liability is recorded



Oct. 31
Some service has been provided; some revenue is recorded

UNEARNED REVENUES

Companies record cash received before revenue is earned by increasing a liability account called **unearned revenues**. Examples are rent, magazine subscriptions, and customer deposits for future service. Airlines such as **United**, **American**, and **Delta**, for instance, treat receipts from the sale of tickets as unearned revenue until they provide the flight service. Similarly, colleges consider tuition received prior to the start of a semester as unearned revenue.

Unearned revenues are the opposite of prepaid expenses. Indeed, unearned revenue on the books of one company is likely to be a prepayment on the books of the company that made the advance payment. For example, a landlord will have unearned rent revenue when a tenant has prepaid rent.

When a company receives cash for future services, it increases (credits) an unearned revenue account (a liability) to recognize the liability. Later, the company earns revenues by providing service. It may not be practical to make daily journal entries as the revenue is earned. Instead, we delay recognizing earned revenue until the end of the period. Then the company makes an adjusting entry to record the revenue that has been earned and to show the liability that remains. Typically, prior to adjustment, liabilities are overstated and revenues are understated. Therefore, as shown in Illustration 3-10, the adjusting entry for unearned revenues results in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account.

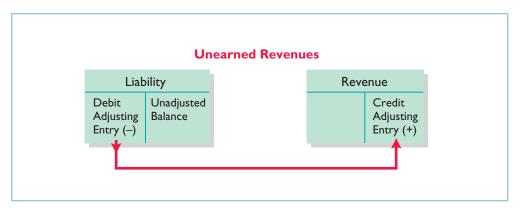


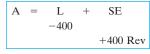
Illustration 3-10Adjusting entries for unearned revenues

Pioneer Advertising Agency Inc. received \$1,200 on October 2 from R. Knox for advertising services expected to be completed by December 31. Pioneer credited the payment to Unearned Service Revenue; this account shows a balance of \$1,200 in the October 31 trial balance. Analysis reveals that the company earned \$400 of those fees in October. Thus, it makes the following adjusting entry.

ALTERNATIVE TERMINOLOGY

Unearned revenue is sometimes referred to as deferred revenue.





Cash Flows no effect

After the company posts the adjusting entry, the accounts show:

U	nearne	d Revenue		Servic	e Revenue	
10/31 Adj.	400	10/2	1,200		10/31 Bal.	10,000
		10/31 Bal.	800		31 Adj.	400

Illustration 3-11Revenue accounts after prepayments adjustment

The liability Unearned Revenue now shows a balance of \$800. That amount represents the remaining prepaid advertising services to be performed in the future. At the same time, Service Revenue shows total revenue of \$10,400 earned in October. Without this adjustment, revenues and net income are understated by \$400 in the income statement. Also, liabilities are overstated and stockholders' equity understated by \$400 on the October 31 balance sheet.

Illustration 3-12 summarizes the accounting for unearned revenues.

ACCOUNTING FOR UNEARNED REVENUES						
Reason for Accounts Before Adjusting Examples Adjustment Adjustment Entry						
Rent, magazine subscriptions, customer deposits for future service.	Unearned revenues recorded in liability accounts have been earned.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues			

Illustration 3-12 Accounting for unearned revenues

ACCOUNTING ACROSS THE ORGANIZATION



Turning Gift Cards into Revenue

Those of you interested in marketing know that gift cards are among the hottest tools in merchandising today. Customers purchase gift cards and give them to someone for later use. In a recent year gift-card sales topped \$95 billion.

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is used by the customer? How should expired gift cards be accounted for? In its 2004 balance sheet Best Buy reported unearned revenue related to gift cards of \$300 million.

Source: Robert Berner, "Gift Cards: No Gift to Investors," Business Week (March 14, 2005), p. 86.

Suppose that Robert Jones purchases a \$100 gift card at Best Buy on December 24, 2007, and gives it to his wife, Devon, on December 25, 2007. On January 3, 2008, Devon uses the card to purchase \$100 worth of CDs. When do you think Best Buy should recognize revenue, and why?

Before You Go On...

REVIEW IT

- 1. What are the four types of adjusting entries?
- 2. What is the effect on assets, stockholders' equity, expenses, and net income if a company does not make a prepaid expense adjusting entry?
- 3. What is the effect on liabilities, stockholders' equity, revenues, and net income if a company does not make an unearned revenue adjusting entry?
- 4. Using PepsiCo's Consolidated Statement of Income, what was the amount of depreciation expense for 2005 and 2004? (See Note 4 to the financial statements.) The answer to this question appears on page 140.



DO IT

The ledger of Hammond, Inc. on March 31, 2008, includes the following selected accounts before adjusting entries.

	Debit	Credit
Prepaid Insurance	3,600	
Office Supplies	2,800	
Office Equipment	25,000	
Accumulated Depreciation—Office Equipment		5,000
Unearned Revenue		9,200

An analysis of the accounts shows the following.

- 1. Insurance expires at the rate of \$100 per month.
- 2. Supplies on hand total \$800.
- 3. The office equipment depreciates \$200 a month.
- 4. One-half of the unearned revenue was earned in March.

Prepare the adjusting entries for the month of March.

Action Plan

■ Make adjusting entries at the end of the period for revenues earned and expenses incurred in the period.

■ Don't forget to make adjusting entries for prepayments. Failure to adjust for prepayments leads to overstatement of the asset or liability and related understatement of the expense or revenue.							
Solution							
1. Insurance Expense	100						
Prepaid Insurance (To record insurance expired)		100					
2. Office Supplies Expense	2,000						
Office Supplies (To record supplies used)		2,000					
3. Depreciation Expense	200						
Accumulated Depreciation—Office Equipment (To record monthly depreciation)		200					
4. Unearned Revenue	4,600						
Service Revenue		4,600					
(10 record revenue for services provided)	(To record revenue for services provided)						
Related exercise material: BE3-3, BE3-4, BE3-5, and BE3-6.							

Adjusting Entries for Accruals

The second category of adjusting entries is **accruals**. Companies make adjusting entries for accruals to record revenues earned and expenses incurred in the current accounting period that have not been recognized through daily entries.

STUDY OBJECTIVE 6

Prepare adjusting entries for accruals.

ACCRUED REVENUES

Revenues earned but not yet recorded at the statement date are **accrued revenues**. Accrued revenues may accumulate (accrue) with the passing of time, as in the case of interest revenue and rent revenue. Or they may result from services that have been performed but are neither billed nor collected. The former are unrecorded because the earning process (e.g., of interest and rent) does not involve daily transactions. The latter may be unrecorded because the company has provided only a portion of the total service.

An adjusting entry for accrued revenues serves two purposes: (1) It shows the receivable that exists at the balance sheet date, and (2) it records the revenues earned during the period. Prior to adjustment, both assets and revenues are understated. Therefore, as Illustration 3-13 shows, an adjusting entry for accrued revenues increases (debits) an asset account and increases (credits) a revenue account.

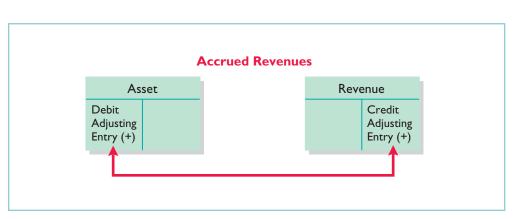
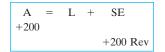




Illustration 3-13Adjusting entries for accrued revenues

In October Pioneer Advertising Agency Inc. earned \$200 for advertising services that have not been recorded. Pioneer makes the following adjusting entry on October 31.



Cash Flows



After Pioneer posts the adjusting entry, the accounts show:

Illustration 3-14 Receivable and revenue accounts after accrual adjustment

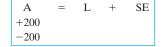
Acc	counts]	Receivable	Service	Reven	ue	
10/31 Adj.	200			10/31		10,000
				31		400
				31	Adj.	200
				10/31	Bal.	10,600

ETHICS NOTE

Computer Associates
International was accused of
backdating sales—that is, saying
that a sale that occurred at the
beginning of one quarter occurred
at the end of the previous quarter,
in order to achieve the previous
quarter's sales targets.

The asset Accounts Receivable indicates that clients owe \$200 at the balance sheet date. The balance of \$10,600 in Service Revenue represents the total revenue Pioneer earned during the month (\$10,000 + \$400 + \$200). Without the adjusting entry, assets and stockholders' equity on the balance sheet, and revenues and net income on the income statement, are understated.

On November 10, Pioneer receives cash of \$200 for the services performed in October and makes the following entry.



Cash Flows +200



Nov. 10	Cash	200	
	Accounts Receivable		200
	(To record cash collected on account)		

The company records collection of cash on account with a debit (increase) to Cash and a credit (decrease) to Accounts Receivable.

Illustration 3-15 summarizes the accounting for accrued revenues.

Illustration 3-15Accounting for accrued revenues

ACCOUNTING FOR ACCRUED REVENUES								
Reason for Accounts Before Adjusting Examples Adjustment Adjustment Entry								
Interest, rent, services performed but not collected.	Revenues have been earned but not yet received in cash or recorded.	Assets under- stated. Revenues understated.	Dr. Assets Cr. Revenues					

ALTERNATIVE TERMINOLOGY

Accrued expenses are also called accrued liabilities.

ACCRUED EXPENSES

Expenses incurred but not yet paid or recorded at the statement date are accrued expenses. Interest, rent, taxes, and salaries are typical accrued expenses. Accrued expenses result from the same causes as accrued revenues. In fact, an accrued expense on the books of one company is an accrued revenue to another company. For example, Pioneer's \$200 accrual of revenue is an accrued expense to the client that received the service.

An adjusting entry for accrued expenses serves two purposes: (1) It records the obligations that exist at the balance sheet date, and (2) it recognizes the expenses

of the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore, as Illustration 3-16 shows, an adjusting entry for accrued expenses increases (debits) an expense account and increases (credits) a liability account.

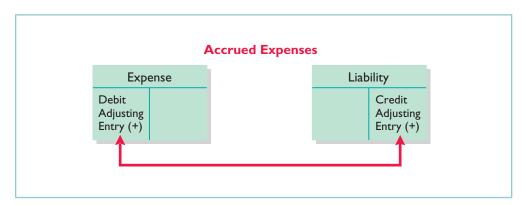


Illustration 3-16Adjusting entries for accrued expenses

On the next few pages, we will look in more detail at some specific types of accrued expenses, beginning with accrued interest.

Accrued Interest. Pioneer Advertising Agency Inc. signed a \$5,000, 3-month note payable on October 1. The note requires Pioneer to pay interest at an annual rate of 12%.

Three factors determine the amount of interest accumulation: (1) the face value of the note, (2) the interest rate, which is always expressed as an annual rate, and (3) the length of time the note is outstanding. For Pioneer, the total interest due on the note at its due date is \$150 (\$5,000 face value \times 12% interest rate \times 3/12 time period). The interest is thus \$50 per month. Illustration 3-17 shows the formula for computing interest and its application to Pioneer Advertising Agency Inc. for the month of October. Note that the time period is expressed as a fraction of a year.

HELPFUL HINT

Interest is a cost of borrowing money that accumulates with the passage of time.

Illustration 3-17Formula for computing interest

Pioneer makes the following accrued expense adjusting entry on October 31.

A = L + SE -50 Exp +50

Cash Flows no effect

After the company posts this adjusting entry, the accounts show:

Interest	Expense	Interest Payable				
10/31 Adj. 50		10/31	Adj. 50			

Illustration 3-18 Interest accounts after adjustment

²We will consider the computation of interest in more depth in later chapters.

Interest Expense shows the interest charges for the month of October. Interest Payable shows the amount of interest owed at the statement date. (As of October 31, they are the same because October is the first month of the note payable.) Pioneer will not pay the interest until the note comes due at the end

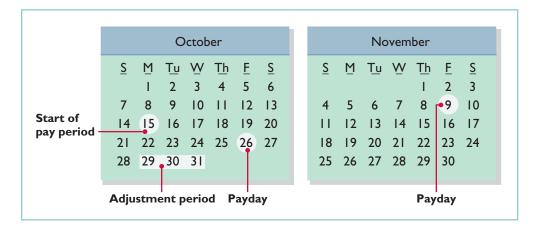
of three months. Companies use the Interest Payable account, instead of crediting (increasing) Notes Payable, in order to disclose the two types of obligations—interest and principal—in the accounts and statements. Without this adjusting entry, liabilities and interest expense are understated, and net income and stockholders' equity are overstated.

Accrued Salaries. Companies pay for some types of expenses after the services have been performed. Examples are employee salaries and commissions. Pioneer last paid salaries on October 26; the next payday is November 9. As the calendar in Illustration 3-19 shows, three working days remain in October (October 29–31).

ETHICS NOTE

A report released by Fannie Mae's board of directors stated that improper adjusting entries at the mortgage-finance company resulted in delayed recognition of expenses caused by interest-rate changes. The motivation for such accounting apparently was the desire to hit earnings estimates.

Illustration 3-19Calendar showing Pioneer's pay periods



At October 31, the salaries for the last three days of the month represent an accrued expense and a related liability. The employees receive total salaries of \$2,000 for a five-day work week, or \$400 per day. Thus, accrued salaries at October 31 are \$1,200 ($$400 \times 3$). Pioneer makes the following adjusting entry:

$$A = L + SE -1,200 Exp +1,200$$

Cash Flows no effect

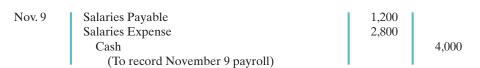
After the company posts this adjusting entry, the accounts show:

Illustration 3-20					
Salary accounts after					
adiustment					

Salaries	Expense	Salaries	Payable	e	
10/26 4,000			10/31	Adj.	1,200
31 Adj. 1,200					
10/31 Bal. 5,200					

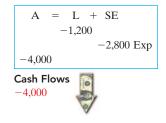
After this adjustment, the balance in Salaries Expense of \$5,200 (13 days \times \$400) is the actual salary expense for October. The balance in Salaries Payable of \$1,200 is the amount of the liability for salaries Pioneer owes as of October 31. Without the \$1,200 adjustment for salaries, Pioneer's expenses are understated \$1,200, and its liabilities are understated \$1,200.

Pioneer Advertising pays salaries every two weeks. The next payday is November 9, when the company will again pay total salaries of \$4,000. The payment will consist of \$1,200 of salaries payable at October 31 plus \$2,800 of salaries expense for November (7 working days as shown in the November calendar \times \$400). Therefore, Pioneer makes the following entry on November 9.



This entry eliminates the liability for Salaries Payable that Pioneer recorded in the October 31 adjusting entry. It also records the proper amount of Salaries Expense for the period between November 1 and November 9.

Illustration 3-21 summarizes the accounting for accrued expenses.



ACCOUNTING FOR ACCRUED EXPENSES						
Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry			
Interest, rent, salaries	Expenses have been incurred but not yet paid in cash or recorded.	Expenses understated. Liabilities understated.	Dr. Expenses Cr. Liabilities			

Illustration 3-21Accounting for accrued expenses

Before You Go On. . .

REVIEW IT

- 1. If an accrued revenue adjusting entry is not made, what is the effect on assets, stockholders' equity, revenues, and net income?
- 2. If an accrued expense adjusting entry is not made, what is the effect on liabilities, stockholders' equity, expenses, and net income?

DO IT

Calvin and Hobbs are the new owners of Micro Computer Services Inc. At the end of August 2008, their first month of ownership, Calvin and Hobbs are trying to prepare monthly financial statements. They have the following information for the month.

- 1. At August 31, Micro Computer owed employees \$800 in salaries that will be paid on September 1.
- 2. On August 1, Micro Computer borrowed \$30,000 from a local bank on a 15-year note. The annual interest rate is 10%.
- 3. Service revenue unrecorded in August totaled \$1,100.

Prepare the adjusting entries needed at August 31, 2008.

Action Plan

- Make adjusting entries at the end of the period for revenues earned and expenses incurred in the period.
- Don't forget to make adjusting entries for accruals. Adjusting entries for accruals will increase both a balance sheet and an income statement account.

Solution 1. Salaries Expense Salaries Payable (To record accrued salaries)	800	800
2. Interest Expense Interest Payable (To record interest) $(\$30,000 \times 10\% \times 1/12 = \$250)$	250	250
3. Accounts Receivable Service Revenue (To record revenue for services provided)	1,100	1,100
Related exercise material: <i>BE3-7</i> , <i>E3-5</i> , <i>E3-6</i> , <i>E3-7</i> , <i>E3-8</i> , <i>E3-9</i> , <i>E3-10</i> , <i>A</i>	E3-11, E3-12, ar	The Navigator

The Navigator

Summary of Journalizing and Posting

Illustrations 3-22 and 3-23 show the journalizing and posting of adjusting entries for Pioneer Advertising Agency Inc. on October 31. The ledger identifies all adjustments by the reference J2 because they have been recorded on page 2 of the general journal. The company may insert a center caption "Adjusting Entries" between the last transaction entry and the first adjusting entry in the journal. When you review the general ledger in Illustration 3-23, note that the entries highlighted in color are the adjustments.

Illustration 3-22 General journal showing adjusting entries

HELPFUL HINT

(1) Adjusting entries should not involve debits or credits to cash.
(2) Evaluate whether the adjustment makes sense. For example, an adjustment to recognize supplies used should increase supplies expense.
(3) Double-check all computations.
(4) Each adjusting entry affects one balance sheet account and one income statement account.

	GENERAL JOURNAL J2						
Date	Account Titles and Explanation	Ref.	Debit	Credit			
2008	Adjusting Entries						
Oct. 31	Advertising Supplies Expense Advertising Supplies (To record supplies used)	631 126	1,500	1,500			
31	Insurance Expense Prepaid Insurance (To record insurance expired)	722 130	50	50			
31	Depreciation Expense Accumulated Depreciation—Office Equipment (To record monthly depreciation)	711 158	40	40			
31	Unearned Revenue Service Revenue (To record revenue for services provided)	209 400	400	400			
31	Accounts Receivable Service Revenue (To record revenue for services provided)	112 400	200	200			
31	Interest Expense Interest Payable (To record interest on notes payable)	905 230	50	50			
31	Salaries Expense Salaries Payable (To record accrued salaries)	726 212	1,200	1,200			

	GENERAL LEDGER										
		Casl	h		No. 101		Ir	iterest]	Payable		No. 230
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2008			40.000			2008					
Oct. 1 2		J1 J1	10,000		10,000 11,200	Oct. 31	Adj. entry	J2	l	50	50
3		J1	1,200	900	10,300		C	ommo	n Stock		No. 311
4		J1		600	9,700	Date	Explanation	Ref.	Debit	Credit	Balance
20		J1		500	9,200	2008					
26 31		J1 J1	10,000	4,000	5,200 15,200	Oct. 1		J1		10,000	10,000
31			ŕ	ı			Re	tained	Earnings		No. 320
Data	1	1	eceivable		No. 112	Date	Explanation	Ref.	Debit	Credit	Balance
Date 2008	Explanation	Ref.	Debit	Credit	Balance	2008					
2008 Oct. 31	Adj. entry	J2	200		200		I	l	l	l	l
other	3							Divid	ends		No. 332
Date	Explanation	Ref.	Supplies Debit	Credit	No. 126 Balance	Date	Explanation	Ref.	Debit	Credit	Balance
$\frac{Date}{2008}$	Explanation	Kei.	Deon	Credit	Datatice	2008		T4	500		500
Oct. 5		J1	2,500		2,500	Oct. 20	I	J1	500	l	500
31	Adj. entry	J2	2,500	1,500	1,000			ervice F	Revenue		No. 400
	Prer	oaid Ins	surance		No. 130	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008		¥4		40.000	40.000
2008	Explanation	1101.	Been	Credit	Bulance	Oct. 31	Adj. entry	J1 J2		10,000 400	10,000 10,400
Oct. 4		J1	600		600	31	Adj. entry	J2		200	10,400
31	Adj. entry	J2		50	550				oplies Ex		No. 631
	Offi	ce Equ	ipment		No. 157	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008	Explanation	KCI.	Debit	Credit	Datatice
2008	-					Oct. 31	Adj. entry	J2	1,500		1,500
Oct. 1		J1	5,000		5,000		•		n Expens	20	No. 711
Accumu	llated Deprecia	ation—	Office E	quipment	No. 158	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008	Laplanation	IXCI.	Deon	Cicuit	Datanec
2008						Oct. 31	Adj. entry	J2	40		40
Oct. 31	Adj. entry	J2		40	40				Expense		No. 722
	N	otes Pa	yable		No. 200	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008	Zapidilation	1101.	Beent	Crean	Bulance
2008						Oct. 31	Adj. entry	J2	50		50
Oct. 1	l	J1	I	5,000	5,000		Sa	alaries l	Expense		No. 726
	Acc	ounts l	Payable		No. 201	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008					
2008						Oct. 26		J1	4,000		4,000
Oct. 5	l	J1	I	2,500	2,500	31	Adj. entry	J2	1,200		5,200
	Unea	arned I	Revenue		No. 209]	Rent E	xpense		No. 729
Date	Explanation	Ref.	Debit	Credit	Balance	Date	Explanation	Ref.	Debit	Credit	Balance
2008						2008					
Oct. 2	A di ontre	J1 J2	400	1,200	1,200	Oct. 3		J1	900		900
31	Adj. entry				800		In	terest l	Expense		No. 905
-		aries P	· ·	G "	No. 212	Date	Explanation	Ref.	Debit	Credit	Balance
Date	Explanation	Ref.	Debit	Credit	Balance	2008					
2008 Oct. 31	Adj. entry	J2		1,200	1,200	Oct. 31	Adj. entry	J2	50		50
00.31	Auj. entry	34		1,400	1,400						

THE ADJUSTED TRIAL BALANCE AND FINANCIAL STATEMENTS

STUDY OBJECTIVE 7

Describe the nature and purpose of an adjusted trial balance.

The company has journalized and posted all adjusting entries. Next it prepares another trial balance from the ledger accounts. This is called an **adjusted trial balance**. Its purpose is to **prove the equality** of the total debit balances and the total credit balances in the ledger after all adjust-

ments. The accounts in the adjusted trial balance contain all data that the company needs to prepare financial statements.

Preparing the Adjusted Trial Balance

Illustration 3-24 presents the adjusted trial balance for Pioneer Advertising Agency Inc., prepared from the ledger accounts in Illustration 3-23. The amounts highlighted in color are those affected by the adjusting entries. Compare these amounts to those in the unadjusted trial balance in Illustration 3-3 on page 98.

Illustration 3-24Adjusted trial balance

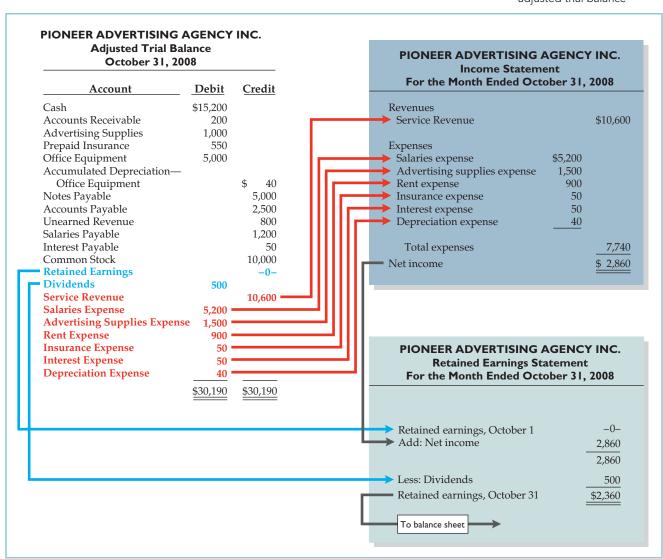
	Dr.	Cr.
Cash	\$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment	5,000	\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
Common Stock		10,000
Retained Earnings		-0-
Dividends	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	

Preparing Financial Statements

Companies can prepare financial statements directly from the adjusted trial balance. Illustrations 3-25 and 3-26 show the interrelationships of data in the adjusted trial balance and the financial statements.

As Illustration 3-25 shows, companies first prepare the income statement from the revenue and expense accounts. Next, they use the Retained Earnings and Dividends accounts and the net income (or net loss) from the income statement to prepare the retained earnings statement. As Illustration 3-26 shows, companies then prepare the balance sheet from the asset and liability accounts, the common stock account, and the ending retained earnings balance as reported in the retained earnings statement.

Illustration 3-25
Preparation of the income statement and retained earnings statement from the adjusted trial balance



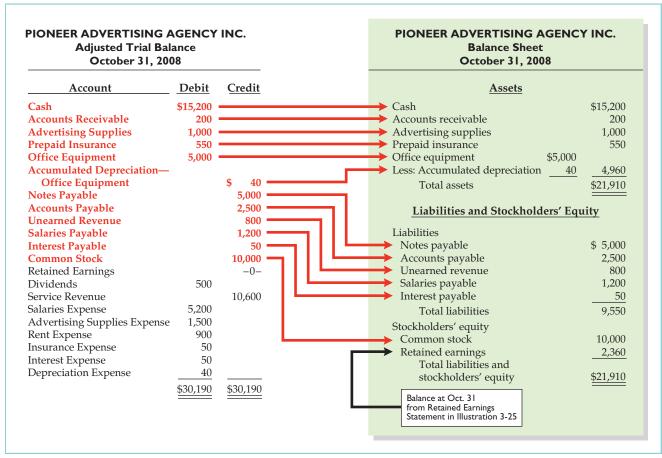


Illustration 3-26Preparation of the balance sheet from the adjusted trial balance

Before You Go On...

REVIEW IT

- 1. What is the purpose of an adjusted trial balance?
- 2. How do companies prepare an adjusted trial balance?





Be sure to read **ALL ABOUT YOU:** *Is Your Old Computer a Liability?* on the next page for information on how topics in this chapter apply to you.

all about Y & U

Is Your Old Computer a Liability?

Do you have an old computer or two in your garage? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete *each day*. Yet, in a recent year, only 11% of computers were recycled. It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it.

What about companies? Many have potential pollution or environmental-disposal problems—not only for electronic gadgets, but also for the lead paint or asbestos they sold. How do we fit these issues into the accounting equation? Are these costs and related liabilities that companies should report?

In the past, two arguments were made for excluding pollution and environmental costs from the financial statements of product manufacturers. First, companies argued that pollution wasn't their responsibility. If it wasn't their responsibility, then there was no liability. Second, even if there was a liability, companies argued that they could not easily estimate its amount.

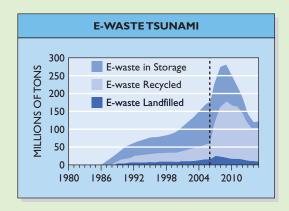
These arguments may be as out-of-date as last year's cell phone model. Increasingly, states are putting environmental liabilities into the accounting equation by passing laws that hold companies responsible for the toxic waste from their discarded products. Also, courts are levying steep fines for environmental cleanup caused by product waste.

Some Facts

- * California adds \$6 to \$10 of sales tax to the cost of computers and televisions to fund recycling programs.
- * Each cathode ray tube (CRT) monitor contains 4–6 pounds of lead. Consumer electronic products account for about 40% of the lead found in landfills.
- * Environmental groups put a resolution on Apple Computer's 2006 shareholder meeting agenda requiring the company to study how it can increase recycling.
- * The average household has two to three old computers in its garage or storage area.

About the Numbers

The nearby chart shows the amount of electronic products, in millions of tons, in storage, now being recycled, and in landfills.



Source for graph: Silicon Valley Toxics Coalition, "Poison PCs and Toxic TVs," www.svtc.org/cleancc/pubs/ppcttv2004.pdf, p. 5.

What Do You Think?

Should companies accrue for environmental clean-up costs as liabilities on their financial statements?

YES: As more states impose laws holding companies responsible, and as more courts levy pollution-related fines, it becomes increasingly likely that companies will have to pay large amounts in the future.

NO: The amounts still are too difficult to estimate. Putting inaccurate estimates on the financial statements reduces their usefulness. Instead, why not charge the costs later, when the actual environmental clean-up or disposal occurs, at which time the company knows the actual cost?

Sources: Lorraine Woellert, "HP Wants Your Old PCs Back," *Business Week*, April 10, 2006, pp. 82-83; "Poison PCs and Toxic TVs: E-waste Tsunami to Roll Across the U.S.: Are We Prepared?" 2004 report of the Silicon Valley Toxics Coalition.

Demonstration Problem



Green Thumb Lawn Care Inc. began operating on April 1. At April 30, the trial balance shows the following balances for selected accounts.

Prepaid Insurance	\$ 3,600
Equipment	28,000
Notes Payable	20,000
Unearned Revenue	4,200
Service Revenue	1,800

Analysis reveals the following additional data.

- 1. Prepaid insurance is the cost of a 2-year insurance policy, effective April 1.
- 2. Depreciation on the equipment is \$500 per month.
- 3. The note payable is dated April 1. It is a 6-month, 12% note.
- 4. Seven customers paid for the company's 6 months' lawn service package of \$600 beginning in April. The company performed services for these customers in April.
- 5. Lawn services provided other customers but not recorded at April 30 totaled \$1,500.

Instructions

Prepare the adjusting entries for the month of April. Show computations.

action plan

- ✓ Note that adjustments are being made for one month.
- Make computations carefully.
- ✓ Select account titles carefully.
- ✓ Make sure debits are made first and credits are indented.
- Check that debits equal credits for each entry.

Solution

GENERAL JOURNAL

J1

	CENTER NE COUNTY NE			
Date	Account Titles and Explanation	Ref.	Debit	Credit
	Adjusting Entries			
Apr. 30	Insurance Expense Prepaid Insurance		150	150
	(To record insurance expired: $\$3,600 \div 24 = \150 per month)			130
30	Depreciation Expense Accumulated Depreciation—Equipment (To record monthly depreciation)		500	500
30	Interest Expense Interest Payable (To record interest on notes payable: $$20,000 \times 12\% \times 1/12 = 200)		200	200
30	Unearned Revenue Service Revenue (To record service revenue: $$600 \div 6 = 100 ; $$100 \text{ per month} \times 7 = 700)		700	700
30	Accounts Receivable Service Revenue (To record revenue for services provided)		1,500	1,500

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SUMMARY OF STUDY OBJECTIVES



- **1 Explain the time period assumption.** The time period assumption assumes that the economic life of a business is divided into artificial time periods.
- **2 Explain the accrual basis of accounting.** Accrual-basis accounting means that companies record events that
- change a company's financial statements in the periods in which those events occur, rather than in the periods in which the company receives or pays cash.
- **3 Explain the reasons for adjusting entries.** Companies make adjusting entries at the end of an accounting period.

- Such entries ensure that companies record revenues in the period in which they are earned and that they recognize expenses in the period in which they are incurred.
- 4 Identify the major types of adjusting entries. The major types of adjusting entries are deferrals (prepaid expenses and unearned revenues), and accruals (accrued revenues and accrued expenses).
- **5 Prepare adjusting entries for deferrals.** Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals to record the portion of the prepayment that represents the expense incurred or the revenue earned in the current accounting period.
- 6 Prepare adjusting entries for accruals. Accruals are either accrued revenues or accrued expenses. Companies make adjusting entries for accruals to record revenues earned and expenses incurred in the current accounting period that have not been recognized through daily entries.
- **7 Describe the nature and purpose of an adjusted trial balance.** An adjusted trial balance shows the balances of all accounts, including those that have been adjusted, at the end of an accounting period. Its purpose is to prove the equality of the total debit balances and total credit balances in the ledger after all adjustments.



GLOSSARY



- **Accrual-basis accounting** Accounting basis in which companies record transactions that change a company's financial statements in the periods in which the events occur. (p. 95).
- **Accruals** Adjusting entries for either accrued revenues or accrued expenses. (p. 97).
- **Accrued expenses** Expenses incurred but not yet paid in cash or recorded. (p. 106).
- **Accrued revenues** Revenues earned but not yet received in cash or recorded. (p. 105).
- **Adjusted trial balance** A list of accounts and their balances after the company has made all adjustments. (p. 112).
- **Adjusting entries** Entries made at the end of an accounting period to ensure that companies follow the revenue recognition and matching principles. (p. 97).
- **Book value** The difference between the cost of a depreciable asset and its related accumulated depreciation. (p. 102).
- **Calendar year** An accounting period that extends from January 1 to December 31. (p. 95).
- **Cash-basis accounting** Accounting basis in which companies record revenue when they receive cash and an expense when they pay cash. (p. 95).
- **Contra asset account** An account offset against an asset account on the balance sheet. (p. 101).

- **Deferrals** Adjusting entries for either prepaid expenses or unearned revenues. (p. 97).
- **Depreciation** The allocation of the cost of an asset to expense over its useful life in a rational and systematic manner. (p. 101).
- **Fiscal year** An accounting period that is one year in length. (p. 95).
- **Interim periods** Monthly or quarterly accounting time periods. (p. 95).
- **Matching principle** The principle that companies match efforts (expenses) with accomplishments (revenues). (p. 96).
- **Prepaid expenses** Expenses paid in cash that benefit more than one accounting period and that are recorded as assets. (p. 98).
- **Revenue recognition principle** The principle that companies recognize revenue in the accounting period in which it is earned. (p. 95).
- **Time period assumption** An assumption that accountants can divide the economic life of a business into artificial time periods. (p. 94).
- **Unearned revenues** Cash received and recorded as liabilities before revenue is earned. (p. 102).
- **Useful life** The length of service of a productive facility. (p. 101).

APPENDIX Alternative Treatment of Prepaid Expenses and Unearned Revenues

In discussing adjusting entries for prepaid expenses and unearned revenues, we illustrated transactions for which companies made the initial entries to balance sheet accounts. In the case of prepaid expenses, the company debited the prepayment to an asset account. In the case of unearned revenue, the company credited a liability account to record the cash received.

STUDY OBJECTIVE 8

Prepare adjusting entries for the alternative treatment of deferrals.

Some companies use an alternative treatment: (1) When a company prepays an expense, it debits that amount to an expense account. (2) When it receives payment for future services, it credits the amount to a revenue account. In this appendix, we describe the circumstances that justify such entries and the different adjusting

entries that may be required. This alternative treatment of prepaid expenses and unearned revenues has the same effect on the financial statements as the procedures described in the chapter.

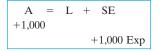
Prepaid Expenses

Prepaid expenses become expired costs either through the passage of time (e.g., insurance) or through consumption (e.g., advertising supplies). If, at the time of purchase, the company expects to consume the supplies before the next financial statement date, it may choose to debit (increase) an expense account rather than an asset account. This alternative treatment is simply more convenient.

Assume that Pioneer Advertising Agency Inc. expects that it will use before the end of the month all of the supplies purchased on October 5. A debit of \$2,500 to Advertising Supplies Expense (rather than to the asset account Advertising Supplies) on October 5 will eliminate the need for an adjusting entry on October 31. At October 31, the Advertising Supplies Expense account will show a balance of \$2,500, which is the cost of supplies used between October 5 and October 31.

But what if the company does not use all the supplies? For example, what if an inventory of \$1,000 of advertising supplies remains on October 31? Obviously, the company would need to make an adjusting entry. Prior to adjustment, the expense account Advertising Supplies Expense is overstated \$1,000, and the asset account Advertising Supplies is understated \$1,000. Thus Pioneer makes the following adjusting entry.

1,000



Cash Flows

after adjustment

no effect

Oct. 31 Advertising Supplies
Advertising Supplies Expense
(To record supplies inventory)

After the company posts the adjusting entry, the accounts show:

Illustration 3A-1 Prepaid expenses accounts

Advertising Supplies		Advertising Supplies Expense				
10/31 Adj.	1,000		10/5	2,500	10/31 Adj.	1,000
			10/31 Bal.	1,500		

After adjustment, the asset account Advertising Supplies shows a balance of \$1,000, which is equal to the cost of supplies on hand at October 31. In addition, Advertising Supplies Expense shows a balance of \$1,500. This is equal to the cost of supplies used between October 5 and October 31. Without the adjusting entry expenses are overstated and net income is understated by \$1,000 in the October income statement. Also, both assets and stockholders' equity are understated by \$1,000 on the October 31 balance sheet.

Illustration 3A-2 compares the entries and accounts for advertising supplies in the two adjustment approaches.

Illustration 3A-2 Adjustment approaches a comparison

	Prepayment Initially Debited to Asset Account (per chapter)	Prepayment Initially Debited to Expense Account (per appendix)		
Oct. 5	Advertising Supplies 2,500 Accounts Payable 2,500	Oct. 5 Advertising Supplies Expense 2,500 Accounts Payable 2,500		
Oct. 31	Advertising Supplies Expense 1,500 Advertising Supplies 1,500	Oct. 31 Advertising Supplies 1,000 Advertising Supplies Expense 1,000		

After Pioneer posts the entries, the accounts appear as follows.

(per chapter) Advertising Supplies			(per appendix) Advertising Supplies				
10/5	2,500	10/31 Adj.	1,500	10/31 Adj.	1,000		
10/31 Bal.	1,000						
Advertising Supplies Expense			se	Adve	ertising S	upplies Expens	se
	1,500			10/5	2,500	10/31 Adj.	1,000
10/31 Adj.	1,500				/	U	

Illustration 3A-3 Comparison of accounts

Note that the account balances under each alternative are the same at October 31: Advertising Supplies \$1,000, and Advertising Supplies Expense \$1,500.

Unearned Revenues

Unearned revenues become earned either through the passage of time (e.g., unearned rent) or through providing the service (e.g., unearned fees). Similar to the case for prepaid expenses, companies may credit (increase) a revenue account when they receive cash for future services.

To illustrate, assume that Pioneer Advertising Agency Inc. received \$1,200 for future services on October 2. Pioneer expects to perform the services before October 31.³ In such a case, the company credits Service Revenue. If it in fact earns the revenue before October 31, no adjustment is needed.

However, if at the statement date Pioneer has not performed \$800 of the services, it would make an adjusting entry. Without the entry, the revenue account Service Revenue is overstated \$800, and the liability account Unearned Revenue is understated \$800. Thus, Pioneer makes the following adjusting entry.



After Pioneer posts the adjusting entry, the accounts show:

\$800 on the October 31 balance sheet.

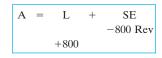
Unearned Revenue			Service Revenue			
	10/31 Adj.	800	10/31 Ad	lj. 800	10/2	1,200
					10/31 Bal.	400

The liability account Unearned Revenue shows a balance of \$800. This equals the services that will be provided in the future. In addition, the balance in Service Revenue equals the services provided in October. Without the adjusting entry, both revenues and net income are overstated by \$800 in the October income statement. Also, liabilities are understated by \$800, and stockholders' equity is overstated by

Illustration 3A-5 compares the entries and accounts for service revenue earned and unearned in the two adjustment approaches.

HELPFUL HINT

The required adjusted balances here are Service Revenue \$400 and Unearned Revenue \$800.



Cash Flows

no effect

Illustration 3A-4 Unearned revenue accounts after adjustment

³This example focuses only on the alternative treatment of unearned revenues. In the interest of simplicity, we have ignored the entries to Service Revenue pertaining to the immediate earning of revenue (\$10,000) and the adjusting entry for accrued revenue (\$200).

Illustration 3A-5

Adjustment approaches—a comparison

Unearned Revenue Initially Credited to Liability Account (per chapter)				Unearned Revenue Initially Credited to Revenue Account (per appendix)			
Oct. 2	Cash Unearned Revenue	1,200	1,200	Oct. 2	Cash Service Revenue	1,200	1,200
Oct. 31	Unearned Revenue Service Revenue	400	400	Oct. 31	Service Revenue Unearned Revenue	800	800

After Pioneer posts the entries, the accounts appear as follows.

Illustration 3A-6Comparison of accounts

(per chapter) Unearned Revenue			(per appendix) Unearned Revenue								
10/31	Adj.	400	10/2		1,200				10/31	Adj.	800
			10/31	Bal.	800						
	Service Revenue			Service Revenue							
			10/31	Adj.	400	10/31	Adj.	800	10/2		1,200
									10/31	Bal.	400

Note that the balances in the accounts are the same under the two alternatives: Unearned Revenue \$800, and Service Revenue \$400.

Summary of Additional Adjustment Relationships

Illustration 3A-7 Summary of basic relationships for deferrals

Illustration 3A-7 provides a summary of basic relationships for deferrals.

Type of Adjustment	Reason for Adjustment	Account Balances before Adjustment	Adjusting Entry
1. Prepaid expenses	(a) Prepaid expenses initially recorded in asset accounts have been used.	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
	(b) Prepaid expenses initially recorded in expense accounts have not been used.	Assets understated Expenses overstated	Dr. Assets Cr. Expenses
2. Unearned revenues	(a) Unearned revenues initially recorded in liability accounts have been earned.	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
	(b) Unearned revenues initially recorded in revenue accounts have not been earned.	Liabilities understated Revenues overstated	Dr. Revenues Cr. Liabilities

Alternative adjusting entries do not apply to accrued revenues and accrued expenses because no entries occur before companies make these types of adjusting entries.

SUMMARY OF STUDY OBJECTIVE FOR APPENDIX



8 Prepare adjusting entries for the alternative treatment of deferrals. Companies may initially debit prepayments to an expense account. Likewise, they may credit unearned revenues to a revenue account. At the end of the period, these accounts may be overstated. The adjusting

entries for prepaid expenses are a debit to an asset account and a credit to an expense account. Adjusting entries for unearned revenues are a debit to a revenue account and a credit to a liability account.

*Note: All asterisked Questions, Exercises, and Problems relate to material in the appendix to the chapter.

SELF-STUDY QUESTIONS



Answers are at the end of the chapter.

- (SO 1) 1. The time period assumption states that:
 - a. revenue should be recognized in the accounting period in which it is earned.
 - **b.** expenses should be matched with revenues.
 - c. the economic life of a business can be divided into artificial time periods.
 - d. the fiscal year should correspond with the calendar year.
- (SO 2) 2. The principle or assumption dictating that efforts (expenses) be matched with accomplishments (revenues) is the:
 - a. matching principle.
 - b. cost assumption.
 - c. periodicity principle.
 - d. revenue recognition principle.
- (SO 2) 3. One of the following statements about the accrual basis of accounting is false. That statement is:
 - a. Events that change a company's financial statements are recorded in the periods in which the events occur.
 - **b.** Revenue is recognized in the period in which it is earned.
 - c. This basis is in accord with generally accepted accounting principles.
 - d. Revenue is recorded only when cash is received, and expense is recorded only when cash is paid.
- (SO 3) 4. Adjusting entries are made to ensure that:
 - **a.** expenses are recognized in the period in which they are incurred.
 - **b.** revenues are recorded in the period in which they are earned.
 - c. balance sheet and income statement accounts have correct balances at the end of an accounting period.
 - d. all of the above.
- (SO 4) 5. Each of the following is a major type (or category) of adjusting entries except:
 - a. prepaid expenses.
 - b. accrued revenues.
 - c. accrued expenses.
 - d. earned revenues.
- (SO 5) 6. The trial balance shows Supplies \$1,350 and Supplies Expense \$0. If \$600 of supplies are on hand at the end of the period, the adjusting entry is:

a. Supplies	600	
Supplies Expense		600
b. Supplies	750	
Supplies Expense		750

- c. Supplies Expense **Supplies** 750 d. Supplies Expense 600 Supplies 600
- 7. Adjustments for unearned revenues:
- (SO 5)
 - a. decrease liabilities and increase revenues.
 - **b.** have an assets and revenues account relationship.
 - c. increase assets and increase revenues.
- **d.** decrease revenues and decrease assets.
- **8.** Adjustments for accrued revenues:
 - (SO 6)
 - a. have a liabilities and revenues account relationship.
 - **b.** have an assets and revenues account relationship.
 - c. decrease assets and revenues.
 - d. decrease liabilities and increase revenues.
- **9.** Kathy Siska earned a salary of \$400 for the last week of (SO 6) September. She will be paid on October 1. The adjusting entry for Kathy's employer at September 30 is:
 - a. No entry is required.

2 1		
b. Salaries Expense	400	
Salaries Payable		400
c. Salaries Expense	400	
Cash		400
d. Salaries Payable	400	
Cash		400

- **10.** Which of the following statements is *incorrect* concerning (SO 7) the adjusted trial balance?
 - a. An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.
 - **b.** The adjusted trial balance provides the primary basis for the preparation of financial statements.
 - The adjusted trial balance lists the account balances segregated by assets and liabilities.
 - d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.
- *11. The trial balance shows Supplies \$0 and Supplies Expense (SO 8) \$1,500. If \$800 of supplies are on hand at the end of the period, the adjusting entry is:
 - **a.** Debit Supplies \$800 and credit Supplies Expense \$800.
 - **b.** Debit Supplies Expense \$800 and credit Supplies \$800.
 - c. Debit Supplies \$700 and credit Supplies Expense \$700.
 - d. Debit Supplies Expense \$700 and credit Supplies \$700.

Go to the book's website,

www.wiley.com/college/weygandt, for Additional Self-Study questions.



OUESTIONS

- 1. (a) How does the time period assumption affect an accountant's analysis of business transactions?
 - (b) Explain the terms fiscal year, calendar year, and interim periods.
- 2. State two generally accepted accounting principles that relate to adjusting the accounts.
- 3. Rick Marsh, a lawyer, accepts a legal engagement in March, performs the work in April, and is paid in May. If Marsh's

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law firm prepares monthly financial statements, when should it recognize revenue from this engagement? Why?

- 4. Why do accrual-basis financial statements provide more useful information than cash-basis statements?
- **5.** In completing the engagement in question 3, Marsh pays no costs in March, \$2,000 in April, and \$2,500 in May (incurred in April). How much expense should the firm deduct from revenues in the month when it recognizes the revenue? Why?
- 6. "Adjusting entries are required by the cost principle of accounting." Do you agree? Explain.
- 7. Why may a trial balance not contain up-to-date and complete financial information?
- 8. Distinguish between the two categories of adjusting entries, and identify the types of adjustments applicable to each category.
- 9. What is the debit/credit effect of a prepaid expense adjusting entry?
- 10. "Depreciation is a valuation process that results in the reporting of the fair market value of the asset." Do you agree? Explain.
- 11. Explain the differences between depreciation expense and accumulated depreciation.
- 12. Shinn Company purchased equipment for \$18,000. By the current balance sheet date, \$6,000 had been depreciated. Indicate the balance sheet presentation of the data.
- 13. What is the debit/credit effect of an unearned revenue adjusting entry?
- 14. A company fails to recognize revenue earned but not yet received. Which of the following accounts are involved in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense? For the accounts selected, indicate whether they would be debited or credited in the entry.
- 15. A company fails to recognize an expense incurred but not paid. Indicate which of the following accounts is debited and which is credited in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense.

- **16.** A company makes an accrued revenue adjusting entry for \$900 and an accrued expense adjusting entry for \$700. How much was net income understated prior to these entries? Explain.
- 17. On January 9, a company pays \$5,000 for salaries, of which \$2,000 was reported as Salaries Payable on December 31. Give the entry to record the payment.
- 18. For each of the following items before adjustment, indicate the type of adjusting entry (prepaid expense, unearned revenue, accrued revenue, and accrued expense) that is needed to correct the misstatement. If an item could result in more than one type of adjusting entry, indicate each of the types.
 - (a) Assets are understated.
 - **(b)** Liabilities are overstated.
 - (c) Liabilities are understated.
 - (d) Expenses are understated.
 - (e) Assets are overstated.
 - (f) Revenue is understated.
- 19. One-half of the adjusting entry is given below. Indicate the account title for the other half of the entry.
 - (a) Salaries Expense is debited.
 - **(b)** Depreciation Expense is debited.
 - (c) Interest Payable is credited.
 - (d) Supplies is credited.
 - (e) Accounts Receivable is debited.
 - (f) Unearned Service Revenue is debited.
- 20. "An adjusting entry may affect more than one balance sheet or income statement account." Do you agree? Why or why not?
- 21. Why is it possible to prepare financial statements directly from an adjusted trial balance?
- *22. Adel Company debits Supplies Expense for all purchases of supplies and credits Rent Revenue for all advanced rentals. For each type of adjustment, give the adjusting

BRIEF EXERCISES



Indicate why adjusting entries are needed.

(SO 3)

adjusting entries.

Identify the major types of

(SO 4)

Prepare adjusting entry for supplies.

(SO 5)

BE3-1 The ledger of Dey Company includes the following accounts. Explain why each account may require adjustment.

- (a) Prepaid Insurance
- (c) Unearned Revenue
- **(b)** Depreciation Expense
- (d) Interest Payable

BE3-2 Nunez Company accumulates the following adjustment data at December 31. Indicate (a) the type of adjustment (prepaid expense, accrued revenues and so on), and (b) the status of accounts before adjustment (overstated or understated).

- 1. Supplies of \$100 are on hand.
- 2. Services provided but not recorded total \$900.
- **3.** Interest of \$200 has accumulated on a note payable.
- **4.** Rent collected in advance totaling \$800 has been earned.

BE3-3 Windsor Advertising Company's trial balance at December 31 shows Advertising Supplies \$6,700 and Advertising Supplies Expense \$0. On December 31, there are \$2,700 of supplies on hand. Prepare the adjusting entry at December 31, and using T accounts, enter the balances in the accounts, post the adjusting entry, and indicate the adjusted balance in each account.

BE3-4 At the end of its first year, the trial balance of Denton Company shows Equipment \$30,000 and zero balances in Accumulated Depreciation-Equipment and Depreciation Expense. Depreciation for the year is estimated to be \$5,000. Prepare the adjusting entry for depreciation at December 31, post the adjustments to T accounts, and indicate the balance sheet presentation of the equipment at December 31.

Prepare adjusting entry for depreciation.

(SO5)

BE3-5 On July 1, 2008, Spahn Co. pays \$18,000 to Randle Insurance Co. for a 3-year insurance contract. Both companies have fiscal years ending December 31. For Spahn Co., journalize and post the entry on July 1 and the adjusting entry on December 31.

BE3-6 Using the data in BE3-5, journalize and post the entry on July 1 and the adjusting entry

on December 31 for Randle Insurance Co. Randle uses the accounts Unearned Insurance

Prepare adjusting entry for prepaid expense.

(SO 5)

Prepare adjusting entry for unearned revenue.

(SO 5)

BE3-7 The bookkeeper for Oglesby Company asks you to prepare the following accrued adjusting entries at December 31.

Prepare adjusting entries for accruals.

(SO 6)

1. Interest on notes payable of \$400 is accrued.

Revenue and Insurance Revenue.

Accounts Receivable

Prepaid Insurance

- 2. Services provided but not recorded total \$1,500.
- 3. Salaries earned by employees of \$900 have not been recorded.

Use the following account titles: Service Revenue, Accounts Receivable, Interest Expense, Interest Payable, Salaries Expense, and Salaries Payable.

BE3-8 The trial balance of Bair Company includes the following balance sheet accounts. Identify the accounts that may require adjustment. For each account that requires adjustment, indicate (a) the type of adjusting entry (prepaid expenses, unearned revenues, accrued revenues, and accrued expenses) and (b) the related account in the adjusting entry.

Interest Pavable

Unearned Service Revenue

Accumulated Depreciation—Equipment

Prepare an income statement

Analyze accounts in an unadjusted trial balance.

from an adjusted trial balance. (SO 7)

(SO 4)

The adjusted trial balance of Harmony Company, Inc. at December 31, 2008, includes the following accounts: Common Stock \$15,600; Dividends \$6,000; Service Revenue \$35,400; Salaries Expense \$16,000; Insurance Expense \$2,000; Rent Expense \$4,000; Supplies Expense \$1,500; and Depreciation Expense \$1,300. Prepare an income statement for the year.

> Prepare a retained earnings statement from an adjusted trial balance.

BE3-10 Partial adjusted trial balance data for Harmony Company, Inc. is presented in BE3-9. The balance in Common Stock is the balance as of January 1. Prepare a retained earnings statement for the year assuming net income is \$10,600 for the year and retained earnings is \$0 on January 1.

(SO 7)

*BE3-11 Duncan Company records all prepayments in income statement accounts. At April 30, the trial balance shows Supplies Expense \$2,800, Service Revenue \$9,200, and zero balances in related balance sheet accounts. Prepare the adjusting entries at April 30 assuming (a) \$1,000 of supplies on hand and **(b)** \$3,000 of service revenue should be reported as unearned.

Prepare adjusting entries under alternative treatment of deferrals.

(SO 8)

EXERCISES



E3-1 Jo Seacat has prepared the following list of statements about the time period assumption.

1. Adjusting entries would not be necessary if a company's life were not divided into artificial time periods.

2. The IRS requires companies to file annual tax returns.

- 3. Accountants divide the economic life of a business into artificial time periods, but each transaction affects only one of these periods.
- **4.** Accounting time periods are generally a month, a quarter, or a year.
- **5.** A time period lasting one year is called an interim period.
- **6.** All fiscal years are calendar years, but not all calendar years are fiscal years.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

E3-2 On numerous occasions, proposals have surfaced to put the federal government on the accrual basis of accounting. This is no small issue. If this basis were used, it would mean that billions in unrecorded liabilities would have to be booked, and the federal deficit would increase substantially.

Explain the time period assumption. (SO 1)

Distinguish between cash and accrual basis of accounting.

(SO 2)

Instructions

- (a) What is the difference between accrual-basis accounting and cash-basis accounting?
- **(b)** Why would politicians prefer the cash basis over the accrual basis?
- **(c)** Write a letter to your senator explaining why the federal government should adopt the accrual basis of accounting.

E3-3 Conan Industries collected \$100,000 from customers in 2008. Of the amount collected, \$25,000 was from revenue earned on account in 2007. In addition, Conan earned \$40,000 of revenue in 2008, which will not be collected until 2009.

Conan Industries also paid \$70,000 for expenses in 2008. Of the amount paid, \$30,000 was for expenses incurred on account in 2007. In addition, Conan incurred \$42,000 of expenses in 2008, which will not be paid until 2009.

Instructions

- (a) Compute 2008 cash-basis net income.
- **(b)** Compute 2008 accrual-basis net income.

E3-4 Emeril Corporation encounters the following situations:

- **1.** Emeril collects \$1,000 from a customer in 2008 for services to be performed in 2009.
- **2.** Emeril incurs utility expense which is not yet paid in cash or recorded.
- 3. Emeril's employees worked 3 days in 2008, but will not be paid until 2009.
- 4. Emeril earned service revenue but has not yet received cash or recorded the transaction.
- **5.** Emeril paid \$2,000 rent on December 1 for the 4 months starting December 1.
- **6.** Emeril received cash for future services and recorded a liability until the revenue was earned
- 7. Emeril performed consulting services for a client in December 2008. On December 31, it billed the client \$1,200.
- 8. Emeril paid cash for an expense and recorded an asset until the item was used up.
- 9. Emeril purchased \$900 of supplies in 2008; at year-end, \$400 of supplies remain unused.
- 10. Emeril purchased equipment on January 1, 2008; the equipment will be used for 5 years.
- 11. Emeril borrowed \$10,000 on October 1, 2008, signing an 8% one-year note payable.

Instructions

2008.

Identify what type of adjusting entry (prepaid expense, unearned revenue, accrued expense, accrued revenue) is needed in each situation, at December 31, 2008.

E3-5 Drew Carey Company has the following balances in selected accounts on December 31,

Accounts Receivable \$-0-Accumulated Depreciation—Equipment -0-Equipment 7,000 Interest Payable -0-Notes Payable 10,000 Prepaid Insurance 2,100 Salaries Payable -()-2,450 Supplies

All the accounts have normal balances. The information below has been gathered at December 31, 2008.

40,000

- 1. Drew Carey Company borrowed \$10,000 by signing a 12%, one-year note on September 1, 2008
- 2. A count of supplies on December 31, 2008, indicates that supplies of \$800 are on hand.
- 3. Depreciation on the equipment for 2008 is \$1,000.

Unearned Consulting Revenue

- **4.** Drew Carey Company paid \$2,100 for 12 months of insurance coverage on June 1,2008.
- **5.** On December 1, 2008, Drew Carey collected \$40,000 for consulting services to be performed from December 1, 2008, through March 31, 2009.
- **6.** Drew Carey performed consulting services for a client in December 2008. The client will be billed \$4,200.
- **7.** Drew Carey Company pays its employees total salaries of \$9,000 every Monday for the preceding 5-day week (Monday through Friday). On Monday, December 29, employees were paid for the week ending December 26. All employees worked the last 3 days of 2008.

Compute cash and accrual accounting income.

(SO 2)

Identify the type of adjusting entry needed.

(SO 4)

Prepare adjusting entries from selected data.

(SO 5, 6)

Identify types of adjustments and account relationships.

(SO 4, 5, 6)

Instructions

Prepare adjusting entries for the seven items described on page 124.

E3-6 Affleck Company accumulates the following adjustment data at December 31.

- 1. Services provided but not recorded total \$750.
- **2.** Store supplies of \$300 have been used.
- 3. Utility expenses of \$225 are unpaid.
- **4.** Unearned revenue of \$260 has been earned.
- 5. Salaries of \$900 are unpaid.
- **6.** Prepaid insurance totaling \$350 has expired.

Instructions

For each of the above items indicate the following.

- (a) The type of adjustment (prepaid expense, unearned revenue, accrued revenue, or accrued expense).
- **(b)** The status of accounts before adjustment (overstatement or understatement).

E3-7 The ledger of Piper Rental Agency on March 31 of the current year includes the following selected accounts before adjusting entries have been prepared.

Prepare adjusting entries from selected account data.

(SO 5, 6)

	<u>Debit</u>	<u>Credit</u>
Prepaid Insurance	\$ 3,600	
Supplies	2,800	
Equipment	25,000	
Accumulated		
Depreciation—Equipment		\$ 8,400
Notes Payable		20,000
Unearned Rent		9,900
Rent Revenue		60,000
Interest Expense	-0-	
Wages Expense	14,000	

An analysis of the accounts shows the following.

- 1. The equipment depreciates \$400 per month.
- 2. One-third of the unearned rent was earned during the quarter.
- **3.** Interest of \$500 is accrued on the notes payable.
- 4. Supplies on hand total \$700.
- **5.** Insurance expires at the rate of \$200 per month.

Instructions

Prepare the adjusting entries at March 31, assuming that adjusting entries are made **quarterly**. Additional accounts are: Depreciation Expense, Insurance Expense, Interest Payable, and Supplies Expense.

E3-8 Andy Wright, D.D.S., opened a dental practice on January 1, 2008. During the first month of operations the following transactions occurred.

- **1.** Performed services for patients who had dental plan insurance. At January 31, \$875 of such services was earned but not yet recorded.
- 2. Utility expenses incurred but not paid prior to January 31 totaled \$520.
- **3.** Purchased dental equipment on January 1 for \$80,000, paying \$20,000 in cash and signing a \$60,000, 3-year note payable. The equipment depreciates \$400 per month. Interest is \$500 per month.
- **4.** Purchased a one-year malpractice insurance policy on January 1 for \$12,000.
- 5. Purchased \$1,600 of dental supplies. On January 31, determined that \$400 of supplies were on hand.

Instructions

Prepare the adjusting entries on January 31. Account titles are: Accumulated Depreciation—Dental Equipment, Depreciation Expense, Service Revenue, Accounts Receivable, Insurance Expense, Interest Expense, Interest Payable, Prepaid Insurance, Supplies, Supplies Expense, Utilities Expense, and Utilities Payable.

Prepare adjusting entries. (SO 5, 6)

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Prepare adjusting entries. (SO 5, 6)

E3-9 The trial balance for Pioneer Advertising Agency is shown in Illustration 3-3, p. 98. In lieu of the adjusting entries shown in the text at October 31, assume the following adjustment data.

- **1.** Advertising supplies on hand at October 31 total \$500.
- **2.** Expired insurance for the month is \$100.
- 3. Depreciation for the month is \$50.
- 4. Unearned revenue earned in October totals \$600.
- 5. Services provided but not recorded at October 31 are \$300.
- 6. Interest accrued at October 31 is \$70.
- 7. Accrued salaries at October 31 are \$1,500.

Prepare the adjusting entries for the items above.

Prepare correct income statement.

(SO 5, 6)

- E3-10 The income statement of Benning Co. for the month of July shows net income of \$1,400 based on Service Revenue \$5,500, Wages Expense \$2,300, Supplies Expense \$1,200, and Utilities Expense \$600. In reviewing the statement, you discover the following.
- 1. Insurance expired during July of \$400 was omitted.
- 2. Supplies expense includes \$200 of supplies that are still on hand at July 31.
- 3. Depreciation on equipment of \$150 was omitted.
- **4.** Accrued but unpaid wages at July 31 of \$300 were not included.
- **5.** Services provided but unrecorded totaled \$500.

Instructions

Prepare a correct income statement for July 2008.

Analyze adjusted data.

(SO 4, 5, 6, 7)

E3-11 A partial adjusted trial balance of Sila Company at January 31, 2008, shows the following.

SILA COMPANY

Adjusted Trial Balance January 31, 2008

	Debit	Credit
Supplies	\$ 850	
Prepaid Insurance	2,400	
Salaries Payable		\$ 800
Unearned Revenue		750
Supplies Expense	950	
Insurance Expense	400	
Salaries Expense	1,800	
Service Revenue		2,000

Instructions

Answer the following questions, assuming the year begins January 1.

- (a) If the amount in Supplies Expense is the January 31 adjusting entry, and \$500 of supplies was purchased in January, what was the balance in Supplies on January 1?
- (b) If the amount in Insurance Expense is the January 31 adjusting entry, and the original insurance premium was for one year, what was the total premium and when was the policy purchased?
- (c) If \$3,500 of salaries was paid in January, what was the balance in Salaries Payable at December 31, 2007?
- (d) If \$1,600 was received in January for services performed in January, what was the balance in Unearned Revenue at December 31, 2007?

E3-12 Selected accounts of Tabor Company are shown below and on page 127.

Journalize basic transactions and adjusting entries.

(SO 5, 6)

	Supplies	Expense
7/31	800	

Supplies			Salaries Payable			
7/1 Bal.	1,100	7/31	800		7/31	1,200
7/10	400					

Accounts Receivable		Unearned Revenue				
7/31	500		7/31	900	7/1 Bal.	1,500
					7/20	1,000
Salaries Expense		Service Revenue				
7/15	1,200				7/14	2,000
7/31	1,200				7/31	900
					7/31	500

Instructions

After analyzing the accounts, journalize (a) the July transactions and (b) the adjusting entries that were made on July 31. (*Hint:* July transactions were for cash.)

E3-13 The trial balances before and after adjustment for Garcia Company at the end of its fiscal year are presented below.

Prepare adjusting entries from analysis of trial balances.

(SO 5, 6, 7)

GARCIA COMPANY

Trial Balance August 31, 2008

	Before Adjustment		After Adjustment	
	Dr.	Cr.	Dr.	Cr.
Cash	\$10,400		\$10,400	
Accounts Receivable	8,800		9,800	
Office Supplies	2,300		700	
Prepaid Insurance	4,000		2,500	
Office Equipment	14,000		14,000	
Accumulated Depreciation—Office Equipment		\$ 3,600		\$ 4,500
Accounts Payable		5,800		5,800
Salaries Payable		-0-		1,100
Unearned Rent		1,500		600
Common Stock		10,000		10,000
Retained Earnings		5,600		5,600
Service Revenue		34,000		35,000
Rent Revenue		11,000		11,900
Salaries Expense	17,000		18,100	
Office Supplies Expense	-0-		1,600	
Rent Expense	15,000		15,000	
Insurance Expense	-0-		1,500	
Depreciation Expense	-0-		900	
	\$71,500	\$71,500	\$74,500	\$74,500

Instructions

Prepare the adjusting entries that were made.

E3-14 The adjusted trial balance for Garcia Company is given in E3-13.

Instructions

Prepare the income statement and a retained earnings statement for the year and the balance sheet at August 31.

E3-15 The following data are taken from the comparative balance sheets of Girard Billiards Club, which prepares its financial statements using the accrual basis of accounting.

December 31	2008	2007	
Fees receivable from members	\$14,000	\$ 9,000	
Unearned fees revenue	17,000	25,000	

Fees are billed to members based upon their use of the club's facilities. Unearned fees arise from the sale of gift certificates, which members can apply to their future use of club facilities.

Prepare financial statements from adjusted trial balance.

(SO 7)

Record transactions on accrual basis; convert revenue to cash receipts.

(SO 5, 6)

The 2008 income statement for the club showed that fees revenue of \$153,000 was earned during the year.

Instructions

(*Hint:* You will probably find it helpful to use T accounts to analyze these data.)

- (a) Prepare journal entries for each of the following events that took place during 2008.
 - (1) Fees receivable from 2007 were all collected.
 - (2) Gift certificates outstanding at the end of 2007 were all redeemed.
 - (3) An additional \$35,000 worth of gift certificates were sold during 2008. A portion of these was used by the recipients during the year; the remainder was still outstanding at the end of 2008
 - (4) Fees for 2008 for services provided to members were billed to members.
 - (5) Fees receivable for 2008 (i.e., those billed in item [4] above) were partially collected.
- (b) Determine the amount of cash received by the club, with respect to fees, during 2008.

Journalize adjusting entries. (SO 8)

***E3-16** Colin Mochrie Company has the following balances in selected accounts on December 31, 2008.

Consulting Revenue	\$40,000
Insurance Expense	2,100
Supplies Expense	2,450

All the accounts have normal balances. Colin Mochrie Company debits prepayments to expense accounts when paid, and credits unearned revenues to revenue accounts when received. The following information below has been gathered at December 31, 2008.

- 1. Colin Mochrie Company paid \$2,100 for 12 months of insurance coverage on June 1, 2008.
- 2. On December 1, 2008, Colin Mochrie Company collected \$40,000 for consulting services to be performed from December 1, 2008, through March 31, 2009.
- 3. A count of supplies on December 31, 2008, indicates that supplies of \$800 are on hand.

Instructions

Prepare the adjusting entries needed at December 31, 2008.

Journalize transactions and adjusting entries.

(SO 8)

***E3-17** At Natasha Company, prepayments are debited to expense when paid, and unearned revenues are credited to revenue when received. During January of the current year, the following transactions occurred.

- Jan. 2 Paid \$1,800 for fire insurance protection for the year.
 - 10 Paid \$1,700 for supplies.
 - 15 Received \$6,100 for services to be performed in the future.

On January 31, it is determined that \$2,500 of the services fees have been earned and that there are \$800 of supplies on hand.

Instructions

- (a) Journalize and post the January transactions. (Use T accounts.)
- **(b)** Journalize and post the adjusting entries at January 31.
- (c) Determine the ending balance in each of the accounts.

EXERCISES: SET B



Visit the book's website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Exercise Set B.

PROBLEMS: SET A



Prepare adjusting entries, post to ledger accounts, and prepare adjusted trial balance.

P3-1A Tony Masasi started his own consulting firm, Masasi Company, Inc., on June 1, 2008. The trial balance at June 30 is shown on page 129.

(SO 5, 6, 7)

MASASI COMPANY, INC.

Trial Balance June 30, 2008

Account Number		Debit	Credit
101	Cash	\$ 7,150	
112	Accounts Receivable	6,000	
126	Supplies	2,000	
130	Prepaid Insurance	3,000	
157	Office Equipment	15,000	
201	Accounts Payable		\$ 4,500
209	Unearned Service Revenue		4,000
311	Common Stock		21,750
400	Service Revenue		7,900
726	Salaries Expense	4,000	
729	Rent Expense	1,000	
		\$38,150	\$38,150

In addition to those accounts listed on the trial balance, the chart of accounts for Masasi Company, Inc. also contains the following accounts and account numbers: No. 158 Accumulated Depreciation—Office Equipment, No. 212 Salaries Payable, No. 244 Utilities Payable, No. 631 Supplies Expense, No. 711 Depreciation Expense, No. 722 Insurance Expense, and No. 732 Utilities Expense.

Other data:

- 1. Supplies on hand at June 30 are \$600.
- 2. A utility bill for \$150 has not been recorded and will not be paid until next month.
- **3.** The insurance policy is for a year.
- **4.** \$2,500 of unearned service revenue has been earned at the end of the month.
- 5. Salaries of \$2,000 are accrued at June 30.
- **6.** The office equipment has a 5-year life with no salvage value. It is being depreciated at \$250 per month for 60 months.
- 7. Invoices representing \$1,000 of services performed during the month have not been recorded as of June 30.

Instructions

- (a) Prepare the adjusting entries for the month of June. Use J3 as the page number for your journal.
- **(b)** Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances and place a check mark in the posting reference column.
- (c) Prepare an adjusted trial balance at June 30, 2008.

P3-2A Neosho River Resort, Inc. opened for business on June 1 with eight air-conditioned units. Its trial balance before adjustment on August 31 is as follows.

NEOSHO RIVER RESORT, INC.

Trial Balance August 31, 2008

Account Number		Debit	Credit
101	Cash	\$ 19,600	
126	Supplies	3,300	
130	Prepaid Insurance	6,000	
140	Land	25,000	
143	Cottages	125,000	
149	Furniture	26,000	
201	Accounts Payable		\$ 6,500
208	Unearned Rent		7,400
275	Mortgage Payable		80,000
311	Common Stock		100,000
332	Dividends	5,000	
429	Rent Revenue		80,000
622	Repair Expense	3,600	
726	Salaries Expense	51,000	
732	Utilities Expense	9,400	
	•	\$273,900	\$273,900

(c) Adj. trial balance \$41,550

Prepare adjusting entries, post, and prepare adjusted trial balance, and financial statements.

(SO 5, 6, 7)



In addition to those accounts listed on the trial balance, the chart of accounts for Neosho River Resort also contains the following accounts and account numbers: No. 112 Accounts Receivable, No. 144 Accumulated Depreciation—Cottages, No. 150 Accumulated Depreciation—Furniture, No. 212 Salaries Payable, No. 230 Interest Payable, No. 320 Retained Earnings, No. 620 Depreciation Expense—Cottages, No. 621 Depreciation Expense—Furniture, No. 631 Supplies Expense, No. 718 Interest Expense, and No. 722 Insurance Expense.

Other data:

- 1. Insurance expires at the rate of \$400 per month.
- **2.** A count on August 31 shows \$600 of supplies on hand.
- 3. Annual depreciation is \$6,000 on cottages and \$2,400 on furniture.
- **4.** Unearned rent of \$4,100 was earned prior to August 31.
- **5.** Salaries of \$400 were unpaid at August 31.
- 6. Rentals of \$1,000 were due from tenants at August 31. (Use Accounts Receivable.)
- 7. The mortgage interest rate is 9% per year. (The mortgage was taken out on August 1.)

Instructions

- (a) Journalize the adjusting entries on August 31 for the 3-month period June 1-August 31.
- **(b)** Prepare a ledger using the three-column form of account. Enter the trial balance amounts and post the adjusting entries. (Use J1 as the posting reference.)
- (c) Prepare an adjusted trial balance on August 31.
- (d) Prepare an income statement and a retained earnings statement for the 3 months ending August 31 and a balance sheet as of August 31.

Prepare adjusting entries and financial statements.

(c) Adj. trial balance \$278,000

(d) Net income \$14,100

Ending retained

earnings \$9,100 Total assets \$199,900

(SO 5, 6, 7)

P3-3A Fernetti Advertising Agency, Inc. was founded by John Fernetti in January of 2007. Presented below are both the adjusted and unadjusted trial balances as of December 31, 2008.

FERNETTI ADVERTISING AGENCY, INC.

Trial Balance December 31, 2008

	Unadjusted		Adjusted	
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 11,000		\$ 11,000	
Accounts Receivable	20,000		22,500	
Art Supplies	8,600		5,000	
Prepaid Insurance	3,350		2,500	
Printing Equipment	60,000		60,000	
Accumulated Depreciation		\$ 28,000		\$ 34,000
Accounts Payable		5,000		5,000
Interest Payable		-0-		150
Notes Payable		5,000		5,000
Unearned Advertising Fees		7,200		5,600
Salaries Payable		-0-		1,300
Common Stock		25,000		25,000
Retained Earnings		500		500
Dividends	12,000		12,000	
Advertising Revenue		58,600		62,700
Salaries Expense	10,000		11,300	
Insurance Expense			850	
Interest Expense	350		500	
Depreciation Expense			6,000	
Art Supplies Expense			3,600	
Rent Expense	4,000		4,000	
	\$129,300	\$129,300	\$139,250	\$139,250

Instructions

- (a) Journalize the annual adjusting entries that were made.
- (b) Prepare an income statement and a retained earnings statement for the year ending December 31, 2008, and a balance sheet at December 31.
- (c) Answer the following questions.
 - (1) If the note has been outstanding 6 months, what is the annual interest rate on that note?
 - (2) If the company paid \$12,500 in salaries in 2008, what was the balance in Salaries Payable on December 31, 2007?
- (b) Net income \$36,450 **Ending retained** earnings \$24,950 Total assets \$67,000
- (c) (1) 6% (2) \$2,500

P3-4A A review of the ledger of Remington Company at December 31, 2008, produces the following data pertaining to the preparation of annual adjusting entries.

- 1. Salaries Payable \$0. There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of \$800 each per week, and three employees earn \$600 each per week. December 31 is a Tuesday. Employees do not work weekends. All employees worked the last 2 days of December.
- 2. Unearned Rent \$324,000. The company began subleasing office space in its new building on November 1. At December 31, the company had the following rental contracts that are paid in full for the entire term of the lease.

Preparing adjusting entries. (SO 5, 6)

- 1. Salaries expense \$2,320
- 2. Rent revenue \$74,000

Term			Number of
Date	(in months)	Monthly Rent	Leases
Nov. 1	6	\$4,000	5
Dec. 1	6	8,500	4

- 3. Prepaid Advertising \$15,000. This balance consists of payments on two advertising contracts. The contracts provide for monthly advertising in two trade magazines. The terms of the contracts are as follows.
- 3. Advertising expense \$4,800

Contract	Date	Amount	Number of Magazine Issues
A650	May 1	\$5,400	12
B974	Oct. 1	9,600	24

The first advertisement runs in the month in which the contract is signed.

- 4. Notes Payable \$120,000. This balance consists of a note for one year at an annual interest rate 4. Interest expense \$6,300 of 9%, dated June 1.

Instructions

Prepare the adjusting entries at December 31, 2008. (Show all computations.)

P3-5A On September 1, 2008, the account balances of Rand Equipment Repair, Inc. were as follows.

No.	Debits		No.	Credits	
101	Cash	\$ 4,880	154	Accumulated Depreciation	\$ 1,500
112	Accounts Receivable	3,520	201	Accounts Payable	3,400
126	Supplies	2,000	209	Unearned Service Revenue	1,400
153	Store Equipment	15,000	212	Salaries Payable	500
			311	Common Stock	15,000
			320	Retained Earnings	3,600
		\$25,400			\$25,400

Journalize transactions and follow through accounting cycle to preparation of financial statements.

(SO 5, 6, 7)



During September the following summary transactions were completed.

- Sept. 8 Paid \$1,400 for salaries due employees, of which \$900 is for September.
 - 10 Received \$1,200 cash from customers on account.
 - 12 Received \$3,400 cash for services performed in September.
 - 15 Purchased store equipment on account \$3,000.
 - 17 Purchased supplies on account \$1,200.
 - 20 Paid creditors \$4,500 on account.
 - 22 Paid September rent \$500.
 - 25 Paid salaries \$1,250.
 - 27 Performed services on account and billed customers for services provided \$1,500.
 - 29 Received \$650 from customers for future service.

Adjustment data consist of:

- **1.** Supplies on hand \$1,200.
- 2. Accrued salaries payable \$400.
- 3. Depreciation is \$100 per month.
- **4.** Unearned service revenue of \$1,450 is earned.

Instructions

- (a) Enter the September 1 balances in the ledger accounts.
- (b) Journalize the September transactions.
- (c) Post to the ledger accounts. Use J1 for the posting reference. Use the following accounts: No. 407 Service Revenue, No. 615 Depreciation Expense, No. 631 Supplies Expense, No. 726 Salaries Expense, and No. 729 Rent Expense.
- (d) Prepare a trial balance at September 30.
- (e) Journalize and post adjusting entries.
- **(f)** Prepare an adjusted trial balance.
- (g) Prepare an income statement and a retained earnings statement for September and a balance sheet at September 30.

***P3-6A** Givens Graphics Company, Inc. was organized on January 1, 2008, by Sue Givens. At the end of the first 6 months of operations, the trial balance contained the following accounts.

- (d) Trial balance \$30,150
- (f) Adj. trial balance \$30,650
- (g) Net income \$1,200 Ending retained earnings \$4,800 Total assets \$23,900

Prepare adjusting entries, adjusted trial balance, and financial statements using appendix.

(SO 5, 6, 7, 8)

Debits		Credits	
Cash	\$ 9,500	Notes Payable	\$ 20,000
Accounts Receivable	14,000	Accounts Payable	9,000
Equipment	45,000	Common Stock	22,000
Insurance Expense	1,800	Graphic Revenue	52,100
Salaries Expense	30,000	Consulting Revenue	6,000
Supplies Expense	3,700		
Advertising Expense	1,900		
Rent Expense	1,500		
Utilities Expense	1,700		
	\$109,100		\$109,100

Analysis reveals the following additional data.

- **1.** The \$3,700 balance in Supplies Expense represents supplies purchased in January. At June 30, \$1,300 of supplies was on hand.
- 2. The note payable was issued on February 1. It is a 9%, 6-month note.
- **3.** The balance in Insurance Expense is the premium on a one-year policy, dated March 1, 2008.
- **4.** Consulting fees are credited to revenue when received. At June 30, consulting fees of \$1,500 are unearned.

- **5.** Graphic revenue earned but unrecorded at June 30 totals \$2,000.
- **6.** Depreciation is \$2,000 per year.

Instructions

- (a) Journalize the adjusting entries at June 30. (Assume adjustments are recorded every 6 months.)
- **(b)** Prepare an adjusted trial balance.
- (c) Prepare an income statement and a retained earnings statement for the 6 months ended June 30 and a balance sheet at June 30.

(b) Adj. trial balance \$112,850

(c) Net income \$18,750 Ending retained earnings \$18,750 Total assets \$72,000

PROBLEMS: SET B

P3-1B Linda Ace started her own consulting firm, Modine Consulting, Inc. on May 1, 2008. The trial balance at May 31 is as follows.

Prepare adjusting entries, post to ledger accounts, and prepare an adjusted trial balance.

(SO 5, 6, 7)

MODINE CONSULTING, INC.

Trial Balance May 31, 2008

Account Number		Debit	Credit
			Credit
101	Cash	\$ 7,700	
112	Accounts Receivable	4,000	
126	Supplies	1,500	
130	Prepaid Insurance	4,800	
149	Office Furniture	9,600	
201	Accounts Payable		\$ 3,500
209	Unearned Service Revenue		3,000
311	Common Stock		19,100
400	Service Revenue		6,000
726	Salaries Expense	3,000	
729	Rent Expense	1,000	
		\$31,600	\$31,600

In addition to those accounts listed on the trial balance, the chart of accounts for Modine Consulting also contains the following accounts and account numbers: No. 150 Accumulated Depreciation—Office Furniture, No. 212 Salaries Payable, No. 229 Travel Payable, No. 631 Supplies Expense, No. 717 Depreciation Expense, No. 722 Insurance Expense, and No. 736 Travel Expense.

Other data:

- 1. \$500 of supplies have been used during the month.
- 2. Travel expense incurred but not paid on May 31, 2008, \$200.
- **3.** The insurance policy is for 2 years.
- **4.** \$1,000 of the balance in the unearned service revenue account remains unearned at the end of the month.
- **5.** May 31 is a Wednesday, and employees are paid on Fridays. Modine Consulting has two employees, who are paid \$700 each for a 5-day work week.
- **6.** The office furniture has a 5-year life with no salvage value. It is being depreciated at \$160 per month for 60 months.
- **7.** Invoices representing \$1,000 of services performed during the month have not been recorded as of May 31.

Instructions

- (a) Prepare the adjusting entries for the month of May. Use J4 as the page number for your journal.
- (b) Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances and place a check mark in the posting reference column.
- (c) Prepare an adjusted trial balance at May 31, 2008.

Prepare adjusting entries, post, and prepare adjusted trial balance, and financial statements.

(c) Adj. trial balance \$33,800

P3-2B The Elston Motel, Inc. opened for business on May 1, 2008. Its trial balance before adjustment on May 31 is as follows.

(SO 5, 6, 7)



ELSTON MOTEL, INC.

Trial Balance May 31, 2008

Account Number		Debit	Credit
101	Cash	\$ 2,500	
126	Supplies	1,900	
130	Prepaid Insurance	2,400	
140	Land	15,000	
141	Lodge	70,000	
149	Furniture	16,800	
201	Accounts Payable		\$ 5,300
208	Unearned Rent		3,600
275	Mortgage Payable		40,000
311	Common Stock		55,000
429	Rent Revenue		9,200
610	Advertising Expense	500	ŕ
726	Salaries Expense	3,000	
732	Utilities Expense	1,000	
		\$113,100	\$113,100

In addition to those accounts listed on the trial balance, the chart of accounts for Elston Motel also contains the following accounts and account numbers: No. 142 Accumulated Depreciation-Lodge, No. 150 Accumulated Depreciation-Furniture, No. 212 Salaries Payable, No. 230 Interest Payable, No. 320 Retained Earnings, No. 619 Depreciation Expense— Lodge, No. 621 Depreciation Expense—Furniture, No. 631 Supplies Expense, No. 718 Interest Expense, and No. 722 Insurance Expense.

Other data:

- 1. Insurance expires at the rate of \$200 per month.
- 2. A count of supplies shows \$500 of unused supplies on May 31.
- 3. Annual depreciation is \$3,600 on the lodge and \$3,000 on furniture.
- **4.** The mortgage interest rate is 12%. (The mortgage was taken out on May 1.)
- **5.** Unearned rent of \$2,500 has been earned.
- 6. Salaries of \$800 are accrued and unpaid at May 31.

Instructions

- (a) Journalize the adjusting entries on May 31.
- (b) Prepare a ledger using the three-column form of account. Enter the trial balance amounts and post the adjusting entries. (Use J1 as the posting reference.)
- (c) Prepare an adjusted trial balance on May 31.
- (d) Prepare an income statement and a retained earnings statement for the month of May and a balance sheet at May 31.

(c) Adj. trial balance \$114,850

(d) Net income \$3,850 **Ending retained** earnings \$3,850 Total assets \$106,450 P3-3B Ortega Co., Inc. was organized on July 1, 2008. Quarterly financial statements are prepared. The unadjusted and adjusted trial balances as of September 30 are shown below.

Prepare adjusting entries and financial statements.

(SO 5, 6, 7)

ORTEGA CO., INC.

Trial Balance September 30, 2008

	Unadjusted		Adjusted	
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 6,700		\$ 6,700	
Accounts Receivable	400		900	
Supplies	1,200		1,000	
Prepaid Rent	1,500		900	
Equipment	15,000		15,000	
Accumulated Depreciation—Equipment				\$ 350
Notes Payable		\$ 5,000		5,000
Accounts Payable		1,510		1,510
Salaries Payable				600
Interest Payable				50
Unearned Rent		900		500
Common Stock		14,000		14,000
Dividends	600		600	
Commission Revenue		14,000		14,500
Rent Revenue		400		800
Salaries Expense	9,000		9,600	
Rent Expense	900		1,500	
Depreciation Expense			350	
Supplies Expense			200	
Utilities Expense	510		510	
Interest Expense			50	
	\$35,810	\$35,810	\$37,310	\$37,310

Instructions

- (a) Journalize the adjusting entries that were made.
- (b) Prepare an income statement and a retained earnings statement for the 3 months ending September 30 and a balance sheet at September 30.
- (c) If the note bears interest at 12%, how many months has it been outstanding?

P3-4B A review of the ledger of Yoda Company at December 31, 2008, produces the following data pertaining to the preparation of annual adjusting entries.

- 1. Prepaid Insurance \$8,600. The company has separate insurance policies on its buildings and its motor vehicles. Policy B4564 on the building was purchased on July 1, 2007, for \$6,000. The policy has a term of 3 years. Policy A2958 on the vehicles was purchased on January 1, 2008, for \$3,600. This policy has a term of 2 years.
- 2. Unearned Subscriptions \$49,000. The company began selling magazine subscriptions in 2008 on an annual basis. The magazine is published monthly. The selling price of a subscription is \$50. A review of subscription contracts reveals the following.

(b)	Net income \$3,090
	Ending retained
	earnings \$2,490
	Total assets \$24 150

Prepare adjusting entries (SO 5, 6)

- 1. Insurance expense \$3,800
- 2. Subscription revenue \$7,000

Subscription	Number of		
Date	Subscriptions		
October 1	200		
November 1	300		
December 1	480		
	980		

- 3. Notes Payable \$60,000. This balance consists of a note for 6 months at an annual interest rate 3. Interest expense \$1,800 of 9%, dated September 1.

4. Salaries expense \$2,850

Journalize transactions and

follow through accounting cycle to preparation of finan-

cial statements. (SO 5, 6, 7)

4. Salaries Payable \$0. There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of \$500 each per week, and three employees earn \$750 each per week. December 31 is a Wednesday. Employees do not work weekends. All employees worked the last 3 days of December.

Instructions

Prepare the adjusting entries at December 31, 2008.

P3-5B On November 1,2008, the account balances of Rondeli Equipment Repair were as follows.

No.	Debits		No.	Credits	
101	Cash	\$ 2,790	154	Accumulated Depreciation	\$ 500
112	Accounts Receivable	2,510	201	Accounts Payable	2,100
126	Supplies	2,000	209	Unearned Service Revenue	1,400
153	Store Equipment	10,000	212	Salaries Payable	500
	• •		311	Common Stock	10,000
			320	Retained Earnings	2,800
		\$17,300			\$17,300

During November the following summary transactions were completed.

Nov. 8 Paid \$1,100 for salaries due employees, of which \$600 is for November.

- 10 Received \$1,200 cash from customers on account.
- 12 Received \$1,400 cash for services performed in November.
- 15 Purchased store equipment on account \$3,000.
- 17 Purchased supplies on account \$500.
- 20 Paid creditors on account \$2,500.
- 22 Paid November rent \$300.
- 25 Paid salaries \$1,300.
- 27 Performed services on account and billed customers for services provided \$400.
- 29 Received \$550 from customers for future service.

Adjustment data consist of:

- 1. Supplies on hand \$500.
- 2. Accrued salaries payable \$500.
- **3.** Depreciation for the month is \$100.
- **4.** Unearned service revenue of \$1,150 is earned.

Instructions

- (a) Enter the November 1 balances in the ledger accounts.
- **(b)** Journalize the November transactions.
- (c) Post to the ledger accounts. Use J1 for the posting reference. Use the following accounts: No. 407 Service Revenue, No. 615 Depreciation Expense, No. 631 Supplies Expense, No. 726 Salaries Expense, and No. 729 Rent Expense.
- (d) Prepare a trial balance at November 30.
- (e) Journalize and post adjusting entries.
- (f) Prepare an adjusted trial balance.
- **(g)** Prepare an income statement and a retained earnings statement for November and a balance sheet at November 30.

(d) Trial balance \$20,150

(f) Adj. trial balance \$20,750

(g) Net loss \$1,850; Ending retained earnings \$950 Total assets \$15,350

PROBLEMS: SET C



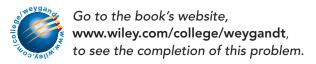
Visit the book's website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Problem Set C.

CONTINUING COOKIE CHRONICLE

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 and 2.)

CCC3 It is the end of November and Natalie has been in touch with her grandmother. Her grandmother asked Natalie how well things went in her first month of business. Natalie, too,

would like to know if she has been profitable or not during November. Natalie realizes that in order to determine Cookie Creations' income, she must first make adjustments.



BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem PepsiCo, Inc.

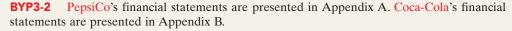


BYP3-1 The financial statements of PepsiCo are presented in Appendix A at the end of this textbook.

Instructions

- (a) Using the consolidated financial statements and related information, identify items that may result in adjusting entries for prepayments.
- **(b)** Using the consolidated financial statements and related information, identify items that may result in adjusting entries for accruals.
- **(c)** Using the Selected Financial Data and 5-Year Summary, what has been the trend since 2001 for net income?

Comparative Analysis ProblemPepsiCo, Inc. vs. The Coca-Cola Company





Instructions

Based on information contained in these financial statements, determine the following for each company.

- (a) Net increase (decrease) in property, plant, and equipment (net) from 2004 to 2005.
- (b) Increase (decrease) in selling, general, and administrative expenses from 2004 to 2005.
- (c) Increase (decrease) in long-term debt (obligations) from 2004 to 2005.
- (d) Increase (decrease) in net income from 2004 to 2005.
- (e) Increase (decrease) in cash and cash equivalents from 2004 to 2005.

Exploring the Web

BYP3-3 A wealth of accounting-related information is available via the Internet. For example the Rutgers Accounting Web offers access to a great variety of sources.



Address: www.accounting.rutgers.edu/ or go to www.wiley.com/college/weygandt

Steps: Click on **Accounting Resources**. (*Note*: Once on this page, you may have to click on the **text only** box to access the available information.)

Instructions

- (a) List the categories of information available through the **Accounting Resources** page.
- **(b)** Select any one of these categories and briefly describe the types of information available.

CRITICAL THINKING



Decision Making Across the Organization

BYP3-4 Happy Camper Park Inc. was organized on April 1, 2007, by Amaya Berge. Amaya is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Amaya prepared the following income statement for the quarter that ended March 31, 2008.

HAPPY CAMPER PARK INC.

Income Statement
For the Quarter Ended March 31, 2008

Revenues		
Rental revenue		\$90,000
Operating expenses		
Advertising	\$ 5,200	
Wages	29,800	
Utilities	900	
Depreciation	800	
Repairs	4,000	
Total operating expenses		40,700
Net income		\$49,300

Amaya thought that something was wrong with the statement because net income had never exceeded \$20,000 in any one quarter. Knowing that you are an experienced accountant, she asks you to review the income statement and other data.

You first look at the trial balance. In addition to the account balances reported above in the income statement, the ledger contains the following additional selected balances at March 31, 2008.

Supplies	\$ 6,200
Prepaid Insurance	7,200
Notes Payable	12,000

You then make inquiries and discover the following.

- 1. Rental revenues include advanced rentals for summer occupancy \$15,000.
- 2. There were \$1,700 of supplies on hand at March 31.
- 3. Prepaid insurance resulted from the payment of a one-year policy on January 1, 2008.
- **4.** The mail on April 1, 2008, brought the following bills: advertising for week of March 24, \$110; repairs made March 10, \$260; and utilities, \$180.
- **5.** There are four employees, who receive wages totaling \$300 per day. At March 31, 2 days' wages have been incurred but not paid.
- **6.** The note payable is a 3-month, 10% note dated January 1, 2008.

Instructions

With the class divided into groups, answer the following.

- (a) Prepare a correct income statement for the quarter ended March 31, 2008.
- **(b)** Explain to Amaya the generally accepted accounting principles that she did not recognize in preparing her income statement and their effect on her results.

Communication Activity

BYP3-5 In reviewing the accounts of Keri Ann Co. at the end of the year, you discover that adjusting entries have not been made.

Instructions

Write a memo to Keri Ann Nickels, the owner of Keri Ann Co., that explains the following: the nature and purpose of adjusting entries, why adjusting entries are needed, and the types of adjusting entries that may be made.

Ethics Case

BYP3-6 Bluestem Company is a pesticide manufacturer. Its sales declined greatly this year due to the passage of legislation outlawing the sale of several of Bluestem's chemical pesticides. In the coming year, Bluestem will have environmentally safe and competitive chemicals to replace these discontinued products. Sales in the next year are expected to greatly exceed any prior year's. The decline in sales and profits appears to be a one-year aberration. But even so, the company president fears a large dip in the current year's profits. He believes that such a dip could cause a significant drop in the market price of Bluestem's stock and make the company a takeover target.

To avoid this possibility, the company president calls in Cathi Bell, controller, to discuss this period's year-end adjusting entries. He urges her to accrue every possible revenue and to defer as many expenses as possible. He says to Cathi, "We need the revenues this year, and next year can easily absorb expenses deferred from this year. We can't let our stock price be hammered down!" Cathi didn't get around to recording the adjusting entries until January 17, but she dated the entries December 31 as if they were recorded then. Cathi also made every effort to comply with the president's request.

Instructions

- (a) Who are the stakeholders in this situation?
- **(b)** What are the ethical considerations of (1) the president's request and (2) Cathi's dating the adjusting entries December 31?
- (c) Can Cathi accrue revenues and defer expenses and still be ethical?

"All About You" Activity



BYP3-7 In the "All About You" feature in this chapter (p. 115), you learned how important it is that companies report or disclose information about all liabilities, including potential liabilities related to environmental clean-up. There are many situations in which you will be asked to provide personal financial information about your assets, liabilities, revenue, and expenses. Sometimes you will face difficult decisions regarding what to disclose and how to disclose it.

Instructions

Suppose that you are putting together a loan application to purchase a home. Based on your income and assets, you qualify for the mortgage loan, but just barely. How would you address each of the following situations in reporting your financial position for the loan application? Provide responses for each of the following questions.

- (a) You signed a guarantee for a bank loan that a friend took out for \$20,000. If your friend doesn't pay, you will have to pay. Your friend has made all of the payments so far, and it appears he will be able to pay in the future.
- **(b)** You were involved in an auto accident in which you were at fault. There is the possibility that you may have to pay as much as \$50,000 as part of a settlement. The issue will not be resolved before the bank processes your mortgage request.
- (c) The company at which you work isn't doing very well, and it has recently laid off employees. You are still employed, but it is quite possible that you will lose your job in the next few months.

Answers to Insight and Accounting Across the Organization Questions

How Long Will "The Force" Be with Us?, p. 96

- Q: What accounting principle does this example illustrate?
- A: This situation demonstrates the difficulty of matching expenses to revenues.
- Q: How will financial results be affected if the expenses are recognized over a period that is *less than* that used for revenues?
- A: If expenses are recognized over a period that is less than that used for revenues, earnings will be understated during the early years and overstated during the later years.
- Q: What if the expenses are recognized over a period that is *longer than* that used for revenues?
- A: If the expenses are recognized over a period that is longer than that used for revenues, earnings will be overstated during the early years and understated in later years. In either case, management and stockholders could be misled.

Companies Change Advertising Treatment, p. 100

- Q: Why might the new accounting method cause companies sometimes to spend less on advertising?
- A: Under the old approach companies could delay to future periods the expensing of advertising costs. Under that approach, money spent this period did not necessarily immediately reduce income. Under the new approach, a dollar spent on advertising immediately reduces this year's income. If the company is concerned that it might not hit this year's earnings target, it might decide to reduce its advertising spending.

Turning Gift Cards into Revenue, p. 104

- Q: Suppose that Robert Jones purchases a \$100 gift card at Best Buy on December 24, 2007, and gives it to his wife, Devon, on December 25, 2007. On January 3, 2008, Devon uses the card to purchase \$100 worth of CDs. When do you think Best Buy should recognize revenue, and why?
- A: According to the revenue recognition principle, companies should recognize revenue when earned. In this case revenue is not earned until Best Buy provides the goods. Thus, when Best Buy receives cash in exchange for the gift card on December 24, 2007, it should recognize a liability, Unearned Revenue, for \$100. On January 3, 2008, when Devon Jones exchanges the card for merchandise, Best Buy should recognize revenue and eliminate \$100 from the balance in the Unearned Revenue account.



Authors' Comments on *All About You*: Is Your Old Computer a Liability?, p. 115

The balance sheet should provide a fair representation of what a company owns and what it owes. If significant obligations of the company are not reported on the balance sheet, the company's net worth (its equity) will be overstated. While it is true that it is not possible to estimate the *exact* amount of future environmental clean-up costs, it is becoming clear that companies will be held accountable.

Therefore, it doesn't seem reasonable to not accrue for environmental costs. Recognition of these liabilities provides a more accurate picture of the company's financial position. It also has the potential to improve the environment. As companies are forced to report these amounts on their financial statements, they will start to look for more effective and efficient means to reduce toxic waste, and therefore reduce their costs.



Answer to PepsiCo Review It Question 4, p. 104

Per Note 4, PepsiCo's 2005 depreciation expense is \$1,103 million; 2004 depreciation expense was \$1,062 million.

Answers to Self-Study Questions

1. c 2. a 3. d 4. d 5. d 6. c 7. a 8. b 9. b 10. c *11. a