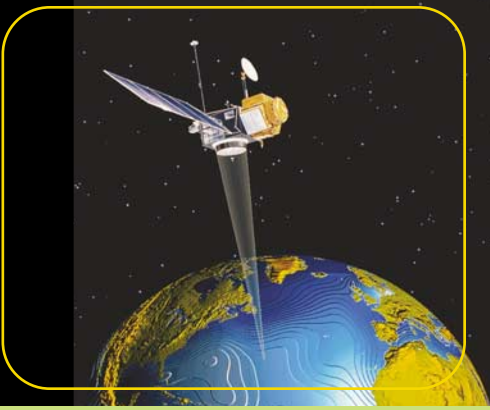
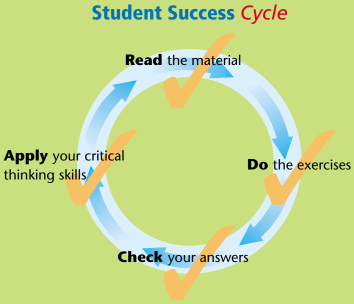
CHAPTER 4

Adjusting Accounts for Financial Statements



Creative Accounting



Brampton, Ontario—The RCMP (Royal Canadian Mounted Police) opened a criminal investigation regarding irregular accounting practices at Nortel Networks Corp., Canada's largest high-tech company and one of the world's leading suppliers of telecommunications equipment. Analysts have speculated that the firing of chief executive Frank Dunn, the CFO, and the controller stem from Nortel making 2002 earnings look artificially worse than they were and 2003 earnings look better. Why? It is assumed that this was done so executives could collect an estimated $20 million in bonuses linked to the company's return to profitability. The company currently provides biweekly performance updates required by the Ontario Securities Commission, auditing Nortel's results going back to 2000. Nortel is facing about $1 billion in class-action lawsuits related to the accounting scandal. The lesson to be learned is that creative accounting beyond the boundaries of GAAP is extremely costly.

http://www.nortel.com

CRITICAL THINKING CHALLENGE

Assuming you were a Nortel executive, how could you inflate 2003 earnings and shrink 2002 earnings? Explain how GAAP were violated by this strategy.

learning objectives

LO1 Describe the purpose of adjusting accounts at the end of a period.

LO2 Explain how the time period, matching, and revenue recognition principles affect the adjusting process.

LO3 Explain accrual accounting and cash basis accounting and how accrual accounting adds to the usefulness of financial statements.

LO4 Prepare and explain adjusting entries for prepaid expenses, amortization, unearned revenues, accrued expenses, and accrued revenues.

LO5 Explain how accounting adjustments link to financial statements.

LO6 Explain and prepare an adjusted trial balance.

LO7 Prepare financial statements from an adjusted trial balance.

*APPENDIX 4A

***LO8** Explain and prepare correcting entries.

*APPENDIX 4B

***LO9** Identify and explain two alternatives in recording prepaids and unearned revenues.

An asterisk (*) identifies appendix material.

chapter preview

Financial statements P. 26 reflect revenues when earned and expenses when incurred. This is known as *accrual basis accounting*. Accrual basis accounting is achieved by following the steps of the accounting cycle P. 75. We described the first four of these steps in Chapter 3.

An important part of the accounting cycle is the adjustment of account balances. The adjusted account balances are what is reported in financial statements that are prepared according to generally accepted accounting principles P. 31. Adjustment of accounts is necessary so that financial statements at the end of a reporting period reflect the effects of all transactions. This chapter emphasizes Steps Five and Six of the accounting cycle as highlighted in Exhibit 4.1. Preparation of financial statements, Step Seven of the accounting cycle, is reinforced in this chapter, with an emphasis on how *adjusting entries* impact the financial statements. Nortel, in the chapter opener, likely used adjusting entries to play an important role in producing irregular financial statements. To illustrate the adjusting process, we continue with the example of Finlay Interiors used in previous chapters.

Purpose of Adjusting

LO1 Describe the purpose of adjusting accounts at the end of a period.

The usual process during an accounting period is to record *external transactions*. **External transactions** are exchanges between two parties; these were the focus of Chapters 2 and 3. After external transactions are recorded, several accounts in the ledger need adjustment for their balances to appear in financial statements. This need arises because *internal transactions* remain unrecorded. **Internal transactions** represent exchanges within an organization that affect the accounting equation and are the focus of this chapter.

An example is the cost of certain assets that expire or are used up as time passes. The Prepaid Insurance account of Finlay Interiors is one of these. Finlay Interiors' trial balance (Exhibit 4.2) shows Prepaid Insurance with a balance of $2,400. This amount is the premium for two years of insurance protection beginning on January 1, 2011. By January 31, 2011, because one month's coverage is used up, the $2,400 is no longer the correct account balance for Prepaid Insurance. The Prepaid Insurance account balance must be reduced by one month's cost, or $100 ($2,400/24 months). The income statement P. 27 must report this $100 cost as insurance expense for January.

Another example is the $3,600 balance in Supplies. Part of this balance includes the cost of supplies that were used in January. The cost of the supplies used must be reported as an expense in January. The balances of both the Prepaid Insurance and Supplies accounts must be *adjusted* before they are reported on the January 31 balance sheet P. 29.

Another adjustment necessary for Finlay Interiors relates to one month's usage of furniture. The balances of the Unearned Consulting Revenue, Consulting Revenue, and Salaries Expense accounts often also need adjusting before they appear on the statements. We explain *why* this adjusting process is carried out in the next section.

Exhibit 4.1

Steps in the Accounting Cycle Introduced in Chapter 4

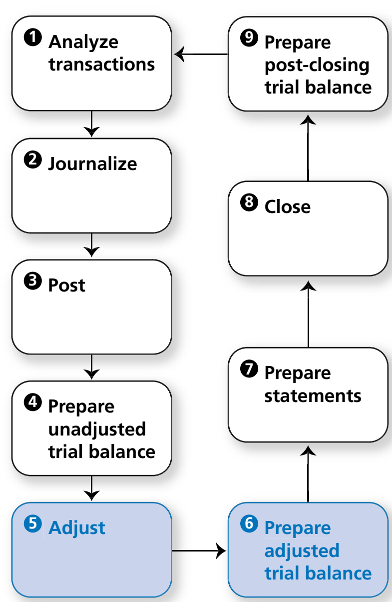


Exhibit 4.2

Trial Balance

FINLAY INTERIORS Trial Balance January 31, 2011		
	Debit	**Credit**
Cash	$ 8,070	
Accounts receivable	-0-	
Prepaid insurance	2,400	
Supplies	3,600	
Furniture	6,000	
Accounts payable		$ 200
Unearned consulting revenue		3,000
Notes payable		6,000
Carol Finlay, capital		10,000
Carol Finlay, withdrawals	600	
Consulting revenue		3,800
Rental revenue		300
Rent expense	1,000	
Salaries expense	1,400	
Utilities expense	230	
Totals	$23,300	$23,300

GAAP and the Adjusting Process

LO2 Explain how the time period, matching, and revenue recognition principles affect the adjusting process.

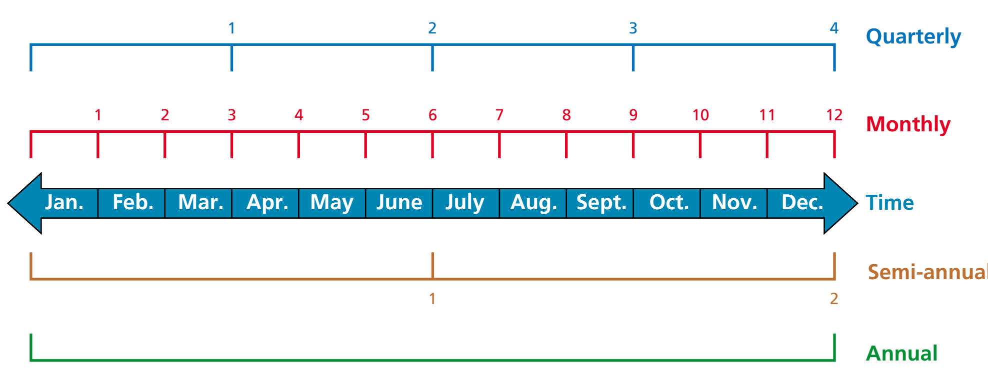
The adjusting process is based on three generally accepted accounting principles: the time period principle, the revenue recognition principle, and the matching principle. In this section, we explain how GAAP add to the usefulness of financial statements.

The Accounting Period

The adjusting process is often linked to timeliness of information. Information must reach decision makers frequently and promptly, therefore accounting systems need to prepare periodic reports at regular intervals. This results in an accounting process impacted by the *time period principle*. The **time period principle** assumes that an organization's activities can be divided into specific time periods such as a month, a three-month quarter, or a year, as illustrated in Exhibit 4.3.

Exhibit 4.3

Accounting Periods



Time periods covered by statements are called **accounting periods** (or **reporting periods**). Reports covering a one-year period are known as *annual financial statements*. Recall that a company can adopt a *fiscal year* P. 27 based on the *calendar year* P. 27 or its *natural business year* P. 27.

Many organizations also prepare **interim financial reports** covering one, three (quarterly), or six (semi-annual) months of activity.

Recognizing Revenues and Expenses

Because of the need for regular reporting of information, activities are often reported on or before their completion so as not to mislead decision makers. These activities are recorded through the adjusting process. Two main generally accepted accounting principles are used in the adjusting process: the *matching principle* and the *revenue recognition principle*. The **matching principle** aims to report or *match* expenses in the same accounting period as the revenues they helped to earn. For example, assume that as part of a $500 consulting services contract Finlay Interiors is to supply a detailed written plan to one of its customers in March. In the process of earning this $500 in revenue, Finlay Interiors will use $150 of office supplies purchased and paid for in February. The $150 of office supplies used in *March* is an expense that will be reported on the *March* income statement even though the supplies were purchased and paid for in February. The $150 of office supplies used in March must be ***matched*** against the $500 of March revenues in accordance with the matching principle. Financial statements will reflect accurate information about the income actually earned during the period only if expenses are properly matched against the revenues they helped to create.

To illustrate *revenue recognition*, we will look at two situations. First, assume that in March, Finlay Interiors provides $500 of consulting services to a client and collects the cash immediately. The $500 of revenue is earned in March and is reported on the March income statement in accordance with the revenue recognition principle. Second, assume that Finlay Interiors collected $1,000 of cash in March for work to be done in April. The $1,000 of revenue will be earned in April and will therefore be reported on the April income statement; the $1,000 will *not* be reported as revenue in March because it has not yet been earned. A major goal of the adjusting process is to have revenue *recognized* (reported) in the time period when it is *earned* regardless of when the cash is actually received. This concept is the foundation on which the *accrual basis of accounting* was developed.

Accrual Basis Compared to Cash Basis

LO3 Explain accrual accounting and cash basis accounting and how accrual accounting adds to the usefulness of financial statements.

Accrual basis accounting is founded on the revenue recognition principle, where revenues and expenses are *recognized* or recorded when earned or incurred regardless of when cash is received or paid. The word *accrual* and its root word *accrue* mean *to accumulate* or *to add*. So accrual basis accounting means that revenues and expenses must be *added* or *matched* to the *time period* in which they actually happened; when cash was received or paid is irrelevant to the recording of revenues and expenses. Accrual basis accounting then, is based on the three GAAP of *revenue recognition*, *matching*, and *time period*.

In contrast, **cash basis accounting** recognizes revenues and expenses when *cash* is received or paid. Cash basis accounting for the income statement, balance sheet, and statement of owner's equity is *not* consistent with generally accepted accounting principles. It is commonly held that accrual basis accounting provides a better indication of business performance than information about current cash receipts and payments. Accrual basis accounting also increases the comparability of financial statements from one period to another. Yet information about cash flows is also useful. This is why companies also include a cash flow statement, discussed in Chapter 19.

Accrual Basis Accounting

Revenues (= when earned)
− Expenses (= when incurred)
Net Income

Cash Basis Accounting

Revenues (= cash receipts)
− Expenses (= cash payments)
Net Income

CHECKPOINT Read Apply Do Check

1. Describe a company's annual reporting period.
2. Why do companies prepare interim financial statements?
3. What accounting principles most directly lead to the adjusting process?
4. Is cash basis accounting consistent with generally accepted accounting principles?

Do: QS 4-1, QS 4-2

Adjusting Accounts

The process of adjusting accounts is similar to our process of analyzing and recording transactions in Chapter 3. We must analyze each account balance and the transactions that affect it to determine any needed adjustments. An **adjusting entry** is recorded at the ***end*** of the accounting period to bring an asset or liability account balance to its proper amount. This entry also updates the related expense or revenue account and is necessary to prepare the financial statements. Adjustments are journalized in the General Journal and then posted to accounts in the ledger like any other entry. This next section shows the mechanics of adjusting entries and their links to financial statements.

Framework for Adjustments

LO4 Prepare and explain adjusting entries for prepaid expenses, amortization, unearned revenues, accrued expenses, and accrued revenues.

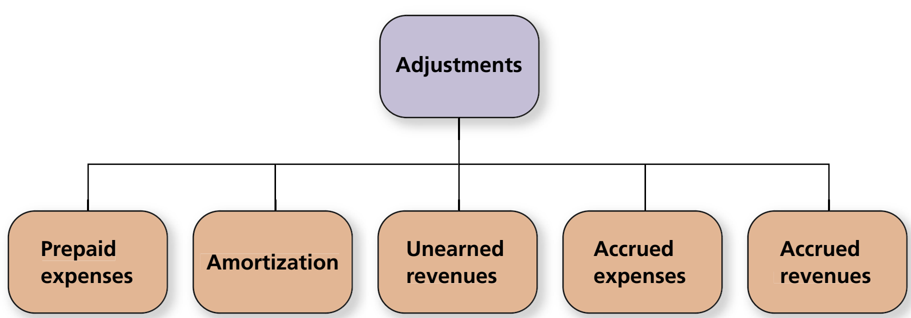
It is helpful to group adjustments by their timing of cash receipt or payment in comparison to when they are recognized as revenues or expenses. Exhibit 4.4 identifies the five main adjustments, each of which is detailed in the following sections.

Exhibit 4.4

Framework for Adjustments

Extend Your Knowledge

SSC 4-1



Adjusting Prepaid Expenses

Prepaid expenses[1] refer to items *paid for* in advance of receiving their benefits. Prepaid expenses are assets. As these assets are used, their costs become expenses. Adjusting entries for prepaids involve increasing (debiting) expenses and decreasing (crediting) assets as shown in Exhibit 4.5.

[1] Prepaids are also called *deferrals* because the recognition of the expense or revenue on the income statement is *deferred* to a future accounting period.

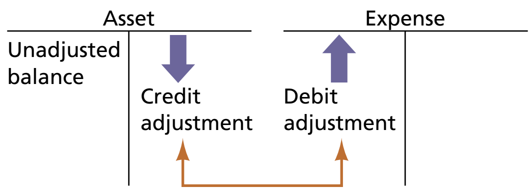


Exhibit 4.5

Adjusting for Prepaid Expenses

The three common prepaid expenses are insurance, supplies, and amortization.

Prepaid Insurance

We illustrate prepaid insurance using Finlay Interiors' payment of $2,400 for two years of insurance protection beginning on January 1, 2011. The following entry records the purchase of the insurance:

Jan. 1	Prepaid Insurance..	2,400	
	Cash		2,400
	To record purchase of insurance for 24 months.		

By January 31, one month's insurance coverage is used, causing a portion of the asset Prepaid Insurance to become an expense. This expense is $100 ($2,400 × 1/24). Our adjusting entry to record this expense and reduce the asset is:

Adjustment (a)

Jan. 31	Insurance Expense..	100	
	Prepaid Insurance................................		100
	To record expired insurance.		

Posting this adjusting entry affects the accounts shown in Exhibit 4.6:

Prepaid Insurance			
Jan. 1	2,400	100	Jan. 31
Balance	2,300		

Insurance Expense		
Jan. 31	100	

Exhibit 4.6

Insurance Accounts After Adjusting for Prepaids

After posting, the $100 balance in Insurance Expense and the $2,300 balance in Prepaid Insurance are ready for reporting in the financial statements. If the adjustment is *not* made at January 31, then (a) expenses are understated by $100 and net income is overstated by $100 for the January income statement, and (b) both Prepaid Insurance and owner's equity are overstated by $100 in the January 31 balance sheet.

Supplies

Finlay Interiors purchased $3,600 of supplies in January and used some of them during this month. Daily usage of supplies was not recorded in Finlay Interiors' accounts because this information was not needed. When we report account balances in financial statements only at the end of a month, recordkeeping costs can be reduced by making only one adjusting entry at that time. This entry needs to record the total cost of all supplies used in the month.

The cost of supplies used during January must be recognized as an expense. Finlay Interiors calculates ("takes inventory of") the remaining unused supplies. The cost of the remaining supplies is then deducted from the cost of the purchased supplies to calculate the amount used. Finlay Interiors has $2,550 of supplies remaining out of the $3,600 ($2,500 + $1,100) purchased in January. The $1,050 difference between these two amounts is the cost of the supplies used. This amount is January's Supplies Expense. Our adjusting entry to record this expense and reduce the Supplies asset account is:

Adjustment (b)

Jan. 31	Supplies Expense	1,050	
	Supplies		1,050
	To record supplies used.		

Posting this adjusting entry affects the accounts shown in Exhibit 4.7:

Exhibit 4.7

Supplies Accounts After Adjusting for Prepaids

Supplies			
Jan. 1	2,500	1,050	Jan. 31
1	1,100		
Balance	2,550		

Supplies Expense		
Jan. 31	1,050	

The balance of the Supplies account is $2,550 after posting and equals the cost of remaining unused supplies. If the adjustment is *not* made at January 31, then (a) expenses are understated by $1,050 and net income overstated by $1,050 for the January income statement, and (b) both Supplies and owner's equity are overstated by $1,050 in the January 31 balance sheet.

Other Prepaid Expenses

There are other prepaid expenses (including Prepaid Rent), which are accounted for in exactly the same manner as Insurance and Supplies above. We should also note that some prepaid expenses are both paid for and fully used up within a single accounting period. One example is when a company pays monthly rent on the first day of each month. The payment creates a prepaid expense on the first day of each month that fully expires by the end of the month. In these special cases, we can record the cash paid with a debit to the expense account instead of an asset account.

CHECKPOINT Read Apply Do Check

5. If the entry to adjust Prepaid Insurance was not recorded, what effect would this have on each component of the accounting equation?

Do: QS 4-3

Adjusting for Amortization[2]

Capital assets include long-term tangible assets (such as **property, plant and equipment**) that are used to produce and sell products and services, and **intangible assets** (such as patents) that convey the right to use a product or process. These assets are expected to provide benefits for more than one period. Examples of property, plant and equipment assets are land, buildings, machines, vehicles and fixtures. Because these assets (except for land) wear out or decline in usefulness as they are used, an expense must be recorded to match the cost of the asset over the periods benefited. **Amortization** is the process of computing expense from matching (or allocating) the cost of capital assets over their expected useful lives.

[2] In 1990, the revised *CICA Handbook*, section 3600, recommended the use of the term *amortization* instead of **depreciation**, but the use of *depreciation* was not ruled out. Also, *fixed assets* was replaced by *capital assets*. Despite these recommendations, the new terminology has not yet been adopted by all users. Thus, *depreciation* continues to be a common term.

Finlay Interiors uses furniture in earning revenue. This furniture's cost must be amortized to match the cost of the furniture over the time that the furniture helps earn revenue. Recall that Finlay Interiors purchased furniture for $6,000 on January 1. Carol Finlay expects the furniture to have a useful life (benefit period) of two years. Carol expects to sell the furniture for about $1,200 at the end of two years. This means that the *net cost* expected to expire over the estimated useful life is $4,800 (=$6,000 − $1,200).

There are several methods that we can use to allocate this $4,800 net cost to expense. Finlay Interiors uses *straight-line amortization*.[3] The **straight-line amortization method** allocates equal amounts of an asset's net cost over its estimated useful life. When the $4,800 net cost is divided by the asset's useful life of 24 months (2 years × 12 months per year), we get an average monthly cost of $200 ($4,800/24). Our adjusting entry to record monthly amortization expense is:

Straight-Line Amortization

Calculated as:

$$= \frac{\text{Cost of asset} - \text{Estimated value at end of estimated useful life}}{\text{Estimated useful life}}$$

$$= \frac{\$6{,}000 - \$1{,}200}{24 \text{ months}}$$

$$= \underline{\underline{\$200}} \text{ per month}$$

Adjustment (c)

Jan.	31	Amortization Expense, Furniture....................	200	
		Accumulated Amortization, Furniture....		200
		To record monthly amortization on furniture.		

Posting this adjusting entry affects the accounts shown in Exhibit 4.8:

Exhibit 4.8

Accounts After Amortization Adjustments

Furniture			
Jan. 1	6,000		
Bal.	6,000		

Accumulated Amortization, Furniture			
		200	Jan. 31

Amortization Expense, Furniture			
Jan. 31	200		

Accumulated amortization is recorded in a *contra asset account*. A **contra account** is an account that is linked with another account and has an opposite normal balance to its counterpart. It is reported as a subtraction from the other account's balance. On Finlay Interiors' balance sheet, the balance in the contra asset account, *Accumulated Amortization, Furniture,* will be subtracted from the Furniture account balance as shown in Exhibit 4.10. The cost of the asset less its accumulated amortization is the **book value of the asset**. The **market value of an asset** is the amount it can be sold for. Market value is not tied to the book value of an asset.

After posting the adjustment, the *Furniture* account less its *Accumulated Amortization, Furniture* account equals the January 31 balance sheet amount for this asset. The balance in the Amortization Expense, Furniture account is the expense reported in the January income statement. If the adjustment is *not* made at January 31, then (a) expenses are understated by $200 and net income is overstated by $200 for the January income statement, and (b) both assets and owner's equity are overstated by $200 in the January 31 balance sheet.

The use of the contra asset account Accumulated Amortization allows balance sheet readers to know both the cost of assets and the total amount of amortization charged to expense to date. Notice that the title of the contra account is *Accumulated* Amortization. This means that the account includes *total* amortization expense for all prior periods when the assets were being used. Finlay Interiors'

[3] We explain the details of *amortization* methods in Chapter 12. We briefly describe the straight-line method here to help you understand the adjusting process.

Furniture and Accumulated Amortization, Furniture accounts would appear on March 31, 2011, as shown in Exhibit 4.10, after the three monthly adjusting entries detailed in Exhibit 4.9.

Exhibit 4.9

Accounts After Three Months of Amortization Adjustments

Furniture			
Jan. 1	6,000		
Total	6,000		

Accumulated Amortization, Furniture			
		200	Jan. 31
		200	Feb. 28
		200	Mar. 31
		600	Total

Exhibit 4.10

Accumulated Amortization Contra Account in the Balance Sheet

Assets		
Cash		$
Furniture	**$6,000**	
Less: Accumulated amortization	**600**	**5,400**
Total assets...		$

CHECKPOINT Read Apply Do Check

6. If the year-end adjusting entry to record amortization expense was not recorded, what effect would this have on each component of the accounting equation?
7. Explain what a contra account is.

Do: QS 4-4

JUDGEMENT CALL

Answer—p. 151

Small Business Owner

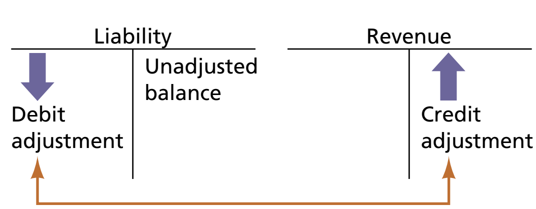
You are preparing to make an offer to purchase a small family-run restaurant. The manager gives you a copy of her amortization schedule for the restaurant's building and equipment. It shows costs of $75,000 and accumulated amortization of $55,000. This leaves a net total for building and equipment of $20,000. Is this information valuable in deciding on a purchase offer for the restaurant?

Adjusting Unearned Revenues

Unearned revenues refer to cash received in advance of providing products and services. Unearned revenues, also known as *deferred revenues*, are a *liability*. When cash is accepted, an obligation to provide products and services is also accepted. As products and services are provided, the amount of unearned revenues becomes *earned* revenues. Adjusting entries for unearned revenues involve increasing (crediting) revenues and decreasing (debiting) unearned revenues as shown in Exhibit 4.11. These adjustments reflect economic events (including passage of time) that impact unearned revenues.

Exhibit 4.11

Adjusting for Unearned Revenues



We see an example of unearned revenues in Rogers Communications' 2005 annual report. Rogers reports unearned revenue of $176.3 million on its balance sheet that includes subscriber deposits and amounts received related to services to be provided in the future. Another example is WestJet, which reports advance (unearned) ticket sales at December 31, 2005, of $127,450,000.

Finlay Interiors also has unearned revenues. On January 26, Finlay Interiors agreed to provide consulting services to a client for a fixed fee of $1,500 per month. On that same day, this client paid the first two months' fees in advance, covering the period from January 27 to March 27. The entry to record the cash received in advance is:

Jan. 26	Cash	3,000	
	Unearned Consulting Revenue		3,000
	Received advance payment for services over the next two months.		

This advance payment increases cash and creates an obligation to do consulting work over the next two months. As time passes, Finlay Interiors will earn this payment. No external transactions are linked with this earnings process. By January 31, Finlay Interiors provides five days' service that amounts to consulting revenue of $250 (=$1,500 × 5/30). The revenue recognition principle implies that $250 of unearned revenue is reported as revenue on the January income statement. The adjusting entry to reduce the liability account and recognize earned revenue is:

Adjustment (d)

Jan. 31	Unearned Consulting Revenue	250	
	Consulting Revenue		250
	To record the earned portion of revenue received in advance calculated as $1,500 × 5/30.		

The accounts look as shown in Exhibit 4.12 after posting the adjusting entry.

Exhibit 4.12

Unearned Revenue and Revenue Accounts After Adjustments

Unearned Consulting Revenue			
Jan. 31	250	3,000	Jan. 26
		2,750	Balance

Consulting Revenue			
		2,200	Jan. 10
		1,600	15
		250	31
		4,050	Total

The adjusting entry transfers $250 out of Unearned Consulting Revenue (a liability account) to a revenue account. If the adjustment is *not* made, then (a) revenue and net income are understated by $250 in the January income statement, and (b) Unearned Consulting Revenue is overstated and owner's equity understated by $250 on the January 31 balance sheet.

CHECKPOINT Read Apply Do Check

8. AltaCo credited Unearned Revenue for $20,000 received on November 3, 2011, for work to be done just prior to Christmas. The work was completed as scheduled. If Unearned Revenue is not adjusted at year-end to reflect the completion of the work, which GAAP will be violated and why?

9. Describe how an unearned revenue arises. Give an example.

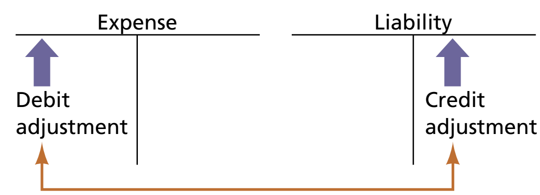
Do: QS 4-5

Adjusting Accrued Expenses

Accrued expenses refer to costs incurred in a period that are both unpaid and unrecorded. Accrued expenses are part of expenses and reported on the income statement. Adjusting entries for recording accrued expenses involve increasing (debiting) expenses and increasing (crediting) liabilities as shown in Exhibit 4.13.

Exhibit 4.13

Adjusting for Accrued Expenses



Common examples of accrued expenses are interest, salaries, rent, and taxes. We use interest and salaries to show how to adjust accounts for accrued expenses.

Accrued Interest Expense

It is common for companies to have accrued interest expense on notes payable and certain accounts payable at the end of a period. Interest expense is incurred with the passage of time. Unless interest is paid on the last day of an accounting period, we need to adjust accounts for interest expense incurred but not yet paid.

Interest of $35 has accrued on Finlay Interiors' $6,000, 7%, six-month note payable for the month of January.[4] The journal entry is:

Adjustment (e)

Jan.	31	Interest Expense	35	
		Interest Payable		35
		To record accrued interest.		

After the adjusting entry is posted, the expense and liability accounts appear as shown in Exhibit 4.14.

Exhibit 4.14

Notes Payable and Interest Accounts After Accrual Adjustments

Notes Payable			
		6,000	Jan. 1

Interest Expense			
Jan. 31	35		

Interest Payable			
		35	Jan. 31

This means that $35 of interest expense is reported on the income statement and that $35 interest payable is reported on the balance sheet. Notice that the Notes Payable account is *not* affected by recording interest. If the interest adjustment is not made, then (a) Interest Expense is understated and net income overstated by $35 in the January income statement, and (b) Interest Payable is understated and owner's equity overstated by $35 on the January 31 balance sheet.

[4] Interest on the $6,000, 7%, six-month note payable was calculated using the formula

Interest = Principal of the note × Annual interest rate × Time expressed in years OR $i = Prt$.

Therefore $\$6,000 \times 7\% \times \frac{1}{12} = \$35$.
Where the term of the note is in days, Interest = Principal × Rate × $\frac{\text{Exact days}}{365}$.
Interest is discussed in greater detail in Chapter 10.

The $6,000 principal and total interest of $210 ($6,000 × 7% × 6/12 = $210) will be paid six months from January 1, the date the note was issued.[5]

Accrued Salaries Expense

Finlay Interiors' only employee earns $70 per day or $350 for a five-day workweek beginning on Monday and ending on Friday. This employee gets paid every two weeks on Friday. On the 14th and the 28th of January, the wages are paid, recorded in the journal, and posted to the ledger. The *unadjusted* Salaries Expense and Cash paid for salaries appear as shown in Exhibit 4.15.

Cash		
	700	Jan. 14
	700	28

Salaries Expense		
Jan. 14	700	
28	700	

Exhibit 4.15

Salary and Cash Accounts Before Adjusting

The calendar in Exhibit 4.16 shows one working day after the January 28 payday (January 31). This means that the employee earns one day's salary by the close of business on Monday, January 31. While this salary expense is incurred, it is not yet paid or recorded by the company. The period-end adjusting entry to account for accrued salaries is:

Adjustment (f)

Jan. 31	Salaries Expense	70	
	Salaries Payable		70
	To record one day's accrued salary; 1 × $70.		

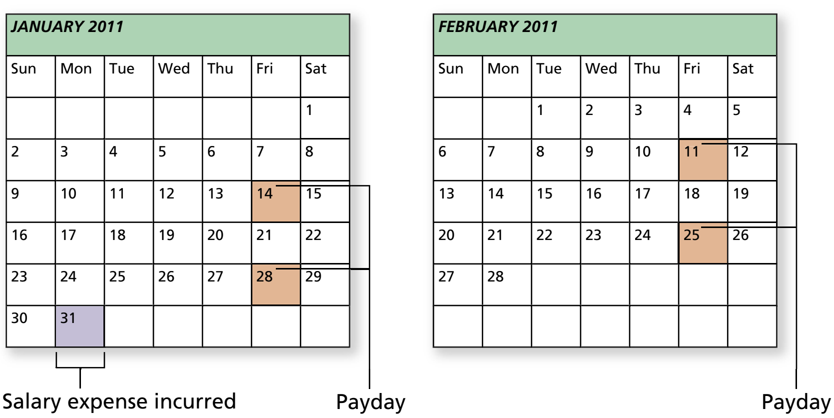


Exhibit 4.16

Salary Accrual Period and Paydays

[5] When the note payable and accrued interest are paid on July 1, six months after the date of issue on January 1, the entry would be (assuming interest expense of $35 per month has accrued):

July 1	Notes Payable	6,000	
	Interest Payable	210	
	Cash		6,210
	To record payment of note payable and accrued interest.		

After the adjusting entry is posted, the expense and liability accounts appear as shown in Exhibit 4.17.

Exhibit 4.17

Salary Accounts After Accrual Adjustments

Salaries Expense		
Jan. 14	700	
28	700	
31	70	
Total	1,470	

Salaries Payable		
	70	Jan. 31

Extend Your Knowledge

SSC 4-2

This means that $1,470 of salaries expense is reported on the income statement and that $70 in salaries payable (liability) is reported in the balance sheet. If the adjustment is *not* made, then (a) Salaries Expense is understated and net income overstated by $70 in the January income statement, and (b) Salaries Payable is understated and owner's equity overstated by $70 on the January 31 balance sheet.

The accrued salaries are paid on the first payday of the next bi-weekly period, which occurs on Friday, February 11. The entry includes the added salaries expense for the 9 days worked in February:

Feb. 11	Salaries Payable	70	
	Salaries Expense	630	
	Cash		700
	Paid two weeks' salary including one day accrued in January (1 day at $70; 9 days at $70 = $630).		

CHECKPOINT Read Apply Do Check

10. In error, the May utility bill for $6,900 was not included in the May 31 adjusting entries. What effect would this error have on the components of the accounting equation?

11. What is an accrued expense? Give an example.

12. Music-Mart records $1,000 of accrued salaries on December 31. Five days later on January 5 (the next payday), salaries of $7,000 are paid. What is the January 5 entry?

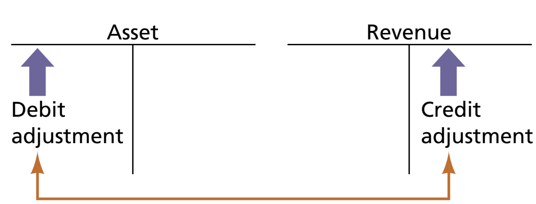
Do: QS 4-6

Adjusting Accrued Revenues

When products and services are delivered, we expect to receive payment for them. **Accrued revenues** refer to revenues earned in a period that are both unrecorded and not yet received in cash (or other assets). Accrued revenues are part of revenues and must be reported on the income statement. The adjusting entries increase (debit) assets and increase (credit) revenues as shown in Exhibit 4.18.

Exhibit 4.18

Adjusting for Accrued Revenues



Common examples of accrued revenues are fees for services and products, interest, and rent. We use service fees and interest to show how to adjust accounts for accrued revenues.

Accrued Services Revenue

Accrued revenues are earned but unrecorded because either the customer has not paid for them or the seller has not yet billed the customer. Finlay Interiors provides us with an example of an accrued revenue. In the second week of January, Finlay Interiors agreed to provide consulting services to a client for a fixed fee of $2,700 per month from January 11 to February 10, or 30 days of service. The client agrees to pay $2,700 cash to Finlay Interiors on February 10, 2011, when the service period is complete.

At January 31, 2011, 20 days of services are already provided to the client. Since the contracted services are not yet entirely provided, the client is not yet billed nor has Finlay Interiors recorded the services already provided. Finlay Interiors has earned $1,800 (=$2,700 × 20/30). The *revenue recognition principle* implies that we must report the $1,800 on the January income statement because it is earned in January. The balance sheet also must report that this client owes Finlay Interiors $1,800. The year-end adjusting entry to account for accrued consulting services revenue is:

Adjustment (g)

Jan. 31	Accounts Receivable	1,800	
	Consulting Revenue		1,800
	To record 20 days' accrued revenue.		

After the adjusting entry is posted, the affected accounts look as shown in Exhibit 4.19.

Exhibit 4.19

Receivable and Revenue Accounts After Accrual Adjustments

Accounts Receivable			
Jan. 15	1,900	1,900	Jan. 25
31	1,800		
Balance	1,800		

Consulting Revenue			
		2,200	Jan. 10
		1,600	15
		250	31
		1,800	31
		5,850	Total

Accounts receivable are reported on the balance sheet at $1,800, and $5,850 of revenues are reported on the income statement. If the adjustment is *not* made, then (a) both Consulting Revenue and net income are understated by $1,800 in the January income statement, and (b) both Accounts Receivable and owner's equity are understated by $1,800 on the January 31 balance sheet.

When the first month's fee is received on February 10, Finlay Interiors makes the following entry to remove the accrued asset (accounts receivable) and recognize the added 10 days of revenue earned in February:

Feb. 10	Cash	2,700	
	Accounts Receivable		1,800
	Consulting Revenue		900
	Received cash for accrued asset and earned consulting revenue; $900 = $2,700 × 10/30.		

Accrued Interest Revenue

In addition to the accrued interest expense we described earlier, interest can yield an accrued revenue when a company is owed money (or other assets) by a debtor. If a company is holding notes or accounts receivable that produce interest revenue, we must adjust the accounts to record any earned and yet uncollected interest revenue. The adjusting entry is similar to the one for accruing services revenue, with a debit to Interest Receivable (asset) and a credit to Interest Revenue (equity).

CHECKPOINT Read Apply Do Check

13. An adjusting entry to record $6,000 of accrued interest revenue was omitted due to an oversight. What effect would this error have on the components of the accounting equation?

Do: QS 4-7, QS 4-8

Adjustments and Financial Statements

LO5 Explain how accounting adjustments link to financial statements.

Exhibit 4.20 lists the five major types of transactions requiring adjustment. Adjusting entries are necessary for each. Understanding this exhibit is important to understanding the adjusting process and its link to financial statements. Remember that each adjusting entry affects both income statement accounts and balance sheet accounts.

Exhibit 4.20

Summary of Adjustments and Financial Statement Links

	Before Adjusting					
Type	**Balance Sheet Account**	**Income Statement Account**	**Adjusting Entry**			
Prepaid Expense	Asset & equity overstated	Expense understated	Dr Expense.............. Cr Asset	XX	 XX	where XX = how much of the prepaid was used during the period
Amortization	Asset & equity overstated	Expense understated	Dr Expense.............. Cr Contra Asset.....	XX	 XX	where XX = how much of the asset's cost was matched as an expense to the period
Unearned Revenues	Liability overstated; equity understated	Revenue understated	Dr Liability............... Cr Revenue	XX	 XX	where XX = how much of the liability was earned during the period
Accrued Expenses	Liability understated; equity overstated	Expense understated	Dr Expense.............. Cr Liability	XX	 XX	where XX = the amount of the unpaid and unrecorded expense for the period
Accrued Revenues	Asset & equity understated	Revenue understated	Dr Asset................... Cr Revenue	XX	 XX	where XX = the amount of the uncollected and unrecorded revenue for the period

Note that adjusting entries related to the framework in Exhibit 4.20 never affect cash.[6] A common error made by students learning to prepare adjusting entries is either to debit or to credit cash. In the case of prepaids and unearned revenues, cash has already been correctly recorded; it is the prepaids and unearned revenues account balances that need to be *fixed* or adjusted. In the case of accrued revenues and expenses, cash will be received or paid in the future and is not to be accounted for until that time; it is the revenue or expense account balance that needs to be fixed or adjusted. Amortization is a non-cash transaction and therefore does not affect cash.

Exhibit 4.21 summarizes the adjusting entries of Finlay Interiors on January 31. The posting of adjusting entries to individual ledger accounts was shown when we described the transactions above and is not repeated here. Adjusting entries are often set apart from other journal entries with the caption Adjusting Entries, as shown in Exhibit 4.21.

[6] Adjusting entries related to bank reconciliations affect cash but these adjustments are excluded from the framework in Exhibit 4.20 and will be discussed in Chapter 9.

Exhibit 4.21

Journalizing Adjusting Entries of Finlay Interiors

Finlay Interiors

GENERAL JOURNAL				Page 2
Date	**Account Titles and Explanations**	**PR**	**Debit**	**Credit**
2011	**Adjusting Entries**			
Jan. 31	Insurance Expense		100	
	Prepaid Insurance			100
	To record expired insurance; $2,400/24.			
31	Supplies Expense		1,050	
	Supplies			1,050
	To record supplies used; $3,600 − $2,550.			
31	Amortization Expense, Furniture		200	
	Accumulated Amortization, Furniture			200
	To record monthly amortization on furniture; $6,000 − $1,200 = $4,800/24.			
31	Unearned Consulting Revenue		250	
	Consulting Revenue			250
	To record earned revenue received in advance; $1,500 × 5/30.			
31	Interest Expense		35	
	Interest Payable			35
	To record one month of accrued interest.			
31	Salaries Expense		70	
	Salaries Payable			70
	To record one day's accrued salary; 1 × $70.			
31	Accounts Receivable		1,800	
	Consulting Revenue			1,800
	To record 20 days of accrued revenue; $2,700 × 20/30.			

14. Explain how adjusting entries are linked to the components of the accounting equation.

Do: QS 4-9, QS 4-10

CHECKPOINT

Read Apply Do Check

mid-chapter demonstration problem

Read Apply Do Check

The owner of a lawn service company prepares ***monthly*** financial statements.

Part A

Prepare the appropriate adjusting entries for July 31 based on the following information available at the end of July.

a. The annual insurance amounting to $1,200 went into effect on July 1. The Prepaid Insurance account was debited and Cash credited on the same date.

b. The lawn service company's lawn tractor was purchased for $3,200 last year. The value of the lawn tractor at the end of its estimated four-year useful life was determined to be $800. This information was made available to record amortization for July.

c. A customer paid for the entire summer's service in April. The journal entry credited the Unearned Service Fees account when the payment was received. The monthly fee is $500.

d. The last weekly salary of $1,400 was paid to employees on Friday, July 27. Employees are paid based on a five-day workweek. Salaries for July 30 and 31 have accrued.

e. Service fees of $1,800 were earned by July 31 but not recorded.

Part B

Refer to (d) above. Prepare the entry to pay the salaries on Friday, August 3.

Analysis component:

Refer to the opening chapter vignette. Nortel understated its 2002 earnings. Omitting which of the adjustments in Part A would accomplish this?

solution to *Mid-Chapter Demonstration Problem*

Part A

a.	July 31	Insurance Expense	100	
		Prepaid Insurance		100
		To record insurance for July.		
b.	31	Amortization Expense, Lawn Tractor	50	
		Accumulated Amortization, Lawn Tractor		50
		Amortization for July, calculated as $3,200 − $800 = $2,400/48 months = $50/month.		
c.	31	Unearned Service Fees	500	
		Service Fees Earned		500
		To record service fees earned for July.		
d.	31	Salaries Expense	560	
		Salaries Payable		560
		To record salaries for the last two days of July, calculated as $1,400/5 = $280/day × 2 days = $560		
e.	31	Accounts Receivable	1,800	
		Service Fees Earned		1,800
		To record accrued service revenue for July.		

Part B

Aug. 3	Salaries Payable	560	
	Salaries Expense	840	
	Cash		1400
	To record payment of weekly salaries; where salaries expense is calculated as $1,400/5 = $280/day × 3 days = $840.		

Analysis component:

Omitting adjustments (c) and (e) would cause revenues to be understated; hence, earnings or net income would also be understated.

Adjusted Trial Balance

LO6 Explain and prepare an adjusted trial balance.

An **unadjusted trial balance** is a listing of accounts and balances prepared *before* adjustments are recorded. An **adjusted trial balance** is a list of accounts and balances prepared *after* adjusting entries are recorded and posted to the ledger. Exhibit 4.22 shows the unadjusted and adjusted trial balances for Finlay Interiors at January 31, 2011. Notice several new accounts arising from the adjusting entries. The listing of accounts is also slightly changed to match the order listed in the Chart of Accounts in Appendix II at the end of the book.

Exhibit 4.22

Unadjusted and Adjusted Trial Balance for Finlay Interiors

Finlay Interiors
Trial Balances
January 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	**Cr.**	**Dr.**	**Cr.**	**Dr.**	**Cr.**
Cash	$ 8,070				$ 8,070	
Accounts receivable			(g)1,800		1,800	
Supplies	3,600			(b)1,050	2,550	
Prepaid insurance	2,400			(a) 100	2,300	
Furniture	6,000				6,000	
Accumulated amortization, furniture				(c) 200		$ 200
Accounts payable		$ 200				200
Interest payable				(e) 35		35
Salaries payable				(f) 70		70
Unearned consulting revenue		3,000	(d) 250			2,750
Notes payable		6,000				6,000
Carol Finlay, capital		10,000				10,000
Carol Finlay, withdrawals	600				600	
Consulting revenue		3,800		(d) 250 (g)1,800		5,850
Rental revenue		300				300
Amortization expense, furniture			(c) 200		200	
Salaries expense	1,400		(f) 70		1,470	
Interest expense			(e) 35		35	
Insurance expense			(a) 100		100	
Rent expense	1,000				1,000	
Supplies expense			(b)1,050		1,050	
Utilities expense	230				230	
Totals	$23,300	$23,300	$3,505	$3,505	$25,405	$25,405

Preparing Financial Statements

LO7 Prepare financial statements from an adjusted trial balance.

We can prepare financial statements directly from information in the *adjusted* trial balance. An adjusted trial balance includes all balances appearing in financial statements. We know that a trial balance summarizes information in the ledger by listing accounts and their balances. This summary is easier to work from than the entire ledger when preparing financial statements.

Exhibit 4.23 shows how Finlay Interiors' revenue and expense balances are transferred from the adjusted trial balance to (1) the income statement, and (2) the statement of owner's equity. Note how we use the net income and withdrawals account to prepare the statement of owner's equity.

Exhibit 4.23

Preparing the Income Statement and Statement of Owner's Equity from the Adjusted Trial Balance

Finlay Interiors
Adjusted Trial Balance
January 31, 2011

Acct. No.	Account Title	Debit	Credit
101	Cash	$ 8,070	
106	Accounts receivable	1,800	
125	Supplies	2,550	
128	Prepaid insurance	2,300	
167	Furniture	6,000	
168	Accumulated amortization, furniture		$ 200
201	Accounts payable		200
203	Interest payable		35
209	Salaries payable		70
236	Unearned consulting revenue		2,750
240	Notes payable		6,000
301	Carol Finlay, capital		10,000*
302	Carol Finlay, withdrawals	600	
403	Consulting revenue		5,850
406	Rental revenue		300
614	Amortization expense, furniture	200	
622	Salaries expense	1,470	
633	Interest expense	35	
637	Insurance expense	100	
641	Rent expense	1,000	
651	Supplies expense	1,050	
690	Utilities expense	230	
	Totals	$25,405	$25,405

*Recall that this balance is the result of a $10,000 investment by Carol Finlay during January 2011.

Step One Prepare income statement

Finlay Interiors
Income Statement
For Month Ended January 31, 2011

Revenues:		
Consulting revenue	$5,850	
Rental revenue	300	
Total revenues		$6,150
Operating expenses:		
Salaries expense	$1,470	
Supplies expense	1,050	
Rent expense	1,000	
Utilities expense	230	
Amortization expense, furniture	200	
Insurance expense	100	
Interest expense	35	
Total operating expenses		4,085
Net income		$2,065

Step Two Prepare statement of owner's equity

Finlay Interiors
Statement of Owner's Equity
For Month Ended January 31, 2011

Carol Finlay, capital, January 1		$ -0-
Add: Investments by owner	$10,000	
Net income	2,065	12,065
Total		$12,065
Less: Withdrawal by owner		600
Carol Finlay, capital, January 31		$11,465

To balance sheet in Exhibit 4.24

Exhibit 4.24 shows how Finlay Interiors' asset and liability balances on the adjusted trial balance are transferred to the balance sheet. The ending owner's equity is determined on the statement of owner's equity and transferred to the balance sheet. There are different formats for the balance sheet. The **account form balance sheet**, used in previous chapters, lists assets on the left and liabilities and owner's equity on the right side of the balance sheet. Its name comes from its link to the accounting equation, *Assets* = *Liabilities* + *Equity*. The balance sheet in Exhibit 2.11 (on P. 42) is in account form. The **report form balance sheet** lists items vertically, as shown in Exhibit 4.24. Both forms are widely used and are considered equally helpful to users. For consistency, we will use the report form in the preparation of financial statements from this point forward.

We usually prepare financial statements in the order shown: income statement, statement of owner's equity, and balance sheet. This order makes sense since the balance sheet uses information from the statement of owner's equity, which in turn uses information from the income statement.

Exhibit 4.24

Preparing the Balance Sheet from the Adjusted Trial Balance

Finlay Interiors

Finlay Interiors
Adjusted Trial Balance
January 31, 2011

Acct. No.	Account Title	Debit	Credit
101	Cash	$ 8,070	
106	Accounts receivable	1,800	
125	Supplies	2,550	
128	Prepaid insurance	2,300	
167	Furniture	6,000	
168	Accumulated amortization, furniture		$ 200
201	Accounts payable		200
203	Interest payable		35
209	Salaries payable		70
236	Unearned consulting revenue		2,750
240	Notes payable		6,000
301	Carol Finlay, capital		10,000
302	Carol Finlay, withdrawals	600	
403	Consulting revenue		5,850
406	Rental revenue		300
614	Amortization expense, furniture	200	
622	Salaries expense	1,470	
633	Interest expense	35	
637	Insurance expense	100	
641	Rent expense	1,000	
651	Supplies expense	1,050	
690	Utilities expense	230	
	Totals	$25,405	$25,405

Step Three Prepare balance sheet

Finlay Interiors
Balance Sheet
January 31, 2011

Assets		
Cash		$ 8,070
Accounts receivable		1,800
Supplies		2,550
Prepaid insurance		2,300
Furniture	$ 6,000	
Less: Accumulated amortization	200	5,800
Total assets		$ 20,520
Liabilities		
Accounts payable	$ 200	
Interest payable	35	
Salaries payable	70	
Unearned consulting revenue	2,750	
Notes payable	6,000	
Total liabilities		$ 9,055
Owner's Equity		
Carol Finlay, capital		11,465
Total liabilities and owner's equity		$ 20,520

From statement of owner's equity in Exhibit 4.23

CHECKPOINT Read Apply Do Check

15. Jordan Air Company has the following information in its unadjusted and adjusted trial balances:

	Unadjusted Debit	Unadjusted Credit	Adjusted Debit	Adjusted Credit
Prepaid insurance	$6,200		$5,900	
Salaries payable		$ -0-		$1,400

What are the adjusting entries that Jordan Air likely recorded?

16. What types of accounts are taken from the adjusted trial balance to prepare an income statement?

17. In preparing financial statements from an adjusted trial balance, what statement is usually prepared first? second? third? Explain why.

Do: QS 4-11

JUDGEMENT CALL

Answer—p. 151

Financial Officer

You are the financial officer for a retail outlet company. At the calendar year-end when you are reviewing adjusting entries to record accruals, you are called into the president's office. The president asks about accrued expenses and instructs you not to record these expenses until next year because they will not be paid until January or later. The president also asks how much the current year's revenues increased because of the recent purchase order from a new customer. You state that there is no effect on sales until next year because the purchase order says merchandise is to be delivered after January 15 and that is when your company plans to make delivery. The president points out that the order is already received, and your company is ready to make delivery, and tells you to record this sale in the current year. Your company would report a net income instead of a net loss if you carried out the president's orders for adjusting accruals. What do you do?

Summary

LO1 Describe the purpose of adjusting accounts at the end of a period. After external transactions are recorded, several accounts need adjusting for their balances to be correct because internal transactions remain unrecorded. The purpose of adjusting accounts at the end of a period is to recognize unrecorded revenues and expenses.

LO2 Explain how the time period, matching, and revenue recognition principles affect the adjusting process. The value of information is often linked to its timeliness, so accounting systems prepare periodic reports at regular intervals such as a month, a three-month quarter, or a year. Adjustments are made so that revenues and expenses are recognized as they occur and matched to the proper period.

LO3 Explain accrual accounting and cash basis accounting and how accrual accounting adds to the usefulness of financial statements. Accrual accounting recognizes revenue when earned and expenses when incurred, not necessarily when cash inflows and outflows occur. Cash basis accounting recognizes revenues when cash is received and expenses when cash is paid; it is not in accordance with GAAP.

LO4 Prepare and explain adjusting entries for prepaid expenses, amortization, unearned revenues, accrued expenses, and accrued revenues. Prepaid expenses, an asset, refer to items paid for in advance of receiving their benefits. As this asset is used, its cost becomes an expense.

Dr. Expense	xx	
Cr. Prepaid		xx
To adjust prepaid for amount used.		

Amortization is the expense created by spreading the cost of capital assets over the periods these assets are used. Accumulated Amortization, a contra asset account, is credited to track the total amount of the capital asset used.

Dr. Amortization Expense	xx	
Cr. Accumulated Amortization		xx
To adjust for amortization.		

Unearned revenues, a liability, refer to cash received in advance of providing products and services. As products and services are provided, the amount of unearned revenues becomes earned revenues.

Dr. Unearned Revenue	xx	
Cr. Revenue		xx
To adjust for unearned revenue that is earned.		

Accrued expenses are costs incurred in a period that are unpaid and unrecorded.

Dr. Expense	xx	
Cr. Liability		xx
To adjust for unrecorded and unpaid expenses.		

Accrued revenues are revenues earned in a period that are unrecorded and not yet collected.

Dr. Receivable	xx	
Cr. Revenue		xx
To adjust for unrecorded revenues not yet collected.		

LO5 Explain how accounting adjustments link to financial statements. Accounting adjustments bring an asset or liability account balance to its correct amount and update related expense or revenue accounts. Every adjusting entry affects one or more income statement *and* balance sheet accounts. An adjusting entry never affects cash. Adjustments are necessary for transactions that extend over more than one period. Exhibit 4.20 summarizes financial statement links by type of adjustment.

LO6 Explain and prepare an adjusted trial balance. An adjusted trial balance is a list of accounts and balances prepared after adjusting entries are recorded and posted to the ledger. Financial statements are often prepared from the adjusted trial balance.

LO7 Prepare financial statements from an adjusted trial balance. We can prepare financial statements directly from the adjusted trial balance that includes all account balances. Revenue and expense balances are transferred to the income statement and statement of owner's equity. Asset, liability, and owner's equity balances are transferred to the balance sheet. We usually prepare statements in the following order: income statement, statement of owner's equity, and balance sheet.

guidance answers to JUDGEMENT CALL

Small Business Owner

We know that amortization is a process of cost allocation, not asset valuation. Knowing the amortization schedule of the restaurant is not especially useful in your estimation of what the restaurant's building and equipment are currently worth. Your assessment of the age, quality, and usefulness of the building and equipment is much more important. Also, you would use the current market values of similar assets in estimating the value of this restaurant's building and equipment.

Financial Officer

It appears that you must make a choice to follow the president's orders or not to follow them. The requirements of acceptable practice are clear. Omitting adjustments and early recognition of revenue can mislead users of financial statements (including managers, owners, and lenders). One action is to request a second meeting with the president where you explain that accruing expenses and recognizing revenue when earned are required practices. You should also mention the ethical implications of not complying with accepted practice. Point out that the president's orders involve intentional falsification of the statements. If the president persists, you might discuss the situation with legal counsel and any auditors involved. Your ethical action might cost you this job. But the potential pitfalls of falsification of statements, reputation loss, personal integrity, and other costs are too great.

guidance answers to CHECKPOINT

Read Apply Do Check

1. An annual reporting (or accounting) period covers one year and refers to the preparation of annual financial statements. The annual reporting period can follow the calendar year or a fiscal year. The fiscal year can follow the business's natural business year.
2. Interim (less than one year) financial statements are prepared to provide decision makers with information frequently and promptly.
3. The revenue recognition principle, the time period principle, and the matching principle lead most directly to the adjusting process.
4. No. Cash basis accounting is not consistent with generally accepted accounting principles.
5. If Prepaid Insurance is not adjusted, assets and equity will be overstated.
6. If the adjusting entry to record amortization was not recorded, assets and equity would be overstated.
7. A contra account is an account that is subtracted from the balance of a related account. Use of a contra account often provides more complete information than simply reporting a net amount.
8. Matching will be violated because revenues earned will not be assigned to the correct accounting period.
9. An unearned revenue arises when cash is (or other assets are) received from a customer before the services and products are delivered to the customer. Magazine subscription receipts in advance are one example.
10. The omission of the $6,900 interest expense accrual will cause liabilities to be understated by $6,900 and equity to be overstated by $6,900.
11. An accrued expense refers to costs incurred in a period that are both unpaid and unrecorded prior to adjusting entries. One example is salaries earned by employees but not yet paid at the end of a period.
12. The January 5 entry to settle the accrued salaries and pay for added salaries is:

Jan. 5	Salaries Payable..........................	1,000	
	Salaries Expense..........................	6,000	
	Cash		7,000
	Paid salary including accrual from December.		

13. The omission of an adjusting entry to record $6,000 of accrued interest would cause assets and equity to be each understated by $6,000.

14. The various adjusting entries are linked to the accounting equation as follows: (a) adjustment of prepaids and the recording of amortization cause assets and equity to decrease; (b) adjustment of unearned amounts causes liabilities to decrease and equity to increase; (d) accrual of revenues causes assets and equity to increase; and (e) accrual of expenses causes liabilities to increase and equity to decrease.

15. The probable adjusting entries of Jordan Air are:

Insurance Expense	300	
Prepaid Insurance		300
To record insurance expired.		

Salaries Expense	1,400	
Salaries Payable		1,400
To record accrued salaries.		

16. Revenue accounts and expense accounts.

17. The income statement is usually prepared first, followed by the statement of owner's equity because net income (loss) from the income statement flows into the statement of owner's equity. The balance sheet is then prepared since the ending capital balance from the statement of owner's equity flows into the equity section of the balance sheet.

Read Apply Do Check

demonstration problem

The following information continues with The Cutlery, featured in the Chapter 3 Demonstration Problem. After the first month of business, The Cutlery's August 31, 2011, unadjusted trial balance appeared as follows:

THE CUTLERY
Trial Balance
August 31, 2011

Account	Debit	Credit
Cash	$ 1,530	
Accounts receivable	-0-	
Prepaid insurance	600	
Furniture	600	
Store equipment	16,200	
Accounts payable		$ 875
Unearned haircutting services revenue		500
Barbara Schmidt, capital		18,000
Barbara Schmidt, withdrawals	200	
Haircutting services revenue		855
Wages expense	125	
Rent expense	900	
Hydro expense	75	
Totals	$20,230	$20,230

The following additional information is available for the *month* just ended:

a. Amortization of $50 per month will be taken on the furniture.

b. It is estimated that the store equipment will have no value at the end of its estimated five-year (or 60-month) useful life. Barbara Schmidt will record a full month of amortization for August.

c. It was determined that the balance in unearned revenue at August 31 should be $420.

d. The prepaid insurance represents six months of insurance beginning August 1.

e. Accrued revenues at August 31 totalled $65.

Required

1. Prepare the adjusting entries needed on August 31, 2011, to record the previously unrecorded items.
2. Prepare T-accounts for accounts affected by the adjusting entries. Post the adjusting entries to the T-accounts.
3. Prepare an adjusted trial balance.
4. Prepare an income statement, a statement of owner's equity, and a balance sheet.

Analysis component:

Calculate the net effect of the adjusting entries on the balance sheet. Is net income positively or negatively affected by these adjusting entries overall? Could the opposite effect be achieved? If so, how?

Planning the Solution

- Analyze the information for each situation to determine which accounts need to be updated with an adjustment.
- Calculate the size of each adjustment and prepare the necessary journal entries.
- Show the amount entered by each adjustment in the designated accounts and determine the adjusted balance.
- Determine each entry's effect on net income for the year and on total assets, total liabilities, and owner's equity at the end of the year.
- Using the adjusted balances, prepare an adjusted trial balance.
- Using the adjusted trial balance, prepare the income statement, statement of owner's equity, and balance sheet.
- Analyze the adjusting entries and calculate the effect on each component of the accounting equation.

solution to *Demonstration Problem*

1. Adjusting journal entries.

a.	Aug. 31	Amortization Expense, Furniture	50	
		Accumulated Amortization, Furniture		50
		To record amortization expense for the month of August for the furniture.		
b.	31	Amortization Expense, Store Equipment	270	
		Accumulated Amortization, Store Equipment		270
		To record amortization expense for the month; $16,200/60 months = $270/month.		

c.	31	Unearned Haircutting Services Revenue.........	80	
		Haircutting Services Revenue................		80
		To recognize haircutting services revenues earned; $500 − $420 = $80.		

d.	31	Insurance Expense..	100	
		Prepaid Insurance................................		100
		To adjust for the expired portion of prepaid insurance; $600/6 months = $100/month.		

e.	31	Accounts Receivable....................................	65	
		Haircutting Services Revenue................		65
		To record revenues earned.		

2.

Accounts Receivable

Debit		Credit	
(e)	65		

Prepaid Insurance

Debit		Credit	
Balance	600	100	(d)
Balance	500		

Accumulated Amortization, Furniture

Debit		Credit	
		50	(a)

Accumulated Amortization, Store Equipment

Debit		Credit	
		270	(b)

Unearned Haircutting Services Revenue

Debit		Credit	
(c)	80	500	Balance
		420	Balance

Haircutting Services Revenue

Debit		Credit	
		855	Balance
		80	(c)
		65	(e)
		1,000	Balance

Amortization Expense, Furniture

Debit		Credit	
(a)	50		

Amortization Expense, Store Equipment

Debit		Credit	
(b)	270		

Insurance Expense

Debit		Credit	
(d)	100		

3.

THE CUTLERY
Adjusted Trial Balance
August 31, 2011

Account	Debit	Credit
Cash	$ 1,530	
Accounts receivable	65	
Prepaid insurance...	500	
Furniture	600	
Accumulated amortization, furniture		$ 50
Store equipment	16,200	
Accumulated amortization, store equipment....		270
Accounts payable...		875
Unearned haircutting services revenue		420
Barbara Schmidt, capital		18,000
Barbara Schmidt, withdrawals	200	
Haircutting services revenue...........................		1,000
Amortization expense, furniture	50	
Amortization expense, store equipment	270	
Wages expense	125	
Insurance expense..	100	
Rent expense	900	
Hydro expense...	75	
Totals	$20,615	$20,615

4.

THE CUTLERY
Income Statement
For Month Ended August 31, 2011

Revenues:		
Haircutting services revenue		$1,000
Operating expenses:		
Rent expense	$900	
Amortization expense, store equipment	270	
Wages expense	125	
Insurance expense	100	
Hydro expense	75	
Amortization expense, furniture	50	
Total operating expenses		1,520
Net loss		$ 520

THE CUTLERY
Statement of Owner's Equity
For Month Ended August 31, 2011

Barbara Schmidt, capital, August 1		$ -0-
Add: Investments by owner		18,000
Total		$18,000
Less: Withdrawals by owner	$200	
Net loss	520	720
Barbara Schmidt, capital, August 31		$17,280

THE CUTLERY
Balance Sheet
August 31, 2011

Assets		
Cash		$ 1,530
Accounts receivable		65
Prepaid insurance		500
Furniture	$ 600	
Less: Accumulated amortization	50	550
Store equipment	$16,200	
Less: Accumulated amortization	270	15,930
Total assets		$18,575
Liabilities		
Accounts payable	$ 875	
Unearned haircutting services revenue	420	
Total liabilities		$ 1,295
Owner's Equity		
Barbara Schmidt, capital		17,280
Total liabilities and owner's equity		$18,575

Reminder: The net loss on the income statement flows into the statement of owner's equity. The August 31 balance in capital on the statement of owner's equity is reported on the balance sheet.

Analysis component:

The net effect of the adjustments on assets, liabilities, and equity is detailed below.

Entry	a.	b.	c.	d.	e.	Net effect
Assets	$50 ↓	$270 ↓	No effect	$100 ↓	$65 ↑	$355 ↓
Liabilities	No effect	No effect	$80 ↓	No effect	No effect	$80 ↓
Equity	$50 ↓	$270 ↓	$80 ↑	$100 ↓	$65 ↑	$275 ↓

Equity decreased by $275 as a result of the adjusting entries. Each of the adjustments that affected equity were income statement items (revenues or expenses) therefore net income was negatively affected by the adjusting entries (a net decrease in income of $275).

The opposite effect could have been achieved if accrued revenues (Dr Receivables and Cr Revenues) plus the adjustment of unearned amounts (Dr Unearned Revenues and Cr Revenues) were greater than the adjustment of prepaids (Dr Expense and Cr Prepaid) plus amortization (Dr Amortization Expense and Cr Accumulated Amortization) and accrued expenses (Dr Expense and Cr Payable).

APPENDIX 4A

Correcting Errors

LO8 Explain and prepare correcting entries.

Correcting entries, as the term implies, account for the correction of errors, and are not to be confused with adjusting entries.

If an error in a journal entry is discovered before the error is posted, it can be corrected in a manual system by drawing a line through the incorrect information. The correct information is written above it to create a record of change for the auditor. Many computerized systems allow the operator to replace the incorrect information directly.

When an error in a journal entry is *not* discovered until after it is posted, the usual practice is to correct the error by creating *another* journal entry.[7] This *correcting entry* removes the amount from the wrong account and records it to the correct account. For example, suppose we recorded a purchase of office supplies with an incorrect debit to Office Equipment as follows:

Oct.	14	Office Equipment	1,600	
		Cash		1,600
		To record the purchase of office supplies.		

Once posted, the Office Supplies account balance is understated by $1,600 and the Office Equipment account balance is overstated by the same amount. When we discover the error three days later, a correcting entry is made using either one or two entries as shown below:

17	Office Supplies	1,600	
	Office Equipment		1,600
	To correct the entry of October 14 that incorrectly debited Office Equipment instead of Office Supplies.		

OR

17	Cash	1,600	
	Office Equipment		1,600
	To reverse the incorrect entry.		
17	Office Supplies	1,600	
	Cash		1,600
	To journalize the purchase of office supplies correctly.		

In the approach to the left, the credit removes the error and the debit correctly records supplies. Alternatively, the two entries on the right could be used: the first entry reverses the incorrect entry *entirely*, and the second entry records the transaction as it should have been. Both methods achieve the same final results.

Computerized systems often use similar correcting entries. The exact procedure depends on the system used and management policy. Yet nearly all systems include controls to show when and where a correction is made.

CHECKPOINT Read Apply Do Check

18. On March 14, Accounts Receivable was debited for $4,100 and Service Revenue was credited for $4,100. At the end of the month, it was discovered that the March 14 entry should have been credited to Rent Revenue. What correcting entry is required?

Do: *QS 4-12, *QS 4-13

[7] For tracking purposes, correcting entries must be referenced to the incorrect entry and any calculations are to be documented.

APPENDIX 4B

Alternatives in Recording Prepaids and Unearned Revenues

This section explains two alternatives in recording prepaid expenses and unearned revenues. We show the sequence of journal entries for both alternatives.

LO9 Identify and explain two alternatives in recording prepaids and unearned revenues.

Recording Prepaid Expenses in Expense Accounts

We explained that prepaid expenses are assets when they are purchased and are recorded with debits to asset accounts. Adjusting entries transfer the used amounts to expense accounts at the end of an accounting period.

There is an acceptable alternative practice of recording *all* prepaid expenses with debits to expense accounts. If any prepaids remain unused at the end of an accounting period, then adjusting entries transfer the unused portions from expense accounts to asset accounts. The financial statements are identical under either procedure, but the adjusting entries are different.

To illustrate, let's look at Finlay Interiors' cash payment for 24 months of insurance coverage beginning on January 1. Finlay Interiors recorded that payment with a debit to an asset account, but it could have been recorded as a debit to an expense account. Exhibit 4B.1 shows these alternatives:

Exhibit 4B.1

Initial Entry for Prepaid Expenses for Two Alternatives

		Payment Recorded as Asset		Payment Recorded as Expense	
Jan. 1	Prepaid Insurance	2,400			
	Cash		2,400		
1	Insurance Expense			2,400	
	Cash				2,400

On January 31, insurance protection for one month is used up. This means $100 ($2,400/24) is the expense for January. Exhibit 4B.2 shows that the adjusting entry depends on how the original payment is recorded:

Exhibit 4B.2

Adjusting Entry for Prepaid Expenses for Two Alternatives

		Payment Recorded as Asset		Payment Recorded as Expense	
Jan. 31	Insurance Expense	100			
	Prepaid Insurance		100		
31	Prepaid Insurance			2,300	
	Insurance Expense				2,300

When these entries are posted, we can see in Exhibit 4B.3 that these two alternatives give identical adjusted account balances at January 31.

Exhibit 4B.3

Account Balances Under Two Alternatives for Recording Prepaid Expenses

Payment Recorded as Asset

Prepaid Insurance			
Jan. 1	2,400	100	Jan. 31
Balance	2,300		

Insurance Expense			
Jan. 31	100		

Payment Recorded as Expense

Prepaid Insurance			
Jan. 31	2,300		

Insurance Expense			
Jan. 1	2,400	2,300	Jan. 31
Balance	100		

Recording Unearned Revenues in Revenue Accounts

Unearned revenues are liabilities requiring delivery of products and services and are recorded as credits to liability accounts when cash and other assets are received. Adjusting entries at the end of an accounting period transfer to revenue accounts the earned portion of unearned revenues.

An acceptable alternative is to record *all* unearned revenues with credits to revenue accounts. If any revenues are unearned at the end of an accounting period, then adjusting entries transfer the unearned portions from revenue accounts to unearned revenue accounts. While the adjusting entries are different for these two alternatives, the financial statements are identical.

To illustrate, let's look at Finlay Interiors' January 26 receipt of $3,000 for consulting services covering the period January 27 to March 27. Finlay Interiors recorded this transaction with a credit to a liability account. The alternative, shown in Exhibit 4B.4, is to record it with a credit to a revenue account as follows:

Exhibit 4B.4

Initial Entry for Unearned Revenues for Two Alternatives

		Receipt Recorded as Liability		Receipt Recorded as Revenue	
Jan. 26	Cash	3,000			
	Unearned Consulting Revenue		3,000		
26	Cash			3,000	
	Consulting Revenue				3,000

By the end of the accounting period (January 31), Finlay Interiors earns $250 of this revenue. This means that $250 of the liability is satisfied. Depending on how the initial receipt is recorded, the adjusting entry is (Exhibit 4B.5):

Exhibit 4B.5

Adjusting Entry for Unearned Revenues for Two Alternatives

		Receipt Recorded as Liability		Receipt Recorded as Revenue	
Jan. 31	Unearned Consulting Revenue	250			
	Consulting Revenue		250		
31	Consulting Revenue			2,750	
	Unearned Consulting Revenue				2,750

After adjusting entries are posted, the two alternatives give identical adjusted account balances at January 31 as shown in Exhibit 4B.6.

Exhibit 4B.6

Account Balances Under Two Alternatives for Recording Unearned Revenues

Receipt Recorded as Liability

Unearned Consulting Revenue			
Jan. 31	250	3,000	Jan. 26
		2,750	Balance

Consulting Revenue			
		250	Jan. 31

Receipt Recorded as Revenue

Unearned Consulting Revenue			
		2,750	Jan. 31

Consulting Revenue			
Jan. 31	2,750	3,000	Jan. 26
		250	Balance

19. Miller Company records cash receipts of unearned revenues and cash payments of prepaid expenses in balance sheet accounts. Bud Company records these items in income statement accounts. Explain any difference in the financial statements of these two companies from their alternative ways of recording prepaids.

Do: *QS 4-14

CHECKPOINT Read Apply Do Check

Summary of Appendix 4A and Appendix 4B

LO8 **Explain and prepare correcting entries.** A correcting entry is required when an error in a journal entry is not discovered until after it has been posted. The correcting entry can be done in one of two ways: the incorrect portion of the entry can be corrected, or the entire incorrect entry can be reversed and the correct entry recorded; both methods accomplish the same result.

LO9 **Identify and explain two alternatives in recording prepaids and unearned revenues.** It is acceptable to charge all prepaid expenses to expense accounts when they are purchased. When this is done, adjusting entries must transfer any unexpired amounts from expense accounts to asset accounts. It is also acceptable to credit all unearned revenues to revenue accounts when cash is received. In this case the adjusting entries must transfer any unearned amounts from revenue accounts to unearned revenue accounts.

guidance answers to CHECKPOINT Read Apply Do Check

18. The correcting entry can be done in one of two ways:

31	Service Revenue............................	4,100	
	Rent Revenue		4,100
	To correct the March 14 entry.		

OR

31	Service Revenue............................	4,100	
	Accounts Receivable		4,100
	To reverse the incorrect March 14 entry.		
31	Accounts Receivable	4,100	
	Rent Revenue		4,100
	To enter the correct entry for March 14.		

19. When adjusting entries are correctly prepared, the financial statements of these companies will be identical under both methods.

Glossary

Account form balance sheet A balance sheet that lists assets on the left and liabilities and owner's equity on the right side of the balance sheet. (p. 148)

Accounting period Time frame covered by financial statements and other reports; also called *reporting periods*. (p. 133)

Accrual basis accounting The approach to preparing financial statements that uses the adjusting process to recognize revenues when earned and expenses when incurred, not when cash is paid or received; the basis for generally accepted accounting principles. (p. 133)

Accrued expenses Costs incurred in a period that are both unpaid and unrecorded; adjusting entries for recording accrued expenses involve increasing (debiting) expenses and increasing (crediting) liabilities. (p. 140)

Accrued revenues Revenues earned in a period that are both unrecorded and not yet received in cash (or other assets); adjusting entries for recording accrued revenues involve increasing (debiting) assets and increasing (crediting) revenues. (p. 142)

Adjusted trial balance A listing of accounts and balances prepared after adjustments are recorded and posted to the ledger. (p. 147)

Adjusting entry A journal entry at the end of an accounting period to bring an asset or liability account balance to its proper amount while also updating the related expense or revenue account. (p. 134)

Amortization The expense created by allocating the cost of plant and equipment to the periods in which they are used; represents the expense of using the assets. (p. 136)

Book value of an asset The cost of the asset less its accumulated amortization. (p. 137)

Capital assets Include long-term tangible assets and intangible assets (except goodwill) that are expected to provide benefits for more than one period. (p. 136)

Cash basis accounting Revenues are recognized when cash is received, and expenses are recorded when cash is paid. (p. 133)

Contra account An account linked with another account and having an opposite normal balance; reported as a subtraction from the other account's balance so that more complete information than simply the net amount is provided. (p. 137)

Correcting entries Accounting entries made in order to correct errors. (p. 156)

Depreciation See *amortization*. (p. 136)

External transactions Exchanges between the entity and some other person or organization. (p. 131)

Intangible assets Long-lived assets that have no physical substance but convey a right to use a product or process. (p. 136)

Interim financial reports Financial reports covering less than one year; usually based on one-, three- or six-month periods. (p. 133)

Internal transactions Exchanges within an organization that can also affect the accounting equation. (p. 131)

Market value of an asset Amount an asset can be sold for. Market value is not tied to the book value of an asset. (p. 137)

Matching principle The broad principle that requires expenses to be reported in the same period as the revenues that were earned as a result of the expenses. (p. 133)

Prepaid expenses Items that are paid for in advance of receiving their benefits. These are assets. (p. 134)

Property, plant and equipment Tangible long-lived assets used to produce goods or services. See *capital assets*. (p. 136)

Report form balance sheet A balance sheet that lists items vertically with assets above the liabilities and owner's equity. (p. 148)

Reporting period See *accounting period*. (p. 133)

Straight-line amortization method Allocates equal amounts of an asset's cost to amortization expense during its useful life. (p. 137)

Time period principle A broad principle that assumes that an organization's activities can be divided into specific time periods such as months, quarters, or years. (p. 132)

Unadjusted trial balance A listing of accounts and balances prepared before adjustments are recorded and posted to the ledger. (p. 147)

Unearned revenues Liabilities created when customers pay in advance for products or services; created when cash is received before revenues are earned; satisfied by delivering the products or services in the future. (p. 138)

For more study tools, quizzes, and problem material, visit the **Student Success** *Centre* at **www.mcgrawhill.ca/studentsuccess/FAP**

Questions

1. What type of business is most likely to select a fiscal year that corresponds to the natural business year instead of the calendar year?
2. What is the difference between the cash basis and accrual basis of accounting?
3. Why is the accrual basis of accounting preferred over the cash basis?
4. Where is a prepaid expense reported in the financial statements?
5. What kinds of assets require adjusting entries to record amortization?
6. What contra account is used when recording and reporting the effects of amortization? Why is it used?

7. Where is an unearned revenue reported in the financial statements?
8. What is an accrued revenue? Give an example.
9. Review the consolidated balance sheet of Danier Leather in Appendix I. Identify an asset account that requires adjustment before annual financial statements can be prepared. What would be the effect on the income statement if this asset account were not adjusted?
10. Review the income statement of WestJet in Appendix I. How much amortization was recorded in the adjusting entry for amortization at the end of 2005?
*11. If a company initially records prepaid expenses with debits to expense accounts, what type of account is debited in the adjusting entries for prepaid expenses?

Quick Study

QS 4-1
GAAP and adjusting entries
LO2

For each of the following, identify the primary GAAP that has been violated and explain why.

1. Delta Company prepared its first set of financial statements for the three years ended July 31, 2011.
2. Warren Consulting purchased $9,800 of supplies on September 30, 2011, and debited Office Supplies Expense. Warren's year-end is September 30.
3. On May 3, 2011, Mindy Car Wash collected $3,000 in advance from a new limousine company to begin operating June 1, 2011. Mindy credited a revenue account for the $3,000.
4. On November 15, 2011, TelsCo rented equipment for $1,500. TelsCo is not recording the transaction until it pays (payment is required 15 days from the rental date).

QS 4-2
Accrual and cash accounting
LO3

In its first year of operations, Harris Co. earned $39,000 in revenues and received $33,000 cash from customers. The company incurred expenses of $22,500, but had not paid for $2,250 of them at year-end. In addition, Harris prepaid $3,750 for expenses that would be incurred the next year. Calculate the first year's net income under the cash basis and calculate the first year's net income under the accrual basis.

QS 4-3
Preparing adjusting entries—prepaid expense
LO4

Fargo's Detective Agency purchased a two-year insurance policy on April 1, 2011, paying cash of $7,680. Its year-end is December 31. Record the following:

a. Journal entry on April 1, 2011.
b. Adjusting entry on December 31, 2011.
c. Adjusting entry on December 31, 2012.
d. How much of the insurance policy purchased on April 1, 2011, was actually used during the year 2013?

QS 4-4
Preparing adjusting entries—amortization expenses
LO4

Softrock Minerals purchased a vehicle on March 1, 2011, for cash of $32,000. It will be used by the president for business purposes for four years and then sold for about $8,000. Softrock's year-end is December 31. Record the entry on March 1, 2011, and the adjusting entry required at the year-ends of 2011 and 2012.

QS 4-5
Preparing adjusting entries—unearned revenue
LO4

On November 1, 2011, Fastfoot Industries collected $12,000 from a customer for services to be provided in the future. On December 31, 2011, Fastfoot's year-end, it was determined that $3,000 of this amount remained unearned. Prepare the entries for November 1 and December 31.

QS 4-6
Preparing adjusting entries—accrued expenses
LO4

On December 31, 2011, Allied Consulting received the telephone bill for December usage of $1,840. It must be paid by January 14, 2012. Record the adjusting entry on December 31, 2011, and the entry to record the payment on January 14, 2012.

QS 4-7
Preparing adjusting entries—accrued revenues
LO4

TigrSoft recorded unbilled and uncollected revenues of $17,000 on March 31, 2011. On April 16, $12,000 of these were collected. Prepare the entries for March 31 and April 16.

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

QS 4-8
Preparing adjusting entries
LO4

Stark Company records prepayments of expenses in asset accounts and receipts of unearned revenues in liability accounts. Using the list of accounts provided, identify the debit and credit entry required for each of the annual adjustments described in (a) through (e).

1. Cash
2. Prepaid Advertising
3. Advertising Payable
4. Advertising Expense
5. Accounts Receivable
6. Equipment Expense
7. Amortization Expense
8. Accumulated Amortization—Equipment
9. Equipment
10. Services Revenue Earned
11. Unearned Services Revenue

	Debits	Credits
a. Accrual of unpaid and unrecorded advertising that was used by Stark Company.	______	______
b. Adjustment of Unearned Services Revenue to recognize earned revenue.	______	______
c. Recorded revenue for work completed this accounting period; the cash will be received in the next period.	______	______
d. The cost of Equipment was matched to the time periods benefited.	______	______
e. Adjustment of Prepaid Advertising to recognize the portion used.	______	______

QS 4-9
Recording and analyzing adjusting entries
LO4, 5

Adjusting entries affect one balance sheet account and one income statement account. For the entries listed below, identify the account to be debited and the account to be credited. Indicate which of the two accounts is the income statement account and which is the balance sheet account.

a. Entry to record annual amortization expense.
b. Entry to show wages earned by employees but not yet paid.
c. Entry to show revenue earned that was previously received as cash in advance.
d. Entry to show expiration of prepaid insurance.
e. Entry to show revenue earned but not yet billed.

QS 4-10
Linking adjustments to financial statements
LO5

For each type of adjustment in (a) through (e), indicate the effect on net income (overstated or understated) if the adjustment is not recorded.

	If adjustment is not recorded:			
Type of Adjustment	**Net income will be overstated, understated, or no effect**	**Assets will be overstated, understated, or no effect**	**Liabilities will be overstated, understated, or no effect**	**Owner's Equity will be overstated, understated, or no effect**
a. Prepaid Expenses				
b. Amortization				
c. Unearned Revenues				
d. Accrued Expenses				
e. Accrued Revenues				

QS 4-11
Interpreting adjusting entries
LO4, 6

The following information has been taken from Shank Company's unadjusted and adjusted trial balances at October 31, 2011.

	Unadjusted		Adjusted	
	Debit	**Credit**	**Debit**	**Credit**
Prepaid insurance	$3,100		$2,350	
Interest payable		$ -0-		$ 750
Insurance expense	-0-		750	
Interest expense	-0-		750	

Given this trial balance information, prepare the adjusting journal entries.

***QS 4-12**
Correcting entries
LO8

The following entry was recorded on November 14.

Nov. 14	Salaries Expense	14,800	
	Cash		14,800
	To record supplies expense.		

At month-end, it was discovered that *Supplies Expense* should have been debited on November 14 instead of *Salaries Expense*. Prepare the correcting entry required on November 30.

***QS 4-13**
Correcting entries
LO8

The following entry was recorded on January 10.

Jan. 10	Office Furniture	25,000	
	Accounts Payable		25,000
	To record purchase of computer equipment by borrowing from the bank.		

At month-end, it was discovered that on January 10, computer equipment was purchased for $25,000 by borrowing from the bank. Prepare the correcting entry required on January 31.

***QS 4-14**
Recording prepaids and unearned amounts as expenses and revenues
LO9

Foster Company initially records prepaid and unearned items in income statement accounts. Given Foster Company's practices, what is the appropriate adjusting entry for each of the following at November 30, 2011, the end of the company's first accounting period?

a. There are unpaid salaries of $3,000.
b. Unused office supplies of $800 were counted at year-end. There was no beginning balance in office supplies.
c. Earned but unbilled consulting fees of $2,300 were discovered.
d. It was determined that there were unearned fees of $4,200.

Exercises

Exercise 4-1
Identifying adjusting entries
LO4

For each entry (1) to (12) below, enter the letter of the explanation that describes it in the blank space to the left. You can use some letters more than once.

a. To record amortization expense.
b. To record an accrued expense.
c. To record the use of a prepaid expense.
d. To record accrued revenue.
e. To record the earning of previously unearned revenue.
f. Not an adjusting entry.

____ 1.	Amortization Expense	3,000	
	Accumulated Amortization		3,000
____ 2.	Unearned Professional Fees	2,000	
	Professional Fees Earned		2,000
____ 3.	Rent Expense	1,000	
	Prepaid Rent		1,000
____ 4.	Interest Expense	4,000	
	Interest Payable		4,000
____ 5.	Prepaid Rent	3,500	
	Cash		3,500
____ 6.	Salaries Expense	5,000	
	Salaries Payable		5,000
____ 7.	Insurance Expense	6,000	
	Prepaid Insurance		6,000
____ 8.	Salaries Payable	1,500	
	Cash		1,500
____ 9.	Cash	6,500	
	Unearned Professional Fees		6,500
____ 10.	Cash	9,000	
	Interest Receivable		9,000
____ 11.	Interest Receivable	7,000	
	Interest Earned		7,000
____ 12.	Cash	8,000	
	Accounts Receivable		8,000

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

Exercise 4-2
Adjusting entries
LO4

Prepare adjusting journal entries for the year ended December 31, 2011, for each of the independent situations in (a) to (f). Assume that prepaid expenses are initially recorded in asset accounts. Assume that fees collected in advance of work are initially recorded as liabilities.

a. Amortization on the company's equipment for 2011 was estimated to be $32,000.
b. The Prepaid Insurance account had a $14,000 debit balance at December 31, 2011, before adjusting for the costs of any expired coverage. An analysis of the company's insurance policies showed $2,080 of unexpired insurance remaining.
c. The Office Supplies account had a $600 debit balance on January 1, 2011; $5,360 of office supplies were purchased during the year; and the December 31, 2011, count showed that $708 of supplies are on hand.
d. Two-thirds of the work for a $30,000 fee received in advance has now been performed.
e. The Prepaid Insurance account had an $11,200 debit balance at December 31, 2011, before adjusting for the costs of any expired coverage. An analysis of the company's insurance policies showed that $9,200 of coverage had expired.
f. Wages of $8,000 have been earned by workers but not paid as of December 31, 2011.
g. Record the January 6, 2012 payment of $20,000 in wages, inclusive of the $8,000 December 31, 2011, accrual in (f) above.

Exercise 4-3
Adjusting entries
LO4

Enviro Waste's year-end is December 31. The information in (a) to (e) is available at year-end for the preparation of adjusting entries:

a. Of the $18,500 balance in Unearned Revenue, $2,500 remains unearned.
b. The annual building amortization is $10,500.
c. The Spare Parts Inventory account shows an unadjusted balance of $450. A physical count reveals a balance on hand of $100.
d. Unbilled and uncollected services provided to customers totalled $3,550.
e. The utility bill for the month of December was received but is unpaid; $1,300.

Required

Prepare the required adjusting entries at December 31, 2011, for (a) to (e) and the subsequent cash entries required for (f) and (g).

f. The accrued revenues of $3,550 recorded in (d) were collected on January 4, 2012.
g. The $1,300 utility bill accrued in (e) was paid on January 14, 2012.

Exercise 4-4
Adjusting entries
LO4

LesCo's year-end is September 30. The information in (a) to (e) is available at year-end for the preparation of adjusting entries:

a. Of the $18,000 balance in Unearned Revenue, $12,000 has been earned.
b. Furniture costing $7,200 was purchased on September 1 of this accounting period. It will be used for four years and donated to charity after that time.
c. The Office Supplies account shows an unadjusted balance of $6,000. A physical count reveals that $5,000 has been used.
d. Services provided to customers today (year-end) but unbilled total $28,000.
e. Rent of $7,000 for the month of September is unpaid and unrecorded.

Required

Prepare the required adjusting entries at September 30, 2011, for (a) to (e) and the subsequent entries required for (f) and (g).

f. The $28,000 of service revenue accrued in (d) was collected on October 3, 2011.
g. The $7,000 of rent accrued in (e) was paid on October 4, 2011.

Exercise 4-5
Unearned and accrued revenues
LO4

Landmark Properties owns and operates an apartment building and prepares annual financial statements based on a March 31 fiscal year.

a. The tenants of one of the apartments paid five months' rent in advance on November 1, 2010. The monthly rental is $1,500 per month. The journal entry credited the Unearned Rent account when the payment was received. No other entry had been recorded prior to March 31, 2011. Give the adjusting journal entry that should be recorded on March 31, 2011.
b. On January 1, 2011, the tenants of another apartment moved in and paid the first month's rent. The $1,350 payment was recorded with a credit to the Rent Earned account. However, the tenants have not paid the rent for February or March. They have agreed to pay it as soon as possible. Give the adjusting journal entry that should be recorded on March 31, 2011.
c. On April 22, 2011, the tenants described in (b) paid $4,050 rent for February, March, and April. Give the journal entry to record the cash collection.

Exercise 4-6
Identifying adjusting entries
LO4

Selected information in T-account format is presented below. Journalize the most likely adjustments that caused the balances to change.

a. Accounts Receivable

Debit	Credit
Unadjusted Bal. Dec. 31/11 12,000	
Adjusted Bal. Dec. 31/11 14,000	

b. Prepaid Rent

Debit	Credit
Unadjusted Bal. Dec. 31/11 28,000	
Adjusted Bal. Dec. 31/11 20,000	

c. Accumulated Amortization, Machinery

Debit	Credit
	4,800 Unadjusted Bal. Dec. 31/11
	5,200 Adjusted Bal. Dec. 31/11

d. Unearned Fees

Debit	Credit
	3,400 Unadjusted Bal. Dec. 31/11
	600 Adjusted Bal. Dec. 31/11

e. Salaries Expense

Debit	Credit
Unadjusted Bal. Dec. 31/11 70,000	
Adjusted Bal. Dec. 31/11 75,000	

Exercise 4-7
Missing data in supplies expense calculations
LO4, 5

Determine the missing amounts in each of these four independent situations:

	a	b	c	d
Supplies on hand, January 1	$ 300	$1,600	$1,360	?
Supplies purchased during the year	2,100	5,400	?	$6,000
Supplies on hand, December 31	750	?	1,840	800
Supplies expense for the year	?	1,300	9,600	6,575

Exercise 4-8
Adjusting and subsequent cash entries for accrued expenses
LO4

Delcor Management has five part-time employees, each of whom earns $200 per day. They are normally paid on Fridays for work completed on Monday through Friday of the same week. They were all paid in full on Friday, December 28, 2012. The next week, all five of the employees worked only four days because New Year's Day was an unpaid holiday. Show the adjusting entry that would be recorded on Monday, December 31, 2012, Delcor's year-end, and the journal entry that would be made to record paying the employees' wages on Friday, January 4, 2013.

Exercise 4-9
Adjustments and subsequent cash entries for accrued expenses
LO4

The following three situations require adjusting journal entries to prepare financial statements as of April 30, 2011. For each situation, present the adjusting entry and the entry that would be made to record the payment of the accrued liability during May 2011.

a. The company has a $780,000 note payable that requires 0.8% interest to be paid each month on the 20th of the month. The interest was last paid on April 20 and the next payment is due on May 20.

b. The total weekly salaries expense for all employees is $9,000. This amount is paid at the end of the day on Friday of each week with five working days. April 30 falls on Tuesday of this year, which means that the employees had worked two days since the last payday. The next payday is May 3.

c. On April 1, the company retained a lawyer at a flat monthly fee of $2,500. This amount is payable on the 12th of the following month.

Exercise 4-10
Identifying the effects of adjusting entries
LO4, 5

Following are two income statements for Javelin Company for the year ended December 31, 2011. The left column was prepared before any adjusting entries were recorded and the right column includes the effects of adjusting entries. The company records cash receipts and disbursements related to unearned and prepaid items in balance sheet accounts. Analyze the statements and prepare the adjusting entries that must have been recorded. (Note: Of the $12,000 increase in *Fees earned*, 30% represents additional fees earned but not billed. The other 70% was earned by performing services that the customers had paid for in advance.)

JAVELIN COMPANY
Income Statements
For Year Ended December 31, 2011

	Before Adjustments	Adjustments	After Adjustments
Revenues:			
Fees earned	$ 48,000		$ 60,000
Commissions earned	85,000		85,000
Total revenues	$133,000		$145,000
Operating expenses:			
Amortization expense, computers	$ –0–		$ 3,000
Amortization expense, office furniture	–0–		3,500
Salaries expense	25,000		29,900
Insurance expense	–0–		2,600
Rent expense	9,000		9,000
Office supplies expense	–0–		960
Advertising expense	6,000		6,000
Utilities expense	2,500		2,640
Total operating expenses	$ 42,500		$ 57,600
Net income	$ 90,500		$ 87,400

Analysis component:
Identify and explain which GAAP requires that adjusting entries be recorded. By how much would revenues, expenses, and net income be overstated/understated if adjustments were *not* recorded at December 31, 2011, for Javelin Company?

Exercise 4-11
Adjusting entries
LO4, 6

Check figure:
Adjusted trial balance, debits = $65,000

Ayotte Music
Trial Balances
February 28, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$ 5,000					
Accounts receivable	4,500					
Prepaid insurance	700					
Equipment	12,000					
Accumulated amortization, equipment		$ 6,000				
Accounts payable		1,200				
Jane Adams, capital		9,000				
Jane Adams, withdrawals	3,000					
Revenues		45,000				
Amortization expense, equipment	-0-					
Salaries expense	29,000					
Insurance expense	7,000					
Totals	$61,200	$61,200				

Additional information:

a. Annual amortization of the equipment; $2,400.
b. $250 of the Prepaid Insurance balance has expired.
c. Unbilled and unrecorded revenues at year-end totalled $1,400.

Required

Referring to Exhibit 4.22, use the information provided to complete the columns.

Exercise 4-12

Preparing financial statements

LO7

Check figure:
Total assets = $14,950

Using the completed adjusted trial balance columns from Exercise 4-11, prepare an income statement, a statement of owner's equity, and a balance sheet. Assume that the owner made no investments during the year.

Analysis component:

Which GAAP requires the preparation of financial statements?

*Exercise 4-13

Journalizing correcting entries

LO8

For each of the following incorrect entries, journalize the appropriate correcting entry(ies).

a. The purchase of office supplies on credit for $1,800 was recorded as:

Office Supplies	1,800	
Cash		1,800

b. A credit customer paid her account in full: $4,500. This was recorded as:

Cash	4,500	
Revenue		4,500

c. The owner withdrew cash of $1,500. This was recorded as:

Salaries Expense	1,500	
Cash		1,500

d. Work was performed for a customer today and cash of $750 was received. This was recorded as:

Cash	750	
Accounts Receivable		750

Analysis component:

If the error in (b) is not corrected, what is the effect on the income statement and balance sheet?

*Exercise 4-14

Adjustments for prepaid items recorded in expense and revenue accounts

LO9

Classic Customs began operations on December 1, 2011. In setting up the bookkeeping procedures, the company decided to debit expense accounts when the company prepays its expenses and to credit revenue accounts when customers pay for services in advance. Prepare journal entries for items (a) through (c) and adjusting entries as of December 31, 2011, for items (d) through (f):

a. Supplies were purchased on December 1 for $6,000.
b. The company prepaid insurance premiums of $2,880 on December 2.
c. On December 15, the company received an advance payment of $24,000 from one customer for remodelling work.
d. By counting the supplies on December 31, Classic Customs determined that $3,840 were on hand.
e. An analysis of the insurance policies in effect on December 31 showed that $480 of insurance coverage had expired.
f. As of December 31, it was determined that $7,200 of the amount received in advance on December 15 had been earned.

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

*Exercise 4-15

Alternative procedures for revenues received in advance

LO9

Pavillion Company experienced the following events and transactions during July:

July	1	Received $2,000 in advance of performing work for Andrew Renking.
	6	Received $8,400 in advance of performing work for Matt Swarbuck.
	12	Completed the job for Andrew Renking.
	18	Received $7,500 in advance of performing work for Drew Sayer.
	27	Completed the job for Matt Swarbuck.
	31	The job for Drew Sayer has not been started.

a. Give journal entries (including any adjusting entry as of the end of the month) to record these items using the procedure of initially crediting the Unearned Fees account when a payment is received from a customer in advance of performing services.

b. Give journal entries (including any adjusting entry as of the end of the month) to record these items using the procedure of initially crediting the Fees Earned account when a payment is received from a customer in advance of performing services.

c. Under each method, determine the amount of earned fees that should be reported on the income statement for July and the amount of unearned fees that should appear on the balance sheet as of July 31.

Problems

Problem 4-1A

Preparing adjusting entries—prepaid expenses

LO4

Impala Window Washing Services shows the following selected accounts on its December 31, 2011, unadjusted trial balance:

Account	Debit	Credit
Prepaid insurance	$12,000	
Prepaid office rent	72,000	
Prepaid subscriptions.....................	900	
Prepaid equipment rental	36,000	

Required

Prepare the required annual adjusting entries at December 31, 2011, based on the following additional information:

a. The balance in Prepaid Insurance was for a six-month insurance policy purchased and in effect on September 1, 2011.

b. $6,000 of the balance in Prepaid Office Rent had not been used as at December 31, 2011.

c. $240 of the balance in Prepaid Subscriptions had been used as at December 31, 2011.

d. The company paid $36,000 to rent equipment for a three-year period beginning April 1, 2011.

Analysis component:

If the above adjustments were not recorded, identify the types of accounts that would be affected and if they would be over- or understated.

Problem 4-2A

Preparing adjusting entries—amortization expense

LO4

Details regarding Leroux Steel's purchases of plant and equipment items during 2011 follow:

Date of Purchase	Plant and Equipment Item	Cost	Estimated Useful Life	Estimated Sales Value at End of Estimated Useful Life
a. Jan. 1	Machine A	$28,000	5 years	$ -0-
b. Apr. 1	Machine B	56,000	4 years	8,000
c. Nov.1	Machine C	8,400	2 years	1,200

Required

Prepare the adjusting entry at December 31, 2011, Leroux's year-end, for each plant and equipment item.

Analysis component:

What is the purpose of recording amortization? If amortization is not recorded, how would the income statement be affected?

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

Problem 4-3A
Preparing adjusting entries—unearned revenues
LO4

Outdoor's Best pre-sells yard maintenance packages for the gardening season. During October, the company collects cash from clients for Christmas trees to be delivered in December. Snow removal services are also provided. The following selected accounts appear on the November 30, 2011, year-end unadjusted trial balance:

Account	Debit	Credit
Unearned lawn services		$112,500
Unearned garden services..............		20,500
Unearned snow removal services		9,000
Unearned Christmas tree sales		43,500

Required
Prepare adjusting journal entries at November 30, 2011, using the following additional information.
a. $66,000 of the Unearned Lawn Services account represents payments received from customers for the 2012 season. The remainder represents services actually performed during the 2011 season.
b. $19,500 of the Unearned Garden Services account had been earned by November 30, 2011.
c. $8,750 of the Unearned Snow Removal Services account remained unearned at November 30, 2011.
d. Outdoor's arranges with its customers to deliver trees from December 5 to December 20. As a result, the Unearned Christmas Tree Sales account will be earned in total by December 20.

Analysis component:
If the Unearned Lawn Services of $112,500 had been recorded as a revenue when received instead of as a liability, what would the effect have been on the financial statements assuming no year-end adjustments?

Problem 4-4A
Preparing adjusting and subsequent cash entries—accrued expenses
LO4

In reviewing the accounts on March 31 for the month just ended, Mannix Resources discovered the following:
a. Interest of $2,250 had accrued on the note payable as at March 31. It is to be paid on April 2.
b. Unpaid and unrecorded salaries at March 31 totalled $19,600. The $19,600 plus salaries of $29,400 for the first three days of April were paid on April 3.
c. The March telephone bill for $960 is unpaid and unrecorded at March 31. It is to be paid on April 15.
d. Mannix normally pays rent in three-month installments. At March 31, rent of $5,000 per month had not been paid for February, March, or April. The balance owing plus rent for May, June, and July was paid on April 26.
e. Mannix pays commissions to the technicians at the rate of 4% of services performed. During March, total services performed were $960,000. Commissions are unrecorded and unpaid at March 31. Commissions are paid on the 15th of the following month.

Required
Using the information provided above, prepare adjusting journal entries at March 31 along with the appropriate subsequent cash entries.

Problem 4-5A
Preparing adjusting and subsequent cash entries—accrued revenues
LO4

In reviewing the accounts on March 31 for the month just ended, DigiTech discovered the following:
a. DigiTech owns the building that it occupies. Part of the building is rented to E-Quip Company for $3,200 per month. E-Quip had not paid the March rent as at March 31. On April 3, DigiTech collected the rent accrued on March 31.
b. Services performed but unrecorded at March 31 totalled $10,800. This amount was collected on April 7.
c. Interest for the month of March had accrued on a note receivable in the amount of $700. The interest accrued on March 31 was collected on April 1.
d. On February 1, DigiTech signed a $24,000 six-month contract to perform services for a client. DigiTech has been providing the services but as of March 31 no cash had been received. On April 2, DigiTech collected the revenue accrued on March 31.

Required
Using the information provided above, prepare adjusting journal entries at March 31 along with the appropriate subsequent cash entries.

Problem 4-6A
Adjusting entries; adjusted trial balance
LO4, 6

PacRim Careers provides training to individuals who pay tuition directly to the business. The business also offers extension training to groups in off-site locations. PacRim Careers follows the practice of initially recording prepaid expenses and unearned revenues in balance sheet accounts. Facts that require eight adjusting entries on December 31, 2011, the business's year-end, are presented below:

a. An analysis of the company's policies shows that $6,000 of insurance coverage has expired.
b. An inventory shows that teaching supplies costing $5,200 are on hand at the end of the year.
c. The estimated annual amortization on the equipment is $24,000.
d. The estimated annual amortization on the professional library is $12,000.
e. The school offers off-campus services for specific employers. On November 1, the company agreed to do a special six-month course for a client. The contract calls for a monthly fee of $4,400, and the client paid the first five months' fees in advance. When the cash was received, the Unearned Extension Fees account was credited.
f. On October 15, the school agreed to teach a four-month class for an individual for $6,000 tuition per month payable at the end of the class. The services to date have been provided as agreed, but no payment has been received.
g. The school's two employees are paid weekly. As of the end of the year, two days' wages have accrued at the rate of $200 per day for each employee.
h. The balance in the Prepaid Rent account represents the rent for December.

PACRIM CAREERS
Trial Balances
December 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 52,000					
Accounts receivable	-0-					
Teaching supplies	20,000					
Prepaid insurance	30,000					
Prepaid rent	4,000					
Professional library	60,000					
Accumulated amortization, professional library		$ 18,000				
Equipment	140,000					
Accumulated amortization, equipment		32,000				
Accounts payable		72,000				
Salaries payable		-0-				
Unearned extension fees		22,000				
Sheila Carr, capital		127,200				
Sheila Carr, withdrawals	80,000					
Tuition fees earned		204,000				
Extension fees earned		76,000				
Amortization expense, equipment	-0-					
Amortization expense, professional library	-0-					
Salaries expense	96,000					
Insurance expense	-0-					
Rent expense	44,000					
Teaching supplies expense	-0-					
Advertising expense	14,000					
Utilities expense	11,200					
Totals	$551,200	$551,200				

Check figure:
2. Adjusted Trial Balance debits = $603,000

Required
1. Prepare the eight necessary adjusting journal entries.

Analysis component:
2. Refer to the format presented in Exhibit 4.22 and complete the adjusted trial balance using the information in (a) through (h) above.
3. If the adjustments were *not* recorded, calculate the over- or understatement of income.
4. Is it ethical to ignore adjusting entries?

Problem 4-7A
Adjusting entries
LO4

Wedona Energy's year-end is January 31. Based on an analysis of the unadjusted trial balance at January 31, 2011, the following information was available for the preparation of adjusting entries:

a. Equipment purchased on November 1 of this accounting period for $36,000 is estimated to have a useful life of three years. After three years of use, it is expected that the equipment will be scrapped due to technological obsolescence.
b. Of the $9,000 balance in Unearned Consulting Fees, $3,000 had been earned.
c. The Prepaid Rent account showed a balance of $22,500. This was paid on October 1 of this accounting period and represents six months of rent commencing on the same date.
d. Accrued wages at January 31 totalled $9,000.
e. Three months of interest had accrued at the rate of 7% per year on a $42,000 note payable.
f. Unrecorded and uncollected consulting fees at year-end were $4,750.
g. A $1,350 insurance policy was purchased on April 1 of the current accounting period and debited to the Prepaid Insurance account. Coverage began April 1 for 18 months.
h. The annual amortization on the office furniture was $450.
i. Repair revenues accrued at year-end totalled $2,050.
j. The Store Supplies account had a balance of $800 at the beginning of the accounting period. During the year, $1,500 of supplies were purchased and debited to the Store Supplies account. At year-end, a count of the supplies revealed a balance of $150.

Required
Prepare adjusting journal entries on January 31, 2011, based on the above.

Problem 4-8A
Adjusting and subsequent cash journal entries
LO4

RaiLink records prepaid expenses and unearned revenues in balance sheet accounts. The following information concerns the adjusting entries to be recorded on December 31, 2010, for the year just ended.

a. The Office Supplies account started the year with a $6,000 balance. During 2010, the company purchased supplies at a cost of $24,800, which was added to the Office Supplies account. The inventory of supplies on hand at December 31 had a cost of $5,280.
b. An analysis of the company's insurance policies provided these facts:

Policy	Date of Purchase	Years of Coverage	Total Cost
1	April 1, 2009	2	$31,680
2	April 1, 2010	3	26,136
3	August 1, 2010	1	5,400

The total premium for each policy was paid in full at the purchase date, and the Prepaid Insurance account was debited for the full cost. *Appropriate adjusting entries have been made to December 31, 2009.*

c. The company has 15 employees who earn a total of $4,200 in salaries for every working day. They are paid each Monday for their work in the five-day workweek ending on the preceding Friday. December 31, 2010, falls on Monday, and all 15 employees worked the first day of the week. They will be paid salaries for five full days on Monday, January 7, 2011.
d. The company purchased a building on August 1, 2010. The building cost $1,710,000 and is expected to have a $90,000 residual value at the end of its predicted 30-year life.
e. Because the company is not large enough to occupy the entire building, it arranged to rent some space to a tenant at $4,800 per month, starting on November 1, 2010. The rent was paid on time on November 1, and the amount received was credited to the Rent Earned account. However, the tenant has not paid the December rent. The company has worked out an agreement with the tenant, who has promised to pay both December's and January's rent in full on January 15.
f. On November 1, the company also rented space to another tenant for $4,350 per month. The tenant paid five months' rent in advance on that date. The payment was recorded with a credit to the Unearned Rent account.

Required
1. Use the information to prepare adjusting entries as of December 31, 2010.
2. Prepare journal entries to record the subsequent cash transactions in January 2011 described in parts (c) and (e).

Problem 4-9A
Adjusting entries
LO4

Rainmaker Environmental Consultants is just finishing its second year of operations. The company's unadjusted trial balance at October 31, 2011, follows:

Rainmaker Environmental Consultants
Unadjusted Trial Balance
October 31, 2011

Acct. No.	Account	Debit	Credit
101	Cash	$ 28,000	
106	Accounts receivable	56,000	
109	Interest receivable	-0-	
111	Notes receivable	30,000	
126	Supplies	4,600	
128	Prepaid insurance	9,350	
131	Prepaid rent	21,000	
161	Office furniture	61,440	
162	Accumulated amortization, office furniture		$ 20,480
201	Accounts payable		35,000
210	Wages payable		-0-
233	Unearned consulting fees		13,160
301	Jeff Moore, capital		60,000
302	Jeff Moore, withdrawals	16,450	
401	Consulting fees earned		314,600
409	Interest revenue		1,400
601	Amortization expense, office furniture	-0-	
622	Wages expense	147,000	
637	Insurance expense	-0-	
640	Rent expense	64,000	
650	Supplies expense	6,800	
	Totals	$444,640	$444,640

Rainmaker prepares adjustments each October 31. The following additional information is available on October 31, 2011.

a. It was determined that $12,000 of the unearned consulting fees had not yet been earned.
b. It was discovered that $6,000 of the balance in the Consulting Fees Earned account was for services to be performed in November.
c. The balance in the Prepaid Rent account represents three months of rent beginning September 1, 2011.
d. Accrued wages at October 31 totalled $6,800.
e. The office furniture was purchased on March 1, 2010, and has an estimated useful life of two years. After two years of use, it is expected that the furniture will be worthless.
f. Accrued consulting fees at year-end totalled $4,200.
g. Interest of $200 had accrued on the note receivable for the month of October.
h. The balance in the Prepaid Insurance account represents the remaining balance of a two-year policy purchased on April 1, 2010.
i. A count of the supplies on October 31 revealed a balance remaining of $900.

Required
Prepare adjusting journal entries for October 31, 2011, based on the above.

Problem 4-10A
Posting, adjusted trial balance, and preparing financial statements
LO6, 7

Check figures:
3. Adjusted trial balance, debits = $486,560
4. Net income = $35,940

Required
Using the information in Problem 4-9A, complete the following:
1. Set up balance column accounts for Rainmaker Environmental Consultants and enter the balances listed in the unadjusted trial balance.
2. Post the adjusting entries prepared in Problem 4-9A to the accounts.
3. Prepare an adjusted trial balance.
4. Use the adjusted trial balance to prepare an income statement, a statement of owner's equity and a balance sheet. Assume that the owner, Jeff Moore, made no owner investments during the year.

Analysis component:
Assume that total revenues and expenses reported for the year ended October 31, 2010, were $189,000 and $157,600; respectively. Compare the business's financial performance for the years ended October 31, 2010 and 2011.

Note
For Part 1, your instructor may ask you to set up T-accounts instead of balance column accounts. The solution is available in both formats.

Problem 4-11A
Adjusting entries
LO4

Arrow Hospitality showed the following:

Arrow Hospitality
Trial Balances
September 30, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 6,000					
Accounts receivable	11,200					
Repair supplies	2,200					
Prepaid rent	14,000					
Office furniture	26,000					
Accounts payable		$ 8,000				
Notes payable		21,600				
Al Zink, capital		67,758				
Al Zink, withdrawals	5,000					
Hospitality revenues		128,000				
Salaries expense	142,200					
Repair supplies expense	15,500					
Interest expense	1,458					
Internet expenses	1,800					
Totals	$225,358	$225,358				

Additional information available at year-end:

a. Interest of $162 had accrued on the notes payable for the month of September.
b. The office furniture was acquired on February 1, 2011, and has an estimated four-year life. The furniture will be sold for about $2,000 at the end of its four-year life.
c. A count of the Repair Supplies revealed a balance on hand of $700.
d. A review of the Prepaid Rent account showed that $10,000 had been used.
e. Accrued salaries of $2,800 had not been recorded at year-end.
f. The September Internet bill for $100 had been received and must be paid by October 14.
g. Accrued revenues of $6,200 were not recorded at year-end.

Required
Prepare adjusting entries for (a) through (g) using the information provided.

Problem 4-12A
Preparation of financial statements
LO6, 7

Check figures:
1. Adjustments columns = $24,762; Adjusted trial balance columns = $238,620
2. Net loss = $45,320

Required
1. Using the format presented in Problem 4-11A, complete the adjusted trial balance by including the adjusting entries prepared in Problem 4-11A.
2. Prepare an income statement, a statement of owner's equity and a balance sheet based on the adjusted trial balance completed in Part 1. Assume that the owner, Al Zink, made an investment during the year of $3,600.

Analysis component:
Assume that total assets reported at September 30, 2010, were $76,900. Determine what total liabilities and equity were on that date and comment on the change in the financial position from 2010 to 2011.

Problem 4-13A

Preparing financial statements from the adjusted trial balance

LO7

This adjusted trial balance is for GalaVu Entertainment as of December 31, 2011:

	Debit	Credit
Accounts receivable	$ 22,000	
Accounts payable		$ 44,000
Accumulated amortization, automobiles		21,000
Accumulated amortization, equipment		5,000
Advertising expense	25,000	
Amortization expense, automobiles	9,000	
Amortization expense, equipment	5,000	
Automobiles	80,000	
Cash	11,000	
Equipment	65,000	
Fees earned		160,000
Interest earned		8,000
Interest expense	12,000	
Interest payable		6,000
Interest receivable	5,000	
John Conroe, capital		123,900
John Conroe, withdrawals	19,000	
Land	35,000	
Long-term notes payable		115,000
Notes receivable (due in 90 days)	80,000	
Office supplies	4,000	
Office supplies expense	13,000	
Repairs expense, automobiles	8,400	
Salaries expense	90,000	
Salaries payable		5,500
Unearned fees		11,000
Wages expense	16,000	
Totals	$499,400	$499,400

Check figures:
a. Net loss = $10,400
c. Total assets = $276,000

Required

Use the information in the trial balance to prepare:

a. The income statement for the year ended December 31, 2011.

b. The statement of owner's equity for the year ended December 31, 2011, assuming that the owner made additional investments of $50,000 during the year.

c. The balance sheet as of December 31, 2011.

Analysis component:

The owner, John Conroe, is very pleased with the change in the business's financial position. Specifically, he noted that his equity increased. "My banker told me that as long as equity is increasing, my business is doing great." Comment.

Problem 4-14A

Journalizing, posting, adjusted trial balance, adjusting entries, adjusted trial balance, financial statements

LO4, 5, 6, 7

On August 1, 2011, Delanie Tugut began a tour company in the Northwest Territories called Tugut Arctic Tours. The following occurred during the first month of operations:

Aug.	1	Purchased office furniture on account; $5,200.
	1	Delanie Tugut invested $7,000 cash into her new business.
	2	Collected $3,900 in advance for a three-week guided caribou hunt beginning the last week of August.
	3	Paid $6,000 for six months' rent for office space effective August 1.
	4	Received $3,000 for a four-day northern lights viewing tour.
	7	Paid $1,500 for hotel expenses regarding the August 4 tour.
	15	Delanie withdrew cash of $500 for personal use.
	22	Met with a Japanese tour guide to discuss a $150,000 tour contract.
	31	Paid wages of $1,300.

Required

1. Prepare General Journal entries to record the August transactions.
2. Set up the following T-accounts: Cash (101); Prepaid Rent (131); Office Furniture (161); Accumulated Amortization, Office Furniture (162); Accounts Payable (201); Unearned Revenue (233); Delanie Tugut, Capital (301); Delanie Tugut, Withdrawals (302); Revenue (401); Amortization Expense, Office Furniture (602); Wages Expense (623); Rent Expense (640); Telephone Expense (688); and Hotel Expenses (696).
3. Post the entries to the accounts; calculate the ending balance in each account.
4. Prepare an unadjusted trial balance at August 31, 2011.
5. Use the following information to prepare and post adjusting entries on August 31:
   - **a.** The office furniture has an estimated life of four years and a $208 residual value.
   - **b.** Two-thirds of the August 2 advance has been earned.
   - **c.** One month of the Prepaid Rent has been used.
   - **d.** The August telephone bill was not received as of August 31 but amounted to $320.
6. Prepare an adjusted trial balance.
7. Prepare an income statement, a statement of owner's equity, and a balance sheet.

Check figures:
3. Cash balance, Aug. 31/11 = $4,600
4. Dr = $19,100
6. Dr = $19,524
7. Net income = $1,376

Analysis component:
When a company shows revenue on its income statement, does this mean that cash equal to revenues was received during the period in which the revenues were reported?

*Problem 4-15A
Correcting entries
LO8

The accountant for Karma Counselling Services found several errors in reviewing the unadjusted trial balance on September 30. You are to prepare correcting entries based on the following information:

- **a.** The Counselling Fees Earned account included an entry debiting cash for $7,000 that should have been debited to Accounts Receivable.
- **b.** Utilities Expense was debited $1,680 that should have been recorded as Telephone Expense.
- **c.** The *Office* Supplies account shows a credit of $2,800 regarding the use of *Cleaning* Supplies.
- **d.** A transaction involving $19,600 of service revenue performed on account was incorrectly recorded as a debit to Accounts Payable and a credit to Unearned Service Revenue.
- **e.** Equipment was incorrectly debited for $1,200 with a corresponding credit to Accounts Payable regarding supplies that were sold to a neighbouring store on credit.

Required
Journalize the correcting entries required on September 30.

Analysis component:
The error in (b) shows that an incorrect expense account was debited. Since the net effect on the financial statements is nil after recording the correction, is it necessary to prepare a correcting entry for this type of error?

*Problem 4-16A
Recording prepaid expenses and unearned revenues
LO9

Willis Consulting follows the approach of recording prepaid expenses as expenses and unearned revenues as revenues. Willis's unadjusted trial balance for the year ended March 31, 2011, follows.

WILLIS CONSULTING
Trial Balances
March 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 20,000					
Accounts receivable	49,700					
Prepaid rent	–0–					
Prepaid insurance	–0–					
Accounts payable		$ 2,500				
Unearned consulting fees		–0–				
Bruce Willis, capital		15,600				
Consulting fees earned		82,000				
Rent expense	28,000					
Insurance expense	2,400					
Totals	$100,100	$100,100				

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

Additional information:

a. A review of the Consulting Fees Earned account showed that $5,600 of the balance has not yet been earned.

b. The balance in the Rent Expense account was paid on January 15, 2011, and represents seven months of rent beginning February 1, 2011.

c. It was determined that $1,900 of the balance in the Insurance Expense account was used by March 31, 2011.

Check figure:
Adjusted trial balance, debits = $100,100

Required

Refer to Exhibit 4.22 and use the information provided to complete the columns above.

*Problem 4-17A

Recording prepaid expenses and unearned revenues
LO4, 9

The following events occurred for a company during the last two months of its fiscal year ended December 31, 2011:

Nov.	1	Paid $3,000 for future newspaper advertising.
	1	Paid $4,320 for insurance through October 31 of the following year.
	30	Received $6,600 for future services to be provided to a customer.
Dec.	1	Paid $5,400 for the services of a consultant, to be received over the next three months.
	15	Received $15,300 for future services to be provided to a customer.
	31	Of the advertising paid for on November 1, $1,800 worth had not yet been published by the newspaper.
	31	Part of the insurance paid for on November 1 had expired.
	31	Services worth $2,400 had not yet been provided to the customer who paid on November 30.
	31	One-third of the consulting services paid for on December 1 had been received.
	31	The company had performed $6,000 of the services that the customer had paid for on December 15.

Required

1. Prepare the November and December entries for the above activities under the approach that records prepaid expenses as assets and records unearned revenues as liabilities. Also, prepare adjusting entries at the end of the year.

2. Prepare the November and December entries under the approach that records prepaid expenses as expenses and records unearned revenues as revenues. Also, prepare adjusting entries at the end of the year.

Analysis component:

Explain why the alternative sets of entries in requirements 1 and 2 do not result in different financial statement amounts.

Alternate Problems

Problem 4-1B

Preparing adjusting entries—prepaid expenses
LO4

Welsh's Cleaning Services is gathering information for its year-end, April 30, 2011. Selected accounts on the April 30, 2011, unadjusted trial balance are reproduced below:

Account	Debit	Credit
Prepaid equipment rental	$9,000	
Prepaid warehouse rental	7,800	
Prepaid insurance	3,600	
Cleaning supplies	1,450	

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

Required
Prepare the required annual adjusting entries at April 30, 2011, based on the following additional information:

a. The balance in the Prepaid Equipment Rental account is for 18 months of equipment rental that began December 1, 2010.
b. $3,000 of the balance in the Prepaid Warehouse Rental account had been used as of April 30, 2011.
c. The balance in the Prepaid Insurance account represents six months of insurance effective February 1, 2011.
d. A count of the cleaning supplies revealed that $1,200 had been used.

Analysis component:
Which GAAP require the recording of adjusting entries and why?

Problem 4-2B
Preparing adjusting entries—amortization expense
LO4

Details regarding Hornby Bay Consulting's plant and equipment items follow:

Date of Purchase	Plant and Equipment Item	Cost	Estimated Useful Life	Estimated Sales Value at End of Estimated Useful Life
a. Dec. 1, 2010	Furniture	$ 30,600	3 years	$ -0-
b. Mar. 1, 2011	Equipment	210,000	10 years	12,000
c. Nov. 1, 2011	Building	307,600	15 years	70,000

Required
Prepare the adjusting entry to record amortization for each capital asset item at November 30, 2011, Hornby Bay Consulting's year-end.

Analysis component:
What is the purpose of recording amortization? If amortization is not recorded, how would each of the components of the accounting equation be affected?

Problem 4-3B
Preparing adjusting entries—unearned revenues
LO4

Ocean Tours sells scuba diving and kayaking excursions, along with a number of unique sightseeing packages. The company requires a 50% payment from the customer at the time of booking. The following selected accounts appear on Ocean Tours' January 31, 2011, year-end unadjusted trial balance:

Account	Debit	Credit
Unearned heli-tour revenue		$ 26,000
Unearned tour package revenue		480,000
Unearned scuba diving revenue......		133,000
Unearned kayaking tour revenue		64,000

Required
Prepare adjusting journal entries at January 31, 2011, using the following additional information:

a. Ocean Tours has custom helicopter packages in which groups are flown in and out of island retreats. The balance in this unearned account is for a group scheduled for early March 2011.
b. $397,000 of the Unearned Tour Package Revenue account had been earned by January 31, 2011.
c. $36,000 of the Unearned Scuba Diving Revenue account remained unearned at January 31, 2011.
d. $8,350 of the Unearned Kayaking Tour Revenue account represents payments received from customers for February and March 2011.

Analysis component:
Using your understanding of GAAP, explain how and why unearned revenues are adjusted at the end of the accounting period.

Problem 4-4B
Preparing adjusting and subsequent cash entries—accrued expenses
LO4

In reviewing the accounts on September 30, 2011, for the month just ended, WonderWeb Designers discovered the following:

a. Interest of $3,800 had accrued on the bank loan as at September 30. It is to be paid on October 2.
b. Accrued wages at September 30 totalled $27,000. On October 4, the first biweekly payday of October, $45,000 was paid to employees representing the six days accrued on September 30 plus the first four working days in October.
c. The September cell phone bill for $180 was unpaid and unrecorded at September 30. It will be paid on October 5.
d. On September 30, $390 of cable charges were accrued regarding the past two months of usage that were not recorded or paid. This amount was paid on October 2.
e. $1,950 of property taxes covering September were accrued on September 30. This amount was paid on October 15.

Required
Using the information provided above, prepare adjusting journal entries at September 30 along with the appropriate subsequent cash entries.

Problem 4-5B
Preparing adjusting and subsequent cash entries—accrued revenues
LO4

In reviewing the accounts on March 31, 2011, for the month just ended, WonderWeb discovered the following:

a. Interest of $650 had accrued on the note receivable as of March 31. The accrual, representing 25 days in March plus an additional five days in April, was collected on April 5.
b. Accrued consulting fees totalling $5,400 were recorded on March 31. This amount was collected on April 6.
c. Web design work totalling $6,800 was completed on March 31 but not recorded. This amount was collected on April 13.
d. WonderWeb rents the basement of its building to a student. The student has not paid the March rent of $350 as at March 31. On April 27, the March rent plus the rent for April was collected.

Required
Using the information provided above, prepare adjusting journal entries at March 31 along with the appropriate subsequent cash entries.

Problem 4-6B
Adjusting entries; adjusted trial balance
LO4, 6

Design Institute provides one-on-one training to individuals who pay tuition directly to the business and also offers extension training to groups in off-site locations. The business follows the practice of initially recording prepaid expenses and unearned revenues in balance sheet accounts. Presented after the following unadjusted trial balance are facts that will lead to eight adjusting entries as of December 31, 2011.

DESIGN INSTITUTE
Trial Balance
December 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 50,000					
Accounts receivable	-0-					
Teaching supplies	60,000					
Prepaid insurance	18,000					
Prepaid rent	2,600					
Professional library	10,000					
Accumulated amortization, professional library		$ 1,500				
Equipment	30,000					
Accumulated amortization, equipment		16,000				
Accounts payable		12,200				
Salaries payable		-0-				
Unearned extension fees		27,600				
Jay Stevens, capital		68,500				
Jay Stevens, withdrawals	20,000					
Tuition fees earned		105,000				
Extension fees earned		62,000				
Amortization expense, equipment	-0-					
Amortization expense, professional library	-0-					
Salaries expense	43,200					
Insurance expense	-0-					
Rent expense	28,600					
Teaching supplies expense	-0-					
Advertising expense	18,000					
Utilities expense	12,400					
Totals	$292,800	$292,800				

Additional facts available on December 31, 2011, the business's year-end:

a. An analysis of the company's policies shows that $6,400 of insurance coverage has expired.

b. An inventory shows that teaching supplies costing $2,500 are on hand at the end of the year.

c. The estimated annual amortization on the equipment is $4,000.

d. The estimated annual amortization on the professional library is $2,000.

e. The school offers off-campus services for specific operators. On November 1, the company agreed to do a special four-month course for a client. The contract calls for a $4,600 monthly fee, and the client paid the first two months' fees in advance. When the cash was received, the Unearned Extension Fees account was credited.

f. On October 15, the school agreed to teach a four-month class to an individual for $2,200 tuition per month payable at the end of the class. The services have been provided as agreed, and no payment has been received.

g. The school's only employee is paid weekly. As of the end of the year, wages of $540 have accrued.

h. The balance in the Prepaid Rent account represents the rent for December.

Required

1. Prepare the eight necessary adjusting journal entries.

Check figure:
2. Adjusted Trial Balance, debits = $304,840

Analysis component:

2. Refer to the format presented in Exhibit 4.22 and prepare an adjusted trial balance using the information in (a) through (h) above.

3. If the adjustments were *not* recorded, calculate the over- or understatement of income.

4. Is it ethical to ignore adjusting entries?

Problem 4-7B

Adjusting entries

LO4

Boardwalk Equities' year-end is May 31. Based on an analysis of the unadjusted trial balance at May 31, 2011, the following information was available:

a. Machinery costing $21,000 was acquired on September 1 of this accounting period. It is estimated to have a useful life of six years. The machinery will have no value at the end of its six-year life.

b. It was determined that $3,000 of completed work was included in the $8,000 Unearned Revenue account balance at year-end.

c. The Prepaid Insurance account showed a balance of $90,000. This was paid and takes effect on March 1 of this accounting period and represents a two-year policy.

d. Accrued salaries at year-end were $5,000.

e. $2,520 of interest had accrued on the $72,000 note payable.

f. Accrued revenues at year-end totalled $1,700.

g. $12,000 worth of advertising was prepaid on January 1 of the current accounting period and debited to the Prepaid Advertising account. This covered four months of advertising beginning on the same date.

h. The annual amortization on the office equipment was $1,800.

i. Interest revenue accrued at year-end totalled $350.

j. The Office Supplies account had a balance of $2,000 at the beginning of the accounting period. During the year, $5,000 of supplies were purchased and debited to the Office Supplies account. At year-end, a count of the supplies revealed that $5,500 had been used.

Required

Prepare adjusting journal entries based on the above.

Problem 4-8B

Identifying adjusting and subsequent cash journal entries

LO4

Perfecto records prepaid expenses and unearned revenues in balance sheet accounts. The following information concerns the adjusting entries that need to be recorded on October 31, 2012, for the year just ended.

a. The Office Supplies account started the fiscal year with a $500 balance. During the fiscal year, the company purchased supplies at a cost of $3,650, which was added to the Office Supplies account. The inventory of supplies on hand at October 31 had a cost of $700.

b. An analysis of the company's insurance policies provided these facts:

Policy	Date of Purchase	Years of Coverage	Total Cost
1	April 1, 2011	2	$3,000
2	April 1, 2012	3	3,600
3	August 1, 2012	1	660

The total premium for each policy was paid in full at the purchase date, and the Prepaid Insurance account was debited for the full cost.

c. The company has 10 employees who earn a total of $800 for every working day. They are paid each Monday for their work in the five-day workweek ending on the preceding Friday. October 31, 2012 falls on Wednesday, and all 10 employees worked the first three days of the week. They will be paid salaries for five full days on Monday, November 5, 2012.

d. The company purchased a building on August 1, 2012. The building cost $155,000, and is expected to have a $20,000 residual value at the end of its predicted 25-year life.

e. Because the company is not large enough to occupy the entire building, it arranged to rent some space to a tenant at $600 per month, starting on September 1, 2012. The rent was paid on time on September 1, and the amount received was credited to the Rent Earned account. However, the tenant has not paid the October rent. The company has worked out an agreement with the tenant, who has promised to pay both October's and November's rent in full on November 15.

f. On September 1, the company also rented space to another tenant for $525 per month. The tenant paid five months' rent in advance on that date. The payment was recorded with a credit to the Unearned Rent account.

Required

1. Use the information to prepare adjusting entries as of October 31, 2012.
2. Prepare journal entries to record the subsequent cash transactions described in items (c) and (e).

Problem 4-9B
Adjusting journal entries
LO4

Alissa Kay, the owner of Colt Surveying Services, has been in business for two years. The unadjusted trial balance at December 31, regarding the month just ended, follows:

Colt Surveying Services
Unadjusted Trial Balance
December 31, 2011

Acct. No.	Account	Debit	Credit
101	Cash	$ 2,800	
106	Accounts receivable	3,955	
126	Supplies	320	
128	Prepaid advertising	2,800	
131	Prepaid rent	13,500	
167	Surveying equipment	29,000	
168	Accumulated amortization, surveying equipment		$ 3,674
201	Accounts payable		1,900
203	Interest payable		-0-
210	Wages payable		-0-
233	Unearned surveying fees		2,400
251	Notes payable		18,000
301	Alissa Kay, capital		14,326
302	Alissa Kay, withdrawals	2,150	
401	Surveying fees earned		67,049
601	Amortization expense, surveying equipment	1,837	
622	Wages expense	19,863	
633	Interest expense	945	
640	Rent expense	22,000	
650	Supplies expense	1,479	
655	Advertising expense	500	
690	Utilities expense	6,200	
	Totals	$107,349	$107,349

The following additional information is available on December 31, 2011:

a. Amortization on the equipment for the month was $167.
b. $2,000 of the balance in Unearned Surveying Fees is unearned at December 31.
c. The balance in Prepaid Rent is for six months of rent beginning December 1.
d. Accrued wages at month-end were $5,000.
e. December's interest in the amount of $105 had accrued on the notes payable.
f. Accrued surveying fees at month-end totalled $790.
g. The balance in Prepaid Advertising covers four months of advertising beginning December 15.
h. A count of the supplies on December 31 showed $150 had been used.
i. The December electricity bill for $540 was received on December 31. It is unrecorded and unpaid.

Required
Prepare adjusting journal entries based on the above.

Analysis component:
Explain the differences between *Accumulated Amortization* and *Amortization Expense*.

Problem 4-10B

Posting, adjusted trial balance, and preparing financial statements

LO6, 7

Check figures:

3. Adjusted trial balance, debits = $113,951

4. Net income = $6,853

Required

Using the information in Problem 4-9B, complete the following:

1. Set up balance column accounts for Colt Surveying Services and enter the balances listed in the unadjusted trial balance.
2. Post the adjusting entries prepared in Problem 4-9B to the balance column accounts.
3. Prepare an adjusted trial balance.
4. Use the adjusted trial balance to prepare an income statement, a statement of owner's equity and a balance sheet. Assume that the owner, Alissa Kay, made owner investments of $2,000 during the month.

Analysis component:

At December 31, 2011, how much of the business's assets are financed by the owner? by debt? Assuming total assets at the end of the previous month totalled $42,100, did equity financing increase or decrease during December? Generally speaking, is this a favourable or unfavourable change?

Note

For Part 1, your instructor may ask you to set up T-accounts instead of balance column accounts. The solution is available in both formats.

Problem 4-11B

Adjusting entries

LO4

Orca Bay Hockey Holdings showed the following:

Orca Bay Hockey Holdings
Unadjusted Trial Balance
June 30, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 56,000					
Accounts receivable	14,000					
Repair supplies	1,400					
Prepaid arena rental	91,000					
Hockey equipment	214,000					
Accumulated amortization, hockey equipment		$ 82,000				
Accounts payable		2,700				
Unearned ticket revenue		9,800				
Notes payable		80,000				
Ben Gibson, capital		225,700				
Ben Gibson, withdrawals	36,000					
Ticket revenue		275,000				
Salaries expense	175,000					
Arena rental expense	84,000					
Other expenses	3,800					
Totals	$675,200	$675,200				

Additional information available at year-end:

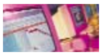
a. The Prepaid Arena Rental of $91,000 was paid on February 1, 2011. It represents seven months of rent on the arena.
b. A count of the Repair Supplies at year-end revealed that $950 had been used.
c. Annual amortization of the hockey equipment was $41,000.
d. A review of the Unearned Ticket Revenue account at year-end showed that included in the balance was $6,300 that had not yet been earned.
e. Accrued salaries of $29,000 had not been recorded at year-end.
f. Interest of $900 had accrued regarding the Notes Payable.
g. On June 5, 2011, cash of $46,000 was received for 2011/2012 Season Tickets (the season begins in October). This amount is included in the Ticket Revenue balance.

Required

Prepare adjusting entries on June 30, 2011, for (a) through (g) using the information provided.

Problem 4-12B
Preparation of financial statements
LO6, 7

Check figures:
1. Adjustments columns = $186,350; Adjusted trial balance columns = $746,100
2. Net loss = $167,150



Required

1. Using the format presented in Problem 4-11B, complete the adjusted trial balance by including the adjusting entries prepared in Problem 4-11B.
2. Prepare an income statement, a statement of owner's equity, and a balance sheet based on the adjusted trial balance completed in Part 1. Assume that the owner, Ben Gibson, made an investment during the year of $10,000.

Analysis component:
Assume that total liabilities reported at June 30, 2010, were $45,000. Determine what equity and total assets were on that date and comment on the change in the financial position from 2010 to 2011.

Problem 4-13B
Preparing financial statements from the adjusted trial balance
LO7

This adjusted trial balance is for Horizon Courier as of December 31, 2011:

	Debit	Credit
Accounts payable		$ 124,000
Accounts receivable	$ 110,000	
Accumulated amortization, equipment		190,000
Accumulated amortization, trucks		48,000
Advertising expense	26,400	
Amortization expense, equipment	46,000	
Amortization expense, trucks	24,000	
Cash	48,000	
Delivery fees earned		580,000
Equipment	260,000	
Interest earned		24,000
Interest expense	25,000	
Interest payable		22,000
Interest receivable	6,000	
Kim Ainesworth, capital		115,000
Kim Ainesworth, withdrawals	40,000	
Land	90,000	
Long-term notes payable		190,000
Notes receivable (due in 90 days)	200,000	
Office supplies	12,000	
Office supplies expense	33,000	
Repairs expense	34,600	
Salaries expense	64,000	
Salaries payable		30,000
Trucks	124,000	
Unearned delivery fees		110,000
Wages expense	290,000	
Totals	$1,433,000	$1,433,000

Check figures:
1. Net income = $61,000
3. Total assets = $612,000

Required
Use the information in the trial balance to prepare:

1. The income statement for the year ended December 31, 2011.
2. The statement of owner's equity for the year ended December 31, 2011, assuming the owner invested $20,000 during 2011.
3. The balance sheet as of December 31, 2011.

Problem 4-14B

Journalizing, posting, adjusted trial balance, adjusting entries, adjusted trial balance, financial statements

LO4, 5, 6, 7

On July 1, 2011, Melanie Thornhill began her third month of operating an electronics repair shop called MT Repairs out of her dad's garage. The following occurred during the third month of operations:

July	1	Collected $1,800 as a deposit for work to be done at the local college in the fall.
	1	Melanie Thornhill withdrew $2,000 cash for personal expenses.
	2	Paid $1,100 for repair supplies purchased on account last month.
	3	Did work for a client and immediately collected $700.
	4	Performed services for a customer and collected $1,800.
	7	Hired a new technician to start next week on a casual basis at $200 per day.
	15	Melanie withdrew cash of $500 for personal use.
	22	Purchased repair supplies for cash; $800.
	31	Paid wages of $1,400.

Required

1. Prepare General Journal entries to record the July transactions.
2. Set up the following T-accounts with June 30 adjusted balances: Cash (101), $3,200; Repair Supplies (131), $1,500; Tools (161), $8,400; Accumulated Amortization, Tools (162), $280; Accounts Payable (201), $1,600; Unearned Revenue (233), $350; Melanie Thornhill, Capital (301) $?; Melanie Thornhill, Withdrawals (302), $0; Revenue (401), $12,900; Amortization Expense, Tools (602), $280; Wages Expense (623), $980; Rent Expense (640), $4,000; and Repair Supplies Expense (696), $1,350.
3. Post the entries to the accounts; calculate the ending balance in each account.
4. Prepare an unadjusted trial balance at July 31, 2011.
5. Use the following information to prepare and post adjusting entries for the month of July:
   a. The tools have an estimated life of five years with no residual value.
   b. One-quarter of the repair supplies balance remained on hand at July 31.
   c. Accrued the July rent expense of $2,000; it will be paid in August.
   d. $1,900 of the unearned revenues remained unearned as at July 31.
6. Prepare an adjusted trial balance.
7. Prepare an income statement, a statement of owner's equity, and a balance sheet.

Check figures:
3. Cash balance, July 31, 2011 = $1,700
4. Dr = $22,910
6. Dr = $25,050
7. Net income = $3,775

Analysis component:
When a company shows expenses on its income statement, does this mean that cash equal to the expenses was paid during the period in which the expenses were reported?

*Problem 4-15B

Correcting entries

LO8

As the accountant for Broden's Telemarketing Services, you discovered the following errors in the May 31 unadjusted trial balance that require correction:

a. Advertising Expense was debited and Accounts Receivable was credited on May 17 for $12,000 of repairs paid for by Broden's.
b. On May 18, Computer Equipment was debited and Accounts Payable was credited, each for $8,000 regarding the purchase of office furniture in exchange for a promissory note.
c. On May 28, Cash was debited and Telemarketing Fees Earned was credited for $10,000 cash received in advance from a client.
d. The Telephone Expense account included $1,800 of delivery expense.
e. The Telemarketing Fees Earned account was credited for $450 of interest revenue.

Required
Journalize the correcting entries required on May 31.

Analysis component:
The error in (e) shows that an incorrect revenue account was credited. Since the net effect on the financial statements is nil after recording the correction, is it necessary to prepare a correcting entry for this type of error?

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

***Problem 4-16B**
Recording prepaid expenses and unearned revenues
LO9

Meli Janitorial Services follows the approach of recording prepaid expenses as expenses and unearned revenues as revenues. Meli's unadjusted trial balance for the year ended October 31, 2011, follows.

MELI JANITORIAL SERVICES
Trial Balances
October 31, 2011

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	$ 29,000					
Accounts receivable	18,000					
Prepaid advertising	–0–					
Cleaning supplies	–0–					
Equipment	62,000					
Accumulated amortization, equipment		$ 3,000				
Unearned window washing fees		–0–				
Unearned office cleaning fees		–0–				
Joel Meli, capital		18,300				
Window washing fees earned		76,000				
Office cleaning fees earned		138,000				
Advertising expense	7,300					
Salaries expense	97,000					
Amortization expense, equipment	–0–					
Cleaning supplies expense	22,000					
Totals	$235,300	$235,300				

Additional information:

a. On October 31, a physical count revealed cleaning supplies on hand of $3,100.
b. Annual amortization on the equipment is $3,000.
c. It was determined that $8,500 of the balance in Office Cleaning Fees Earned had not yet been earned as of October 31.
d. A review of the Window Washing Fees Earned account showed that only $71,000 had been earned as of October 31.
e. $5,000 of the total recorded in the Advertising Expense account had not yet been used.

Required

Refer to Exhibit 4.22 and use the information provided to complete the columns above.

Check figure:
Adjusted trial balance, debits = $238,300

***Problem 4-17B**
Recording prepaid expenses and unearned revenues
LO4, 9

The following occurred for a company during the last two months of its fiscal year ended May 31, 2011:

Apr.	1	Paid $3,450 for future consulting services.
	1	Paid $2,700 for insurance through March 31 of the following year.
	30	Received $7,500 for future services to be provided to a customer.
May	1	Paid $3,450 for future newspaper advertising.
	23	Received $9,450 for future services to be provided to a customer.
	31	Of the consulting services paid for on April 1, $1,500 worth had been received.
	31	Part of the insurance paid for on April 1 had expired.
	31	Services worth $3,600 had not yet been provided to the customer who paid on April 30.
	31	Of the advertising paid for on May 1, $1,050 worth had not been published yet.
	31	The company had performed $4,500 of the services that the customer had paid for on May 23.

An asterisk (*) identifies assignment material based on Appendix 4A or Appendix 4B.

Required

1. Prepare entries for April and May under the approach that records prepaid expenses and unearned revenues in balance sheet accounts. Also, prepare adjusting entries at the end of the year.
2. Prepare entries for April and May under the approach that records prepaid expenses and unearned revenues in income statement accounts. Also, prepare adjusting entries at the end of the year.

Analysis component:

Explain why the alternative sets of entries in requirements 1 and 2 do not result in different financial statement amounts.

Analytical and Review Problem

A & R Problem 4-1

The Salaries Payable account of James Bay Company Limited appears below:

Salaries Payable			
		22,520	Bal. Jan. 1, 2011
Entries during 2011	398,120	388,400	Entries during 2011

The company records the salary expense and related liability at the end of each week and pays the employees on the last Friday of the month.

Required

Calculate:

1. What was the salary expense for 2011?
2. How much was paid to employees in 2011 for work done in 2010?
3. How much was paid to employees in 2011 for work done in 2011?
4. How much will be paid to employees in 2012 for work done in 2011?

Ethics Challenge

EC 4-1

Jackie Houston is a new accountant for Seitzer Company. She is learning on the job from Bob Welch, who has already worked several years for Seitzer. Jackie and Bob are preparing the year-end adjusting entries. Jackie has calculated that amortization expense for the fiscal year should be recorded as:

Amortization Expense, Equipment.................	123,546	
Accum. Amort., Equipment..................		123,546

Bob is rechecking the numbers and says that he agrees with her computation. However, he says that the credit entry should be made directly to the Equipment account. He argues that while accumulated amortization is taught in the classroom, "It is easier to ignore the contra account and just credit the Equipment account directly for the annual amortization. Besides, the balance sheet shows the same amount for total assets under both methods."

Required

1. How should amortization be recorded? Do you support Jackie or Bob?
2. Evaluate the strengths and weaknesses of Bob's reasons for preferring his method.
3. Indicate whether the situation faced by Jackie is an ethical problem.

Focus on Financial Statements

You have given the following information for RPE Consulting for the year ended July 31, 2011.

FFS 4-1

RPE Consulting Trial Balances July 31, 2011						
	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Accounts payable		$ 9,300				$ 10,200
Accounts receivable	$ 12,000				$ 22,460	
Accum. amort., office equipment		12,000				18,000
Advertising expense	13,800				14,700	
Amort. expense, office equipment	–0–				6,000	
Cash	27,000				27,000	
Consulting fees earned		156,000				168,160
Insurance expense	–0–				2,440	
Interest expense	1,400				2,200	
Interest payable		–0–				800
Notes payable		44,000				44,000
Office equipment	92,000				92,000	
Office supplies	18,000				3,000	
Office supplies expense	–0–				15,000	
Prepaid insurance	7,320				4,880	
Ray Edds, capital		28,420				28,420
Ray Edds, withdrawals	10,000				10,000	
Rent expense	13,200				13,200	
Salaries expense	71,000				77,600	
Salaries payable		–0–				6,600
Unearned consulting fees		16,000				14,300
Totals	$265,720	$265,720			$290,480	$290,480

Required

1. Prepare the company's income statement, statement of owner's equity, and balance sheet. Assume that the owner, Ray Edds, invested $20,000 during the year ended July 31, 2011.

Analysis component:

2. Analyze the unadjusted and adjusted trial balances and identify the adjustments that must have been made by inserting them in the two middle columns. Label each entry with a letter.
3. If the adjustments had not been recorded, identify the net overstatement/understatement of each component of the accounting equation.

FFS 4-2

Part 1

Refer to WestJet's income statement on page I-21 in Appendix I at the end of the textbook.

a. Prepare two possible adjusting entries that would have caused 2005 *Guest revenues* to increase.

b. Prepare two possible adjusting entries that would have caused 2005 *Aircraft leasing expenses* to increase.

Part 2

Refer to WestJet's balance sheet on page I-20 in Appendix I at the end of the textbook.

c. Prepare the possible adjusting entry that would have caused the December 31, 2005, balance in *Prepaid expenses and deposits* to decrease.

d. Prepare a possible adjusting entry that would have caused the December 31, 2005, balance in *Accounts payable and accrued liabilities* to increase.

Critical Thinking Mini Case

It's a week before Scotiabank's October 31, 2011, year-end. You are the personnel director and are reviewing some financial information regarding the March 1, 2009, purchase of office furniture for the western region offices totalling $700,000 ($300,000 was paid in cash and the balance was financed over four years at 4% annual interest with annual principal payments of $100,000). The useful life of the furniture was estimated to be five years with a projected resale value at that time of $20,000. Insurance was purchased on the furniture at a cost of $8,000 annually, payable each March 1. You leave the office for the day wondering what needs to be considered regarding these items in preparation for year-end.

Required
Using the elements of critical thinking described on the inside front cover, respond.

Serial Problem

(This comprehensive problem was introduced in Chapter 3 and continues in Chapters 5 and 6. If the Chapter 3 segment has not been completed, the assignment can begin at this point. You need to use the facts presented on PP. 128–129 in Chapter 3. Because of its length, this problem is most easily solved if you use the Working Papers[8] that accompany this book.)

After the success of its first two months, Mary Graham has decided to continue operating Echo Systems. (The transactions that occurred in these months are described in Chapter 3.) Before proceeding in December, Graham adds these new accounts to the chart of accounts for the ledger:

Account	No.
Accumulated Amortization, Office Equipment	164
Accumulated Amortization, Computer Equipment	168
Wages Payable	210
Unearned Computer Services Revenue	236
Amortization Expense, Office Equipment	612
Amortization Expense, Computer Equipment	613
Insurance Expense	637
Rent Expense	640
Computer Supplies Expense	652

Required
1. Prepare journal entries to record each of the following transactions for Echo Systems. Post the entries to the accounts in the ledger.
2. Prepare adjusting entries to record the events described on December 31 (items *a* to *f*). Post the entries to the accounts in the ledger.
3. Prepare an adjusted trial balance as of December 31, 2011.
4. Prepare an income statement for the three months ended December 31, 2011.
5. Prepare a statement of owner's equity for the three months ended December 31, 2011.
6. Prepare a balance sheet as of December 31, 2011.

[8] If students have not purchased the working paper package, the working papers for the serial problem are available online in the Student Success Centre (SSC).

Transactions and other data:

Dec.	3	Paid $2,100 to the Lakeshore Mall for the company's share of mall advertising costs.
	3	Paid $1,200 to repair the company's computer.
	4	Received $7,500 from Alamo Engineering Co. for the receivable from the prior month.
	10	Paid Carly Smith for six days' work at the rate of $200 per day.
	14	Notified by Alamo Engineering Co. that Echo's bid of $12,000 on a proposed project was accepted. Alamo paid an advance of $3,000.
	17	Purchased $2,310 of computer supplies on credit from Abbott Office Products.
	18	Sent a reminder to Fostek Co. to pay the fee for services originally recorded on November 8.
	20	Completed project for Elite Corporation and received $11,250 cash.
	24–28	Took the week off for the holidays.
	31	Received $5,700 from Fostek Co. on its receivable.
	31	Reimbursed Mary Graham's business automobile expenses of 600 kilometres at $1.00 per kilometre.
	31	Mary Graham withdrew $3,600 cash from the business
	31	The following information was collected to be used in adjusting entries prior to preparing financial statements for the company's first three months: **a.** The December 31 inventory of computer supplies was $1,440. **b.** Three months have passed since the annual insurance premium was paid. **c.** As of the end of the year, Carly Smith has not been paid for four days of work at the rate of $200 per day. **d.** The computer is expected to have a four-year life with no residual value. **e.** The office equipment is expected to have a three-year life with no residual value. **f.** Prepaid rent for three of the four months has expired.