3 Measuring Business Income: The Adjusting Process

KEY QUESTIONS		LEARNING OBJECTIVES
When does a sale really happen? And when do we record an expense?	1	Apply the recognition criteria for revenues and expenses
Why can't we wait to record transactions until the cash comes in or the cash goes out?	2	Distinguish accrual-basis accounting from cash-basis accounting
What is the adjusting process and why is it important?	3	Make adjusting entries
How to we get the accounting records ready to prepare the financial statements?	4	Prepare an adjusted trial balance
Remind me. How do we make financial statements?	5	Prepare the financial statements from the adjusted trial balance
How does IFRS apply to adjusting entries?	6	Describe the adjusting-process implications of international financial reporting standards (IFRS)
CHAPTER 3 APPENDIX		
Is there another way to record prepaids?	A1	Account for a prepaid expense recorded initially as an expense
Is there another way to record unearned revenues?	A2	Account for an unearned (deferred) revenue recorded initially as a revenue

Tracy Daytona's
TRIM & DETAIL
Hair, Tanning & Stuff for Guys

Tracy Daytona's Trim and Detail is a NASCAR-themed hair salon whose primary customer base is men. Their business model is unique in that it is a salon that does not look like a salon!

Customers are invited in for more than just haircuts. They offer haircuts, tanning, shaves, and salon products.

How does the owner know if the salon is making money? Can the salon hire another stylist? Would the business be able to get a loan to open a new location? This information to answer these sorts of questions can only come from accurate recordkeeping and the preparation of the financial statements. To produce complete and accurate financial statements, the business needs to account for *all* transactions, even those that may not have typical source documents.

Suppose Tracy Daytona's stylists work today but receive their paycheques next week. If the financial statements need to be prepared before payday next week, wages expense on the income statement would be too low if several days of wages were not recorded. An adjusting entry would ensure that the wages expense and the wages payable liability are included in the accounting records so the income statement and balance sheet are complete and accurate.

Suppose an order of tanning supplies arrived today without an invoice. If the financial statements must be prepared tomorrow, the supplies asset and the account payable to the supplier would be too low if this transaction in not recorded. Again, an adjusting entry will make the accounting records complete, which will lead to complete and accurate financial statements. This chapter will look at adjusting entries—why they are done and how they are done—and the documents accountants use to create the financial statements.

CONNECTING CHAPTER 3

1	2	3	4
Apply the recognition criteria for revenues and expenses	Distinguish accrual basis accounting from cash basis accounting	Make adjusting entries	Prepare and adjusted trial balance
When does a sale really happen? And when do we record an expense?	*Why can't we wait to record cash transactions when the cash comes in or the cash goes out?*	*What is the adjusting process and why is it important?*	*How do we get the accounting records ready to prepare the financial statements?*
Recognition Criteria for Revenues and Expenses, page 125	Accrual-Basis Accounting versus Cash-Basis Accounting, page 126	Adjusting the Accounts, page 128	The Adjusted Trial Balance, page 141
	MyAccountingLab **Video:** Cash Basis versus Accrual Basis Accounting	MyAccountingLab **Videos:** Accrued Expenses Fixed Assets and Depreciation Prepaid Expenses Road Map to Adjusting Entries Unearned Revenue Unearned Revenue Adjusting Entries	MyAccountingLab **Animation:** Accounting Cycle Tutorial (Adjustments)

5	6	A1	A2
Prepare the financial statements from the adjusted trial balance	Describe the adjusting-process implications of international financial reporting standards (IFRS)	Account for a prepaid expense recorded initially as an expense	Account for an unearned (deferred) revenue recorded initially as a revenue
Remind me. How do we prepare the financial statements?	*How does IFRS apply to adjusting entries?*	*Is there another way to record prepaids?*	*Is there another way to record unearned revenues?*
Preparing the Financial Statements from the Adjusted Trial Balance, page 143	Adjusting-Process Implications of International Financial Reporting Standards (IFRS), page 146	Alternative Treatment of Accounting for Prepaid Expenses and Unearned Revenues, page 152	Alternative Treatment of Accounting for Prepaid Expenses and Unearned Revenues, page 152
Relationships among the Three Financial Statements, page 143			
MyAccountingLab **Animation:** (from Chapter 1) Relationships among the Financial Statements **Animation:** Accounting Cycle Tutorial (Financial Statements)			

MyAccountingLab

- Chapter 3: Accounting Cycle Tutorial
- Chapter 3: DemoDoc covering The Adjusting Process
- Chapter 3: Student PowerPoint Slides
- Chapter 3: Audio Chapter Summary

All MyAccountingLab resources can be found in the Chapter Resources section and the Multimedia Library.

The **Summary** for Chapter 3 appears on page 151.
Accounting Vocabulary with definitions appears on page 155–156.

Whether the business is Tracy Daytona's or Hunter Environmental Consulting, the desire to make profits increases the owners' drive to carry on the business. As you study this chapter, consider how important net income is to a business. Getting a true picture of net income will be the focus of this chapter.

At the end of each accounting period, the entity prepares its financial statements. The period may be one month, three months, six months, or a full year. Tracy Daytona's is typical. The company reports internally on a monthly basis. It reports at the end of its year to its banker and other external users, providing audited financial statements.

Accounting Cycle

1. Identify and analyze transactions	Chapter 1
2. Record transactions in a journal	Chapter 2
3. Post (copy) from the journal to the accounts in the ledger	Chapter 2
4. Prepare the trial balance	Chapter 2
5. Journalize and post adjusting entries	Chapter 3
6. Prepare the financial statements	Chapter 3
7. Journalize and post the closing entries	Chapter 4
8. Prepare the postclosing trial balance	Chapter 4

Whatever the length of the period, the end accounting product is the set of financial statements. And one of the most important single amounts in these statements is the net income or net loss for the period. Net income or net loss captures much information: total revenues minus total expenses for the period. A business that consistently earns net income adds value to its owners, its employees, its customers, and society.

An important step in financial statement preparation is the trial balance. The trial balance, introduced in Chapter 2 on page 84, lists the ledger accounts and their balances. The account balances in the trial balance include the effects of the transactions that occurred during the period—cash collections, purchases of assets, payments of bills, sales of assets, and so on. To measure its income, however, a business must do some additional accounting at the end of the period to bring the records up to date before preparing the financial statements. This process is called *adjusting the books* and it consists of making special entries called *adjusting entries.* This chapter focuses on these adjusting entries to show how to measure business income. This is Step 5 of the accounting cycle shown in the margin.

The accounting profession has concepts, assumptions, and principles to guide the measurement of business income. Chief among these are

- the time period assumption,
- the recognition principle for revenues and expenses (including the matching of costs with revenues), and
- the accrual-basis accounting versus cash-basis accounting methods.

In this chapter, we apply these (and other) concepts and principles to measure the income and prepare the financial statements of Hunter Environmental Consulting (HEC) for the month of April. All other companies follow the same principles.

Time-Period Assumption

Managers, investors, and creditors make decisions daily and need periodic readings on the business's progress. The **time-period assumption** ensures that accounting information is reported at regular intervals.

The most basic **accounting period** is one year, and virtually all businesses prepare annual financial statements. For many companies, the annual accounting period is the calendar year from January 1 through December 31. Other companies use a *fiscal year* ending on some date other than December 31. A fiscal year-end date is usually chosen to be at the low point in business activity for the year. Retailers are a notable example. Traditionally, their fiscal year ends on or around January 31, because the low point in their business activity has followed the after-Christmas sales in January; for Sears Canada Inc., which operates stores across Canada, its fiscal year ends on the last Saturday of January.

Managers and investors cannot wait until the end of the year to analyze a company's progress. Companies, therefore, prepare financial statements for *interim* periods, which are less than a year. A series of monthly statements can be combined into quarterly (three month) and semiannual (six month) periods for investors. Given the fast pace of business, managers want financial information more often, so monthly or even daily financial statements provide information for decision making. Most of the discussions in this book are based on an annual accounting period, but the procedures and statements can be applied to interim periods as well.

The remainder of the chapter discusses how to make the adjusting entries to bring the accounts up to date.

Recognition Criteria for Revenues and Expenses

LO 1
When does a sale really happen? And when do we record an expense?

Recognition is the process of including an item in the financial statements of a business. There are two parts to consider. First, we will discuss the recognition of revenue; then, we will discuss the recognition of expenses.

Revenue Recognition

The **recognition criteria for revenues** tell accountants

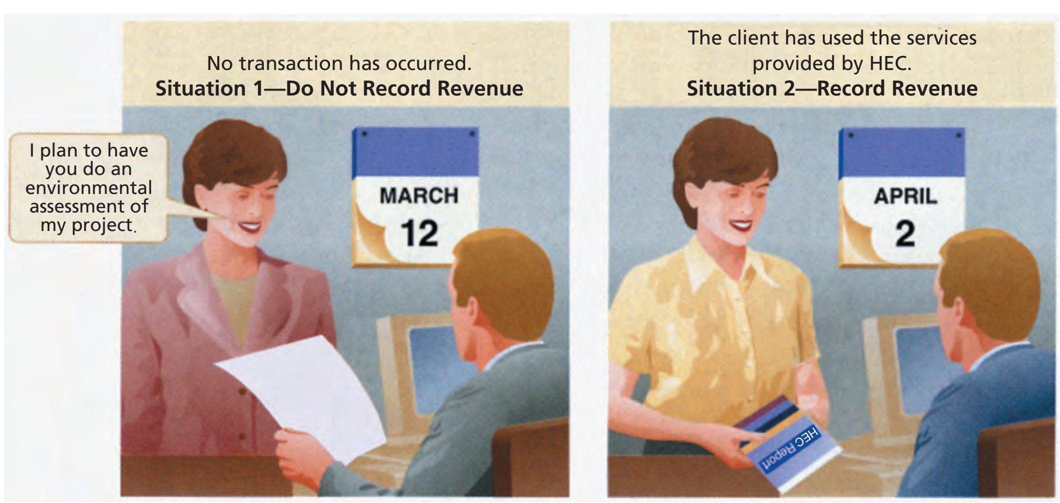
- *When* to record revenue—that is, when to make a journal entry for a revenue transaction.
- The *amount* of revenue to record.

Revenue, defined in Chapter 1, page 17, is the increase in owner's equity from delivering goods and services to customers in the course of operating a business. When we speak of "recording" something in accounting, we mean to make an entry in the journal. That is where the accounting process starts.

When to Record Revenue Revenue-recognition criteria state that revenue should be recorded when it has been earned—but not before. In *most* cases, revenue is earned when the business has delivered a completed good or service to the customer. The business has done everything required by the agreement, including transferring the item to the customer.

Exhibit 3–1 shows two situations that provide guidance on when to record revenue. The first situation illustrates when *not* to record revenue, because the client merely states her plans. Situation 2 illustrates when revenue should be recorded—after HEC has performed the service for the client.

EXHIBIT 3–1 | Recording Revenue: The Recognition Criteria for Revenues



The Amount of Revenue to Record The general principle is to record revenue equal to the cash value of the goods or the service transferred to the customer. Suppose that, in order to obtain a new client, HEC performs environmental assessment services for the price of $5,000. Ordinarily, the business would have charged $7,000 for this service. How much revenue should the business record? The answer is $5,000 because that was the cash value of the transaction. The business will receive only $5,000 cash, and that pinpoints the amount of revenue earned.

Recognition Criteria for Expenses

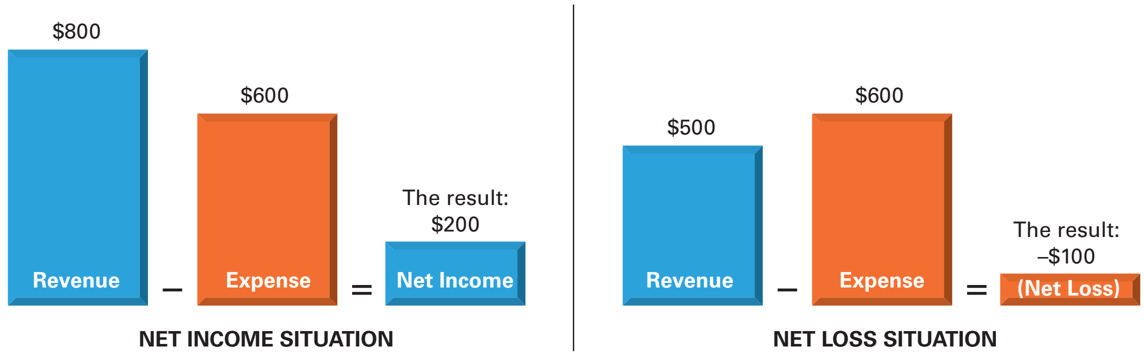
Just as we have criteria that help us determine when to recognize revenue and how much revenue we should record, we also have criteria to help us determine when to recognize expenses. This is commonly referred to as the **matching objective**. Recall that expenses such as utilities and advertising are the costs of assets and services that are consumed when earning revenue. The matching objective directs accountants to

1. Identify all expenses incurred during the accounting period.
2. Measure the expenses.
3. Match the expenses against the revenues earned during that period.

To match expenses against revenues means to subtract the related expenses from the revenues to compute net income or net loss. Exhibit 3–2 illustrates the matching objective.

EXHIBIT 3–2 | Expense Recognition—An Illustration of the Matching Objective

To match expenses against revenues means to subtract the related expenses from the revenues in order to compute net income or net loss.



Accountants follow the matching objective by first identifying the revenues of a period and then the expenses that can be linked to particular revenues. For example, a business that pays sales commissions to its salespeople will have commission expense if the employees make sales. If they make no sales, the business has no commission expense.

Other expenses are not so easy to link with particular sales. HEC's monthly rent expense occurs, for example, regardless of the revenues earned during the period. The matching objective directs accountants to identify these types of expenses with a particular time period, such as a month or a year. If HEC employs an office assistant at a monthly salary of $2,500, the business will record salary expense of $2,500 each month.

How does HEC bring its accounts up to date for preparing the financial statements? We will address this question in the next section.

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1. Why is it important to have recognition criteria for both revenues and expenses?
2. On December 20, 2013, Kobe Company receives an order from Windsor Company for products costing $5,000. The order will not be shipped until January 5, 2014. Kobe Company wants to record the revenue on December 20 so it can include it in the current year's financial statements. As Kobe's accountant, you object to this accounting treatment. Why?
3. On December 20, 2013, Kobe Company receives an order from Windsor Company for products costing $5,000. The order is shipped immediately. Kobe Company pays a commission of 5 percent of the selling price to its sales representative who received the order. This commission will not be paid until January 2014. Kobe's fiscal year end is December 31. What is the journal entry needed to account for the sales commission?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Accrual-Basis Accounting versus Cash-Basis Accounting

LO 2
Why can't we wait to record transactions until the cash comes in or the cash goes out?

Now that you have seen the more correct way to record entries, it needs to be acknowledged that there are really two ways to do accounting:

- **Accrual-basis accounting**, frequently called *accrual accounting*, records the effect of every business transaction as it occurs, no matter when cash receipts and cash payments occur. Accrual accounting is based on the time period assumption and recognition criteria for revenues and expenses. For this reason, most businesses use the accrual basis because it is required by GAAP (which includes both accounting standards for private enterprises [ASPE] and international financial reporting standards [IFRS]). Thus, accrual-basis accounting is the method covered in this book. The Canada Revenue Agency (CRA) requires accrual accounting for income tax purposes except in special cases.
- **Cash-basis accounting** records transactions only when cash receipts and cash payments occur. It ignores receivables, payables, and other expenses covered later in this chapter. Only very small businesses tend to use cash-basis accounting.

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Video: Cash Basis versus Accrual Basis

Exhibit 3–3 illustrates the difference between the accrual basis and the cash basis of accounting for a real estate agent. For an expense transaction, notice that the accrual basis records the payable and the expense when the advertisement is put in the newspaper, whereas the cash basis records the expense only when it is paid. For a revenue transaction, notice that the accrual basis records a receivable and a revenue when the agent earns the commission by completing the sale, whereas the cash basis records the revenue only when the cash is received 30 days later.

As we saw in Exhibit 1–6 on page 13 and on the inside back cover of this book, the objective of financial statements is to communicate information that is useful to users. Accrual-basis accounting provides more complete information than does cash-basis accounting. This difference is important because the more complete the data, the better equipped decision makers are to reach accurate conclusions about the firm's financial health and future prospects. Three concepts used in accrual accounting are the accounting period, the recognition principle, and the time-period assumption.

EXHIBIT 3–3 | Accrual-Basis Accounting versus Cash-Basis Accounting

Accrual Basis

Expense Example: Suppose Ali Chow, a real estate agent, purchased $2,000 of newspaper advertising on account on January 14 and will pay the newspaper in 30 days (on February 13).

Jan 14	Advertising Expense	2,000	
	Accounts Payable		2,000
	Purchased advertising on account.		

Feb 13	Accounts Payable	2,000	
	Cash		2,000
	Paid for advertising purchased on account.		

The accrual basis records the advertising expense when the real estate agent places the advertisement on January 14. The accrual basis also records the Accounts Payable liability on January 14 since the agent owes money to the newspaper on that date.

Ali Chow
Balance Sheet
January 14, 2014

Cash	$15,000	Accounts payable	$ 2,000
Accts receivable	-		
		A. Chow, Capital	$13,000
Total assets	$15,000	Total liab & equity	$15,000

Ali Chow
Income Statement
For the Period Ended January 14, 2014

Revenue		$11,000
Expenses		
Advertising	2,000	
Phone	150	
Rent	300	
Total expenses		2,450
Net income		$ 8,550

Cash Basis

Jan 14 No journal entry because no cash was paid.

Feb 13	Advertising Expense	2,000	
	Cash		2,000
	Purchased advertising on January 14.		

The cash-basis accounting records are not accurate and complete on January 14 because they do not show the expense or the liability at that date.

Ali Chow
Balance Sheet
January 14, 2014

Cash	$ 15,000	Accounts payable	$ -
Accts receivable	-		
		A. Chow, Capital	$15,000
Total assets	$15,000	Total liab & equity	$15,000

Ali Chow
Income Statement
For the Period Ended January 14, 2014

Revenue		$11,000
Expenses		
Advertising	-	
Phone	150	
Rent	300	
Total expenses		450
Net Income		$10,550

Accrual Basis

Revenue Example: Suppose Ali Chow sold the house that was advertised and earned commission in the amount of $15,000 when the deal closed on March 8. She will collect no cash until April 7.

March 8	Accounts Receivable	15,000	
	Commission Revenue		15,000
	Earned revenue on account.		

April 7	Cash	15,000	
	Accounts Receivable		15,000
	Cash received on account.		

The accrual basis records the revenue when Ali earns the revenue by selling the house in March. The accrual basis also records the Accounts Receivable as an asset on March 8 since Ali is owed this amount for the service performed.

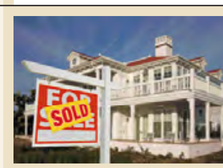
Ali Chow
Balance Sheet
March 8, 2014

Cash	$17,000	Accounts payable	$ -
Accts receivable	15,000		
		A. Chow, Capital	$ 32,000
Total assets	$32,000	Total liab & equity	$ 32,000

Ali Chow
Income Statement
For the Period Ended March 8, 2014

Revenue		$ 26,000
Expenses		
Advertising	2,000	
Phone	600	
Rent	300	
Total expenses		2,900
Net Income		$ 23,100

Cash Basis



Mar 8 No journal entry because no cash was received.

April 7	Cash	15,000	
	Commission Revenue		15,000
	Earned revenue on March 8.		

The cash-basis accounting records are not accurate and complete on March 8 because no transaction is recorded on that date. The cash basis records the revenue in the wrong accounting period, which is one of the problems with using this method.

Ali Chow
Balance Sheet
March 8, 2014

Cash	$ 17,000	Accounts payable	$ -
Accts receivable	-		
		A. Chow, Capital	$ 17,000
Total assets	$ 17,000	Total liab & equity	$ 17,000

Ali Chow
Income Statement
For the Period Ended March 8, 2014

Revenue		$11,000
Expenses		
Advertising	2,000	
Phone	600	
Rent	300	
Total expenses		2,900
Net Income		$ 8,100

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4. All parts of the financial statements are important in describing the financial condition of a business. Which financial statement would be most helpful to Tracy Daytona's management in evaluating the company's performance for 2014?
5. Suppose HEC collects $6,000 from customers on January 1. The company will earn the $6,000 evenly during January, February, and March. How much service revenue will HEC report each month under (a) accrual-basis accounting and (b) cash-basis accounting?
6. Suppose HEC prepays $1,500 for internet advertising on October 1. The ads will run during October, November, and December. How much advertising expense will HEC report each month under (a) accrual-basis accounting and (b) cash-basis accounting?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Adjusting the Accounts

LO 3
What is the adjusting process and why is it important?

At the end of the period, the accountant prepares the financial statements. This end-of-the-period process begins with the trial balance that lists the accounts and their balances after the period's transactions have been recorded in the journal and posted to the accounts in the ledger. We prepared trial balances in Chapter 2. Any trial balance created to this point was an *unadjusted trial balance* because it was prepared before the adjusting entries were recorded.

For illustration purposes, assume Exhibit 3–4 is the unadjusted trial balance of Hunter Environmental Consulting (HEC) at April 30, 2014. (Account numbers are not shown. The transactions reflected in Exhibit 3–4 are different from those described in earlier chapters, so the accounts and balances here differ from those in earlier chapters). This unadjusted trial balance includes some new accounts that will be explained in this chapter. It lists most, but not all, of the revenue accounts and the expenses of the company for the month of April.

EXHIBIT 3–4 | Unadjusted Trial Balance

HUNTER ENVIRONMENTAL CONSULTING
Unadjusted Trial Balance
April 30, 2014

Cash	$ 31,000	
Accounts receivable	14,000	
Office supplies	1,500	
Prepaid insurance	3,600	
Land	50,000	
Furniture	45,000	
Accounts payable		$ 12,000
Unearned service revenue		3,000
Lisa Hunter, capital		120,100
Lisa Hunter, withdrawals	6,000	
Service revenue		24,000
Rent expense	3,000	
Salaries expense	4,000	
Utilities expense	1,000	
Total	$159,100	$159,100

Accrual-basis accounting requires adjusting entries at the end of the period in order to produce correct balances for the financial statements.

Adjusting entries assign revenues to the period in which they are earned and expenses to the period in which they are incurred. Adjusting entries also update the asset and liability accounts. They are needed to

1. Measure properly the period's income on the income statement.
2. Bring related asset and liability accounts to correct balances for the balance sheet.

The end-of-the-period process of updating the accounts is called *adjusting the accounts, making the adjusting entries,* or *adjusting the books.* This chapter shows the adjusting process as it moves from the unadjusted trial balance to the adjusted trial balance.

REAL WORLD EXAMPLE

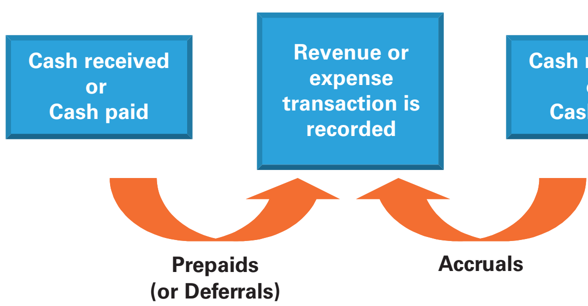
This monthly end-of-the-period process of updating the accounts is called "month end" and keeps many accounting department staff members very busy!

Prepaids (Deferrals) and Accruals

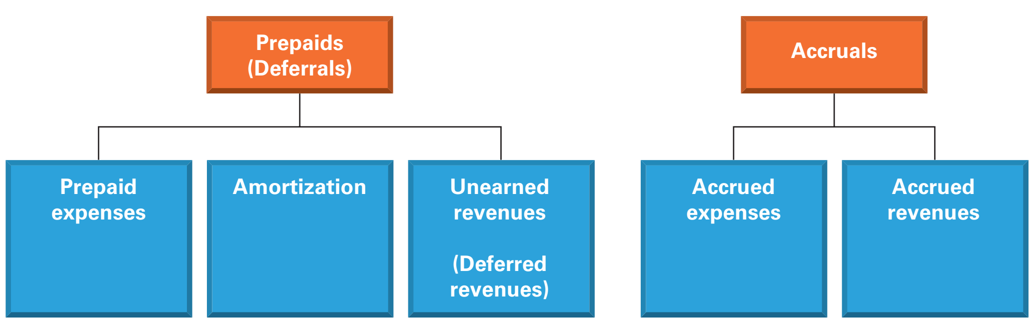
Two basic types of adjustments are *prepaids* and *accruals.* In a *prepaid*-type adjustment, the cash is paid or received before the related expense or revenue is recorded. Prepaids are also called *deferrals* because the recording of the expense or the revenue is deferred to periods after cash is paid or received. *Accrual*-type adjustments are the opposite of prepaids. For accruals, we record the expense or revenue before the related cash is paid or received. The following timeline helps to show the difference between prepaids and accruals:

LEARNING TIPS

Watch out! Accrual-basis accounting and accruals are not exactly the same thing! *Accrual-basis accounting* means recording transactions as they happen even if no cash is exchanged. There are two types of adjustments required to accomplish accrual-basis accounting: prepaids and *accruals.*



Adjusting entries can be further divided into five categories:



The core of this chapter is the discussion of these five categories of adjusting entries on pages 130–138. ***Study this material carefully because it is the most challenging topic in all of introductory accounting.***

Prepaid Expenses

KEY POINTS

Prepaid expenses are assets, not expenses.

Prepaid expenses are advance payments of expense. The category includes various assets that typically expire or are used up in the near future. Prepaid rent and prepaid insurance are examples of prepaid expenses. They are called "prepaid" expenses because they are expenses that are paid in advance. (Salary expense and utilities expense, among others, are *not* typical examples of prepaid expenses because they are rarely, if ever, paid in advance.) All companies, large and small, must make adjustments regarding prepaid expenses to show what has been used up and reflect an accurate asset balance on the balance sheet. For example, Tracy Daytona's makes prepayments for rent, tanning supplies, and insurance. Prepaid expenses are assets, not expenses, since they represent a potential future economic benefit.

REAL WORLD EXAMPLE

In a computerized accounting system, the adjusting entry could be created to occur automatically in each subsequent accounting period until the prepaid account has a zero balance.

Prepaid Insurance Business insurance is usually paid in advance. This prepayment creates an asset for the policyholder, because the policyholder has purchased the future benefit of insurance protection. Suppose HEC purchases a business liability insurance policy on April 1, 2014. The cost of the insurance is $3,600 for one year of coverage. The entry to record the payment is a debit to the asset account, Prepaid Insurance, as follows:

Apr. 1	Prepaid Insurance	3,600	
	Cash		3,600
	Paid annual premium for business liability insurance.		

After posting, Prepaid Insurance appears as follows:

ASSETS
Prepaid Insurance

Apr. 1	3,600		

The trial balance at April 30, 2014, lists Prepaid Insurance as an asset with a debit balance of $3,600. Throughout April, the Prepaid Insurance account maintains this beginning balance, as shown in Exhibit 3–4 (page 10). But $3,600 is *not* the amount of Prepaid Insurance for HEC's balance sheet at April 30, 2014. Why?

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Video: Prepaid Expenses

At April 30, Prepaid Insurance should be adjusted to remove from its balance the amount of insurance that has been used up, which is one month's worth. By definition, the amount of an asset that has been used, or has expired, is an *expense.* The adjusting entry transfers one-twelfth, or $300 ($\$3,600 \times \frac{1}{12}$), of the debit balance from Prepaid Insurance to Insurance Expense. The debit side of the entry records an increase in Insurance Expense and the credit records a decrease in the asset Prepaid Insurance.

Apr. 30	Insurance Expense	300	
	Prepaid Insurance		300
	To record insurance expense ($\$3,600 \times \frac{1}{12}$).		

After posting, Prepaid Insurance and Insurance Expense show correct ending balances at April 30, 2014 as follows:

ASSETS
Prepaid Insurance

Apr. 1	3,600	**Apr. 30**	**300**
Bal.	3,300		

EXPENSES
Insurance Expense

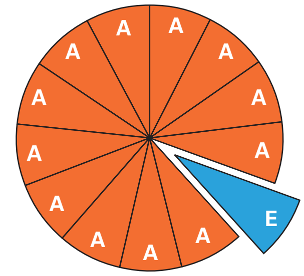
Apr. 30	**300**		
Bal.	300		

Correct asset amount, $3,300 which is 11/12 of $3,600 → **Total accounted for, $3,600** ← **Correct expense amount, $300 which is 1/12 of $3,600**

The full $3,600 has been accounted for. As shown in the diagram in the margin, eleven-twelfths measures the asset, and one-twelfth measures the expense. Recording this expense illustrates the matching objective. A similar journal entry would be made at the end of the month for the next eleven months, eventually bringing the Prepaid Insurance balance to zero and the Insurance Expense balance to $3,600.

The same analysis applies to a prepayment of 12 months' rent. The only difference is in the account titles, which would be Prepaid Rent and Rent Expense instead of Prepaid Insurance and Insurance Expense.

The chapter appendix shows an alternative treatment of prepaid expenses where the expense is recorded first and the adjusting entry sets up the asset. The end result on the financial statements is the same as that for the method given here.



A = One month's Prepaid Insurance of $300, an asset

E = April's Insurance Expense of $300, an expense

The whole circle represents the full year of insurance coverage divided into 12 monthly pieces.

Supplies Supplies are accounted for in the same way as prepaid expenses. Suppose that, on April 2, HEC paid cash of $1,500 for office supplies.

Apr. 2	Office Supplies	1,500	
	Cash		1,500
	Paid cash for office supplies.		

Assume that the business purchased no additional office supplies during April. The April 30 trial balance, therefore, lists Office Supplies with a $1,500 debit balance as shown in Exhibit 3–4. But HEC's April 30 balance sheet should *not* report supplies of $1,500. Why?

During April, HEC used supplies in performing services for clients. The cost of the supplies used is the measure of *supplies expense* for the month. To measure HEC's supplies expense during April, Lisa Hunter counts the supplies on hand at the end of the month. This is the amount of the asset still available to the business. Assume the count indicates that supplies costing $1,000 remain. Subtracting the entity's $1,000 of supplies on hand at the end of April from the cost of supplies available during April ($1,500) measures supplies expense during the month ($500).

Cost of asset available during the period	−	Cost of asset on hand at the end of the period	=	Cost of asset used (expense) during the period
$1,500	−	**$1,000**	=	**$500**

This same analysis could be done using a T-account:

ASSETS
Office Supplies

Apr. 2	1,500	
		Solve for the amount used during the period (in this case, $1,500 − $1,000 = $500)
Bal. Apr. 30	1,000	

The April 30 adjusting entry updates the Office Supplies account and records the supplies expense for April as follows:

Apr. 30	Supplies Expense	500	
	Office Supplies		500
	To record supplies expense ($1,500 − $1,000).		

After posting, the Office Supplies and Supplies Expense accounts hold correct ending balances:

ASSETS Office Supplies					EXPENSES Supplies Expense		
Apr 2	1,500	**Apr. 30**	**500**	→	**Apr. 30**	**500**	
Bal.	1,000				Bal.	500	

Correct asset amount, $1,000	→	Total accounted for, $1,500	←	Correct expense amount, $500

The Office Supplies account enters the month of May with a $1,000 balance, and the adjustment process is repeated each month until the asset is used up.

Amortization of Property, Plant, and Equipment, and Intangible Assets

LEARNING TIPS

An expense is recorded whenever a good or service is used. As plant and equipment are used, the portion of the cost that is used during the period is an expense called *amortization.*

The accrual basis of accounting also applies to how businesses account for capital assets. **Property, plant, and equipment (PPE)** are identifiable **tangible capital assets**, which are physical assets such as land, buildings, furniture, vehicles, machinery, and equipment. All of these tangible capital assets except land decline in usefulness as they age. This decline is an *expense* to the business. Land (or the "property" in "property, plant, and equipment") is the only tangible capital asset that does not decline in usefulness.

Accountants systematically spread the cost of each type of plant and equipment less any residual (or salvage) value over its *estimated* useful life. The *CICA Handbook* calls this process of allocating the cost of plant and equipment to an expense account over its life **amortization**. (Another term for amortization in common usage is *depreciation.*)

Many companies also acquire or use **intangible assets**, which are capital assets with no physical form such as patents and trademarks, in their business. An intangible asset should be amortized over its useful life. This topic will be discussed in more detail in Chapter 10.

Similarity to Prepaid Expenses The concept of accounting for plant and equipment and amortization expense is the same as for prepaid expenses. In a sense, plant and equipment are large prepaid expenses that expire over a number of periods. For both prepaid expenses and plant and equipment, the business purchases an asset that wears out or is used up. As the asset is used, more and more of its cost is transferred from the asset account to the expense account. The major difference between prepaid expenses and capital assets is the length of time it takes for the asset to lose its usefulness (or expire). Prepaid expenses usually expire within a year, whereas plant and equipment assets remain useful for a number of years.

REAL WORLD EXAMPLE

In the United States, depreciation is the term used for writing down tangible assets. Amortization is used for intangible assets. Many Canadian companies also use this convention as the *CICA Handbook* only *recommends* the use of the term amortization but does not require it.

Consider HEC's operations. Suppose that, on April 3, the business purchased furniture for $45,000 and made this journal entry:

Apr. 3	Furniture	45,000	
	Cash		45,000
	Purchased office furniture.		

After posting, the Furniture account appears as follows:

ASSETS Furniture		
Apr. 3	45,000	

In accrual-basis accounting, an asset is recorded when the furniture is acquired. Then, a portion of the asset's cost is transferred from the asset account to Amortization Expense each period that the asset is used. This method matches the asset's expense to the revenue of the period, which is an application of the matching objective.

Lisa Hunter believes the furniture will remain useful for five years and be virtually worthless at the end of its life. One common way to calculate the amount of amortization to be recorded is the straight-line method. It divides the cost of the asset (less any residual or salvage value) by its useful life so that the same amount of amortization is recorded for each full year the asset provides value to its owner:

$$\textbf{Straight-line Amortization Expense} = \frac{\text{Cost} - \text{Salvage value}}{\text{Useful life in years}}$$

In the case of HEC, the adjusting entries are prepared monthly, so the annual amortization expense must be divided by 12 to get the monthly cost. Other methods for calculating amortization will be covered in Chapter 10.

$$\begin{aligned}\text{Straight-line Amortization Expense} &= \frac{\text{Cost} - \text{Salvage value}}{\text{Useful life in years}} \\ &= \frac{\$45{,}000 - \$0}{5} \\ &= \$9{,}000 \text{ per year}\end{aligned}$$

To find the monthly expense amount:

- Divide the annual amount by 12: $9,000 ÷ 12 = $750 per month.

Alternatively:

- The useful life could be shown as 60 months (5 years × 12 months = 60 months).
- The calculation would be $45,000 ÷ 60 = $750 per month.

Amortization expense for April is recorded by the following adjusting entry:

Apr. 30	Amortization Expense—Furniture	750	
	Accumulated Amortization—Furniture		750
	To record monthly amortization expense on furniture.		

The Accumulated Amortization Account Accumulated Amortization—Furniture is credited—not Furniture—because the original cost of any property, plant, and equipment acquisition should remain in the asset account as long as the business uses the asset. Accountants and managers may refer to the Furniture account to see how much the asset cost. This information is useful in a decision about whether to replace the furniture and the amount to pay. Accountants use the **Accumulated Amortization** account to show the cumulative sum of all amortization expense from the date of acquiring the tangible capital asset. Therefore, the balance in this account increases over the life of the asset—the account balance continues to "accumulate" over the life of the asset.

Accumulated Amortization is a *contra asset* account. It is an asset account with a normal credit balance. (Recall from Chapter 2, page 69, that the normal balance of an account is the side of the account where increases are recorded.) A **contra account** has two main characteristics:

- A contra account has a companion account.
- A contra account's normal balance (debit or credit) is the opposite of the companion account's normal balance.

In this case, Accumulated Amortization—Furniture is the contra account that accompanies Furniture. It appears in the ledger directly after Furniture. Furniture has a debit balance, and therefore Accumulated Amortization—Furniture, a contra asset, has a credit balance. *All contra asset accounts have credit balances.*

REAL WORLD EXAMPLE

As with prepaid expenses, in most accounting software programs, the adjusting entry for amortization can be programmed to occur automatically each month for the duration of the asset's life.

MyAccountingLab

Video: Fixed Assets and Depreciation

KEY POINTS

Use a separate Amortization Expense account and Accumulated Amortization account for each major type of tangible asset. (Amortization Expense—Furniture, Amortization Expense—Buildings, and so on.)

A business carries an accumulated amortization (or accumulated depreciation) account for each depreciable tangible asset. If a business has a building and a machine, for example, it will carry the accounts Accumulated Amortization—Building, and Accumulated Amortization—Machine.

After posting the amortization, the Furniture, Accumulated Amortization—Furniture, and Amortization Expense—Furniture accounts of HEC are as follows:

ASSETS Furniture			CONTRA ASSET Accumulated Amortization— Furniture			EXPENSES Amortization Expense— Furniture		
Apr. 3	45,000			**Apr. 30**	**750**	**Apr. 30**	750	
Bal.	45,000			Bal.	750	Bal.	750	

Carrying Value The balance sheet reports both Furniture and Accumulated Amortization—Furniture. Because it is a contra account, the balance of Accumulated Amortization—Furniture is subtracted from the balance of Furniture. This net amount (cost minus accumulated amortization) of a capital asset is called its **carrying value**, or *net carrying value*, or *book value*, as shown for Furniture:

Furniture	$45,000
Less: Accumulated Amortization—Furniture	750
Furniture, net	$44,250

Suppose HEC owns a building that cost $120,000, on which annual amortization is $6,000. The amount of amortization for one month would be $500 ($6,000 ÷ 12), and the following entry records amortization for April.

Apr. 30	Amortization Expense—Building	500	
	Accumulated Amortization—Building		500
	To record monthly amortization on building.		

The balance sheet at April 30 would report HEC's property, plant, and equipment as shown in Exhibit 3–5.

REAL WORLD EXAMPLE

The Accumulated Amortization accounts may or may not be combined on the balance sheet and the Amortization Expense accounts may or may not be combined on the income statement. It depends on the company and its financial-statement presentation.

EXHIBIT 3–5 Property, Plant, and Equipment on the Balance Sheet of Hunter Environmental Consulting (April 30)

Property, Plant, and Equipment		
Furniture	$ 45,000	
Less: Accumulated amortization—furniture	750	$ 44,250
Building	120,000	
Less: Accumulated amortization—building	500	119,500
Property, Plant, and Equipment, Net		$163,750

Exhibit 3–6 shows information about Gildan Activewear Inc., the company whose financial statements appear in Appendix A of this text and on MyAccountingLab. In its 2011 financial statements, the balance sheet reports Property, Plant, and Equipment of $565,398 (amount in thousands of U.S. dollars) and Note 4 of the financial statements shows the details. The first column shows the cost, the middle column shows the accumulated depreciation (the term used by Gildan), and the third column shows the net book value (carrying value) for each type of capital asset.

EXHIBIT 3–6 Reporting of Property, Plant, and Equipment for Gildan Activewear Inc. (Amounts in Thousands of U.S. Dollars) from Appendix A

From Note 4 of the financial statements:

	Cost	Accumulated Amortization	Net Book Value
Land	$ 35,549	$ —	$ 35,549
Buildings and improvements	196,531	47,124	149,407
Manufacturing equipment	511,543	227,935	283,608
Other equipment	99,256	49,970	49,286
Assets not yet utilized in operations	47,548	—	47,548
Total	$890,427	$325,029	$565,398

Let's now return to HEC's situation.

Accrued expenses

Businesses incur many expenses before they pay cash. Payment is not due until later but no bill or invoice is provided to signal the payable. Consider an employee's salary. An employee earns pay every day but is not paid daily. The employer's salary expense and salary payable grow as the employee works, so the liability is said to *accrue.* Another example is interest expense on a note payable. Interest accumulates over time but, by the terms of the agreement, is only paid at a later date. This interest liability must be shown on the financial statements.

The term **accrued expense** refers to an expense that the business has incurred but has not yet paid. An accrued expense *always* creates a liability. Therefore, accrued expenses can be viewed as the opposite of prepaid expenses.

It is time-consuming to make hourly, daily, or even weekly journal entries to accrue expenses. Consequently, the accountant waits until the end of the period. Then an adjusting entry brings each expense (and related liability) up to date just before the financial statements are prepared.

KEY POINTS

Prepaid expenses and accrued expenses are opposites. A prepaid expense is paid first and expensed later. An accrued expense is expensed first and paid later.

Accruing Salaries Expense Most companies pay their employees at predetermined times. Suppose HEC pays its two employees $4,000 bi-monthly (on the 15th and on the last day of the month). Suppose, for illustration purposes, that this is the calendar for April with the two paydays circled:

APRIL

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30

MyAccountingLab

Video: Accrued Expenses

Assume that, if either payday falls on a weekend, HEC pays the employees on the following Monday.

During April, HEC paid its employees' salaries of $4,000 on Friday, April 15, and recorded the following entry:

Apr. 15	Salaries Expense	4,000	
	Cash		4,000
	To pay salary.		

LEARNING TIPS

One way of thinking about an accrued expense is that it is like an accounts payable but without an invoice.

REAL WORLD EXAMPLE

The account Salaries Expense can also be called Salary Expense if there is one employee, or Wages Expense, or Salaries and Wages Expense. These accounts all refer to payments to employees for the work they have done for a company.

After posting, the Salaries Expense account is

EXPENSES
Salaries Expense

Apr. 15	4,000	

The trial balance at April 30 (Exhibit 3–4, page 128) includes Salaries Expense, with its debit balance of $4,000. Because April 30, the second payday of the month, falls on a Saturday, the second $4,000 payment will be made on Monday, May 2. Without an adjusting entry, this second $4,000 amount is not included in the April 30 trial balance amount for Salaries Expense, even though the expense has been incurred. Therefore, at April 30, the business adjusts for additional *salaries expense* and *salaries payable* of $4,000 by recording an increase in each of these accounts as follows:

Apr.	30	Salaries Expense	4,000	
		Salaries Payable		4,000
		To accrue salaries expense.		

After posting, the Salaries Expense and Salaries Payable accounts are updated to April 30:

EXPENSES
Salaries Expense

Apr. 15	4,000	
Apr. 30	**4,000**	
Bal.	8,000	

LIABILITIES
Salaries Payable

	Apr. 30	**4,000**
	Bal.	4,000

REAL WORLD EXAMPLE

Many companies, such as Tracy Daytona's, pay their employees on the last business day *before* the end of the period, to allow employees to make rent and other payments due at the beginning of the month. In such a situation, no accrual for Salaries Expense would be made.

The accounts at April 30 now contain the complete salaries information for the month of April. The expense account has a full month's salaries, and the liability account shows the portion that the business still owes at April 30.

HEC will record the payment of this liability on Monday, May 2 as follows:

May	2	Salaries Payable	4,000	
		Cash		4,000
		To record the payment of the salary payable.		

This payment entry does not affect April or May expenses because the April expense was recorded on April 15 and April 30. This entry only records the payment of the payable. May expense will be recorded in a like manner, starting on May 15.

All accrued expenses are recorded with similar entries—a debit to the appropriate expense account and a credit to the related liability account.

Accrued Revenues

LEARNING TIPS

One way of thinking about an accrued revenue is that it is like an accounts receivable but without an invoice.

In this case, it would be inappropriate to send an invoice for the part of the work completed as the agreement is for payment of a monthly amount on the 15th of the month. Work was completed so the revenue must be recognized with an adjusting entry.

As we have just seen, expenses can occur before the cash payment, and that creates an accrued expense. Likewise, businesses often earn revenue before they collect the cash. Collection occurs later. Revenue that has been earned but not yet invoiced or collected is called an **accrued revenue**.

Assume HEC is hired on April 15 by Rock Creek Development to provide environmental consulting services on a monthly basis. Under this agreement, Rock Creek will pay HEC $3,000 monthly, with the first payment on May 15. During April, HEC will earn half a month's fee, $1,500, for work performed April 15 through April 30. On April 30, HEC makes the following adjusting entry to record an increase in Accounts Receivable and Service Revenue:

Apr.	30	Accounts Receivable	1,500	
		Service Revenue		1,500
		To accrue service revenue ($3,000 × $\frac{1}{2}$).		

We see from the unadjusted trial balance in Exhibit 3–4 (page 128) that Accounts Receivable has an unadjusted balance of $14,000. The Service Revenue unadjusted balance is $24,000. Posting the April 30 adjustment has the following effects on these two accounts:

ASSETS
Accounts Receivable

	14,000	
Apr. 30	**1,500**	
Bal.	15,500	

REVENUES
Service Revenue

		24,000
	Apr. 30	**1,500**
	Bal.	25,500

This adjusting entry illustrates the concept of revenue recognition. Without the adjustment, HEC's financial statements would be misleading—they would understate Accounts Receivable and Service Revenue by $1,500 each.

All accrued revenues are accounted for similarly: debit a receivable account and credit a revenue account.

Unearned Revenues

Some businesses collect cash from customers in advance of doing work for them. Receiving cash in advance creates a liability called **unearned revenue** or **deferred revenue**. The company owes a product or service to the customer or the money back. Only when the job is completed will the business have earned the revenue.

Suppose a developer, River Rock Real Estate, engages HEC to provide consulting services, agreeing to pay $3,000 monthly in advance beginning immediately. Suppose HEC receives in advance the first payment and begins work on April 20. HEC records the cash receipt and the related increase in the business's liabilities as follows:

Apr. 20	Cash	3,000	
	Unearned Service Revenue		3,000
	Received revenue in advance.		

After posting, the account appears as follows:

LIABILITIES
Unearned Service Revenue

	Apr. 20	3,000

Unearned Service Revenue is a liability because it represents HEC's obligation to perform service for the client. The April 30 unadjusted trial balance (Exhibit 3–4) lists Unearned Service Revenue with a $3,000 credit balance prior to the adjusting entries. During the last 10 days of the month—April 21 through April 30—HEC will have *earned* one-third (10 days divided by April's total 30 days) of the $3,000, or $1,000. Therefore, the accountant makes the following adjustment to decrease the liability, Unearned Service Revenue, and to record an increase in Service Revenue as follows:

Apr. 30	Unearned Service Revenue	1,000	
	Service Revenue		1,000
	To record service revenue earned and paid from the advance ($3,000 × $\frac{1}{3}$).		

This adjusting entry shifts $1,000 of the total amount of unearned service revenue from the liability account to the revenue account. After posting, the balance of Service Revenue is increased by $1,000 (10 days of revenue was earned) and the balance of Unearned Service Revenue has been reduced by $1,000 to $2,000 (as less

KEY POINTS

An unearned revenue is a liability, *not* a revenue. With all unearned revenue, cash is received before the work is performed or the goods are delivered.

REAL WORLD EXAMPLE

An unearned revenue to one company is a prepaid expense to the company that made the payment. Consider River Rock Real Estate. River Rock had prepaid for consulting services—an asset. HEC had unearned consulting revenue—a liability.

MyAccountingLab

Videos: Unearned Revenue and Unearned Revenue Adjusting Entries work (only 20 days) is still unearned, or due to be performed). Now, both accounts have their correct balances at April 30, as follows:

LIABILITIES
Unearned Service Revenue

Apr. 30	**1,000**	Apr. 20	3,000
		Bal.	2,000

REVENUES
Service Revenue

		24,000
	Apr. 30	1,500
	Apr. 30	**1,000**
	Bal.	26,500

Correct liability amount, $2,000 (which is 2/3 of $3,000, or 20 days of work due) → **Total accounted for, $3,000** ← **Correct revenue amount, $1,000 (which is 1/3 of $3,000, or 10 days of revenue earned)**

All types of revenues that are collected in advance are accounted for similarly: debit a liability (to reduce the liability) and credit a revenue (to increase the revenue). Remember, an unearned revenue is a liability, not a revenue.

Summary of the Adjusting Process

Exhibit 3–7 summarizes the timing of prepaid-type and accrual-type adjusting entries (in blue) and shows the related journal entries made before or after them.

EXHIBIT 3–7 | Timing of Prepaid and Accrual Adjustments* (Examples and amounts are from pages 12–20)

PREPAIDS—The cash transaction occurs initially. (The expense is incurred or the revenue is earned later.)

	Initially				Later		
Prepaid expenses	Pay expense in advance and record an asset:			→	Record the expense later and decrease the asset:		
	Prepaid Expense (e.g., Insurance)	3,600			Expense (e.g., Insurance)	300	
	Cash		3,600		Prepaid Expense (e.g., Insurance)		300
Amortization	Purchase the asset:			→	Record the expense later:		
	Asset (e.g., Furniture)	45,000			Amortization Expense—Asset (e.g., Furniture)	750	
	Cash		45,000		Accum. Amort.—Asset (e.g., Furniture)		750
Unearned revenues	Receive cash in advance and record unearned revenue (a liability):			→	Record the revenue later and decrease unearned revenue:		
	Cash	3,000			Unearned Revenue (e.g., Consulting)	1,000	
	Unearned Revenue (e.g., Consulting)		3,000		Revenue (e.g., Consulting Service)		1,000

ACCRUALS—The cash transaction occurs later. (The expense is incurred or the revenue is earned first.)

	Initially				Later		
Accrued expenses	Record (accrue) an expense first and the related payable:			→	Pay the liability later:		
	Expense (e.g., Salaries)	4,000			Payable (e.g., Salaries)	4,000	
	Payable (e.g., Salaries)		4,000		Cash		4,000
Accrued revenues	Record (accrue) a revenue first and the related receivable:			→	Collect cash later:		
	Receivable (e.g., from customer)	1,500			Cash	1,500	
	Revenue (e.g., Consulting Service)		1,500		Receivable (e.g., from customer)		1,500

The authors thank Darrel Davis and Alfonso Oddo for suggesting this exhibit.
*See the Appendix of this chapter for an alternative treatment of accounting for prepaid expenses and accruals.

No adjusting entry debits or credits Cash because the cash transactions are recorded at other times. (The exception to this rule is an adjusting entry that is made to correct an error involving Cash.) The chapter appendix shows an alternative treatment of unearned revenues and prepaid expenses.

The adjusting process has two purposes, which are summarized in Exhibit 3–8:

1. Accurately measure net income or net loss on the *income statement*. Every adjusting entry affects either a revenue or an expense account.
2. Update the *balance sheet*. Every adjusting entry affects either an asset or a liability account. Note that these are highlighted in Exhibit 3–8.

MyAccountingLab

Video: Roadmap to Adjusting Entries

LEARNING TIPS

Make note of the information in Exhibit 3–8—copy it somewhere or flag this page to study again later!

EXHIBIT 3–8 Summary of Adjusting Entries

		Type of Account	
	Category of Adjusting Entry	**Debited**	**Credited**
Prepaid-type	Prepaid expense	Expense	Asset
	Amortization	Expense	Contra asset
	Unearned revenue	Liability	Revenue
Accrual-type	Accrued expense	Expense	Liability
	Accrued revenue	Asset	Revenue

Adapted from material provided by Beverly Terry.

✓JUST CHECKING

MyAccountingLab

7. Check off Yes or No to indicate whether each of the following accounts would usually require an adjusting entry.

Account	Yes	No
Accounts Receivable		
Building		
Interest Payable		

Account	Yes	No
Supplies		
Cash		
Prepaid Insurance		

8. At the beginning of the month, Supplies were $500. During the month, the company purchased $600 of supplies. At month's end, $400 of supplies were still on hand.
   a. What was the cost of supplies used during the month? Where is this item reported?
   b. What is the ending balance of Supplies? Where is this item reported?
   c. Make the adjusting entry to update the Supplies account at the end of the month.
9. Identify the accounts affected by each of the following transactions, and state whether each account is debited or a credited.

Transaction	Income Statement Account (Dr/Cr)	Balance Sheet Account (Dr/Cr)
a. Revenue is earned but not yet billed.		
b. Prepaid rent expired during the month.		
c. Annual amortization is recorded.		
d. Salaries earned by employees has not been paid yet.		
e. Revenue was earned that was paid for by a customer in advance.		

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

EXHIBIT 3–9 | Journalizing and Posting the Adjusting Entries of Hunter Environmental Consulting

PANEL A: Information for Adjustments at April 30, 2014

a. Prepaid insurance expired during April, $300.
b. Supplies remaining on hand at April 30, 2014, $1,000.
c. Amortization on furniture for the month of April, $750.
d. Accrued salaries expense, $4,000.
e. Accrued service revenue, $1,500.
f. Amount of unearned service revenue that was earned during April, $1,000.

PANEL B: Adjusting Entries (there are no blank lines between journal entries to save space)

a. Insurance Expense	300	
Prepaid Insurance		300
To record insurance expense.		
b. Supplies Expense	500	
Office Supplies		500
To record supplies used.		
c. Amortization Expense—Furniture	750	
Accumulated Amortization—Furniture		750
To record amortization on furniture.		
d. Salaries Expense	4,000	
Salaries Payable		4,000
To accrue salaries expense.		
e. Accounts Receivable	1,500	
Service Revenue		1,500
To accrue service revenue.		
f. Unearned Service Revenue	1,000	
Service Revenue		1,000
To record unearned revenue that has been earned.		

PANEL C: Amounts Posted to T-Accounts

ASSETS

Cash

Bal. 31,000	

Accounts Receivable

Bal. 14,000	
(e) 1,500	
Bal. 15,500	

Office Supplies

Bal. 1,500	(b) 500
Bal. 1,000	

Prepaid Insurance

Bal. 3,600	(a) 300
Bal. 3,300	

Land

Bal. 50,000	

Furniture

Bal. 45,000	

Accumulated Amortization—Furniture

	(c) 750

LIABILITIES

Accounts Payable

	Bal. 12,000

Salary Payable

	(d) 4,000
	Bal. 4,000

Unearned Service Revenue

(f) 1,000	Bal. 3,000
	Bal. 2,000

OWNER'S EQUITY

Lisa Hunter, Capital

	Bal. 120,100

Lisa Hunter, Withdrawals

Bal. 6,000	

REVENUES

Service Revenue

	Bal. 24,000
	(e) 1,500
	(f) 1,000
	Bal. 26,500

EXPENSES

Amortization Expense—Furniture

(c) 750	
Bal. 750	

Insurance Expense

(a) 300	
Bal. 300	

Rent Expense

Bal. 3,000	

Salaries Expense

Bal. 4,000	
(d) 4,000	
Bal. 8,000	

Supplies Expense

(b) 500	
Bal. 500	

Utilities Expense

Bal. 1,000	

Exhibit 3–9 summarizes the adjusting entries of HEC at April 30. The adjustments are identified by their letter.

- Panel A of the exhibit briefly describes the data for each adjustment.
- Panel B gives the adjusting entries.
- Panel C shows the accounts after they have been posted.

The Adjusted Trial Balance

MyAccountingLab

Accounting Cycle Tutorial
Adjustments

LO 4
How do we get the accounting records ready to prepare the financial statements?

This chapter began with the trial balance before any adjusting entries—the unadjusted trial balance (Exhibit 3–4). After the adjustments are journalized and posted, the accounts appear as shown in Exhibit 3–9, Panel C. A useful step in preparing the financial statements is to list the accounts, along with their adjusted balances, on an **adjusted trial balance**. This document has the advantage of listing all the accounts and their adjusted balances in a single place. Exhibit 3–10 shows the preparation of the adjusted trial balance.

Exhibit 3–10 shows the first six columns of a *work sheet*. We will consider the complete work sheet in Chapter 4. For now, simply note how clearly this format presents the data. The information in the Account Title column and in the Trial Balance columns is drawn directly from the ledger (in our example, from the T-accounts in Exhibit 3–9). The two Adjustments columns list the debit and credit adjustments directly across from the appropriate account title. Each adjusting debit and credit is identified by a letter in parentheses that refers to the adjusting entry

EXHIBIT 3–10 | Preparation of the Adjusted Trial Balance

HUNTER ENVIRONMENTAL CONSULTING
Preparation of Adjusted Trial Balance
April 30, 2014

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	
Cash	31,000				31,000		
Accounts receivable	14,000		(e) 1,500		15,500		
Supplies	1,500			(b) 500	1,000		
Prepaid insurance	3,600			(a) 300	3,300		
Furniture	45,000				45,000		
Accumulated amortization—furniture		0		(c) 750		750	Balance Sheet (Exhibit 3–13)
Land	50,000				50,000		
Accounts payable		12,000				12,000	
Salaries payable		0		(d) 4,000		4,000	
Unearned service revenue		3,000	(f) 1,000			2,000	
Lisa Hunter, capital		120,100				120,100	Statement of Owner's Equity (Exhibit 3–12)
Lisa Hunter, withdrawals	6,000				6,000		
Service revenue		24,000		(e) 1,500 (f) 1,000		26,500	
Amortization expense	0		(c) 750		750		
Insurance expense	0		(a) 300		300		
Rent expense	3,000				3,000		Income Statement (Exhibit 3–11)
Salaries expense	4,000		(d) 4,000		8,000		
Supplies expense	0		(b) 500		500		
Utilities expense	1,000				1,000		
	159,100	159,100	8,050	8,050	165,350	165,350	

LEARNING TIPS

To make it easier to add up the amounts across the columns, consider the following rules for where to write the balance:

- A debit + a debit = a debit
- A credit + a credit = a credit
- When there is a debit and a credit, the difference between the amounts goes on the side that started with the greater number.

in Exhibit 3–9. For example, the debit labelled (a) on the work sheet refers to the debit adjusting entry of $300 to Insurance Expense in Panel B of Exhibit 3–9. The corresponding credit—labelled (a)—refers to the $300 credit to Prepaid Insurance.

The Adjusted Trial Balance columns give the adjusted account balances. Each amount on the adjusted trial balance of Exhibit 3–10 is computed by combining the amounts from the unadjusted trial balance plus or minus the adjustments. For example, Accounts Receivable starts with a debit balance of $14,000. Adding the $1,500 debit amount from adjusting entry (e) gives Accounts Receivable an adjusted balance of $15,500. The supplies account begins with a debit balance of $1,500. After the $500 credit adjustment, its adjusted balance is $1,000. More than one entry may affect a single account, as is the case for Service Revenue. If an account is unaffected by the adjustments, it will show the same amount on both the adjusted and unadjusted trial balances. This is true for the Cash, Furniture, Accounts Payable, and Lisa Hunter, Withdrawals accounts, to name a few.

Companies use accounting software to print out an unadjusted trial balance. For example, at Tracy Daytona's, the accounting software is used to print a monthly trial balance. The accountant then analyzes the amounts on the trial balance. This analysis results in the adjusting entries. Tracy Daytona's posts the adjusting entries to update its ledger accounts. The unadjusted trial balance has now become the company's *adjusted* trial balance.

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10. The following information was taken from Wing Company's unadjusted trial balance and shows a few related adjusting entries from the company's journal. Calculate the adjusted trial balance amounts for each account shown.

Account Title	Partial Unadjusted Trial Balance		Related Adjustments		Partial Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	2,900					
Supplies	4,000			1,000		
Prepaid insurance	4,800			1,600		
Truck	40,000					
Accumulated amortization—truck		24,800		7,000		
Unearned revenue		2,500	1,500			

11. The following information was taken from Petawawa Company's unadjusted trial balance and adjusted trial balance. Calculate the adjustment amounts for each account shown. Only one adjustment affected each account.

Account Title	Partial Unadjusted Trial Balance		Related Adjustments		Partial Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Supplies	6,000				2,500	
Prepaid insurance	3,200				1,800	
Unearned revenue		5,500				1,500
Service revenue		55,000				58,000
Insurance expense	0				1,500	
Supplies expense	2,900				5,900	

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

KEY POINTS

The differences between the amounts in the unadjusted trial balance in Exhibit 3–4 and in the adjusted trial balance of Exhibit 3–10 result from the adjusting entries. If the adjusting entries were not given, you could determine them by computing the differences between the adjusted and unadjusted amounts.

Preparing the Financial Statements from the Adjusted Trial Balance

LO 5
Remind me. How do we make financial statements?

The April financial statements of Hunter Environmental Consulting (HEC) can be prepared from the adjusted trial balance in Exhibit 3–10. The right margin shows how the accounts are distributed from the adjusted trial balance to three of the four main financial statements.

- The income statement (Exhibit 3–11) is created using the revenue and expense accounts.
- The statement of owner's equity (Exhibit 3–12) shows the reasons for the change in the owner's capital account during the period.
- The balance sheet (Exhibit 3–13) reports the assets, liabilities, and owner's equity.

The essential features of all financial statements are as follows:

Heading:

- Name of the entity
- Title of the statement
- Date of the statement, or period covered by the statement

Body of the statement Many large companies list expenses in descending order of amount, as shown in Exhibit 3–11; many small and medium-sized companies list expenses in alphabetical or account number order. However, Miscellaneous Expense, a catch-all account for expenses that do not fit in another category, is usually reported last. Miscellaneous Expense should be a relatively low dollar amount. If it is not, new expense accounts should be created.

Relationships among the Three Financial Statements

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Accounting Cycle Tutorial
Financial Statements

The arrows in Exhibits 3–11, 3–12, and Exhibit illustrate the relationships among the income statement, the statement of owner's equity, and the balance sheet. (The relationships among the financial statements were introduced in Chapter 1, page 24.) Consider why the income statement is prepared first and the balance sheet last.

1. The income statement reports net income or net loss, calculated by subtracting expenses from revenues. Because revenues and expenses are owner's equity accounts, their net figure is then transferred to the statement of owner's equity. Note that net income in Exhibit 3–11, $12,950, increases owner's equity in Exhibit 3–12. A net loss would decrease owner's equity.
2. Capital is a balance sheet account, so the ending balance in the statement of owner's equity is transferred to the balance sheet. To solidify your understanding of this relationship, trace the $127,050 figure from Exhibit 3–12 to Exhibit 3–13.

You may be wondering why the total assets on the balance sheet ($145,050 in Exhibit 3–13) do not equal the total debits on the adjusted trial balance ($165,350 in Exhibit 3–10). Likewise, the total liabilities and owner's equity do not equal the total credits on the adjusted trial balance ($165,350 in Exhibit 3–10). One reason for these differences is that Accumulated Amortization—Furniture and Lisa Hunter, Withdrawals are contra accounts. Recall that contra accounts are

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Review the Animation from Chapter 1: Relationships among the Financial Statements *subtracted* from their companion accounts on the balance sheet. However, on the adjusted trial balance, contra accounts are *added* as a debit or credit in their respective columns.

EXHIBIT 3–11 | Income Statement

HUNTER ENVIRONMENTAL CONSULTING		
Income Statement		
For the Month Ended April 30, 2014		
Revenue:		
Service revenue		$26,500
Expenses:		
Salaries expense	$8,000	
Rent expense	3,000	
Utilities expense	1,000	
Amortization expense	750	
Supplies expense	500	
Insurance expense	300	
Total expenses		13,550
Net income		$12,950

EXHIBIT 3–12 | Statement of Owner's Equity ①

HUNTER ENVIRONMENTAL CONSULTING	
Statement of Owner's Equity	
For the Month Ended April 30, 2014	
Lisa Hunter, capital, April 1, 2014	$120,100
Add: Net income	12,950
	133,050
Less: Withdrawals	6,000
Lisa Hunter, capital, April 30, 2014	$127,050

EXHIBIT 3–13 | Balance Sheet ②

HUNTER ENVIRONMENTAL CONSULTING				
Balance Sheet				
April 30, 2014				
Assets			**Liabilities**	
Cash		$ 31,000	Accounts payable	$ 12,000
Accounts receivable		15,500	Salaries payable	4,000
Supplies		1,000	Unearned service revenue	2,000
Prepaid insurance		3,300		
Furniture	$45,000		Total liabilities	18,000
Less: Accumulated amortization—furniture	750	44,250	**Owner's Equity**	
Land		50,000	Lisa Hunter, capital	127,050
Total assets		$145,050	Total liabilities and owner's equity	$145,050

WHY IT'S DONE THIS WAY

A primary focus in this chapter has been on various types of adjustments. You now know that these adjustments are all"non-cash"and they are recorded to provide more relevant financial statements to users. In terms of the accounting framework in Exhibit 1–6 in Chapter 1 (and on the back inside cover of this book), let's take a closer look at the role of adjustments.

A good example of this role can be found by examining prepaid accounts. Assume that a company has purchased its business insurance for the next year. If we look at ***Level 4*** of the accounting framework, we quickly realize that this transaction should be recognized as a financial transaction and we should measure the transaction at its cost. ***Level 3*** of the accounting framework tells us that the company would categorize this transaction as an asset, since there is future economic benefit to the company—the company has insurance coverage for the next year. Thus, we have now recognized an asset, which is prepaid insurance. By recording and measuring the transaction in this manner, we have provided information that is relevant and reliable at the time the insurance is purchased.

As the year goes along, however, we use up the prepaid asset. The insurance coverage will expire a year from the date it was purchased, so the value of the prepaid asset declines with the passage of time. If we were to prepare the financial statements five months after the insurance was purchased, would the balance sheet be relevant if it still showed the prepaid insurance at its original cost? The answer is no. Since the insurance policy only has seven months of coverage remaining, we need to adjust the value of the prepaid insurance by expensing the used-up portion. By completing the adjustment, our financial statements remain both reliable and relevant to users (***Level 2*** of the accounting framework) and the balance sheet and income statement will communicate useful information to users (***Level 1***).

Ethical Issues in Accrual Accounting

Like most other aspects of life, accounting poses ethical challenges. At the most basic level, accountants must be honest in their work. Only with honest and complete information, including accounting data, can people expect to make wise decisions. An example will illustrate the importance of ethics in accrual accounting.

Suppose Hunter Environmental Consulting (HEC) has been quite successful, so Lisa Hunter decides to open a second office. She needs to borrow $50,000 to set it up with computers, furniture, and minor renovations. Suppose further that HEC understated expenses purposely to make net income higher than it should be on the company's income statement. This could be accomplished by not accruing expenses so that the total expenses are reported at an amount lower than their true amount. A banker could be tricked into lending money to HEC because the company appears to be more profitable than it really is. Then, if HEC could not repay the loan, the bank might lose money if Lisa Hunter cannot repay HEC's loan herself—all because the banker relied on incorrect accounting information.

Accrual accounting provides several opportunities for unethical accounting. Recall from earlier in this chapter that amortization expense is an estimated figure. No business can foresee exactly how long its buildings and equipment will last, so accountants must estimate these assets' useful lives. Accountants then record amortization on capital assets over their *estimated* useful lives. A dishonest proprietor could buy a five-year asset and amortize it over 10 years. For each of the first five years, the company will report less amortization expense, and more net income, than it should. Or a dishonest business owner could overlook amortization expense altogether. Failing to record amortization would overstate net income. In both these situations, people who rely on the company's financial statements, such as bank lenders, can be deceived into doing business with the company. Accounting information must be honest and complete—completely ethical—to

REAL WORLD EXAMPLE

The rules of conduct of the various professional accounting associations (discussed in Chapter 1) prohibit accountants from being associated with false or misleading financial information.

serve its intended purpose. As you progress through introductory accounting, you will see other situations that challenge the ethics of accountants.

The cash basis of accounting poses fewer ethical challenges because cash is not an estimated figure. Either the company has the cash, or it does not. Therefore, the amount of cash a company reports is rarely disputed. By contrast, adjusting entries for accrued expenses, accrued revenues, and amortization must often be estimated. Whenever there is an estimate, the accountant may be asked by managers or owners of the business to use the adjusting process to make the company look different from its true condition. Even with added ethical challenges, the accrual basis provides more complete accounting information than the cash basis. That is why accounting rests on the accrual basis.

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12. Examine HEC's adjusted trial balance in Exhibit 3–10. Suppose the accountant forgot to record the $4,000 accrual of salaries expense at April 30. What net income would HEC have reported for April? What total assets, total liabilities, and total owner's equity would the balance sheet have reported at April 30?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

LO 6

How does IFRS apply to adjusting entries?

Adjusting-Process Implications of International Financial Reporting Standards (IFRS)

The concept of accrual accounting is accepted around the world. The accounting guidelines for all countries recommend the use of accrual accounting. Consequently, the adjustment process that has been described in this chapter is applicable in all developed countries that provide standards for the preparation of financial statements.

The use of IFRS for publicly accountable enterprises has no direct impact on the adjusting process for these companies. Companies reporting under IFRS and ASPE go through the same adjusting process. In terms of the accrual journal entries we have seen in this chapter, the most significant difference between IFRS and ASPE is in the terms used in the amortization journal entries. IFRS specify that *depreciation* is the term to be used, whereas ASPE allow both *amortization* and *depreciation* to be used. Thus, you will see the terms *Accumulated Depreciation* and *Depreciation Expense* on IFRS financial statements. ASPE companies might choose to use the IFRS terms to be consistent with companies reporting under IFRS.

As we will see in future chapters, there is an impact on the way the financial statements are presented for companies reporting under IFRS versus ASPE. This topic will be discussed in Chapter 4.

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13. Do international financial reporting standards (IFRS) for publicly accountable enterprises in Canada have an impact on the adjusting process for these companies?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Summary Problem for Your Review

The unadjusted trial balance of Retail Employment Specialists pertains to November 30, 2014, which is the end of its year-long (fiscal) accounting period.

RETAIL EMPLOYMENT SPECIALISTS Unadjusted Trial Balance November 30, 2014		
Cash	$ 13,800	
Accounts receivable	10,000	
Supplies	2,000	
Furniture	20,000	
Accumulated amortization—furniture		$ 8,000
Building	100,000	
Accumulated amortization—building		60,000
Land	44,000	
Accounts payable		4,000
Salaries payable		0
Unearned service revenue		16,000
Gerry Barg, capital		64,000
Gerry Barg, withdrawals	50,000	
Service revenue		120,000
Salaries expense	32,000	
Supplies expense	0	
Amortization expense—furniture	0	
Amortization expense—building	0	
Miscellaneous expense	200	
Total	$272,000	$272,000

Data needed for the adjusting entries include:

a. A count of supplies on November 30 shows $400 of supplies on hand.
b. Amortization for the year on furniture, $4,000.
c. Amortization for the year on building, $2,000.
d. Salaries owed at year end but not yet paid, $1,000.
e. Service revenue that must be accrued, $2,600.
f. Of the $16,000 balance of unearned service revenue, $6,000 was earned during the year.

Required

1. Open the ledger accounts with their unadjusted balances using T-account format.
2. Journalize Retail Employment Specialists' adjusting entries at November 30, 2014. Identify entries by their letter as in Exhibit 3–9 (page 140).
3. Write the trial balance on a form as shown in Exhibit 3–10 (page 141), enter the adjusting entries, and prepare an adjusted trial balance on this form.
4. Prepare the income statement, the statement of owner's equity, and the balance sheet. Draw the arrows linking these three statements.
5. Post the adjusting entries into the T-accounts.

Key Fact: Fiscal year ended November 30, 2014.

SOLUTION

Requirements 1 and 5

For Requirement 1, create a T-account for each account name listed in the November 30, 2014, trial balance on the previous page. Insert the opening balances into the T-accounts from the trial balance, ensuring debit and credit balances on the trial balance are debit and credit balances in the T-accounts.

For Requirement 5, work slowly and check your work to make sure each transaction is posted to the proper T-account, and no transactions were missed.

ASSETS

Cash

Bal. 13,800	

Accounts Receivable

Bal. 10,000	
(e) 2,600	
Bal. 12,600	

Supplies

Bal. 2,000	(a) 1,600
Bal. 400	

Furniture

Bal. 20,000	

Accumulated Amortization—Furniture

	Bal. 8,000
	(b) 4,000
	Bal. 2,000

Building

Bal. 100,000	

Accumulated Amortization—Building

	Bal. 60,000
	(c) 2,000
	Bal. 62,000

Land

Bal. 44,000	

LIABILITIES

Accounts Payable

	Bal. 4,000

Salaries Payable

	(d) 1,000
	Bal. 1,000

Unearned Service Revenue

(f) 6,000	Bal. 16,000
	Bal. 10,000

OWNER'S EQUITY

Gerry Barg, Capital

	Bal. 64,000

Gerry Barg, Withdrawals

Bal. 50,000	

REVENUE

Service Revenue

	Bal. 120,000
	(e) 2,600
	(f) 6,000
	Bal. 128,600

EXPENSES

Salaries Expense

Bal. 32,000	
(d) 1,000	
Bal. 33,000	

Supplies Expense

(a) 1,600	
Bal. 1,600	

Amortization Expense—Furniture

(b) 4,000	
Bal. 4,000	

Amortization Expense—Building

(c) 2,000	
Bal. 2,000	

Miscellaneous Expense

Bal. 200	

Requirement 2

Refer to the rules shown in Exhibit 3–8, on page 139 to assist you with preparing the adjusting entries. (Blank lines do not appear between journal entries to save space.)

Transaction a is explained more fully: On the November 30, 2014, trial balance, Supplies has a balance of $2,000. If the supplies on hand at year end are $400, then make an adjusting entry for the $1,600 of supplies that were used ($2,000 – $400). Increase Supplies Expense (expense) and decrease Supplies (assets).

The remaining transactions do not require further calculations to determine the amounts of the adjustments.

	2014			
a.	Dec. 31	Supplies Expense	1,600	
		Supplies		1,600
		To record supplies used ($2,000 – $400).		
b.	Dec. 31	Amortization Expense—Furniture	4,000	
		Accumulated Amortization—Furniture		4,000
		To record amortization expense on furniture.		
c.	Dec. 31	Amortization Expense—Building	2,000	
		Accumulated Amortization—Building		2,000
		To record amortization expense on building.		
d.	Dec. 31	Salaries Expense	1,000	
		Salaries Payable		1,000
		To accrue salary expense.		
e.	Dec. 31	Accounts Receivable	2,600	
		Service Revenue		2,600
		To accrue service revenue.		
f.	Dec. 31	Unearned Service Revenue	6,000	
		Service Revenue		6,000

LEARNING TIPS This might be a helpful tool to use when creating the journal entries.

Assets		=	Liabilities		+	Owner's Equity										
Assets		=	Liabilities		+	Owner, Capital		−	Owner, Withdrawals		+	Revenues		−	Expenses	
Dr	Cr		Dr	Cr		Dr	Cr		Dr	Cr		Dr	Cr		Dr	Cr
+	−		−	+		−	+		+	−		−	+		+	−

Requirement 3

Write the account balances from the November 30, 2014, trial balance in the first two columns (the Trial Balance columns). Write the adjustment amounts from Requirement 2 in the next two columns. For each account name, add across (or subtract across) the amounts in the first four columns to fill in the Adjusted Trial Balance columns. Ensure total debits equal total credits for each pair of columns, then double underline the totals to show they are final.

RETAIL EMPLOYMENT SPECIALISTS
Preparation of Adjusted Trial Balance
November 30, 2014

	Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	13,800				13,800	
Accounts receivable	10,000		(e) 2,600		12,600	
Supplies	2,000			(a) 1,600	400	
Furniture	20,000				20,000	
Accumulated amortization—furniture		8,000		(b) 4,000		12,000
Building	100,000				100,000	
Accumulated amortization—building		60,000		(c) 2,000		62,000
Land	44,000				44,000	
Accounts payable		4,000				4,000
Salaries payable		0		(d) 1,000		1,000
Unearned service revenue		16,000	(f) 6,000			10,000
Gerry Barg, capital		64,000				64,000
Gerry Barg, withdrawals	50,000				50,000	
Service revenue		120,000		(e) 2,600		128,600
				(f) 6,000		
Salaries expense	32,000		(d) 1,000		33,000	
Supplies expense	0		(a) 1,600		1,600	
Amortization expense—furniture	0		(b) 4,000		4,000	
Amortization expense—building	0		(c) 2,000		2,000	
Miscellaneous expense	200				200	
	272,000	272,000	17,200	17,200	281,600	281,600

The title of each statement must include the name of the company, the name of the statement, and either the specific period of time covered or the date of the statement. It is critical that the time period be clearly defined.

Gather all the revenue and expense account names and amounts from the Adjusted Trial Balance columns of the work sheet.

Expenses are listed here from highest to lowest dollar amount, with Miscellaneous Expense always listed as the final expense item. They could also be listed alphabetically.

Requirement 4

RETAIL EMPLOYMENT SPECIALISTS Income Statement For the Year Ended November 30, 2014		
Revenues:		
Service revenue		$128,600
Expenses:		
Salaries Expense	$33,000	
Amortization expense—furniture	4,000	
Amortization expense—building	2,000	
Supplies expense	1,600	
Miscellaneous expense	200	
Total expenses		40,800
Net income		$ 87,800

①

Beginning owner's equity and withdrawals are from the Adjusted Trial Balance columns of the work sheet. The net income amount is transferred from the income statement.

RETAIL EMPLOYMENT SPECIALISTS Statement of Owner's Equity For the Year Ended November 30, 2014	
G. Barg, capital, December 1, 2013	$ 64,000
Add: Net income	87,800
	151,800
Less: Withdrawals	50,000
G. Barg, capital, November 30, 2014	$101,800

②

Note that the date format is different for the balance sheet. This statement shows the financial position on one specific date.

Gather all the asset and liability accounts and amounts from the Adjusted Trial Balance. The owner's equity amount is transferred from the statement of owner's equity.

It is vital that Total assets = Total liabilities + Owner's equity.

RETAIL EMPLOYMENT SPECIALISTS Balance Sheet November 30, 2014				
Assets			**Liabilities**	
Cash		$ 13,800	Accounts payable	$ 4,000
Accounts receivable		12,600	Salaries payable	1,000
Supplies		400	Unearned service revenue	10,000
Furniture	$20,000		Total liabilities	15,000
Less: Accumulated amortization	12,000	8,000	**Owner's Equity**	
Building	100,000		G. Barg, capital	101,800
Less: Accumulated amortization	62,000	38,000		
Land		44,000		
Total assets		$116,800	Total liabilities and owner's equity	$116,800

Summary

1 Learning Objective 1: Apply the recognition criteria for revenues and expenses.

When does a sale really happen? And when do we record an expense?

- The *recognition criteria for revenues tells one when to record revenue* and the amount of revenue to record. The *matching objective* guides accounting for expenses. It directs accountants to match expenses against the revenues earned during a particular period of time.

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2 Learning Objective 2: Distinguish accrual-basis accounting from cash-basis accounting.

Why can't we wait to record transactions until the cash comes in or cash goes out?

- *Accrual-basis accounting:* Business events are recorded as they occur. This is part of GAAP, and, therefore, a basis for ASPE and IFRS.
- *Cash-basis accounting:* Only those events that affect cash are recorded. It omits important events such as purchases and sales of assets on account. It also distorts the financial statements by labelling as expenses those cash payments that have long-term effects, such as the purchases of buildings and equipment.

Pg. 126

MyAccountingLab Video: Cash Basis versus Accrual Basis

3 Learning Objective 3: Make adjusting entries.

What is the adjusting process, and why is it important?

- *Adjusting entries* are made at the end of the period and they update the accounts for preparation of the financial statements. They can be divided into five categories: *prepaid expenses, amortization, accrued expenses, accrued revenues,* and *unearned revenues.*
- The formula for straight-line amortization is (Cost – Salvage value) ÷ Useful life.

Pg. 128

MyAccountingLab Videos: Accrued Expenses, Fixed Assets and Depreciation, Prepaid Expenses, Road Map to Adjusting Entries, Unearned Revenue, Unearned Revenue Adjusting Entries

4 Learning Objective 4: Prepare an adjusted trial balance.

How do we get the accounting records ready to prepare the financial statements?

- To prepare the *adjusted trial balance* using a form with columns, enter the adjusting entries next to the *unadjusted trial balance* first, then the adjusting entries in the next two columns, then compute each account's balance by adding or subtracting horizontally and placing the results in the *adjusted trial balance* columns.

Pg. 141

MyAccountingLab Animation: Accounting Cycle Tutorial (Adjustments)

5 Learning Objective 5: Prepare the financial statements from the adjusted trial balance.

Remind me. How do we prepare the financial statements?

- The three financial statements are related as follows: Income, shown on the *income statement*, increases the owner's capital, which also appears on the *statement of owner's equity*. The ending balance of capital is the last amount reported on the *balance sheet*.
- We can now trace the flow of accounting information through these steps:

  Business Transaction ⟶ Source Documents ⟶ Journal Entry ⟶ Posting to Ledger Accounts ⟶ Unadjusted Trial Balance ⟶ Adjusting Entries ⟶ Adjusted Trial Balance ⟶ Financial Statements

Pg. 143

MyAccountingLab Animation: Accounting Cycle Tutorial (Financial Statements)
Animation: Relationships Among the Financial Statements

6 Learning Objective 6: Describe the adjusting-process implications of international financial reporting standards (IFRS).

How does IFRS apply to adjusting entries?

- There is no significant impact on the adjusting process, as accrual accounting is necessary under both IFRS and ASPE.
- Companies reporting under IFRS must use the term *depreciation.* Companies reporting under ASPE can choose to use the term *amortization* or *depreciation.*

Pg. 146

A1 Appendix A1: Account for a prepaid expense recorded initially as an expense.		
Is there another way to record prepaids?	• Yes! First record the full amount of the payment made as an expense and then, at the end of the period, make an adjusting entry to record the portion of the payment that is still not used up.	**Pg. 152**
A2 Appendix A2: Account for an unearned (deferred) revenue recorded initially as a revenue.		
Is there another way to record unearned revenues?	• Yes! First record the full amount of the payment received as a revenue, and then, at the end of the period, make an adjusting entry to record the portion of the revenue that is still not earned.	**Pg. 153**

Check **Accounting Vocabulary** on page 155–156 for all key terms used in Chapter 3 and the **Glossary** on page 000 for all key terms used in the textbook.

CHAPTER REVIEW:

MyAccountingLab	Demo Doc: The Adjusting Process
MyAccountingLab	The Accounting Cycle Tutorial (Adjusting Entries)
MyAccountingLab	Student PowerPoint Slides
MyAccountingLab	Audio Chapter Summary

Note: All MyAccountingLab resources can be found in the Chapter Resources section and the Multimedia Library.

CHAPTER 3 APPENDIX

Alternative Treatment of Accounting for Prepaid Expenses and Unearned Revenues

LO A1
Is there another way to record prepaids?

Chapters 1 through 3 illustrate the most popular way to account for prepaid expenses and unearned revenues. This appendix illustrates an alternative—and equally appropriate—approach to handling prepaid expenses and unearned revenues.

Prepaid Expenses

Prepaid expenses are advance payments of expenses. Prepaid Insurance, Prepaid Rent, Prepaid Advertising, and Prepaid Legal Cost are prepaid expenses. Supplies that will be used up in the current period or within one year are also accounted for as prepaid expenses.

When a business prepays an expense—insurance, for example—it can debit an *asset* account (Prepaid Insurance) as illustrated in the chapter as follows:

Aug. 1	Prepaid Insurance	3,600	
	Cash		3,600

Alternatively, it can debit an *expense* account in the entry to record this cash payment:

Aug. 1	Insurance Expense	3,600	
	Cash		3,600

Regardless of the account debited, the business must adjust the accounts at the end of the period to report the correct amounts of the expense and the asset.

Prepaid Expense Recorded Initially as an Expense

Prepaying an expense creates an asset, as explained under the "Prepaid Insurance" heading on page 130. However, the asset may be so short-lived that it will expire in the current accounting period—within one year or less. Thus the accountant may decide to debit the prepayment to an expense account at the time of payment. A $4,800 cash payment for an advertising contract (for one year, in advance) on August 1, 2014, may be debited to Advertising Expense:

Aug. 1	Advertising Expense	4,800	
	Cash		4,800
	Bought a 12-month advertising contract.		

At December 31, 2014, only five months' prepayment has expired, leaving seven months' advertising still prepaid. In this case, the accountant must transfer $\frac{7}{12}$ of the original prepayment of $4,800, or $2,800, to Prepaid Advertising. At December 31, 2014, the business still has the benefit of the prepayment for January through July of 2011. The December 31, 2014, adjusting entry is as follows:

Adjusting Entries			
Dec. 31	Prepaid Advertising	2,800	
	Advertising Expense		2,800
	Prepaid advertising of $2,800 ($4,800 × $\frac{7}{12}$).		

After posting, the two accounts appear as follows:

ASSETS
Prepaid Advertising

Dec. 31 Adj. 2,800	
Dec. 31 Bal. 2,800	

7 months remaining

EXPENSES
Advertising Expense

Aug. 1 Payment 4,800	Dec. 31 Adj. 2,800
Dec. 31 Bal. 2,000	

5 months expired

The balance sheet for 2014 reports Prepaid Advertising of $2,800, and the income statement for 2014 reports Advertising Expense of $2,000, regardless of whether the business initially debits the prepayment to an asset account or to an expense account.

Unearned (Deferred) Revenues

LO A2 Is there another way to record unearned revenues?

Unearned (deferred) revenues arise when a business collects cash in advance of earning the revenue. The recognition of revenue is *deferred* until later when it is earned. Unearned revenues are liabilities because the business that receives cash owes the other party goods or services to be delivered later.

Unearned (Deferred) Revenue Recorded Initially as a Revenue

Receipt of cash in advance of earning the revenue creates a liability, as discussed earlier in this chapter. Another way to account for the initial receipt of cash is to credit a *revenue* account when the business receives the cash. If the business then earns all the revenue within the period during which it received the cash, no adjusting entry is needed at the end of the period. However, if the business earns only a part of the revenue during the period, it must make adjusting entries at the end of the period.

KEY POINTS

The required adjusting entry depends on the way the transaction was originally recorded.

(1) If the receipt of cash is recorded as a liability before it is earned, the adjusting entry is:

Unearned Revenue	XX	
Revenue		XX

(2) If the receipt of cash is originally recorded as revenue, the adjusting entry is:

Revenue	XX	
Unearned Revenue		XX

These entries are *not* interchangeable.

Suppose on October 1, 2014, a consulting firm records as consulting revenue the receipt of $18,000 cash for revenue to be earned over nine months. The cash receipt entry is

Oct. 1	Cash	18,000	
	Consulting Revenue		18,000
	Received revenue to be earned over nine months.		

At December 31 the firm has earned only $\frac{3}{9}$ of the $18,000, or $6,000. Accordingly, the firm makes an adjusting entry, to transfer the unearned portion ($\frac{6}{9}$ of $18,000, or $12,000) from the revenue account to a liability account as follows:

	Adjusting Entries		
Dec. 31	Consulting Revenue	12,000	
	Unearned Consulting Revenue		12,000
	Adjust for consulting revenue still to be earned.		

The adjusting entry moves the unearned portion ($\frac{6}{9}$ of $18,000, or $12,000) of the original amount into the liability account because the consulting firm still owes consulting service to the client during January through June of 2015. After posting, the total amount ($18,000) is properly divided between the liability account ($12,000) and the revenue account ($6,000), as follows:

LIABILITIES
Unearned Consulting Revenue

	Dec. 31 Adj. 12,000
	Dec. 31 Bal. 12,000

$^{2}/_{3}$ of the balance is still unearned

REVENUE
Consulting Revenue

Dec. 31 Adj. 12,000	Oct. 1 Receipt 18,000
	Dec. 31 Bal. 6,000

$^{1}/_{3}$ of the balance is earned.

The firm's 2014 income statement reports consulting revenue of $6,000, and the balance sheet at December 31, 2014, reports as a liability the unearned consulting revenue of $12,000, regardless of whether the business initially credits a liability account or a revenue account.

SELF-STUDY QUESTIONS

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. Accrual-basis accounting (*p. 126*)
   a. Results in higher income than cash-basis accounting
   b. Leads to the reporting of more complete information than does cash-basis accounting
   c. Is not acceptable under GAAP
   d. Omits adjusting entries at the end of the period
2. Under the recognition criteria for revenues, revenue is recorded (*pp. 125–126*)
   a. At the earliest acceptable time
   b. At the latest acceptable time
   c. After it has been earned, but not before
   d. At the end of the accounting period
3. The matching objective provides guidance in accounting for (*p. 125*)
   a. Expenses
   b. Owner's equity
   c. Assets
   d. Liabilities
4. Adjusting entries (*p. 128*)
   a. Assign revenues to the period in which they are earned
   b. Help to properly measure the period's net income or net loss
   c. Bring asset and liability accounts to correct balances
   d. Do all of the above
5. A building-cleaning firm began November with supplies of $210. During the month, the firm purchased supplies of $250. At November 30, supplies on hand total $160. Supplies expense for the period is (*p. 131*)
   a. $160
   b. $340
   c. $300
   d. $500

6. A building that cost $150,000 has accumulated amortization of $70,000. The carrying value of the building is (*p. 134*)
   a. $70,000   b. $150,000
   b. $80,000   d. $190,000
7. The adjusting entry to accrue salaries expense (*p. 135*)
   a. Debits Salaries Expense and credits Cash
   b. Debits Salaries Payable and credits Salaries Expense
   c. Debits Salaries Payable and credits Cash
   d. Debits Salaries Expense and credits Salaries Payable
8. A business received cash of $3,000 in advance for service that will be provided later. The cash receipt entry debited Cash and credited Unearned Revenue for $3,000. At the end of the period, $1,100 is still unearned. The adjusting entry for this situation will (*p. 129*)
   a. Debit Unearned Revenue and credit Revenue for $1,900
   b. Debit Unearned Revenue and credit Revenue for $1,100
   c. Debit Revenue and credit Unearned Revenue for $1,900
   d. Debit Revenue and credit Unearned Revenue for $1,100
9. The links among the financial statements are (*p. 143*)
   a. Net income from the income statement to the statement of owner's equity
   b. Ending capital from the statement of owner's equity to the balance sheet
   c. Net income from the balance sheet to the income statement.
   d. Both a and b above
10. Accumulated Amortization is reported on (*p. 133*)
   a. The balance sheet
   b. The income statement
   c. The statement of owner's equity
   d. Both a and b

Answers to Self-Study Questions

1. b
2. c
3. a
4. d
5. c ($210 + $250 − $160 = $300)
6. b ($150,000 − 70,000 = $80,000)
7. d
8. a ($3,000 received − $1,100 unearned = $1,900 earned)
9. d
10. a

ACCOUNTING VOCABULARY

Accounting period Time frame, or period of time, covered by financial statements and other reports *(p. 123).*

Accrual-basis accounting Accounting that recognizes (records) the impact of a business event as it occurs, regardless of whether the transaction affected cash *(p. 126).*

Accrued expense An expense that has been incurred but not yet paid in cash *(p. 136).*

Accrued revenue A revenue that has been earned but not yet received in cash *(p. 136).*

Accumulated amortization The cumulative sum of all amortization expense from the date of acquiring a capital asset *(p. 133).*

Adjusted trial balance A list of all the ledger accounts with their adjusted balances *(p. 141).*

Adjusting entry Entry made at the end of the period to assign revenues to the period in which they are earned and expenses to the period in which they are incurred. Adjusting entries help measure the period's income and bring the related asset and liability accounts to correct balances for the financial statements *(p. 129).*

Amortization The term the *CICA Handbook* uses to describe the writing off to expense of the cost of capital assets; also called *depreciation* *(p. 132).*

Carrying value (of property, plant, and equipment) The asset's cost less accumulated amortization *(p. 134).*

Cash-basis accounting Accounting that records only transactions in which cash is received or paid *(p. 126).*

Contra account An account that always has a companion account and whose normal balance is opposite that of the companion account *(p. 133).*

Deferred revenue Another name for unearned revenue *(p. 137).*

Intangible asset An asset with no physical form giving a special right to current and expected future benefits *(p. 132).*

Matching objective The basis for recording expenses. Directs accountants to identify all expenses incurred during the period, measure the expenses, and match them against the revenues earned during that same span of time *(p. 125).*

Prepaid expense A category of miscellaneous assets that is an advance payment of an expense that typically expires or gets used up in the near future. Examples include prepaid rent, prepaid insurance, and supplies *(p. 130).*

Property, plant, and equipment (PPE) Long-lived tangible capital assets, such as land, buildings, and equipment, used to operate a business *(p. 132).*

Recognition criteria for revenues The basis for recording revenues; tells accountants when to record revenue and the amount of revenue to record *(p. 124).*

Tangible capital asset Physical assets expected to be used beyond the current accounting period. Examples include land, building, and equipment *(p. 132).*

Time-period assumption Ensures that accounting information is reported at regular intervals *(p. 123).*

Unearned revenue A liability created when a business collects cash from customers in advance of doing work for the customer. The obligation is to provide a product or a service in the future. Also called *deferred revenue* *(p. 137)*.

SIMILAR ACCOUNTING TERMS

Accounting period	Reporting period
Accrual-basis accounting	Accrual accounting
Adjusting the accounts	Making the adjusting entries; adjusting the books
Amortization	Depreciation; depletion
Carrying value	Book value
Deferred	Unearned
Property, plant, and equipment (PPE)	Capital asset; plant asset; fixed asset; tangible capital asset

Assignment Material

QUESTIONS

1. Distinguish accrual-basis accounting from cash-basis accounting.
2. How long is the basic accounting period? What is a fiscal year? What is an interim period?
3. What two questions do the recognition criteria for revenues help answer?
4. Briefly explain the matching objective.
5. What is the purpose of making adjusting entries?
6. Why are adjusting entries usually made at the end of the accounting period, not during the period?
7. Name five categories of adjusting entries and give an example of each.
8. Do all adjusting entries affect the net income or net loss of the period? Include the definition of an adjusting entry.
9. Why must the balance of Supplies be adjusted at the end of the period?
10. Tascona Supply Company pays $4,800 for an insurance policy that covers four years. At the end of the first year, the balance of its Prepaid Insurance account contains two elements. What are the two elements, and what is the correct amount of each?
11. The title Prepaid Expense suggests that this type of account is an expense. If it is, explain why. If it is not, what type of account is it?
12. What is a contra account? Identify the contra account introduced in this chapter, along with the account's normal balance.
13. The manager of Fast-Out, a convenience store, presents the company's balance sheet to a banker to obtain a loan.

    The balance sheet reports that the company's property, plant, and equipment have a carrying value of $155,000 and accumulated amortization of $75,000. What does *carrying value* of property, plant, and equipment mean? What was the cost of the property, plant, and equipment?
14. Give the entry to record accrued interest revenue of $7,200.
15. Why is unearned revenue a liability? Give an example.
16. Identify the types of accounts (assets, liabilities, and so on) debited and credited for each of the five types of adjusting entries.
17. What purposes does the adjusted trial balance serve?
18. Explain the relationships among the income statement, the statement of owner's equity, and the balance sheet.

19. Richardson Auctioneers failed to record the following adjusting entries at December 31, the end of its fiscal year: (a) accrued expenses, \$1,500; (b) accrued revenues, \$1,700; and (c) amortization, \$3,000. Did these omissions cause net income for the year to be understated or overstated, and by what overall amount?

*20. A company pays \$3,000 on February 1 to rent its office for February, March, and April. Make journal entries dated February 1 to illustrate the two ways this company can record its prepayment of rent.

*21. *Diving Masters Magazine* received \$3,400 for magazine subscriptions in advance and recorded the cash receipt as Subscription Revenue. At the end of the year, only \$1,400 of this revenue has been earned. What is the required year-end adjusting entry?

STARTERS

Starter 3–1 *Sports Online Unlimited* sells annual subscriptions for magazines that are downloaded to customers monthly. The company collects cash in advance and then downloads the magazines to subscribers each month. Suppose the company collected \$80,000 for subscriptions for January to December.

Apply the recognition criteria for revenues to determine (1) when the company should record revenue for this situation and (2) the amount of revenue the company should record for the January-through-March downloads.

Applying the recognition criteria for revenues
1

Starter 3–2 Suppose you work summers house-sitting for people while they are away on vacation. Most of your customers pay you immediately after you finish a job. A few ask you to send them a bill. It is now June 30 and you have collected \$600 from cash-paying customers. Your remaining customers owe you \$1,400. How much service revenue would you have under the (a) cash basis and (b) accrual basis of accounting? Which method of accounting provides more information about your house-sitting business? Explain your answer.

Comparing accrual-basis accounting and cash-basis accounting
2
Service revenue: Cash basis \$600

Starter 3–3 Smith Barnes Designers uses a sophisticated art program for its design work. Suppose the company paid \$5,000 for a Dell computer. Describe how the company would account for the \$5,000 expenditure under (a) the cash basis and (b) the accrual basis. State in your own words why the accrual basis is more realistic for this situation.

Accrual-basis accounting versus cash-basis accounting for expenses
2

Starter 3–4 On April 1, 2014, you prepaid three months of rent, for a total of \$18,000. Give your adjusting entry to record rent expense at April 30, 2014. Include the date of the entry and an explanation. Then, using T-accounts, post to the two accounts involved, and show their balances at April 30, 2014.

Adjusting prepaid expenses
3

Starter 3–5 On May 1, your company paid cash of \$27,000 for computers that are expected to remain useful for three years. At the end of three years, the value of the computers is expected to be zero. Hint: use the formula found on page 133.

Make journal entries to record (a) purchase of the computers on May 1 and (b) amortization on May 31. Include dates and explanations, and use the following accounts: Computer Equipment; Accumulated Amortization—Computer Equipment; and Amortization Expense—Computer Equipment.

Recording amortization
3
(b) Amort. Expense \$750

Starter 3–6 Refer to the data in Starter 3–5.

1. Using T-accounts, post to the accounts listed in Starter 3–5, and show their balances at May 31.
2. What is the computer equipment's carrying value at May 31?

Recording amortization
3
2. Carrying value \$26,250

*These Questions cover Chapter 3 Appendix topics.

Accruing and paying interest expense
3

Starter 3–7 Suppose Ladner Environmental Services (LES) borrowed $50,000 on March 1 by signing a note payable to Royal Bank. LES's interest expense for the remainder of its fiscal year (March through May) is $450 per month.

1. Make LES's adjusting entry to accrue interest expense at May 31. Date the entry and include its explanation.
2. Using T-accounts, post to the two accounts affected by the adjustment.

Accounting for unearned revenues
3

Starter 3–8 *The Big Clipper Magazine* collects cash from subscribers in advance and then mails the magazines to subscribers over a one-year period. Give the adjusting entry that the company makes to record the earning of $10,000 of Subscription Revenue that was collected in advance. Include an explanation for the entry, as illustrated in the chapter.

Cash versus accrual basis
3

Starter 3–9 Starrs Bakery started 12 months ago as a supplier of gluten-free desserts to restaurants all over the province. During its first year of operations, it earned $62,000 in revenues and $51,000 in expenses. The business collected $58,000 from its customers and paid all but $2,500 to its suppliers. Starrs also prepaid $7,500 for prepaid rent and other expenses for the next year. Calculate the net income under the cash basis and then under the accrual basis.

Preparing an adjusted trial balance
4

Adjusted trial bal. total $24,600

Starter 3–10 Scissors Hair Stylists has begun the preparation of its adjusted trial balance as follows:

SCISSORS HAIR STYLISTS
Preparation of Adjusted Trial Balance
December 31, 2014

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	600					
Supplies	800					
Equipment	16,200					
Accumulated amortization—equipment		1,100				
Accounts payable		500				
Interest payable		0				
Note payable		2,900				
Suzanne Byrd, capital		5,300				
Service revenue		13,000				
Rent expense	4,800					
Supplies expense	0					
Amortization expense	0					
Interest expense	400					
	22,800	22,800				

Year-end data:

a. Supplies remaining on hand, $300
b. Amortization, $1,100
c. Accrued interest expense, $700

Complete the company's adjusted trial balance. Identify each adjustment by its letter. To save time, you may write your answer in the spaces provided on the adjusted trial balance.

Note: Starters 3–11 and 3–12 should be used only after completing Starter 3–10.

Starter 3–11 Refer to the data in Starter 3–10. Compute Scissors Hair Stylists' net income for the year ended December 31, 2014.

Computing net income
5

Starter 3–12 Refer to the data in Starter 3–10. Compute Scissors Hair Stylists' total assets at December 31, 2014. Remember that Accumulated Amortization is a contra asset.

Computing total assets
5
Total assets $14,900

EXERCISES

MyAccountingLab

Exercise 3–1

Applying accounting assumptions, criteria, and objectives
1

Identify the accounting assumption, criteria, or objective that gives the most direction on how to account for each of the following situations:

a. The owner of a business desires monthly financial statements to measure the financial progress of the business on an ongoing basis.
b. Expenses of $3,000 must be accrued at the end of the period to measure income properly.
c. A customer states her intention to switch travel agencies. Should the new travel agency record revenue based on this intention? Give the reason for your answer.
d. Expenses of the period total $6,000. This amount should be subtracted from revenue to compute the period's net income.

Exercise 3–2

Accrual-basis accounting
2

Severn Snowmobile Rentals had the following selected transactions during January:

Jan.	1	Paid cash for three month's rent on the showroom building (January, February, and March), $4,200.
	5	Paid electricity expenses, $600 cash.
	9	Received cash for the day's snowmobile rentals, $1,800.
	14	Paid cash for a snowmobile, $6,000. It is expected to last three years.
	23	Rented snowmobiles to a corporate group for a teambuilding event, $1,950. The corporation will pay in 30 days.
	31	Made an adjusting entry for January's rent (from January 1).
	31	Accrued salary expense for January, $850.

Show how each transaction would be handled using the accrual basis of accounting. Assume the company initially records a prepaid expense as an asset. Give the amount of revenue or expense for January. Journal entries are not required. Use the following format for your answer, and show your computations:

Severn Snowmobile Rentals—Amount of Revenue or Expense for January		
Date	Revenue or Expense	Accrual-Basis Amount

Exercise 3–3

Applying the recognition criteria for revenues and the matching objective, accrual basis versus cash basis
1 2
1. Net income $8.6 million

Dominion Storage operates approximately 300 mini-warehouses across Canada. The company's headquarters are in Medicine Hat, Alberta. During 2014, Dominion earned rental revenue of $26.0 million and collected cash of $23.6 million from customers. Total expenses for 2014 were $17.4 million, of which Dominion paid $15.9 million.

Required

1. Apply the recognition criteria for revenues and the matching objective to compute Dominion Storage's net income for 2014.
2. Identify the information that you did not use to compute Dominion Storage's net income. Give the reason for not using the information.

Applying accounting concepts
3
Excel Spreadsheet Template

Exercise 3–4

Write a memo to your supervisor explaining in your own words the concept of amortization as it is used in accounting. Use the following format:

Date:	(fill in)
To:	Supervisor
From:	(Student Name)
Subject:	The concept of amortization

Allocating prepaid expense to asset and expense
1 3
A. Insurance Expense $5,000

Exercise 3–5

Compute the amounts indicated by question marks for each of the following Prepaid Insurance situations. For situations A and B, make the needed journal entry. Consider each situation separately.

	Situation			
	A	B	C	D
Beginning Prepaid Insurance	$ 4,200	$ 5,000	$16,800	$ 5,900
Payments for Prepaid Insurance during the year	19,800	?	15,000	?
Total amount to account for	?	?	31,800	15,600
Ending Prepaid Insurance	19,000	6,000	?	6,000
Insurance Expense	?	$12,000	$25,000	$ 9,600

Determining adjustments
3

Exercise 3–6

Check off the two effects of each of the following transactions:

Transaction	Revenue Earned	Expense Incurred	Liability Incurred	Liability Reduced	Asset Created	Asset Used Up
a. *Country Living Magazine* sent magazines to customers who have paid their subscription.						
b. Young and Rubicam completed work on an advertising plan that will be billed and collected next month.						
c. Automotive Imports recorded the fact that it used up some of the cost of its building.						
d. Classic Ideas Consulting received a cell phone invoice that must be paid next month.						

Accounting equation effects of adjustments
1 3
A. Expenses + $200

Exercise 3–7

Indicate the amount of the adjustment and the types of accounts affected by each of the following transactions for Phil's Garden Emporium. Complete the chart below and indicate the amount of each transaction as well as a "+" to indicate that the account increased or a "–" to indicate a decrease to the account.

a. The annual insurance premium of $1,200 was paid on March 1, 2014 for coverage beginning on that date. At the year end of April 30, 2014, an adjusting entry must be made.

b. At April 30, 2014, there was $900 in salary that was earned by employees but not yet paid to them.

c. At April 30, 2014, the Office Supplies account showed a balance of $1,800. A physical count of the supplies indicated that only $1,500 worth was left. Aside from needing a stern conversation with employees about telling the accounting department about when supplies are used, an adjusting entry is required.

d. Customers prepaid for garden services in January and February for a total of $3,700. In April, some of the work was performed and requires an adjusting entry. The accountant was able to verify that $1,800 of work was still left to be completed in May.

e. Work was completed on April 30, 2014 that was worth $150 but no invoice was prepared because the work crew did not return to the office that day. The work should be recorded as complete in the current fiscal period.

	Income Statement			Balance Sheet		
Transaction	Revenues	Expenses		Assets	Liabilities	Owner's Equity
a.						
b.						
c.						
d.						
e.						

Exercise 3–8

Journalizing adjusting entries
3

Journalize the entries for the following adjustments at January 31, the end of the accounting period:

a. Amortization, $5,000.
b. Prepaid insurance used, $500.
c. Interest expense accrued, $400.
d. Employee salaries owed for Monday through Thursday of a five-day workweek; the weekly payroll is $16,000.
e. Unearned service revenue that becomes earned, $2,000.

Exercise 3–9

Analyzing the effects of adjustments on net income
3

Suppose the adjustments required in Exercise 3–8 were not made. Compute the overall overstatement or understatement of each revenue and expense account as well as the effect on net income as a result of the omission of these adjustments.

Exercise 3–10

Journalizing adjusting entries
3

Journalize the adjusting entry needed at December 31 for each of the following independent situations.

a. On June 1, when we collected $48,000 rent in advance, we debited Cash and credited Unearned Rent Revenue. The tenant was paying for one year's rent in advance. At December 31, we must account for the amount of rent we have earned.
b. Interest revenue of $2,400 has been earned but not yet received on a $60,000 note receivable held by the business.
c. Salaries expense is $7,500 per day—Monday through Friday—and the business pays employees each Friday. This year December 31 falls on a Wednesday.
d. Equipment was purchased last year at a cost of $200,000. The equipment's useful life is five years. It will have no value after five years. Record the year's amortization.
e. On September 1, when we paid $6,000 for a one-year insurance policy, we debited Prepaid Insurance and credited Cash.
f. The business owes interest expense of $7,200 that it will pay early in the next period.
g. The unadjusted balance of the Supplies account is $13,500. The total cost of supplies remaining on hand on December 31 is $4,500.

Exercise 3–11

Recording adjustments in T-accounts
3
Service Revenue bal. $91,500

The accounting records of Event Planners include the following unadjusted balances at March 31: Accounts Receivable, $5,400; Supplies, $2,700; Salaries Payable, $0; Unearned Service Revenue, $3,000; Service Revenue, $88,000; Salaries Expense, $22,000; Rent Expense, $18,000, Utilities Expense, $12,000; and Supplies Expense, $0.

The company's accountant develops the following data for the March 31 adjusting entries:

a. Service revenue accrued, $2,500
b. Unearned service revenue that has been earned, $1,000
c. Supplies on hand, $800
d. Salaries owed to employee, $2,100

Open T-accounts as needed and record the adjustments directly in the accounts, identifying each adjustment amount by its letter. Show each account's adjusted balance. Journal entries are not required.

Exercise 3–12

Explaining unearned revenues
3

Write a paragraph to explain why unearned revenues are liabilities rather than revenues. In your explanation, use the following actual example: *Maclean's Magazine* collects cash from subscribers in advance and later mails the magazines to subscribers over a one-year period. Explain what happens to the unearned subscription revenue over the course of a year as the magazines are mailed to subscribers. Into what other account does the unearned subscription revenue go? Give the adjusting entry that *Maclean's Magazine* would make to record the earning of $75,000 of subscription revenue. Include an explanation for the entry.

Exercise 3–13

Preparing an adjusted trial balance
4

Adjusted trial balance total $75,300

Valley Cleaners, a cleaning service, started the preparation of its adjusted trial balance as follows:

VALLEY CLEANERS
Preparation of Adjusted Trial Balance
June 30, 2014

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	2,400					
Supplies	4,000					
Prepaid insurance	1,800					
Equipment	40,000					
Accumulated amortization—equipment		6,000				
Accounts payable		4,000				
Salaries payable		0				
Unearned service revenue		1,200				
Les Valley, capital		17,000				
Les Valley, withdrawals	8,000					
Service revenue		44,000				
Salaries expense	16,000					
Supplies expense	0					
Amortization expense—equipment	0					
Insurance expense	0					
	72,200	72,200				

During the six months ended June 30, 2014, Valley Cleaners

a. Used supplies worth $800.
b. Used up prepaid insurance of $750.
c. Amortized the equipment a further $2,000.

d. Accrued salaries expense of $1,100 that still must be paid.
e. Earned $600 of the unearned service revenue.

Complete the adjusted trial balance. Identify each adjustment by its letter. To save time, you may write your answers directly in the spaces provided.

Note: Exercises 3–14 and Starter 3–15 should be used only in conjunction with Exercise 3–13.

Exercise 3–14

Refer to the data in Exercise 3–13. Journalize the five adjustments, all dated June 30, 2014.

Using an adjusted trial balance
4

Exercise 3–15

Refer to the data in Exercise 3–13.

a. Compute Valley Cleaners' net income for the period ended June 30, 2014.
b. Compute Valley Cleaners' total assets at June 30, 2014.

Computing net income
5
a. Net income $23,950

Exercise 3–16

The adjusted trial balance below of Smith Advisory Services is incomplete. Enter the adjustment amounts directly in the adjustment columns of the text. Service Revenue is the only account affected by more than one adjustment.

Adjusting the accounts
3 4
Adjustments total $24,700

Excel Spreadsheet Template

SMITH ADVISORY SERVICES
Preparation of Adjusted Trial Balance
May 31, 2014

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash	27,000				27,000	
Accounts receivable	57,000				62,600	
Supplies	8,000				6,400	
Office furniture	160,000				160,000	
Accumulated amortization		108,000				112,000
Salaries payable		0				7,000
Unearned revenue		12,500				6,000
A. Smith, capital		141,000				141,000
A. Smith, withdrawals	65,000				65,000	
Service revenue		108,000				120,100
Salaries expense	34,500				41,500	
Rent expense	18,000				18,000	
Amortization expense	0				4,000	
Supplies expense	0				1,600	
	369,500	369,500			386,100	386,100

Exercise 3–17

Make journal entries for the adjustments that would complete the preparation of the adjusted trial balance in Exercise 3–16. Date the entries and include explanations.

Journalizing adjustments
3 4

Exercise 3–18

Write a business memorandum to your supervisor explaining the difference between the unadjusted amounts and the adjusted amounts in Exhibit 3–10, page 141. Use Accounts Receivable in your explanation. If necessary, refer back to the discussion of Accrued Revenues on page 136.

Explaining the adjusted trial balance
4

Business memos are formatted as follows:

Date:	(fill in)
To:	Supervisor
From:	(Student Name)
Subject:	Difference between the *unadjusted* and the *adjusted* amounts on an adjusted trial balance

Preparing the financial statements
5
Net income $55,000

Exercise 3–19

Refer to the adjusted trial balance in Exercise 3–16. Prepare Smith Advisory Services' income statement and statement of owner's equity for the month ended May 31, 2014, and its balance sheet on that date. Draw the arrows linking the three statements.

Excel Spreadsheet Template

Recording prepaids in two ways
3 A1

*Exercise 3–20

At the beginning of the year, supplies of $4,800 were on hand. During the year, the business paid $10,800 for more supplies. At the end of the year, the count of supplies indicates supplies of $3,400 on hand.

Required

1. Assume that the business records supplies by initially debiting an *asset* account. Therefore, place the beginning balance in the Supplies T-account, and record the above entries directly in the accounts without using a journal.
2. Assume that the business records supplies by initially debiting an *expense* account. Therefore, place the beginning balance in the Supplies Expense T-account, and record the above entries directly in the accounts without using a journal.
3. Compare the ending account balances under both approaches. Are they the same? Explain.

*Exercise 3–21

Recording unearned revenues in two ways
3 A2
Unearned Service Revenue bal. $3,500

At the beginning of the year, a business had a liability to customers of $7,500 for unearned service revenue collected in advance. During the year, the business received advance cash receipts of $20,000. At year end, the company's liability to customers was $3,500 for unearned service revenue collected in advance.

Required

1. Assume that the company records unearned revenues by initially crediting a *liability* account. Open T-accounts for Unearned Service Revenue and Service Revenue, and place the beginning balance in Unearned Service Revenue. Journalize the cash collection and adjusting entries, and post their dollar amounts. As references in the T-accounts, label the balance, the cash receipt, and the adjustment.
2. Assume that the company records unearned revenues by initially crediting a *revenue* account. Open T-accounts for Unearned Service Revenue and Service Revenue, and place the beginning balance in Service Revenue. Journalize the cash collection and adjusting entries, and post their dollar amounts. As references in the T-accounts, label the balance, the cash receipt, and the adjustment.
3. Compare the ending balances in the two accounts. Explain why they are the same or different.

*Exercise 3–22

Recording prepaids as expenses and unearned revenues as revenues, adjusting entries
A1 A2
Supplies Expense Cr $700

Fort Services initially records all prepaid expenses as expenses and all unearned revenues as revenues. Given the following information, prepare the necessary adjusting entries at December 31, 2014, the company's year end.

a. On January 3, 2014, the company's first day of operations, $2,500 of supplies were purchased. A physical count revealed $700 of supplies still on hand at December 31, 2014.
b. On January 4, 2014, a $15,000 payment for insurance was made to an insurance agency for a 30-month policy.
c. On June 30, 2014, Fort Services received nine months' rent totalling $13,500 in advance from a tenant.

* These Exercises cover Chapter 3 Appendix topics.

SERIAL EXERCISE

Exercise 3–23 continues the Kerr Consulting situation from Exercise 2–15 of Chapter 2. If you did not complete Exercise 2–15 you can complete Exercise 3–23 by following the instructions in the note below.

Exercise 3–23

Refer to Exercise 2–15 of Chapter 2. Start from the trial balance and the posted T-accounts that Kerr Consulting prepared at December 31. Make sure the account balances in your trial balance and T- accounts match those in the trial balance at December 31, 2013, shown here.

Adjusting the accounts, preparing an adjusted trial balance, preparing the financial statements

3 4 5

4. Adjusted trial balance total $43,133

6. Net income $784; Total assets $36,717

Note: If you did not do Exercise 2–15, you can complete this Exercise by creating T-accounts for the accounts and balances given in the trial balance at December 31, 2013, shown below.

KERR CONSULTING Unadjusted Trial Balance December 31, 2013		
Cash	$ 27,850	
Accounts receivable	500	
Supplies	500	
Equipment	2,000	
Furniture	6,000	
Accounts payable		$ 6,100
Unearned service revenue		2,000
Alex Kerr, capital		30,000
Alex Kerr, withdrawals	2,000	
Service revenue		4,000
Rent expense	31,000	
Utilities expense	250	
Total	$ 42,100	$42,100

Required

1. Open these new T-accounts: Accumulated Amortization—Equipment; Accumulated Amortization—Furniture; Salaries Payable; Amortization Expense—Equipment; Amortization Expense—Furniture; Supplies Expense.
2. Prepare an adjusted trial balance at December 31. Set up columns for adjustments and for the adjusted trial balance as illustrated in Exhibit 3–10 on page 141.
3. At December 31, the company gathers the following information for the adjusting entries:
   a. Accrued service revenue, $400.
   b. Earned $667 of the service revenue collected in advance on December 21.
   c. Supplies remaining on hand at December 31, $100.
   d. Amortization expense—equipment, $33; furniture, $100.
   e. Accrued $500 expense for the secretary's salaries.
4. Make these adjustments directly in the adjustments columns, and complete the adjusted trial balance at December 31.
5. Journalize and post the adjusting entries into the T-accounts. Label each adjusting amount as *Adj.* and an account balance as *Bal.*
6. Prepare the income statement and statement of owner's equity of Kerr Consulting for the month ended December 31, 2013, and prepare the balance sheet at that date.

CHALLENGE EXERCISE

Exercise 3–24

Computing the financial statement

5

Supplies expense $10,000
Salary expense $91,000
Service revenue $166,000

The adjusted trial balances of Pacific Services at December 31, 2014, and December 31, 2013 include these amounts:

	2014	2013
Supplies	$ 4,000	$ 2,000
Salaries payable	5,000	8,000
Unearned service revenue	26,000	32,000

Analysis of the accounts at December 31, 2014, reveals these transactions for 2014:

Cash payment for supplies	$ 12,000
Cash payment for salaries	94,000
Cash receipts in advance for service revenue	160,000

Compute the amount of supplies expense, salaries expense, and service revenue to report on the Pacific Services income statement for 2014.

BEYOND THE NUMBERS

Beyond the Numbers 3–1

Suppose a new management team is in charge of Wild Roses Inc., a micro-brewery. Assume Wild Roses Inc.'s new top executives rose through the company ranks in the sales and marketing departments and have little appreciation for the details of accounting. Consider the following conversation between two executives:

Stephen Federer, President:	"I want to avoid the hassle of adjusting the books every time we need financial statements. Sooner or later we receive cash for all our revenues, and we pay cash for all our expenses. I can understand cash transactions, but all these accruals confuse me. If I cannot understand our own accounting, I'm fairly certain the average person who invests in our company cannot understand it either. Let's start recording only our cash transactions. I bet it won't make any difference to anyone."
Kate McNamara, Chief Financial Officer:	"Sounds good to me. This will save me lots of headaches. I'll implement the new policy immediately."

Write a business memo to the company president giving your response to the new policy. Identify at least five individual items (such as specific accounts) in the financial statements that will be reported incorrectly. Will outside investors care? Use the format of a business memo given with Exercises 3–18 on page 163.

ETHICAL ISSUE

The net income of Antiques Plus decreased sharply during 2014. Mariah Ciccone, owner of the store, anticipates the need for a bank loan in 2015. Late in 2014, she instructs the accountant to record a $35,000 sale of furniture to the Ciccone family, even though the goods will not be shipped from the manufacturer until January 2015. Ciccone also tells the accountant not to make the following December 31, 2014, adjusting entries:

Salaries owed to employees	$27,000
Prepaid insurance that has expired	1,500

Required

1. Compute the overall effect of these transactions on the store's reported income for 2014.
2. Why did Ciccone take this action? Is this action ethical? Give your reason, identifying the parties helped and the parties harmed by Ciccone's action.
3. As a personal friend, what advice would you give *the accountant*?

PROBLEMS (GROUP A)

MyAccountingLab

Problem 3–1A

Cash-basis versus accrual-basis accounting

1 2

2. Net income $5,700

Kandi's Office Design had the following transactions during January:

Jan.	1	Paid for insurance for January through March, $2,400. It is company policy to record this sort of transaction in an asset account.
	4	Performed design service on account, $7,000.
	5	Purchased office furniture on account, $2,100.
	8	Paid advertising expense, $2,000 cash.
	15	Purchased office equipment for cash, $4,500.
	19	Performed design services and received cash, $9,000.
	24	Collected $3,500 on account for the January 4 service.
	26	Paid account payable from January 5.
	29	Paid salaries expense, $7,500 cash.
	31	Recorded adjusting entry for January insurance expense (see January 1).

Required

1. Show how each transaction would be accounted for using the accrual basis of accounting. Use the format below for your answer, and show your computations. Give the amount of revenue or expense for January. Journal entries are not required.

Amount of Revenue or Expense for October		
Date	**Revenue (Expense)**	**Accrual - Basic Amount**

2. Compute January net income or net loss under the accrual basis of accounting.
3. State why the accrual basis of accounting is preferable to the cash basis.

Problem 3–2A

Applying accounting assumptions, criteria, and objectives

1 3

As the controller of Best Security Systems, you have hired a new bookkeeper, whom you must train. She objects to making an adjusting entry for accrued salaries at the end of the period. She reasons, "We will pay the salaries soon. Why not wait until payment to record the expense? In the end, the result will be the same." Write a business memo to explain to the bookkeeper why the adjusting entry for accrued salaries expense is needed.

This is the format of the business memo:

Date:	(fill in)
To:	New Bookkeeper
From:	(Student Name)
Subject:	Why the adjusting entry for salaries expense is needed

Problem 3–3A

Journalizing adjusting entries

3

c. Supplies Expense $9,200

Journalize the adjusting entry needed on December 31, the company's year end, for each of the following independent cases affecting Eagle Communications:

a. Each Friday the company pays its employees for the current week's work. The amount of the payroll is $15,000 for a five-day workweek. The current accounting period ends on Wednesday.
b. Eagle has received notes receivable from some clients for professional services. During the current year, Eagle has earned interest revenue of $800, which will be received next year.

c. The beginning balance of Supplies was $4,800. During the year the company purchased supplies costing $7,600, and at December 31 the inventory of supplies remaining on hand is $3,200.

d. The company is developing a wireless communication system for a large company, and the client paid Eagle $120,000 at the start of the project. Eagle recorded this amount as Unearned Consulting Revenue. The development will take several months to complete. Eagle executives estimate that the company has earned three-fourths of the total fee during the current year.

e. Amortization for the current year includes the following: Office Furniture, $8,600, and Design Equipment, $16,000. Make a compound entry. Hint: this means to show everything in one journal entry and not two.

f. Details of Prepaid Insurance are shown in the account:

Prepaid Insurance	
Jan. 2 Bal. 6,000	

Eagle Communications prepays a full year's insurance on January 2. Record insurance expense for the year ended December 31 as one annual adjustment for what was used for the year.

Problem 3–4A

Journalizing and posting adjustments to T-accounts, preparing and using the adjusted trial balance

3 4

3. Adjusted trial bal. total $74,035

The trial balance of Kaplan Printing at December 31, 2014, appears below. The data needed for the month-end adjustments follow the trial balance.

KAPLAN PRINTING Unadjusted Trial Balance December 31, 2014		
Cash	$ 5,400	
Accounts receivable	18,600	
Prepaid rent	4,500	
Supplies	1,200	
Furniture and equipment	19,200	
Accumulated amortization—furniture and equipment		$ 5,760
Accounts payable		3,400
Salaries payable		0
Unearned printing revenue		2,400
S. Kaplan, capital		23,140
S. Kaplan, withdrawals	6,000	
Printing revenue		36,500
Salaries expense	12,500	
Rent expense	0	
Amortization expense—furniture and equipment	0	
Advertising expense	3,600	
Supplies expense	0	
Miscellaneous expense	200	
Total	$71,200	$71,200

Adjustment data:

a. Unearned printing revenue still remaining to be earned at December 31, $800.

b. Prepaid rent still available at December 31, $2,000.

c. Supplies used during the month, $450.

d. Amortization for the month, $660.

e. Accrued miscellaneous expense at December 31, $200. (Credit Accounts Payable.)

f. Accrued salaries expense at December 31, $1,975.

Required

1. Open T-accounts for the accounts listed in the trial balance, inserting their December 31 unadjusted balances.
2. Journalize the adjusting entries on December 31, and post them to the T-accounts. Identify the journal entries and posted amounts by their letter.
3. Prepare the adjusted trial balance.
4. How will the company use the adjusted trial balance?

Problem 3–5A

Analyzing and journalizing adjustments
3

Excel Spreadsheet Template

Wolcott Consulting's unadjusted and adjusted trial balances at December 31, 2014, follow:

WOLCOTT CONSULTING Unadjusted and Adjusted Trial Balances December 31, 2014				
	Unadjusted Trial Balance		Adjusted Trial Balance	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**
Cash	11,000		11,000	
Accounts receivable	8,500		13,100	
Supplies	1,100		500	
Prepaid insurance	3,600		2,400	
Furniture	22,500		22,500	
Accumulated amortization—furniture		9,000		13,250
Accounts payable		6,400		6,400
Salaries payable		0		2,600
Interest payable		0		500
Note payable		15,000		15,000
Unearned consulting revenue		3,600		1,800
S. Wolcott, capital		33,550		33,550
S. Wolcott, withdrawals	28,000		28,000	
Consulting revenue		74,000		80,400
Amortization expense—furniture	0		4,250	
Supplies expense	0		600	
Utilities expense	4,600		4,600	
Salaries expense	32,000		34,600	
Rent expense	30,000		30,000	
Interest expense	250		750	
Insurance expense	0		1,200	
	141,550	141,550	153,500	153,500

Required

Journalize the adjusting entries that account for the differences between the two trial balances.

Problem 3–6A

Preparing the financial statements from an adjusted trial balance

3 4 5

1. Net income $314,800

The adjusted trial balance of Cook Antique Auctioneers at the end of its year, December 31, 2014, is shown below.

COOK ANTIQUE AUCTIONEERS Adjusted Trial Balance December 31, 2014		
Cash	$ 9,400	
Accounts receivable	166,000	
Prepaid rent	8,000	
Supplies	4,200	
Equipment	468,420	
Accumulated amortization—equipment		$ 72,000
Office furniture	96,000	
Accumulated amortization—office furniture		38,400
Accounts payable		56,000
Unearned service revenue		8,000
Interest payable		1,100
Salaries payable		4,200
Notes payable		220,000
A. Cook, capital		129,520
A. Cook, withdrawals	92,000	
Service revenue		780,000
Amortization expense—equipment	36,000	
Amortization expense—office furniture	9,600	
Salaries expense	320,000	
Rent expense	48,000	
Interest expense	13,200	
Utilities expense	21,600	
Insurance expense	13,200	
Supplies expense	3,600	
Total	$1,309,220	$1,309,220

Required

1. Prepare Cook Antique Auctioneers' 2014 income statement, statement of owner's equity, and balance sheet. List expenses in decreasing-balance order on the income statement and show total liabilities on the balance sheet. If your three financial statements appear on one page, draw the arrows linking the three financial statements. If they are on separate pages, write a short paragraph describing how the three financial statements are linked. How will what you have learned in this problem help you manage a business?
2. a. Which financial statement reports Cook's results of operations? Were 2014 operations successful? Cite specifics from the financial statements to support your evaluation.

   b. Which statement reports the company's financial position? Does Cook's financial position look strong or weak? Give the reason for your evaluation.

Problem 3–7A

Preparing an adjusted trial balance and the financial statements

3 4 5

2. Net income $6,550

Consider the unadjusted trial balance of Burrows Landscaping at December 31, 2014, and the related month-end adjustment data.

BURROWS LANDSCAPING Unadjusted Trial Balance December 31, 2014		
Cash	$ 24,500	
Accounts receivable	22,000	
Prepaid rent	9,000	
Supplies	5,500	
Equipment	66,000	
Accumulated amortization—equipment		$ 12,650
Accounts payable		7,200
Salaries payable		0
A. Burrows, capital		122,700
A. Burrows, withdrawals	25,000	
Landscaping design revenue		126,000
Salaries expense	82,000	
Rent expense	22,500	
Utilities expense	6,000	
Amortization expense—equipment	6,050	
Supplies expense	0	
Total	$268,550	$268,550

The following adjustments need to be made before the financial statements for the year can be prepared:

Adjustment data:

a. Accrued landscaping design revenue at December 31, $8,500.

b. One month of the prepaid rent had been used. The unadjusted prepaid balance of $9,000 relates to the four-month period December 1, 2014, through March 31, 2015.

c. Supplies remaining on hand at December 31, $900.

d. Amortization on equipment for the month of December. The equipment's expected useful life is 10 years; it will have no value at the end of its useful life, and the straight-line method of amortization is used.

e. Accrued salaries expense at December 31 should be for two days only. The five-day weekly payroll is $10,000.

Required

1. Recopy the trial balance using the format in Exercise 3–10 (page 161), and prepare the adjusted trial balance of Burrows Landscaping at December 31, 2014. Identify each adjusting entry by its letter.
2. Prepare the income statement and the statement of owner's equity for the year ended December 31, 2014, and the balance sheet at December 31, 2014. Draw the arrows linking the three financial statements, or write a short description of how they are linked.

Problem 3–8A

Prepare adjusting entries, an adjusted trial balance, and financial statements.

3 4 5

Net income $158,075

Pace Employment Counsellors provides counselling services to employees of companies that are downsizing. The business had the following account balances:

PACE EMPLOYMENT COUNSELLORS		
Unadjusted Trial Balance		
December 1, 2014		
Cash	$ 19,000	
Accounts receivable	23,200	
Prepaid advertising	1,500	
Supplies	5,000	
Computer equipment	69,000	
Accumulated amortization—computer equipment		0
Building	288,000	
Accumulated amortization—building		0
Land	144,000	
Accounts payable		$ 93,600
B. Pace, capital		330,000
B. Pace, withdrawals	79,000	
Counselling revenue		342,500
Salaries expense	120,000	
Supplies expense	0	
Utilities expense	17,400	
Total	$766,100	$766,100

The following transactions occurred during December:

a. On December 1, paid cash to a marketing firm for four months of advertising work in advance. The contract was for $2,875 per month.

b. On December 6, supplies in the amount of $3,700 were purchased on account.

c. On December 15, the company received a cash advance of $8,000 for work to be performed starting January 1.

d. On December 29, the company provided counselling services to a customer for $15,000, to be paid in 30 days.

The following information was available on December 31, 2014:

e. A physical count shows $7,600 of supplies remaining on hand on December 31.

f. The building has an expected useful life of eight years, with no expected value after eight years. The building was purchased on January 2, and the straight-line method of amortization is used.

g. The computer equipment, purchased on January 2, is expected to be used for four years with no expected value after four years. The straight-line method of amortization is used.

h. The marketing firm has performed one quarter of the work on the contract.

i. The company's Managing Director, who earns $800 per day, worked the last six days of the year and will be paid on January 4, 2015.

Required

1. Journalize the entries.
2. Prepare an adjusted trial balance on December 31, 2014.
3. Prepare an income statement for the year ended December 31, 2014. List expenses in the order of dollar amount, from the greatest amount to the least.
4. Prepare a statement of owner's equity for the year ended December 31, 2014.
5. Prepare a balance sheet at December 31, 2014.

*Problem 3–9A

Recording prepaid rent and service revenue collected in advance in two ways

1 2

Rent Expense bal. $10,000

Park Sales and Service completed the following transactions during 2014:

Aug. 31	Paid $15,000 store rent covering the six-month period ending February 28, 2015.
Dec. 1	Collected $8,000 cash in advance from customers. The service revenue earned will be $1,600 each month over the four-month period ending March 31, 2015.

Required

1. Journalize these entries by debiting an asset account for Prepaid Rent and by crediting a liability account for Unearned Service Revenue. Explanations are not required.
2. Journalize the related adjustments at December 31, 2014.
3. Post the entries to T-accounts, and show their balances at December 31, 2014. Posting references are not required.
4. Repeat Requirements 1 through 3. This time debit Rent Expense for the rent payment and credit Service Revenue for the collection of revenue in advance.
5. Compare the account balances in Requirements 3 and 4. They should be equal.

PROBLEMS (GROUP B)

MyAccountingLab

Problem 3–1B

Accrual-basis accounting

1 2

Rajeesh Skin Clinic experienced the following selected transactions during October:

Oct. 1	Paid for insurance for October through December, $9,000. The payment was recorded in an asset account.
4	Paid utility invoice with cash, $1,200.
5	Performed services on account, $8,000.
9	Purchased office equipment for cash, $7,000.
12	Received cash for services performed, $4,400.
14	Purchased office equipment on account, $2,400.
28	Collected $3,000 on account from October 5.
31	Paid salaries expense, $4,500 cash.
31	Paid account payable from October 14.
31	Recorded adjusting entry for October insurance expense (see October 1).

Required

1. Show how each transaction would be accounted for using the accrual basis of accounting. Use the format below for your answer, and show your computations. Give the amount of revenue or expense for October. Journal entries are not required.

Amount of Revenue or Expense for January		
Date	**Revenue/Expense**	**Accrual - Basic Amount**

2. Compute October net income or net loss under the accrual basis of accounting.
3. Why is the accrual basis of accounting preferable to the cash basis?

Problem 3–2B

Applying accounting assumptions, criteria, and objectives

1 3

Write a business memo to a new bookkeeper to explain the difference between the cash basis of accounting and the accrual basis. Mention the roles of the recognition criteria for revenues and the matching objective in accrual-basis accounting.
This is the format of a business memo:

Date:	(fill in)
To:	Supervisor
From:	(Student Name)
Subject:	Difference between the *unadjusted* and the *adjusted* amounts on an adjusted trial balance

* This Problem covers Chapter 3 Appendix topics.

Problem 3–3B

Journalizing adjusting entries

3

Journalize the adjusting entry needed on December 31, the company's year end, for each of the following independent cases affecting East Coast Contractors:

a. Details of Prepaid Rent are shown in the account:

Prepaid Rent

Jan. 1	Bal. 4,500	
Mar. 31	9,000	
Sept. 30	9,000	

East Coast Contractors pays office rent semiannually on March 31 and September 30. At December 31, part of the last payment is still available to cover January to March of the next year. No rent expense was recorded during the year.

b. East Coast Contractors pays its employees each Friday. The amount of the weekly payroll is $5,000 for a five-day workweek, and the daily salary amounts are equal. The current accounting period ends on Wednesday.

c. East Coast Contractors has lent money to help employees find housing, receiving notes receivable in return. During the current year the entity has earned interest revenue of $1,400 from employees' loans, which it will receive next year.

d. The beginning balance of Supplies was $5,100. During the year the company purchased supplies costing $16,500, and at December 31 the inventory of supplies remaining on hand is $5,500.

e. East Coast Contractors is installing cable in a large building, and the owner of the building paid East Coast Contractors $42,000 as the annual service fee. East Coast Contractors recorded this amount as Unearned Service Revenue. Robin Zweig, the general manager, estimates that the company has earned one-fourth of the total fee during the current year.

f. Amortization for the current year includes: Equipment, $14,000; and Trucks, $33,000. Make a compound entry. Hint: This means include all the accounts in one journal entry.

Problem 3–4B

Journalizing and posting adjustments to T-accounts, preparing the adjusted trial balance

3 4

The trial balance of Wellwood Realty at December 31, 2014, appears below. The data needed for the month-end adjustments follow the trial balance.

WELLWOOD REALTY
Unadjusted Trial Balance
December 31, 2014

Cash	$ 24,180	
Accounts receivable	44,500	
Prepaid rent	8,800	
Supplies	2,100	
Furniture	69,000	
Accumulated amortization—furniture		$ 34,500
Accounts payable		5,800
Salaries payable		0
Unearned commission revenue		6,400
K. Wellwood, capital		75,180
K. Wellwood, withdrawals	12,000	
Commission revenue		48,000
Salaries expense	7,200	
Rent expense	0	
Amortization expense—furniture	0	
Advertising expense	2,100	
Supplies expense	0	
Total	$169,880	$169,880

Adjustment data at December 31:
a. Prepaid rent still available at December 31, $4,400.
b. Supplies used during the month, $1,800.
c. Amortization on furniture for the month, $670.
d. Accrued salaries expense at December 31, $950.
e. Unearned commission revenue still remaining to be earned at December 31, $2,500.

Required

1. Open T-accounts for the accounts listed in the trial balance, inserting their December 31 unadjusted balances.
2. Journalize the adjusting entries and post them to the T-accounts. Key the journal entries and the posted amounts by letter. Show the ending balance of each account.
3. Prepare the adjusted trial balance.
4. How will the company use the adjusted trial balance?

Problem 3–5B

Maalkum Construction's unadjusted and adjusted trial balances at April 30, 2014, are shown below.

Analyzing and journalizing adjustments
3

MAALKUM CONSTRUCTION Unadjusted and Adjusted Trial Balance April 30, 2014				
	Unadjusted Trial Balance		Adjusted Trial Balance	
Account Title	Debit	Credit	Debit	Credit
Cash	24,800		24,800	
Accounts receivable	25,600		32,200	
Supplies	4,900		1,000	
Prepaid rent	9,200		4,600	
Equipment	272,000		272,000	
Accumulated amortization—equipment		81,600		109,100
Accounts payable		29,000		29,000
Wages payable		0		4,200
Unearned service revenue		3,800		800
M. Maalkum, capital		124,100		124,100
M. Maalkum, withdrawals	53,000		53,000	
Service revenue		179,000		188,600
Wages expense	22,000		26,200	
Rent expense	0		4,600	
Amortization expense—equipment	0		27,500	
Supplies expense	0		3,900	
Utilities expense	6,000		6,000	
	417,500	417,500	455,800	455,800

Required

Journalize the adjusting entries that account for the differences between the two trial balances. Recall that wages payable and salaries payable mean the same thing (and wages expense is the same as salaries expense).

Excel Spreadsheet Template

Preparing the financial statements from an adjusted trial balance

5

Problem 3–6B

The adjusted trial balance of Georgian Protection at December 31, 2014, is shown below.

GEORGIAN PROTECTION Adjusted Trial Balance December 31, 2014		
Cash	$ 4,200	
Accounts receivable	28,500	
Supplies	5,200	
Prepaid rent	7,500	
Equipment	162,000	
Accumulated amortization—equipment		$ 38,000
Office furniture	70,000	
Accumulated amortization—office furniture		36,000
Accounts payable		14,800
Interest payable		500
Unearned service revenue		13,800
Notes payable		50,000
M. Wrosek, capital		29,300
M. Wrosek, withdrawals	17,000	
Service revenue		291,000
Amortization expense—equipment	19,000	
Amortization expense—office furniture	6,000	
Salaries expense	105,000	
Rent expense	25,000	
Interest expense	3,500	
Utilities expense	7,200	
Insurance expense	4,800	
Supplies expense	8,500	
Total	$473,400	$473,400

Required

1. Prepare Georgian Protection's 2014 income statement, statement of owner's equity, and balance sheet. List expenses in decreasing-balance order on the income statement and show total liabilities on the balance sheet. If your three financial statements appear on one page, draw the arrows linking the three financial statements. If they are on separate pages, write a short paragraph describing how the three financial statements are linked. How will what you have learned in this problem help you manage a business?
2. a. Which financial statement reports Georgian Protection's results of operations? Were operations successful during 2014? Cite specifics from the financial statements to support your evaluation.

   b. Which statement reports the company's financial position? Does Georgian Protection's financial position look strong or weak? Give the reason for your evaluation.

Problem 3–7B

Preparing an adjusted trial balance and the financial statements

3 4 5

The unadjusted trial balance of LaBarbara Data at December 31, 2014, appears below. Adjustments had been made until November, but no adjustments for December have been made.

LABARBARA DATA		
Unadjusted Trial Balance		
December 31, 2014		
Cash	$ 24,200	
Accounts receivable	38,500	
Prepaid rent	12,000	
Supplies	2,400	
Furniture	72,000	
Accumulated amortization—furniture		$ 13,800
Accounts payable		18,400
Salaries payable		0
J. LaBarbara, capital		125,000
J. LaBarbara, withdrawals	46,000	
Consulting revenue		121,500
Salaries expense	32,000	
Rent expense	33,000	
Utilities expense	12,000	
Amortization expense—furniture	6,600	
Supplies expense	0	
Total	$278,700	$278,700

Adjustment data:

a. Accrued consulting revenue at December 31, $3,800.

b. The prepaid balance of $12,000 represented on year of rent. Four months of prepaid rent have been used.

c. Supplies remaining on hand at December 31, $900.

d. The estimated useful life of the furniture is 10 years, it will have no value at the end of the 10 years, and the straight-line method of amortization is used. Amortization expense had only been taken for the first 11 months.

e. Accrued salaries expense at December 31 for three days. The five-day weekly payroll is $6,000.

Required

1. Using Exhibit 3–10 (page 141) as an example, recopy the trial balance and prepare the adjusted trial balance of LaBarbara Data at December 31, 2014. Key each adjusting entry by letter.
2. Prepare the income statement and the statement of owner's equity for the year ended December 31, 2014, and the balance sheet at December 31, 2014. Draw the arrows linking the three financial statements, or write a short description of how they are linked.

Problem 3–8B

Prepare adjusting entries, an adjusted trial balance, and financial statements. 3 4 5

Paris Communications provides telecommunications consulting services. The business had the following account balances:

PARIS COMMUNICATIONS Unadjusted Trial Balance December 1, 2014		
Cash	$ 19,000	
Accounts receivable	17,100	
Prepaid advertising	13,000	
Supplies	3,900	
Computer equipment	54,000	
Accumulated amortization—computer equipment		$ 0
Furniture	120,000	
Accumulated amortization—furniture		0
Accounts payable		28,000
R. Paris, capital		98,000
R. Paris, withdrawals	45,000	
Consulting revenue		260,600
Salaries expense	82,500	
Supplies expense	0	
Travel expense	32,100	
Total	$386,600	$386,600

The following transactions occurred during December:

a. On December 1, paid cash for an internet advertising consultant for four months of work in advance. The contract was for $3,200 per month. Work will begin on January 1, 2015.

b. On December 10, supplies in the amount of $2,975 were purchased on account.

c. On December 18, the company received a cash advance of $4,000 for work to be performed starting January 1.

d. On December 30, the company provided consulting services to a customer for $12,500; payment will be received in 30 days.

The following adjustments information was available on December 31, 2014:

e. A physical count shows $5,100 of supplies remaining on hand on December 31.

f. The computer equipment has an expected useful life of four years, with no expected value after four years. The computers were purchased on January 2, and the straight-line method of amortization is used.

g. The furniture, purchased on January 2, is expected to be used for eight years, with no expected value after eight years. The straight-line method of amortization is used.

h. On October 1, Paris hired an advertising firm to prepare a marketing plan and agreed to pay the firm $2,200 per month. Paris paid for five months' work in advance and has made no adjusting entries for this during 2014. Record the portion of the prepayment that has been used to date.

i. The company's office manager, who earns $400 per day, worked the last five days of the year and will be paid on January 5, 2015.

Required

1. Journalize the entries.
2. Prepare an adjusted trial balance on December 31, 2014.
3. Prepare an income statement for the year ended December 31, 2014. List expenses in alphabetical order.

4. Prepare a statement of owner's equity for the year ended December 31, 2014.
5. Prepare a balance sheet at December 31, 2014.

*Problem 3–9B

Recording prepaid advertising and flight travel revenue collected in advance in two ways
1 2

Connect Air completed the following transactions during 2014:

Oct. 15 Paid $10,000 for advertising and promotional material covering the four-month period ending February 15, 2015.

Nov. 1 Received $15,600 payment in advance for a series of charter flights. Revenue of $2,600 will be earned each month over the six-month period ending April 30, 2015.

Required

1. Open T-accounts for Advertising Expense, Prepaid Advertising, Unearned Flight Revenue, and Flight Revenue.
2. Journalize these entries by debiting an asset account for Prepaid Advertising and by crediting a liability account for Unearned Flight Revenue. Explanations are not required.
3. Journalize the related adjustments at December 31, 2014.
4. Post the entries to the T-accounts, and show their balances at December 31, 2014. Posting references are not required.
5. Repeat requirements 1 through 4. This time debit Advertising Expense instead of Prepaid Advertising, and credit Flight Revenue instead of Unearned Flight Revenue.
6. Compare the account balances in requirements 4 and 5. They should be equal.

CHALLENGE PROBLEMS

Problem 3–1C

Application of the matching objective
1

The matching objective is well established as a basis for recording expenses.

Required

1. New accountants sometimes state the objective as matching revenues against expenses. Explain to a new accountant why matching revenues against expenses is incorrect.
2. It has been suggested that not-for-profit organizations, such as churches and hospitals, should flip their income statements and show revenues as a deduction from expenses. Why do you think that the suggestion has been made?

Problem 3–2C

Understanding accrual-basis accounting
1 2 3

The basic accounting period is one year and all organizations report on an annual basis. It is common for large companies to report on a semiannual basis, and some even report monthly. Interim reporting has a cost, however.

You are working part-time as an accounting clerk for Hughes Corporation. The company was private and prepared only annual financial statements for its shareholders. Hughes has gone public and now must report quarterly. Joshua Ferguson, your supervisor in the accounting department, is concerned about all the additional work that will be required to produce the quarterly statements.

Required What does Ferguson mean when he talks about "additional work"?

* These Problems cover Chapter 3 Appendix topics.

Extending Your Knowledge

DECISION PROBLEMS

Decision Problem 1

Valuing a business on the basis of its net income
4 5

Cameron Masson has owned and operated Alberta Biotech, a management consulting firm, since its beginning 10 years ago. From all appearances the business has prospered. Masson lives in the fast lane—flashy car, home located in an expensive suburb, frequent trips abroad, and other signs of wealth. In the past few years, you have become friends with him through weekly rounds of golf at the country club. Recently, he mentioned that he has lost his zest for the business and would consider selling it for the right price. He claims that his clientele is firmly established, and that the business "runs on its own." According to Masson, the consulting procedures are fairly simple, and anyone could perform the work.

Assume you are interested in buying this business. You obtain its most recent monthly trial balance, which follows. Assume that revenues and expenses vary little from month to month and April is a typical month.

Your investigation reveals that the trial balance does not include the effects of monthly revenues of $3,300 and expenses totalling $6,300. If you were to buy Alberta Biotech, you would hire a manager so you could devote your time to other duties. Assume that this person would require a monthly salary of $6,000.

ALBERTA BIOTECH Trial Balance April 30, 2014		
Cash	$ 29,100	
Accounts receivable	44,700	
Prepaid expenses	7,800	
Property, plant, and equipment	723,900	
Accumulated amortization—property, plant, and equipment		$568,800
Land	144,000	
Accounts payable		41,400
Salaries payable		0
Unearned consulting revenue		170,100
C. Masson, capital		172,200
C. Masson, withdrawals	27,000	
Consulting revenue		36,900
Salaries expense	10,200	
Rent expense	0	
Utilities expense	2,700	
Amortization expense	0	
Supplies expense	0	
Total	$989,400	$989,400

Required

1. Is this an unadjusted or an adjusted trial balance? How can you tell?
2. Assume that the most you would pay for the business is 40 times the monthly net income you could expect to earn from it. Compute this possible price.
3. Masson states that the lowest price he will accept for the business is $450,000 plus the balance in owner's equity on April 30. Compute this amount.
4. Under these conditions, how much should you offer Masson? Give your reasons.

Decision Problem 2

Understanding the concepts underlying the accrual basis of accounting
1 2

The following independent questions relate to the accrual basis of accounting:

1. It has been said that the only time a company's financial position is known for certain is when the company is wound up and its only asset is cash. Why is this statement true?
2. A friend suggests that the purpose of adjusting entries is to correct errors in the accounts. Is your friend's statement true? What is the purpose of adjusting entries if the statement is wrong?
3. The text suggested that furniture (and each other property, plant, and equipment asset that is amortized) is a form of prepaid expense. Do you agree? Why do you think some accountants view property, plant, and equipment this way?

FINANCIAL STATEMENT CASES

Financial Statement Case 1

Explaining the effects of accruals and deferrals on the financial statements
1 2 3 4

During the year ended October 2, 2011, Gildan Activewear Inc. (Gildan) experienced numerous accruals and deferrals. As a long-term employee of Gildan's accounting and financial staff, it is your job to explain the effects of accruals and deferrals on Gildan's financial statements. (Gildan's financial statements appear in Appendix A at the end of this book and on MyAccountingLab.) Suppose the following questions were raised at the shareholders' meeting:

1. "Prepaid expenses" in the amount of $10,966,000 are listed on the October 2, 2011, balance sheet. What items could be included in this balance, and why is this account listed as a balance sheet account instead of an expense account?
2. The balance sheet lists "Future Income Taxes" in two different places at October 2, 2011. What types of accounts are they shown as and at what amounts?
3. Refer to Note 8 and the account "long-term debt." How large is the current loan? How large is Gildan's "credit facility" at October 2, 2011?
4. "Accounts payable and accrued liabilities" is shown on the balance sheet in the amount of $315,269,000. Define an accrued liability and give an example of items that could be included in this liability.
5. What is "depreciation," and how much depreciation has been recorded to date for the manufacturing equipment at October 2, 2011? (*Hint:* Refer to Note 4 for this amount.)

Financial Statement Case 2

Explaining the effects of accruals and deferrals on the financial statements
1 2 3 4

During the year ended December 31, 2011, Rainmaker Entertainment Inc. (Rainmaker) experienced numerous accruals and deferrals. As a long-term employee of Rainmaker's accounting and financial staff, it is your job to explain the effects of accruals and deferrals on Rainmaker's 2011 financial statements. (Rainmaker's 2011 financial statements appear on MyAccountingLab.) Suppose the following questions were raised at the shareholders' meeting:

1. "Prepaid expenses and deposits" in the amount of $523,760 are listed on the December 31, 2011, balance sheet. What items would be included in this balance, and why is this account listed as a balance sheet account instead of an expense account?
2. "Accounts payable and accrued liabilities" are shown on the balance sheet in the amount of $1,308,881. Define an accrued liability.
3. What is "depreciation and amortization," and how much would have been recorded for the year ended December 31, 2011?

JUST CHECKING Solutions for Chapter 3

1. An important characteristic of financial statements is comparability. Recognition criteria for both revenues and expenses provide guidelines for companies so that comparability can be achieved. When all companies follow the same guidelines, it is easier for a user of the financial information to compare the results between companies. The criteria also have to be applied consistently from year to year so that a user can analyze company performance from one year to the next. There must be comparability from year to year.

2. The revenue has not been earned on December 20. The customer could cancel the order, or Kobe may not be able to fill the order. In order to earn the revenue, the order would have to be delivered, which will not happen until 2014. Thus, the revenue should be recognized in 2014, not in 2013.

3. Expense recognition criteria indicate that all expenses associated with a revenue transaction should be reported in the same fiscal period as the revenue. The sales commission that will be paid to the sales representative came about because of the sales order on December 20. The recognition criteria for revenues suggest that the revenue has been earned in the current year. The matching objective (part of the recognition criteria for expenses) tells us that we should recognize all expenses incurred in the same fiscal period as their related revenue. The company should accrue the commission in the current fiscal year.

4. Although all parts of the financial statements are important in describing the financial condition of a business, the income statement would be most helpful to Tracy Daytona's management in evaluating the company's performance for 2014 because it reports how profitable the company has been for that period.

5. If HEC collects $6,000 from customers on January 1 and will earn the $6,000 evenly during January, February, and March, HEC will report the following service revenue each month under (a) accrual-basis accounting and (b) cash-basis accounting:

		Jan.	Feb.	Mar.
(a) Accrual-basis accounting:	Service revenue	$2,000	$2,000	$2,000
(b) Cash-basis accounting:	Service revenue	$6,000		

Under accrual-basis accounting, HEC records the revenue when the company earns it. This is the correct way to account for revenues.

6. If HEC prepays $1,500 for internet advertising on October 1 and the ads will run during October, November and December, HEC will report the following advertising expense each month under (a) accrual-basis accounting and (b) cash-basis accounting:

		Oct.	Nov.	Dec.
(a) Accrual-basis accounting:	Advertising expense	$ 500	$500	$500
(b) Cash-basis accounting:	Advertising expense	$1,500		

The accrual basis is the correct way to account for the expense.

7.

Account	Yes	No	Account	Yes	No
Accounts Receivable	✓		Supplies	✓	
Building		✓*	Cash		✓
Interest Payable	✓		Prepaid Insurance	✓	

* The Building account is not affected directly. The Accumulated Amortization—Building (a contra account) is updated during the adjusting process.

8. a.

	Beginning balance	$ 500
+	Purchases	600
=	Supplies available	1,100
−	Ending balance	400
=	Expense (supplies used)	$ 700

Report Supplies Expense among the expenses on the income statement.

b. The ending balance of Supplies is $400.
Report Supplies among the assets on the balance sheet.

c. Adjusting entry:

Supplies Expense	700	
Supplies		700
To record supplies expense.		

9.

Transaction	Income Statement Account (Dr/Cr)	Balance Sheet Account (Dr/Cr)
a. Revenue is earned but not yet billed.	Sales Revenue (Cr)	Accounts Receivable (Dr)
b. Prepaid rent expired during the month.	Rent Expense (Dr)	Prepaid Rent (Cr)
c. Annual amortization is recorded.	Amortization Expense (Dr)	Accumulated Amortization (Cr)
d. Salaries earned by employees has not been paid yet.	Salaries expense (Dr)	Salaries Payable (Cr)
e. Revenue was earned that was paid for by a customer in advance.	Sales Revenue (Cr)	Unearned Revenue (Dr)

10. The adjusted trial balance amounts are shown in the final two columns.

	Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	Debit	Credit	Debit	Credit	Debit	Credit
Cash	2,900				2,900	
Supplies	4,000			1,000	3,000	
Prepaid insurance	4,800			1,600	3,200	
Truck	40,000				40,000	
Accumulated amortization—truck		24,800		7,000		31,800
Unearned revenue		2,500	1,500			1,000

11. The adjusting entries are shown in the Adjustments columns.

	Trial Balance		Adjustments		Adjusted Trial Balance	
Account Title	Debit	Credit	Debit	Credit	Debit	Credit
Supplies	6,000			3,500	2,500	
Prepaid insurance	3,200			1,400	1,800	
Unearned revenue		5,500	4,000			1,500
Service revenue		55,000		3,000		58,000
Insurance expense	0		1,500		1,500	
Supplies expense	2,900		3,000		5,900	

12. Omission of the salaries accrual would produce these effects:
   a. Net income on the income statement (Exhibit 3–11) would have been $16,950 ($12,950 + $4,000).
   b. Total assets would have been unaffected by the error—$145,050, as reported on the balance sheet (Exhibit 3–13).
   c. Total liabilities on the balance sheet (Exhibit 3–11) would have been $14,000 ($18,000 – $4,000).
   d. Owner's equity on the balance sheet (Exhibit 3–11) would have been $131,050 ($127,050 + $4,000).

13. No, the use of international financial reporting standards (IFRS) for publicly accountable enterprises in Canada has no direct impact on the adjusting process for these companies. However, there may be an impact on the way the financial statements are presented, as we will see in future chapters.