Chapter 3

Adjusting the Accounts

STUDY OBJECTIVES

After studying this chapter, you should be able to:

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

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- Scan **Study Objectives**
- Read **Feature Story**
- Read **Preview**
- Read text and answer **DO IT!** p. 98, p. 106, p. 111, p. 116
- Work **Comprehensive DO IT!** p. 118
- Review **Summary of Study Objectives**
- Answer **Self-Study Questions**
- Complete **Assignments**

Feature Story

WHAT WAS YOUR PROFIT?

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

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

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

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

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

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Inside Chapter 3...

- **How Long Will "The Force" Be with Us?** (p. 98)
- **Turning Gift Cards into Revenue** (p. 106)

Preview of Chapter 3

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

The content and organization of Chapter 3 are as follows.

Adjusting the Accounts

Timing Issues
- Fiscal and calendar years
- Accrual- vs. cash-basis accounting
- Recognizing revenues and expenses

The Basics of Adjusting Entries
- Types of adjusting entries
- Adjusting entries for deferrals
- Adjusting entries for accruals
- Summary of journalizing and posting

The Adjusted Trial Balance and Financial Statements
- Preparing the adjusted trial balance
- Preparing financial statements

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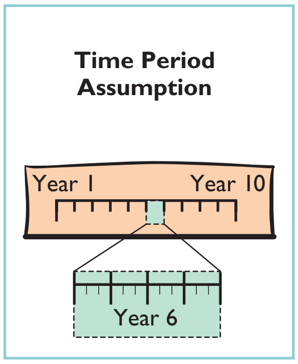
TIMING ISSUES

STUDY OBJECTIVE 1

Explain the time period assumption.

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

However, all companies find it desirable to report the results of their activities on a frequent basis. For example, management usually wants monthly financial statements, and the Internal Revenue Service requires all businesses to file annual tax returns. Therefore, **accountants divide the economic life of a business into artificial time periods**. This convenient assumption is referred to as the **time period assumption**.



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

ALTERNATIVE TERMINOLOGY

The time period assumption is also called the *periodicity assumption.*

Fiscal and Calendar Years

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

An accounting time period that is one year in length is a **fiscal year**. A fiscal year usually begins with the first day of a month and ends twelve months later on the last day of a month. Most businesses use the **calendar year** (January 1 to December 31) as their accounting period. Some do not. Companies whose fiscal year differs from the calendar year include Delta Air Lines, June 30, and Walt Disney Productions, September 30. Sometimes a company's year-end will vary from year to year. For example, PepsiCo's fiscal year ends on the Friday closest to December 31, which was December 30 in 2006 and December 29 in 2007.

Accrual- vs. Cash-Basis Accounting

STUDY OBJECTIVE 2

Explain the accrual basis of accounting.

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

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

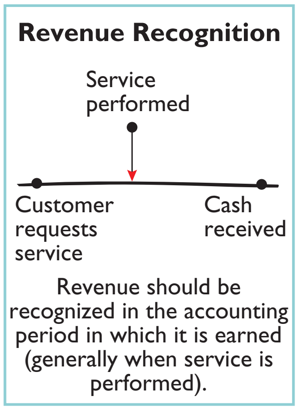
Individuals and some small companies do use cash-basis accounting. The cash basis is justified for small businesses because they often have few receivables and payables. Medium and large companies use accrual-basis accounting.

Recognizing Revenues and Expenses

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

REVENUE RECOGNITION PRINCIPLE

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



MATCHING PRINCIPLE

Accountants follow a simple rule in recognizing expenses: "Let the expenses follow the revenues." That is, expense recognition is tied to revenue recognition. In the dry cleaning example, this principle means that Dave's should report the salary expense incurred in performing the June 30 cleaning service in the income statement for the same period in which it recognizes the service revenue. The critical issue in expense recognition is when the expense makes its contribution to revenue. This may or may not be the same period in which the expense is paid. If Dave's does not pay the salary incurred on June 30 until July, it would report salaries payable on its June 30 balance sheet.

This practice of expense recognition is referred to as the **matching principle**. It dictates that efforts (expenses) be matched with accomplishments (revenues). Illustration 3-1 (page 98) summarizes the revenue and expense recognition principles.

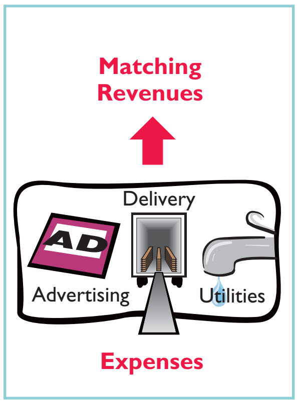
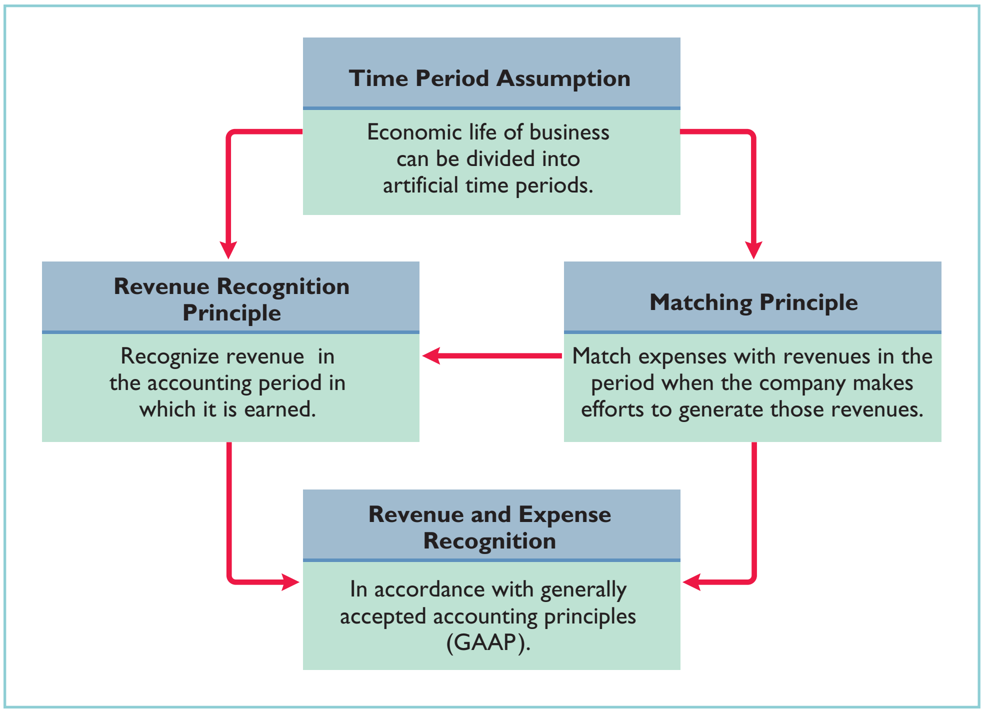


Illustration 3-1
GAAP relationships in revenue and expense recognition



ACCOUNTING ACROSS THE ORGANIZATION

How Long Will "The Force" Be with Us?

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

Yes, it should expense the cost over the economic life of the film. But what *is* its economic life? You must estimate how much revenue you will earn from box office sales, video sales, television, and games and toys—a period that could be less than a year or more than 20 years, as is the case for *Star Wars*. Originally released in 1977, and rereleased in 1997, domestic revenues total over $500 million for *Star Wars* and continue to grow.

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

DO IT!

TIMING CONCEPTS

Numerous timing concepts are discussed on pages 96 to 97. A list of concepts is provided on page 99, on the left, with a description of the concept on the right. There are more descriptions provided than concepts. Match the description of the concept to the concept.

1. ____ Accrual basis accounting.
2. ____Calendar year.
3. ____Time period assumption.
4. ____Matching principle.

(a) Monthly and quarterly time periods.
(b) Efforts (expenses) should be matched with accomplishments (revenues).
(c) Accountants divide the economic life of a business into artificial time periods.
(d) Companies record revenues when they receive cash and record expenses when they pay out cash.
(e) An accounting time period that is one year in length.
(f) An accounting time period that starts on January 1 and ends on December 31.
(g) Companies record transactions in the period in which the events occur.

action plan

✔ Review the glossary terms identified on pages 96–97.
✔ Study carefully the revenue recognition principle, the matching principle, and the time period assumption.

Solution

1. g 2. f 3. c 4. b

Related exercise material: **E3-1, E3-2, E3-3,** and **DO IT! 3-1.**

✔ *The Navigator*

THE BASICS OF ADJUSTING ENTRIES

STUDY OBJECTIVE 3
Explain the reasons for adjusting entries.

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

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

1. Some events are not recorded daily because it is not efficient to do so. For example, companies do not record the daily use of supplies or the earning of wages by employees.
2. Some costs are not recorded during the accounting period because they expire with the passage of time rather than as a result of daily transactions. Examples are rent, insurance, and charges related to the use of equipment.
3. Some items may be unrecorded. An example is a utility bill that the company will not receive until the next accounting period.

WILEY PLUS
Accounting Cycle Tutorial—Making Adjusting Entries

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

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

Types of Adjusting Entries

STUDY OBJECTIVE 4
Identify the major types of adjusting entries.

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

Illustration 3-2
Categories of adjusting entries

Deferrals

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

Accruals

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

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

Illustration 3-3
Trial balance

PIONEER ADVERTISING AGENCY
Trial Balance
October 31, 2010

	Debit	Credit
Cash	$15,200	
Advertising Supplies	2,500	
Prepaid Insurance	600	
Office Equipment	5,000	
Notes Payable		$ 5,000
Accounts Payable		2,500
Unearned Revenue		1,200
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,000
Salaries Expense	4,000	
Rent Expense	900	
	$28,700	$28,700

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

Adjusting Entries for Deferrals

STUDY OBJECTIVE 5
Prepare adjusting entries for deferrals.

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

PREPAID EXPENSES

Just as you might pay for your car insurance six months in advance, companies will pay in advance for some items that cover more than one period. Because accrual accounting requires that expenses are recognized only in the period in which they are incurred, these prepayments are recorded as assets called **prepaid expenses** or **prepayments**. When expenses are prepaid, an asset account is increased (debited) to show the service or benefit that the company will receive in the future. Examples of common prepayments are insurance, supplies, advertising, and rent. In addition, companies make prepayments when they purchase buildings and equipment.

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

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

INTERNATIONAL NOTE

Recording correct financial information requires good internal control. Internal controls are a system of checks and balances designed to detect and prevent fraud and errors. The Sarbanes-Oxley Act requires U.S. companies to enhance their systems of internal control. However, many foreign companies do not have this requirement, and some U.S. companies believe that not having it gives foreign firms unfair advantage in the capital markets.

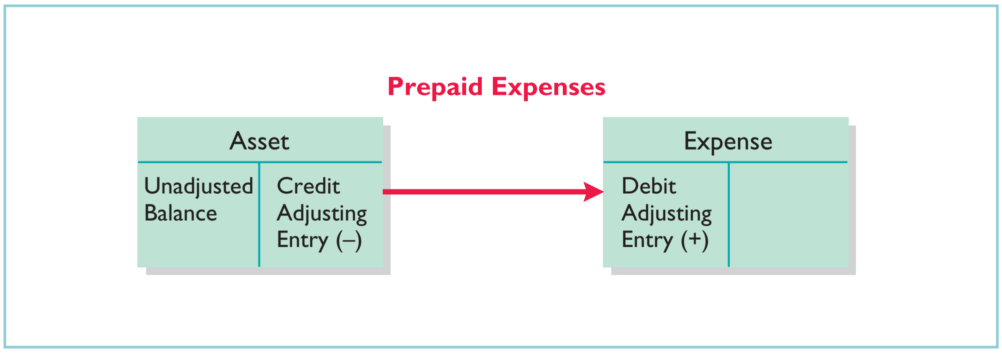
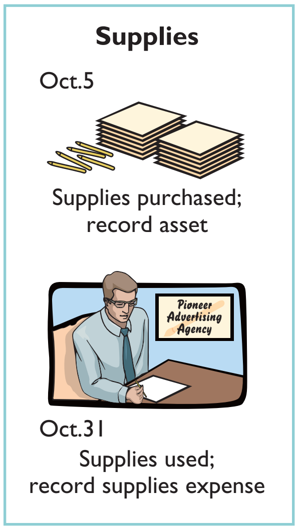


Illustration 3-4
Adjusting entries for prepaid expenses

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

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

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



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

A	=	L	+	OE
				−1,500 Exp
−1,500				

Cash Flows
no effect

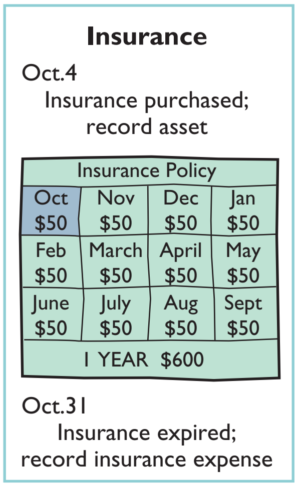
Oct. 31	Advertising Supplies Expense	1,500	
	Advertising Supplies		1,500
	(To record supplies used)		

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

Illustration 3-5
Supplies accounts after adjustment

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

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



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

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

A	=	L	+	OE
				−50 Exp
−50				

Cash Flows
no effect

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

After Pioneer posts the adjusting entry, the accounts show:

Illustration 3-6
Insurance accounts after adjustment

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

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

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

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

Depreciation

Oct.2

Office equipment purchased; record asset

Office Equipment			
Oct $40	Nov $40	Dec $40	Jan $40
Feb $40	March $40	April $40	May $40
June $40	July $40	Aug $40	Sept $40
Depreciation = $480/year			

Oct.31

Depreciation recognized; record depreciation expense

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

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

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

Oct. 31	Depreciation Expense	40	
	Accumulated Depreciation—Office Equipment		40
	(To record monthly depreciation)		

A	=	L	+	OE
				−40 Exp
−40				

Cash Flows
no effect

After the adjusting entry is posted, the accounts show:

Illustration 3-7
Accounts after adjustment for depreciation

Office Equipment	
10/1 5,000	

Accumulated Depreciation—Office Equipment	
	10/31 **Adj.** **40**

Depreciation Expense	
10/31 **Adj.** **40**	

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

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

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

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

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

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

Illustration 3-8
Balance sheet presentation of accumulated depreciation

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

ALTERNATIVE TERMINOLOGY

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

TEACHING HELP

For Pioneer Advertising, what is book value at December 31?
Answer: $4,880 [$5,000 − ($40 × 3)]

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

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

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

Illustration 3-9 summarizes the accounting for prepaid expenses.

Illustration 3-9
Accounting for prepaid expenses

ACCOUNTING FOR PREPAID EXPENSES

Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry
Insurance, supplies, advertising, rent, depreciation	Prepaid expenses recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets

Unearned Revenues

Oct.2

Cash is received in advance; liability is recorded

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

UNEARNED REVENUES

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

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

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

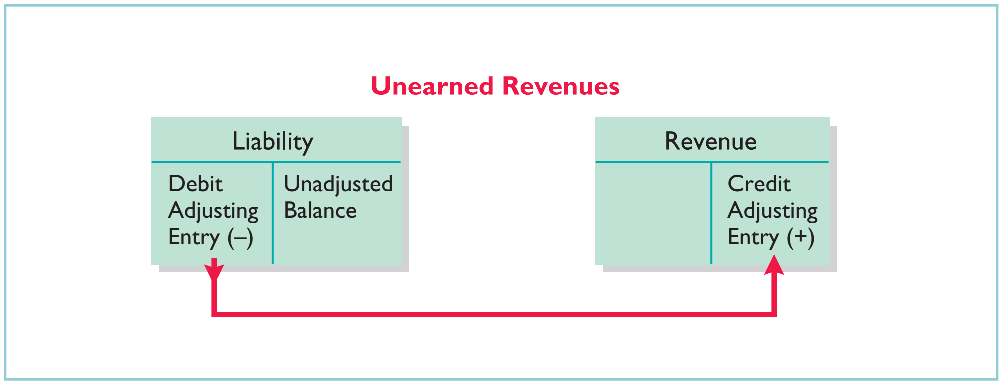


Illustration 3-10
Adjusting entries for unearned revenues

ALTERNATIVE TERMINOLOGY

Unearned revenue is sometimes referred to as *deferred revenue.*

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

Oct. 31	Unearned Revenue	400	
	Service Revenue		400
	(To record revenue for services provided)		

A	=	L	+	OE
		−400		
				+400 Rev

Cash Flows
no effect

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

Unearned Revenue

10/31 **Adj.**	**400**	10/2	1,200
		10/31 Bal.	800

Service Revenue

		10/31 Bal.	10,000
		31 **Adj.**	**400**

Illustration 3-11
Revenue accounts after prepayments adjustment

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

Illustration 3-12 summarizes the accounting for unearned revenues.

TEACHING HELP

If Pioneer Advertising performs one-half of the remaining service in November, what is the amount of the November 30 adjusting entry?
Answer: $400 ($800 ÷ 2).

Illustration 3-12
Accounting for unearned revenues

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

ACCOUNTING ACROSS THE ORGANIZATION

Turning Gift Cards into Revenue

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

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is used by the customer? How should expired gift cards be accounted for? In its 2007 balance sheet Best Buy reported unearned revenue related to gift cards of $300 million.

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

? Suppose that Robert Jones purchases a $100 gift card at Best Buy on December 24, 2010, and gives it to his wife, Devon, on December 25, 2010. On January 3, 2011, Devon uses the card to purchase $100 worth of CDs. When do you think Best Buy should recognize revenue, and why?

DO IT!

ADJUSTING ENTRIES—DEFERRALS

The ledger of Hammond, Inc. on March 31, 2010, includes the following selected accounts before adjusting entries.

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

An analysis of the accounts shows the following.

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

Prepare the adjusting entries for the month of March.

action plan

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

✔ Don't forget to make adjusting entries for prepayments. Failure to adjust for prepayments leads to overstatement of the asset or liability and related understatement of the expense or revenue.

Solution

1. Insurance Expense	100	
Prepaid Insurance		100
(To record insurance expired)		
2. Office Supplies Expense	2,000	
Office Supplies		2,000
(To record supplies used)		
3. Depreciation Expense	200	
Accumulated Depreciation—Office Equipment		200
(To record monthly depreciation)		
4. Unearned Revenue	4,600	
Service Revenue		4,600
(To record revenue for services provided)		

Related exercise material: **BE3-3, BE3-4, BE3-5, BE3-6,** and **DO IT! 3-2.**

The Navigator

Adjusting Entries for Accruals

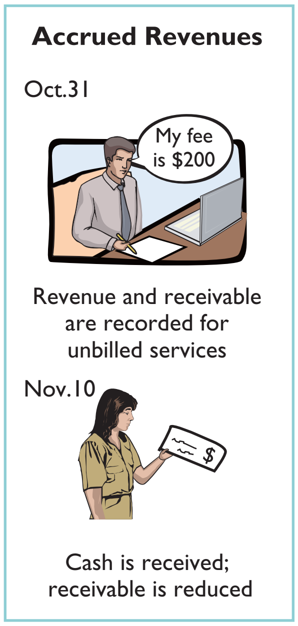
STUDY OBJECTIVE 6
Prepare adjusting entries for accruals.

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

ACCRUED REVENUES

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

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



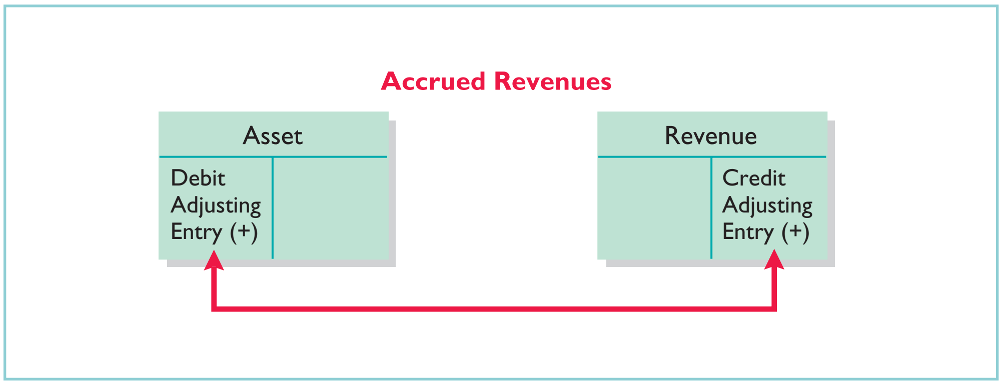


Illustration 3-13
Adjusting entries for accrued revenues

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

A	=	L	+	OE
+200				+200 Rev

Cash Flows
no effect

Oct. 31	Accounts Receivable	200	
	Service Revenue		200
	(To record revenue for services provided)		

After Pioneer posts the adjusting entry, the accounts show:

Illustration 3-14
Receivable and revenue accounts after accrual adjustment

Accounts Receivable

10/31 **Adj.** **200**	

Service Revenue

	10/31 10,000
	31 400
	31 **Adj.** **200**
	10/31 Bal. 10,600

ETHICS NOTE

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

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

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

A	=	L	+	OE
+200				
−200				

Cash Flows
+200

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

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

Illustration 3-15 summarizes the accounting for accrued revenues.

Illustration 3-15
Accounting for accrued revenues

ACCOUNTING FOR ACCRUED REVENUES

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

ACCRUED EXPENSES

ALTERNATIVE TERMINOLOGY

Accrued expenses are also called *accrued liabilities.*

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

An adjusting entry for accrued expenses serves two purposes: (1) It records the obligations that exist at the balance sheet date, and (2) it recognizes the expenses of the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore, as Illustration 3-16 shows, **an adjusting entry for accrued expenses increases (debits) an expense account and increases (credits) a liability account**.

Accrued Expenses

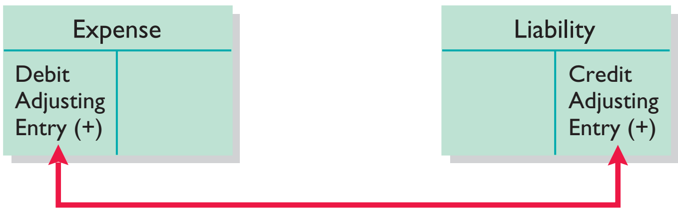


Illustration 3-16
Adjusting entries for accrued expenses

TEACHING HELP
Recognition of an accrued expense does not mean that a company is slow or deficient in paying its debts. The accrued liability may not be due until after the balance sheet date.

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

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

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

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

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
$5,000	×	12%	×	1/12	=	$50

Illustration 3-17
Formula for computing interest

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

Oct. 31	Interest Expense	50	
	Interest Payable		50
	(To record interest on notes payable)		

A	=	L	+	OE
				−50 exp
		+50		

Cash Flows
no effect

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

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

Illustration 3-18
Interest accounts after adjustment

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

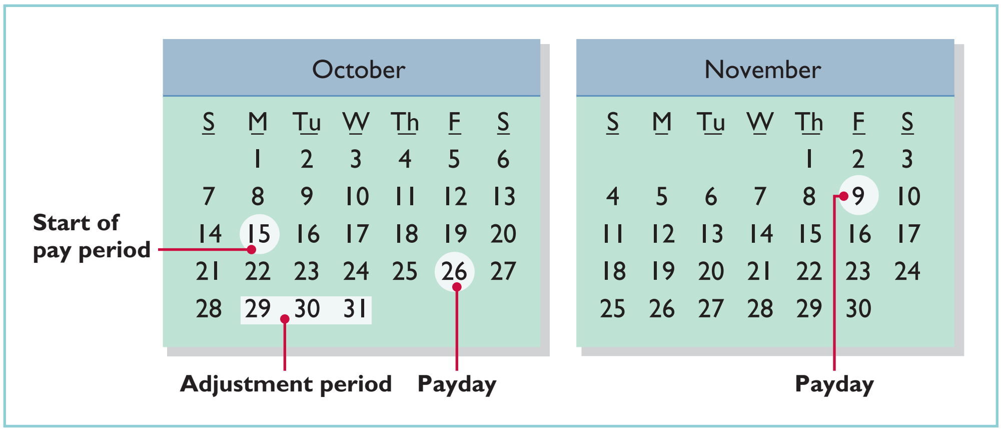
TEACHING HELP
What is the interest payable at November 30 and December 31? Answer: Nov. 30, $100 and Dec. 31, $150.

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

Interest Expense shows the interest charges for the month of October. Interest Payable shows the amount of interest owed at the statement date. (As of October 31, they are the same because October is the first month of the note payable.) Pioneer will not pay the interest until the note comes due at the end of three months. Companies use the Interest Payable account, instead of crediting (increasing) Notes Payable, in order to disclose the two types of obligations—interest and principal—in the accounts and statements. Without this adjusting entry, liabilities and interest expense are understated, and net income and owner's equity are overstated.

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

Illustration 3-19
Calendar showing Pioneer's pay periods



TEACHING HELP
Point out that although we call these entries accruals, we do not put the word *accrued* in the account title.

A	=	L	+	OE
				−1,200 exp
		+1,200		

Cash Flows
no effect

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

Oct. 31	Salaries Expense	1,200	
	Salaries Payable		1,200
	(To record accrued salaries)		

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

Illustration 3-20
Salary accounts after adjustment

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

Salaries Payable			
	10/31	Adj.	1,200

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

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

Nov. 9	Salaries Payable	1,200	
	Salaries Expense	2,800	
	Cash		4,000
	(To record November 9 payroll)		

A	=	L	+	OE
		−1,200		
				−2,800 Exp
−4,000				

Cash Flows
−4,000

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

Illustration 3-21 summarizes the accounting for accrued expenses.

Illustration 3-21
Accounting for accrued expenses

ACCOUNTING FOR ACCRUED EXPENSES

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

DO IT!

ADJUSTING ENTRIES—ACCRUALS

Calvin and Hobbes are the new owners of Micro Computer Services. At the end of August 2010, their first month of ownership, Calvin and Hobbes are trying to prepare monthly financial statements. They have the following information for the month.

1. At August 31, Calvin and Hobbes owed employees $800 in salaries that the company will pay on September 1.
2. On August 1, Calvin and Hobbes borrowed $30,000 from a local bank on a 15-year note. The annual interest rate is 10%.
3. Service revenue unrecorded in August totaled $1,100.

Prepare the adjusting entries needed at August 31, 2010.

action plan

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

Solution

1. Salaries Expense	800	
Salaries Payable		800
(To record accrued salaries)		
2. Interest Expense	250	
Interest Payable		250
(To record interest)		
($\$30{,}000 \times 10\% \times 1/12 = \$250$)		
3. Accounts Receivable	1,100	
Service Revenue		1,100
(To record revenue for services provided)		

Related exercise material: **BE3-7, E3-5, E3-6, E3-7, E3-8, E3-9, E3-10, E3-11, E3-12,** and **DO IT! E3-3.**

✔ The Navigator

Summary of Journalizing and Posting

TEACHING HELP

Point out that the standard form and content of journal entries stated in Chapter 2 also apply to adjusting entries.

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

Illustration 3-22
General journal showing adjusting entries

GENERAL JOURNAL J2

Date	Account Titles and Explanation	Ref.	Debit	Credit
2010	Adjusting Entries			
Oct. 31	Advertising Supplies Expense	631	1,500	
	Advertising Supplies	126		1,500
	(To record supplies used)			
31	Insurance Expense	722	50	
	Prepaid Insurance	130		50
	(To record insurance expired)			
31	Depreciation Expense	711	40	
	Accumulated Depreciation—Office Equipment	158		40
	(To record monthly depreciation)			
31	Unearned Revenue	209	400	
	Service Revenue	400		400
	(To record revenue for services provided)			
31	Accounts Receivable	112	200	
	Service Revenue	400		200
	(To record revenue for services provided)			
31	Interest Expense	905	50	
	Interest Payable	230		50
	(To record interest on notes payable)			
31	Salaries Expense	726	1,200	
	Salaries Payable	212		1,200
	(To record accrued salaries)			

HELPFUL HINT

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

Illustration 3-23
General ledger after adjustment

GENERAL LEDGER

Cash **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		15,200

Accounts Receivable **No. 112**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**	**200**		**200**

Advertising Supplies **No. 126**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 5		J1	2,500		2,500
31	**Adj. entry**	**J2**		**1,500**	**1,000**

Prepaid Insurance **No. 130**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 4		J1	600		600
31	**Adj. entry**	**J2**		**50**	**550**

Office Equipment **No. 157**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 1		J1	5,000		5,000

Accumulated Depreciation—Office Equipment **No. 158**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**		**40**	**40**

Notes Payable **No. 200**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 1		J1		5,000	5,000

Accounts Payable **No. 201**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 5		J1		2,500	2,500

Unearned Revenue **No. 209**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 2		J1		1,200	1,200
31	**Adj. entry**	**J2**	**400**		**800**

Salaries Payable **No. 212**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**		**1,200**	**1,200**

Interest Payable **No. 230**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**		**50**	**50**

C. R. Byrd, Capital **No. 301**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 1		J1		10,000	10,000

C. R. Byrd, Drawing **No. 306**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 20		J1	500		500

Service Revenue **No. 400**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31		J1		10,000	10,000
31	**Adj. entry**	**J2**		**400**	**10,400**
31	**Adj. entry**	**J2**		**200**	**10,600**

Advertising Supplies Expense **No. 631**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**	**1,500**		**1,500**

Depreciation Expense **No. 711**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**	**40**		**40**

Insurance Expense **No. 722**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**	**50**		**50**

Salaries Expense **No. 726**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 26		J1	4,000		4,000
31	**Adj. entry**	**J2**	**1,200**		**5,200**

Rent Expense **No. 729**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 3		J1	900		900

Interest Expense **No. 905**

Date	Explanation	Ref.	Debit	Credit	Balance
2010					
Oct. 31	**Adj. entry**	**J2**	**50**		**50**

THE ADJUSTED TRIAL BALANCE AND FINANCIAL STATEMENTS

STUDY OBJECTIVE 7

Describe the nature and purpose of an adjusted trial balance.

TEACHING HELP

Stress the differences in timing and in content between the two trial balances.

The company has journalized and posted all adjusting entries. Next it prepares another trial balance from the ledger accounts. This is called an **adjusted trial balance**. Its purpose is to **prove the equality** of the total debit balances and the total credit balances in the ledger after all adjustments. The accounts in the adjusted trial balance contain all data that the company needs to prepare financial statements.

Preparing the Adjusted Trial Balance

Illustration 3-24 presents the adjusted trial balance for Pioneer Advertising Agency, prepared from the ledger accounts in Illustration 3-23. The amounts highlighted in color are those affected by the adjusting entries. Compare these amounts to those in the unadjusted trial balance in Illustration 3-3 on page 100. In this comparison, you will see that there are more accounts in the adjusted trial balance as a result of the adjusting entries made at the end of the month.

Illustration 3-24
Adjusted trial balance

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2010

	Dr.	Cr.
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

Preparing Financial Statements

Companies can prepare financial statements directly from the adjusted trial balance. Illustrations 3-25 (below) and 3-26 (on page 116) show the interrelationships of data in the adjusted trial balance and the financial statements.

As Illustration 3-25 shows, companies first prepare the income statement from the revenue and expense accounts. Next, they use the owner's capital and drawing accounts and the net income (or net loss) from the income statement to prepare the owner's equity statement. As Illustration 3-26 (page 116) shows, companies then prepare the balance sheet from the asset and liability accounts and the ending owner's capital balance as reported in the owner's equity statement.

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2010

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation— Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING AGENCY
Income Statement
For the Month Ended October 31, 2010

Revenues		
Service Revenue		$10,600
Expenses		
Salaries expense	$5,200	
Advertising supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		$ 2,860

PIONEER ADVERTISING AGENCY
Owner's Equity Statement
For the Month Ended October 31, 2010

C. R. Byrd; Capital, October 1	$ –0–
Add: Investments by owners	10,000
C. R. Byrd, Capital	10,000
Net income	2,860
	12,860
Less: Drawings	500
C. R. Byrd, Capital, October 31	$12,360

To balance sheet

Illustration 3-25
Preparation of the income statement and owner's equity statement from the adjusted trial balance

PIONEER ADVERTISING AGENCY
Adjusted Trial Balance
October 31, 2010

Account	Debit	Credit
Cash	$15,200	
Accounts Receivable	200	
Advertising Supplies	1,000	
Prepaid Insurance	550	
Office Equipment	5,000	
Accumulated Depreciation—Office Equipment		$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Revenue		800
Salaries Payable		1,200
Interest Payable		50
C. R. Byrd, Capital		10,000
C. R. Byrd, Drawing	500	
Service Revenue		10,600
Salaries Expense	5,200	
Advertising Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	$30,190	$30,190

PIONEER ADVERTISING AGENCY
Balance Sheet
October 31, 2010

Assets

Cash		$15,200
Accounts receivable		200
Advertising supplies		1,000
Prepaid insurance		550
Office equipment	$5,000	
Less: Accumulated depreciation	40	4,960
Total assets		$21,910

Liabilities and Owner's Equity

Liabilities	
Notes payable	$ 5,000
Accounts payable	2,500
Unearned revenue	800
Salaries payable	1,200
Interest payable	50
Total liabilities	9,550
Owner's equity	
C. R. Byrd, Capital	12,360
Total liabilities and owner's equity	$21,910

Capital Balance at Oct. 31 from Owner's Equity Statement in Illustration 3-25

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

DO IT!

TRIAL BALANCE

Skolnick Co. was organized on April 1, 2010. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below.

Debits		Credits	
Cash	$ 6,700	Accumulated Depreciation—Equipment	$ 850
Accounts Receivable	600	Notes Payable	5,000
Prepaid Rent	900	Accounts Payable	1,510
Supplies	1,000	Salaries Payable	400
Equipment	15,000	Interest Payable	50
Bob Skolnick, Drawing	600	Unearned Rent	500
Salaries Expense	9,400	Bob Skolnick, Capital	14,000
Rent Expense	1,500	Commission Revenue	14,200
Depreciation Expense	850	Rent Revenue	800
Supplies Expense	200		
Utilities Expense	510		
Interest Expense	50		
Total debits	$37,310	Total credits	$37,310

(a) Determine the net income for the quarter April 1 to June 30.
(b) Determine the total assets and total liabilities at June 30, 2010.
(c) Determine the amount for Bob Skolnick, Capital at June 30, 2010.

Solution

(a) The net income is determined by adding revenue and subtracting expenses. The net income is computed as follows:

Revenues		
Commission revenue	$14,200	
Rent revenue	800	
Total revenues		$15,000
Expenses		
Salaries expense	$ 9,400	
Rent expense	1,500	
Depreciation expense	850	
Supplies expense	200	
Utilities expense	510	
Interest expense	50	
Total expenses		12,510
Net income		$ 2,490

(b) Total assets and liabilities are computed as follows:

Assets			Liabilities	
Cash		$ 6,700	Notes payable	$5,000
Accounts receivable		600	Accounts payable	1,510
Prepaid rent		900	Salaries payable	400
Supplies		1,000	Interest payable	50
Equipment	$15,000		Unearned rent	500
Less: Accumulated depreciation	850	14,150		
Total assets		$23,350	Total liabilities	$7,460

(c) Bob Skolnick, Capital at June 30, 2010, can be computed in two ways. Using the basic accounting equation (Assets = Liabilities + Owner's equity), we find that total assets are $23,350 and total liabilities are $7,460; therefore owner's equity (Bob Skolnick, Capital) is $15,890 ($23,350 − $7,460).

Another way to compute Skolnick, Capital at June 30, 2010, is as follows:

Bob Skolnick, Capital, April 1		$ −0−
Add: Investments	$14,000	
Net income	2,490	16,490
Less: Drawings		600
Bob Skolnick, Capital, June 30		$15,890

action plan

- ✔ In an adjusted trial balance, all assets, liability, revenue and expense accounts are properly stated.
- ✔ To determine the ending balance in Bob Skolnick, Capital at June 30, 2010, it is necessary to adjust this amount by net income and drawings.

Related exercise material: **BE3-9, BE3-10, E3-11, E3-13, E3-14,** and **DO IT! 3-4.**

✔ The Navigator

Comprehensive DO IT!

Terry Thomas opens the Green Thumb Lawn Care Company on April 1. At April 30, the trial balance shows the following balances for selected accounts.

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

Analysis reveals the following additional data.

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

Instructions

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

action plan

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

Solution to Comprehensive DO IT!

GENERAL JOURNAL J1

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

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SUMMARY OF STUDY OBJECTIVES

1 **Explain the time period assumption.** The time period assumption assumes that the economic life of a business is divided into artificial time periods.

2 **Explain the accrual basis of accounting.** Accrual-basis accounting means that companies record events that change a company's financial statements in the periods in which those events occur, rather than in the periods in which the company receives or pays cash.

3 **Explain the reasons for adjusting entries.** Companies make adjusting entries at the end of an accounting period.

Such entries ensure that companies record revenues in the period in which they are earned and that they recognize expenses in the period in which they are incurred.

4 **Identify the major types of adjusting entries.** The major types of adjusting entries are deferrals (prepaid expenses and unearned revenues), and accruals (accrued revenues and accrued expenses).

5 **Prepare adjusting entries for deferrals.** Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals to record the portion of the prepayment that represents the expense incurred or the revenue earned in the current accounting period.

6 **Prepare adjusting entries for accruals.** Accruals are either accrued revenues or accrued expenses. Companies make adjusting entries for accruals to record revenues earned and expenses incurred in the current accounting period that have not been recognized through daily entries.

7 **Describe the nature and purpose of an adjusted trial balance.** An adjusted trial balance shows the balances of all accounts, including those that have been adjusted, at the end of an accounting period. Its purpose is to prove the equality of the total debit balances and total credit balances in the ledger after all adjustments.

The Navigator

GLOSSARY

Accrual-basis accounting Accounting basis in which companies record transactions that change a company's financial statements in the periods in which the events occur. (p. 97).

Accruals Adjusting entries for either accrued revenues or accrued expenses. (p. 99).

Accrued expenses Expenses incurred but not yet paid in cash or recorded. (p. 108).

Accrued revenues Revenues earned but not yet received in cash or recorded. (p. 107).

Adjusted trial balance A list of accounts and their balances after the company has made all adjustments. (p. 114).

Adjusting entries Entries made at the end of an accounting period to ensure that companies follow the revenue recognition and matching principles. (p. 99).

Book value The difference between the cost of a depreciable asset and its related accumulated depreciation. (p. 104).

Calendar year An accounting period that extends from January 1 to December 31. (p. 96).

Cash-basis accounting Accounting basis in which companies record revenue when they receive cash and an expense when they pay cash. (p. 97).

Contra asset account An account offset against an asset account on the balance sheet. (p. 103).

Deferrals Adjusting entries for either prepaid expenses or unearned revenues. (p. 99).

Depreciation The allocation of the cost of an asset to expense over its useful life in a rational and systematic manner. (p. 103).

Fiscal year An accounting period that is one year in length. (p. 96).

Interim periods Monthly or quarterly accounting time periods. (p. 96).

Matching principle The principle that companies match efforts (expenses) with accomplishments (revenues). (p. 97).

Prepaid expenses Expenses paid in cash that benefit more than one accounting period and that are recorded as assets. (p. 100).

Revenue recognition principle The principle that companies recognize revenue in the accounting period in which it is earned. (p. 97).

Time period assumption An assumption that accountants can divide the economic life of a business into artificial time periods. (p. 96).

Unearned revenues Cash received and recorded as liabilities before revenue is earned. (p. 104).

Useful life The length of service of a long-lived asset. (p. 103).

APPENDIX Alternative Treatment of Prepaid Expenses and Unearned Revenues

STUDY OBJECTIVE 8

Prepare adjusting entries for the alternative treatment of deferrals.

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

Some companies use an alternative treatment: (1) When a company prepays an expense, it debits that amount to an expense account. (2) When it receives payment for future services, it credits the amount to a revenue account. In this appendix, we describe the circumstances that justify such entries and the different adjusting entries that may be required. This alternative treatment of prepaid expenses and unearned revenues has the same effect on the financial statements as the procedures described in the chapter.

Prepaid Expenses

TEACHING HELP
Explain the benefits of studying these alternatives: (1) Some companies use them, and (2) understanding the alternatives should reinforce knowledge of adjusting entries.

TEACHING HELP
Some companies record cash receipts as revenues and cash payments as expenses to establish a simplified routine. Then the CPA makes the adjusting entry at the end of the accounting period.

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

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

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

A	=	L	+	OE
+1,000				
				+1,000 Exp

Cash Flows
no effect

Oct. 31	Advertising Supplies	1,000	
	Advertising Supplies Expense		1,000
	(To record supplies inventory)		

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

Illustration 3A-1
Prepaid expenses accounts after adjustment

Advertising Supplies

Debit			Credit
10/31	Adj.	1,000	

Advertising Supplies Expense

Debit			Credit		
10/5		2,500	10/31	Adj.	1,000
10/31	Bal.	1,500			

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

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

Illustration 3A-2
Adjustment approaches—a comparison

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

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

Illustration 3A-3
Comparison of accounts

(per chapter) Advertising Supplies

10/5		2,500	10/31	**Adj.**	**1,500**
10/31	**Bal.**	**1,000**			

(per appendix) Advertising Supplies

10/31	**Adj.**	**1,000**			

(per chapter) Advertising Supplies Expense

10/31	**Adj.**	**1,500**			

(per appendix) Advertising Supplies Expense

10/5		2,500	10/31	**Adj.**	**1,000**
10/31	**Bal.**	**1,500**			

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

Unearned Revenues

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

To illustrate, assume that Pioneer Advertising received $1,200 for future services on October 2. Pioneer expects to perform the services before October 31.[3] In such a case, the company credits Service Revenue. If it in fact earns the revenue before October 31, no adjustment is needed.

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

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

Oct. 31	Service Revenue	800	
	Unearned Revenue		800
	(To record unearned revenue)		

A	=	L	+	OE
				−800 Rev
		+800		

Cash Flows
no effect

After Pioneer posts the adjusting entry, the accounts show:

Illustration 3A-4
Unearned revenue accounts after adjustment

Unearned Revenue

			10/31	**Adj.**	**800**

Service Revenue

10/31	**Adj.**	**800**	10/2		1,200
			10/31	**Bal.**	**400**

The liability account Unearned Revenue shows a balance of $800. This equals the services that will be provided in the future. In addition, the balance in Service Revenue equals the services provided in October. Without the adjusting entry, both revenues and net income are overstated by $800 in the October income statement. Also, liabilities are understated by $800, and owner's equity is overstated by $800 on the October 31 balance sheet.

Illustration 3A-5, (page 122) compares the entries and accounts for service revenue earned and unearned in the two adjustment approaches.

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

Illustration 3A-5
Adjustment approaches—a comparison

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

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

Illustration 3A-6
Comparison of accounts

(per chapter)

Unearned Revenue

Debit		Credit	
10/31 **Adj.**	**400**	10/2	1,200
		10/31 **Bal.**	**800**

Service Revenue

Debit		Credit	
		10/31 **Adj.**	**400**

(per appendix)

Unearned Revenue

Debit		Credit	
		10/31 **Adj.**	**800**

Service Revenue

Debit		Credit	
10/31 **Adj.**	**800**	10/2	1,200
		10/31 **Bal.**	**400**

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

TEACHING HELP
Stress the new relationships here.

Summary of Additional Adjustment Relationships

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

Illustration 3A-7
Summary of basic relationships for deferrals

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

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

SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

WILEY PLUS

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

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

SELF-STUDY QUESTIONS

WILEY PLUS

Answers are at the end of the chapter.

(SO 1) **1.** The time period assumption states that:
- **a.** revenue should be recognized in the accounting period in which it is earned.
- **b.** expenses should be matched with revenues.
- **c.** the economic life of a business can be divided into artificial time periods.
- **d.** the fiscal year should correspond with the calendar year.

(SO 1) **2.** The time period assumption states that:
- **a.** companies must wait until the calendar year is completed to prepare financial statements.
- **b.** companies use the fiscal year to report financial information.
- **c.** the economic life of a business can be divided into artificial time periods.
- **d.** companies record information in the time period in which the events occur.

(SO 2) **3.** One of the following statements about the accrual basis of accounting is *false*. That statement is:
- **a.** Events that change a company's financial statements are recorded in the periods in which the events occur.
- **b.** Revenue is recognized in the period in which it is earned.
- **c.** This basis is in accord with generally accepted accounting principles.
- **d.** Revenue is recorded only when cash is received, and expense is recorded only when cash is paid.

(SO 2) **4.** The principle or assumption dictating that efforts (expenses) be matched with accomplishments (revenues) is the:
- **a.** matching principle.
- **b.** cost assumption.
- **c.** periodicity principle.
- **d.** revenue recognition principle.

(SO 3) **5.** Adjusting entries are made to ensure that:
- **a.** expenses are recognized in the period in which they are incurred.
- **b.** revenues are recorded in the period in which they are earned.
- **c.** balance sheet and income statement accounts have correct balances at the end of an accounting period.
- **d.** all of the above.

(SO 4) **6.** Each of the following is a major type (or category) of adjusting entries *except:*
- **a.** prepaid expenses.
- **b.** accrued revenues.
- **c.** accrued expenses.
- **d.** earned revenues.

(SO 5) **7.** The trial balance shows Supplies $1,350 and Supplies Expense $0. If $600 of supplies are on hand at the end of the period, the adjusting entry is:

a. Supplies	600	
Supplies Expense		600
b. Supplies	750	
Supplies Expense		750
c. Supplies Expense	750	
Supplies		750
d. Supplies Expense	600	
Supplies		600

8. Adjustments for prepaid expenses: (SO 5)
- **a.** decrease assets and increase revenues.
- **b.** decrease expenses and increase assets.
- **c.** decrease assets and increase expenses.
- **d.** decrease revenues and increase assets.

9. Accumulated Depreciation is: (SO 5)
- **a.** a contra asset account.
- **b.** an expense account.
- **c.** an owner's equity account.
- **d.** a liability account.

10. Queenan Company computes depreciation on delivery equipment at $1,000 for the month of June. The adjusting entry to record this depreciation is as follows: (SO 5)

a. Depreciation Expense	1,000	
Accumulated Depreciation—Queenan Company		1,000
b. Depreciation Expense	1,000	
Delivery Equipment		1,000
c. Depreciation Expense	1,000	
Accumulated Depreciation—Delivery Equipment		1,000
d. Delivery Equipment Expense	1,000	
Accumulated Depreciation—Delivery Equipment		1,000

11. Adjustments for unearned revenues: (SO 5)
- **a.** decrease liabilities and increase revenues.
- **b.** have an assets and revenues account relationship.
- **c.** increase assets and increase revenues.
- **d.** decrease revenues and decrease assets.

12. Adjustments for accrued revenues: (SO 6)
- **a.** have a liabilities and revenues account relationship.
- **b.** have an assets and revenues account relationship.
- **c.** decrease assets and revenues.
- **d.** decrease liabilities and increase revenues.

13. Kathy Siska earned a salary of $400 for the last week of September. She will be paid on October 1. The adjusting entry for Kathy's employer at September 30 is: (SO 6)

a. No entry is required.

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

14. Which of the following statements is *incorrect* concerning the adjusted trial balance? (SO 7)
- **a.** An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.
- **b.** The adjusted trial balance provides the primary basis for the preparation of financial statements.

c. The adjusted trial balance lists the account balances segregated by assets and liabilities.

d. The adjusted trial balance is prepared after the adjusting entries have been journalized and posted.

(SO 8) ***15.** The trial balance shows Supplies $0 and Supplies Expense $1,500. If $800 of supplies are on hand at the end of the period, the adjusting entry is:

a. Debit Supplies $800 and credit Supplies Expense $800.
b. Debit Supplies Expense $800 and credit Supplies $800.
c. Debit Supplies $700 and credit Supplies Expense $700.
d. Debit Supplies Expense $700 and credit Supplies $700.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for Additional Self-Study questions.

The Navigator

QUESTIONS

C **1. (a)** How does the time period assumption affect an accountant's analysis of business transactions?

(b) Explain the terms *fiscal year, calendar year*, and *interim periods*.

C **2.** State two generally accepted accounting principles that relate to adjusting the accounts.

C **3.** Rick Marsh, a lawyer, accepts a legal engagement in March, performs the work in April, and is paid in May. If Marsh's law firm prepares monthly financial statements, when should it recognize revenue from this engagement? Why?

C **4.** Why do accrual-basis financial statements provide more useful information than cash-basis statements?

AP **5.** In completing the engagement in question 3, Marsh pays no costs in March, $2,000 in April, and $2,500 in May (incurred in April). How much expense should the firm deduct from revenues in the month when it recognizes the revenue? Why?

C **6.** "Adjusting entries are required by the cost principle of accounting." Do you agree? Explain.

C **7.** Why may a trial balance not contain up-to-date and complete financial information?

C **8.** Distinguish between the two categories of adjusting entries, and identify the types of adjustments applicable to each category.

C **9.** What is the debit/credit effect of a prepaid expense adjusting entry?

C **10.** "Depreciation is a valuation process that results in the reporting of the fair market value of the asset." Do you agree? Explain.

C **11.** Explain the differences between depreciation expense and accumulated depreciation.

C **12.** Shinn Company purchased equipment for $18,000. By the current balance sheet date, $6,000 had been depreciated. Indicate the balance sheet presentation of the data.

C **13.** What is the debit/credit effect of an unearned revenue adjusting entry?

C **14.** A company fails to recognize revenue earned but not yet received. Which of the following accounts are involved in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense? For the accounts selected, indicate whether they would be debited or credited in the entry.

15. A company fails to recognize an expense incurred but not paid. Indicate which of the following accounts is debited and which is credited in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense. C

16. A company makes an accrued revenue adjusting entry for $900 and an accrued expense adjusting entry for $700. How much was net income understated prior to these entries? Explain. AN

17. On January 9, a company pays $5,000 for salaries, of which $2,000 was reported as Salaries Payable on December 31. Give the entry to record the payment. AP

18. For each of the following items before adjustment, indicate the type of adjusting entry (prepaid expense, unearned revenue, accrued revenue, and accrued expense) that is needed to correct the misstatement. If an item could result in more than one type of adjusting entry, indicate each of the types. AN

(a) Assets are understated.
(b) Liabilities are overstated.
(c) Liabilities are understated.
(d) Expenses are understated.
(e) Assets are overstated.
(f) Revenue is understated.

19. One-half of the adjusting entry is given below. Indicate the account title for the other half of the entry. C

(a) Salaries Expense is debited.
(b) Depreciation Expense is debited.
(c) Interest Payable is credited.
(d) Supplies is credited.
(e) Accounts Receivable is debited.
(f) Unearned Service Revenue is debited.

20. "An adjusting entry may affect more than one balance sheet or income statement account." Do you agree? Why or why not? C

21. Why is it possible to prepare financial statements directly from an adjusted trial balance? C

***22.** Adel Company debits Supplies Expense for all purchases of supplies and credits Rent Revenue for all advanced rentals. For each type of adjustment, give the adjusting entry. AP

23. PEPSICO What was PepsiCo's depreciation expense for 2007 and 2006? K

BRIEF EXERCISES

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

Indicate why adjusting entries are needed.
(SO 3), **C**

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

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

Identify the major types of adjusting entries.
(SO 4), **AN**

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

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

Prepare adjusting entry for supplies.
(SO 5), **AN**

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

Prepare adjusting entry for depreciation.
(SO 5), **AN**

BE3-5 On July 1, 2010, Spahn Co. pays $18,000 to Randle Insurance Co. for a 3-year insurance contract. Both companies have fiscal years ending December 31. For Spahn Co., journalize and post the entry on July 1 and the adjusting entry on December 31.

Prepare adjusting entry for prepaid expense.
(SO 5), **AN**

BE3-6 Using the data in BE3-5, journalize and post the entry on July 1 and the adjusting entry on December 31 for Randle Insurance Co. Randle uses the accounts Unearned Insurance Revenue and Insurance Revenue.

Prepare adjusting entry for unearned revenue.
(SO 5), **AN**

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

Prepare adjusting entries for accruals.
(SO 6), **AN**

1. Interest on notes payable of $400 is accrued.
2. Services provided but not recorded total $1,500.
3. Salaries earned by employees of $900 have not been recorded.

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

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

Analyze accounts in an unadjusted trial balance.
(SO 4), **AN**

Accounts Receivable
Prepaid Insurance
Accumulated Depreciation—Equipment
Interest Payable
Unearned Service Revenue

BE3-9 The adjusted trial balance of Harmony Company at December 31, 2010, includes the following accounts: S. Harmony, Capital $15,600; S. Harmony, Drawing $6,000; Service Revenue $35,400; Salaries Expense $16,000; Insurance Expense $2,000; Rent Expense $4,000; Supplies Expense $1,500; and Depreciation Expense $1,300. Prepare an income statement for the year.

Prepare an income statement from an adjusted trial balance.
(SO 7), **AP**

BE3-10 Partial adjusted trial balance data for Harmony Company is presented in BE3-9. The balance in S. Harmony, Capital is the balance as of January 1. Prepare an owner's equity statement for the year assuming net income is $10,600 for the year.

Prepare an owner's equity statement from an adjusted trial balance.
(SO 7), **AP**

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

Prepare adjusting entries under alternative treatment of deferrals.
(SO 8), **AN**

DO IT! REVIEW

Identify timing concepts.
(SO 1, 2), K

DO IT! 3-1 Numerous timing concepts are discussed on pages 96 and 97. A list of concepts is provided below, on the left, with a description of the concept on the right. There are more descriptions provided than concepts. Match the description of the concept to the concept.

1. ____ Cash basis accounting.
2. ____ Fiscal year.
3. ____ Revenue recognition principle.
4. ____ Matching principle.

(a) Monthly and quarterly time periods.
(b) Accountants divide the economic life of a business into artificial time periods.
(c) Efforts (expenses) should be matched with accomplishments (revenues).
(d) Companies record revenues when they receive cash and record expenses when they pay out cash.
(e) An accounting time period that is one year in length.
(f) An accounting time period that starts on January 1 and ends on December 31.
(g) Companies record transactions in the period in which the events occur.
(h) Recognize revenue in the accounting period in which it is earned.

Prepare adjusting entries for deferrals.
(SO 5), AN

DO IT! 3-2 The ledger of Buerhle, Inc. on March 31, 2010, includes the following selected accounts before adjusting entries.

	Debit	Credit
Prepaid Insurance	2,400	
Office Supplies	2,500	
Office Equipment	30,000	
Unearned Revenue		10,000

An analysis of the accounts shows the following:

1. Insurance expires at the rate of $300 per month.
2. Supplies on hand total $900.
3. The office equipment depreciates $500 per month.
4. 2/5 of the unearned revenue was earned in March.

Prepare the adjusting entries for the month of March.

Prepare adjusting entries for accruals.
(SO 6), AN

DO IT! 3-3 Jose Contreras is the new owner of Curveball Computer Services. At the end of July 2010, his first month of ownership, Jose is trying to prepare monthly financial statements. He has the following information for the month.

1. At July 31, Contreras owed employees $1,100 in salaries that the company will pay in August.
2. On July 1, Contreras borrowed $20,000 from a local bank on a 10-year note. The annual interest rate is 12%.
3. Service revenue unrecorded in July totaled $1,600.

Prepare the adjusting entries needed at July 31, 2010.

Calculate amounts for trial balance.
(SO 7), AN

DO IT! 3-4 Danks Co. was organized on April 1, 2010. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below.

Debits		Credits	
Cash	$ 5,360	Accumulated Depreciation—Equipment	$ 700
Accounts Receivable	480	Notes Payable	4,000
Prepaid Rent	720	Accounts Payable	1,200
Supplies	800	Salaries Payable	300
Equipment	12,000	Interest Payable	40
John Danks, Drawing	500	Unearned Rent	400
Salaries Expense	7,520	John Danks, Capital	11,200
Rent Expense	1,200	Commission revenue	11,360
Depreciation Expense	700	Rent revenue	690
Supplies Expense	160	Total credits	$29,890
Utilities Expense	410		
Interest Expense	40		
Total debits	$29,890		

(a) Determine the net income for the quarter April 1 to June 30.
(b) Determine the total assets and total liabilities at June 30, 2010 for Danks Company.
(c) Determine the amount that appears for John Danks, Capital at June 30, 2010.

EXERCISES

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

Explain the time period assumption.
(SO 1), **C**

1. Adjusting entries would not be necessary if a company's life were not divided into artificial time periods.
2. The IRS requires companies to file annual tax returns.
3. Accountants divide the economic life of a business into artificial time periods, but each transaction affects only one of these periods.
4. Accounting time periods are generally a month, a quarter, or a year.
5. A time period lasting one year is called an interim period.
6. All fiscal years are calendar years, but not all calendar years are fiscal years.

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

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

Distinguish between cash and accrual basis of accounting.
(SO 2), **E**

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

E3-3 Conan Industries collected $100,000 from customers in 2010. Of the amount collected, $25,000 was from revenue earned on account in 2009. In addition, Conan earned $40,000 of revenue in 2010, which will not be collected until 2011.

Compute cash and accrual accounting income.
(SO 2), **AP**

Conan Industries also paid $70,000 for expenses in 2010. Of the amount paid, $30,000 was for expenses incurred on account in 2009. In addition, Conan incurred $42,000 of expenses in 2010, which will not be paid until 2011.

Instructions
(a) Compute 2010 cash-basis net income.
(b) Compute 2010 accrual-basis net income.

(b) Net income $33,000

E3-4 Emeril Corporation encounters the following situations:

Identify the type of adjusting entry needed.
(SO 4), **AN**

1. Emeril collects $1,000 from a customer in 2010 for services to be performed in 2011.
2. Emeril incurs utility expense which is not yet paid in cash or recorded.
3. Emeril's employees worked 3 days in 2010, but will not be paid until 2011.
4. Emeril earned service revenue but has not yet received cash or recorded the transaction.
5. Emeril paid $2,000 rent on December 1 for the 4 months starting December 1.
6. Emeril received cash for future services and recorded a liability until the revenue was earned.
7. Emeril performed consulting services for a client in December 2010. On December 31, it billed the client $1,200.
8. Emeril paid cash for an expense and recorded an asset until the item was used up.
9. Emeril purchased $900 of supplies in 2010; at year-end, $400 of supplies remain unused.
10. Emeril purchased equipment on January 1, 2010; the equipment will be used for 5 years.
11. Emeril borrowed $10,000 on October 1, 2010, signing an 8% one-year note payable.

Instructions
Identify what type of adjusting entry (prepaid expense, unearned revenue, accrued expense, accrued revenue) is needed in each situation, at December 31, 2010.

Prepare adjusting entries from selected data.

(SO 5, 6), **AN**

E3-5 Drew Carey Company has the following balances in selected accounts on December 31, 2010.

Accounts Receivable	$ -0-
Accumulated Depreciation—Equipment	-0-
Equipment	7,000
Interest Payable	-0-
Notes Payable	10,000
Prepaid Insurance	2,100
Salaries Payable	-0-
Supplies	2,450
Unearned Consulting Revenue	40,000

All the accounts have normal balances. The information below has been gathered at December 31, 2010.

1. Drew Carey Company borrowed $10,000 by signing a 12%, one-year note on September 1, 2010.
2. A count of supplies on December 31, 2010, indicates that supplies of $800 are on hand.
3. Depreciation on the equipment for 2010 is $1,000.
4. Drew Carey Company paid $2,100 for 12 months of insurance coverage on June 1, 2010.
5. On December 1, 2010, Drew Carey collected $40,000 for consulting services to be performed from December 1, 2010, through March 31, 2011.
6. Drew Carey performed consulting services for a client in December 2010. The client will be billed $4,200.
7. Drew Carey Company pays its employees total salaries of $9,000 every Monday for the preceding 5-day week (Monday through Friday). On Monday, December 29, employees were paid for the week ending December 26. All employees worked the last 3 days of 2010.

Instructions

Prepare adjusting entries for the seven items described above.

Identify types of adjustments and account relationships.

(SO 4, 5, 6), **AN**

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

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

Instructions

For each of the above items indicate the following.

(a) The type of adjustment (prepaid expense, unearned revenue, accrued revenue, or accrued expense).

(b) The status of accounts before adjustment (overstatement or understatement).

Prepare adjusting entries from selected account data.

(SO 5, 6), **AN**

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

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

An analysis of the accounts shows the following.

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

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

Prepare adjusting entries.
(SO 5, 6), **AN**

E3-8 Andy Wright, D.D.S., opened a dental practice on January 1, 2010. During the first month of operations the following transactions occurred.

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

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

Prepare adjusting entries.
(SO 5, 6), **AN**

E3-9 The trial balance for Pioneer Advertising Agency is shown in Illustration 3-3, p. 100. In lieu of the adjusting entries shown in the text at October 31, assume the following adjustment data.

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

Instructions
Prepare the adjusting entries for the items above.

Prepare correct income statement.
(SO 2, 5, 6, 7), **AN**

E3-10 The income statement of Benning Co. for the month of July shows net income of $1,400 based on Service Revenue $5,500, Wages Expense $2,300, Supplies Expense $1,200, and Utilities Expense $600. In reviewing the statement, you discover the following.

1. Insurance expired during July of $400 was omitted.
2. Supplies expense includes $200 of supplies that are still on hand at July 31.
3. Depreciation on equipment of $150 was omitted.
4. Accrued but unpaid wages at July 31 of $300 were not included.
5. Services provided but unrecorded totaled $500.

Instructions
Prepare a correct income statement for July 2010.

Net income $1,250

Analyze adjusted data.
(SO 4, 5, 6, 7), **AN**

E3-11 A partial adjusted trial balance of Sila Company at January 31, 2010, shows the following.

SILA COMPANY
Adjusted Trial Balance
January 31, 2010

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

Instructions

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

(a) $1,300

(a) If the amount in Supplies Expense is the January 31 adjusting entry, and $500 of supplies was purchased in January, what was the balance in Supplies on January 1?

(b) $4,800: Aug. 1, 2009

(b) If the amount in Insurance Expense is the January 31 adjusting entry, and the original insurance premium was for one year, what was the total premium and when was the policy purchased?

(c) $2,500

(c) If $3,500 of salaries was paid in January, what was the balance in Salaries Payable at December 31, 2009?

(d) $1,150

(d) If $1,600 was received in January for services performed in January, what was the balance in Unearned Revenue at December 31, 2009?

Journalize basic transactions and adjusting entries.

(SO 5, 6, 7), AN

E3-12 Selected accounts of Tabor Company are shown below.

Supplies Expense

7/31	800		

Supplies

7/1 Bal.	1,100	7/31	800
7/10	400		

Salaries Payable

		7/31	1,200

Accounts Receivable

7/31	500		

Unearned Revenue

7/31	900	7/1 Bal.	1,500
		7/20	1,000

Salaries Expense

7/15	1,200		
7/31	1,200		

Service Revenue

		7/14	2,000
		7/31	900
		7/31	500

Instructions

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

Prepare adjusting entries from analysis of trial balances.

(SO 5, 6, 7), AN

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

GARCIA COMPANY
Trial Balance
August 31, 2010

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

Instructions

Prepare the adjusting entries that were made.

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

Prepare financial statements from adjusted trial balance.

(SO 7), **AP**

Instructions

Prepare the income and owner's equity statements for the year and the balance sheet at August 31.

Net income $9,800
Total assets $32,900

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

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

(SO 5, 6), **AN, S**

December 31	2010	2009
Fees receivable from members	$14,000	$ 9,000
Unearned fees revenue	17,000	25,000

Fees are billed to members based upon their use of the club's facilities. Unearned fees arise from the sale of gift certificates, which members can apply to their future use of club facilities. The 2010 income statement for the club showed that fees revenue of $153,000 was earned during the year.

Instructions

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

(a) Prepare journal entries for each of the following events that took place during 2010.
  (1) Fees receivable from 2009 were all collected.
  (2) Gift certificates outstanding at the end of 2009 were all redeemed.
  (3) An additional $35,000 worth of gift certificates were sold during 2010. A portion of these was used by the recipients during the year; the remainder was still outstanding at the end of 2010.
  (4) Fees for 2010 for services provided to members were billed to members.
  (5) Fees receivable for 2010 (i.e., those billed in item [4] above) were partially collected.

(b) Determine the amount of cash received by the club, with respect to fees, during 2010.

Cash received $140,000

***E3-16** Colin Mochrie Company has the following balances in selected accounts on December 31, 2010.

Journalize adjusting entries.

(SO 8), **AN**

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

All the accounts have normal balances. Colin Mochrie Company debits prepayments to expense accounts when paid, and credits unearned revenues to revenue accounts when received. The following information below has been gathered at December 31, 2010.

1. Colin Mochrie Company paid $2,100 for 12 months of insurance coverage on June 1, 2010.
2. On December 1, 2010, Colin Mochrie Company collected $40,000 for consulting services to be performed from December 1, 2010, through March 31, 2011.
3. A count of supplies on December 31, 2010, indicates that supplies of $800 are on hand.

Instructions

Prepare the adjusting entries needed at December 31, 2010.

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

Journalize transactions and adjusting entries.

(SO 8), **AN**

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

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

(c) Insurance expense $150
Supplies expense $900
Service revenue $2,500

Instructions

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

EXERCISES: SET B

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

PROBLEMS: SET A

Prepare adjusting entries, post to ledger accounts, and prepare adjusted trial balance.
(SO 5, 6, 7), **AN**

P3-1A Tony Masasi started his own consulting firm, Masasi Company, on June 1, 2010. The trial balance at June 30 is shown below.

MASASI COMPANY
Trial Balance
June 30, 2010

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

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

Other data:

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

Instructions

(a) Prepare the adjusting entries for the month of June. Use J3 as the page number for your journal.

(b) Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances and place a check mark in the posting reference column.

(c) Prepare an adjusted trial balance at June 30, 2010.

*The check figures you see next to **Problems** are also shown in the students' text.*

(c) Adj. trial balance $41,550

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

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

(SO 5, 6, 7), **AN**

NEOSHO RIVER RESORT
Trial Balance
August 31, 2010

Account Number		Debit	Credit
101	Cash	$ 19,600	
126	Supplies	3,300	
130	Prepaid Insurance	6,000	
140	Land	25,000	
143	Cottages	125,000	
149	Furniture	26,000	
201	Accounts Payable		$ 6,500
209	Unearned Rent Revenue		7,400
275	Mortgage Payable		80,000
301	P. Harder, Capital		100,000
306	P. Harder, Drawing	5,000	
429	Rent Revenue		80,000
622	Repair Expense	3,600	
726	Salaries Expense	51,000	
732	Utilities Expense	9,400	
		$273,900	$273,900

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

Other data:

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

Instructions

(a) Journalize the adjusting entries on August 31 for the 3-month period June 1–August 31.

(b) Prepare a ledger using the three-column form of account. Enter the trial balance amounts and post the adjusting entries. (Use J1 as the posting reference.)

(c) Prepare an adjusted trial balance on August 31.

(d) Prepare an income statement and an owner's equity statement for the 3 months ending August 31 and a balance sheet as of August 31.

(c) Adj. trial balance $278,000
(d) Net income $14,100
Ending capital balance $109,100
Total assets $199,900

P3-3A Fernetti Advertising Agency was founded by John Fernetti in January of 2009. Presented on page 134 are both the adjusted and unadjusted trial balances as of December 31, 2010.

Prepare adjusting entries and financial statements.

(SO 5, 6, 7), **AN**

FERNETTI ADVERTISING AGENCY
Trial Balance
December 31, 2010

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

Instructions

(a) Journalize the annual adjusting entries that were made.

(b) Net income $36,450
Ending capital $49,950
Total assets $67,000
(c) (1) 6%
(2) $2,500

(b) Prepare an income statement and a statement of owner's equity for the year ending December 31, 2010, and a balance sheet at December 31.

(c) Answer the following questions.

(1) If the note has been outstanding 6 months, what is the annual interest rate on that note?

(2) If the company paid $12,500 in salaries in 2010, what was the balance in Salaries Payable on December 31, 2009?

Preparing adjusting entries.
(SO 5, 6), **AN**

P3-4A A review of the ledger of Remington Company at December 31, 2010, produces the following data pertaining to the preparation of annual adjusting entries.

1. Salaries expense $2,320

1. Salaries Payable $0. There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of $800 each per week, and three employees earn $600 each per week. Assume December 31 is a Tuesday. Employees do not work weekends. All employees worked the last 2 days of December.

2. Rent revenue $74,000

2. Unearned Rent $324,000. The company began subleasing office space in its new building on November 1. At December 31, the company had the following rental contracts that are paid in full for the entire term of the lease.

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

3. Advertising expense $4,800

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

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

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

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

4. Interest expense $6,300

Instructions

Prepare the adjusting entries at December 31, 2010. (Show all computations.)

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

(SO 5, 6, 7), **AN**

P3-5A On September 1, 2010, the account balances of Rand Equipment Repair were as follows.

No.	Debits		No.	Credits	
101	Cash	$ 4,880	154	Accumulated Depreciation	$ 1,500
112	Accounts Receivable	3,520	201	Accounts Payable	3,400
126	Supplies	2,000	209	Unearned Service Revenue	1,400
153	Store Equipment	15,000	212	Salaries Payable	500
			301	J. Rand, Capital	18,600
		$25,400			$25,400

During September the following summary transactions were completed.

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

Adjustment data consist of:

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

Instructions

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

(d) Trial balance $30,150
(f) Adj. trial balance $30,650
(g) Net income $1,200
Ending capital $19,800
Total assets $23,900

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

(SO 5, 6, 7, 8), **AN**

***P3-6A** Givens Graphics Company was organized on January 1, 2010, by Sue Givens. At the end of the first 6 months of operations, the trial balance contained the accounts on the next page.

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

Analysis reveals the following additional data.

1. The $3,700 balance in Supplies Expense represents supplies purchased in January. At June 30, $1,300 of supplies was on hand.
2. The note payable was issued on February 1. It is a 9%, 6-month note.
3. The balance in Insurance Expense is the premium on a one-year policy, dated March 1, 2010.
4. Consulting fees are credited to revenue when received. At June 30, consulting fees of $1,500 are unearned.
5. Graphic revenue earned but unrecorded at June 30 totals $2,000.
6. Depreciation is $2,000 per year.

Instructions

(a) Journalize the adjusting entries at June 30. (Assume adjustments are recorded every 6 months.)

(b) Adj. trial balance $112,850

(b) Prepare an adjusted trial balance.

(c) Net income $18,750
Ending capital $40,750
Total assets $72,000

(c) Prepare an income statement and owner's equity statement for the 6 months ended June 30 and a balance sheet at June 30.

PROBLEMS: SET B

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

(SO 5, 6, 7), **AN**

P3-1B Ken Ham started his own consulting firm, Hambone Consulting, on May 1, 2010. The trial balance at May 31 is as follows.

HAMBONE CONSULTING
Trial Balance
May 31, 2010

Account Number		Debit	Credit
101	Cash	$ 5,700	
112	Accounts Receivable	6,000	
126	Supplies	1,900	
130	Prepaid Insurance	3,600	
149	Office Furniture	10,200	
201	Accounts Payable		$ 4,500
209	Unearned Service Revenue		2,000
301	K. Ham, Capital		17,700
400	Service Revenue		7,500
726	Salaries Expense	3,400	
729	Rent Expense	900	
		$31,700	$31,700

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

Supplies Expense, No. 717 Depreciation Expense, No. 722 Insurance Expense, and No. 736 Travel Expense.

Other data:

1. $900 of supplies have been used during the month.
2. Travel expense incurred but not paid on May 31, 2010, $250.
3. The insurance policy is for 2 years.
4. $400 of the balance in the unearned service revenue account remains unearned at the end of the month.
5. May 31 is a Wednesday, and employees are paid on Fridays. Hambone Consulting has two employees, who are paid $800 each for a 5-day work week.
6. The office furniture has a 5-year life with no salvage value. It is being depreciated at $170 per month for 60 months.
7. Invoices representing $1,200 of services performed during the month have not been recorded as of May 31.

Instructions

(a) Prepare the adjusting entries for the month of May. Use J4 as the page number for your journal.
(b) Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances and place a check mark in the posting reference column.
(c) Prepare an adjusted trial balance at May 31, 2010.

(c) Adj. trial balance $34,280

P3-2B The Mound View Motel opened for business on May 1, 2010. Its trial balance before adjustment on May 31 is as follows.

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

(SO 5, 6, 7), **AN**

GLS

MOUND VIEW MOTEL
Trial Balance
May 31, 2010

Account Number		Debit	Credit
101	Cash	$ 3,500	
126	Supplies	2,200	
130	Prepaid Insurance	2,280	
140	Land	12,000	
141	Lodge	60,000	
149	Furniture	15,000	
201	Accounts Payable		$ 4,800
209	Unearned Rent Revenue		3,300
275	Mortgage Payable		35,000
301	Kevin Henry, Capital		46,380
429	Rent Revenue		10,300
610	Advertising Expense	600	
726	Salaries Expense	3,300	
732	Utilities Expense	900	
		$99,780	$99,780

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

Other data:

1. Prepaid insurance is a 1-year policy starting May 1, 2010.
2. A count of supplies shows $750 of unused supplies on May 31.
3. Annual depreciation is $3,000 on the lodge and $2,700 on furniture.
4. The mortgage interest rate is 12%. (The mortgage was taken out on May 1.)
5. Two-thirds of the unearned rent revenue has been earned.
6. Salaries of $750 are accrued and unpaid at May 31.

Instructions

(c) Adj. trial balance $101,355

(d) Net income $4,485
Ending capital balance $50,865
Total assets $92,865

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

Prepare adjusting entries and financial statements.

(SO 5, 6, 7), **AN**

P3-3B Poblano Co. was organized on July 1, 2010. Quarterly financial statements are prepared. The unadjusted and adjusted trial balances as of September 30 are shown below.

POBLANO CO.
Trial Balance
September 30, 2010

	Unadjusted		Adjusted	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Cash	$ 8,700		$ 8,700	
Accounts Receivable	10,400		11,200	
Supplies	1,500		900	
Prepaid Rent	2,200		1,300	
Equipment	18,000		18,000	
Accumulated Depreciation—Equipment				$ 500
Notes Payable		$ 10,000		10,000
Accounts Payable		2,500		2,500
Salaries Payable				725
Interest Payable				100
Unearned Rent Revenue		1,900		1,050
Rikki Poblano, Capital		22,000		22,000
Rikki Poblano, Drawing	1,600		1,600	
Commission Revenue		16,000		16,800
Rent Revenue		1,410		2,260
Salaries Expense	8,000		8,725	
Rent Expense	1,900		2,800	
Depreciation Expense			500	
Supplies Expense			600	
Utilities Expense	1,510		1,510	
Interest Expense			100	
	$53,810	$53,810	$55,935	$55,935

Instructions

(b) Net income $4,825
Ending capital $25,225
Total assets $39,600

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

Prepare adjusting entries

(SO 5, 6), **AN**

P3-4B A review of the ledger of Obi Company at December 31, 2010, produces the following data pertaining to the preparation of annual adjusting entries.

1. Insurance expense $4,650

1. Prepaid Insurance $9,900. The company has separate insurance policies on its buildings and its motor vehicles. Policy B4564 on the building was purchased on April 1, 2009, for $7,200. The policy has a term of 3 years. Policy A2958 on the vehicles was purchased on January 1, 2010, for $4,500. This policy has a term of 2 years.

2. Subscription revenue $6,375

2. Unearned Subscriptions $45,000. The company began selling magazine subscriptions in 2010 on an annual basis. The magazine is published monthly. The selling price of a subscription is $45. A review of subscription contracts reveals the following.

Subscription Date	Number of Subscriptions
October 1	200
November 1	300
December 1	500
	1,000

3. Notes Payable $100,000. This balance consists of a note for 9 months at an annual interest rate of 9%, dated November 1.

3. Interest expense $1,500

4. Salaries Payable $0. There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of $700 each per week, and three employees earn $500 each per week. Assume December 31 is a Tuesday. Employees do not work weekends. All employees worked the last 2 days of December.

4. Salaries expense $2,000

Instructions

Prepare the adjusting entries at December 31, 2010.

P3-5B On November 1, 2010, the account balances of Morelli Equipment Repair were as follows.

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

(SO 5, 6, 7), **AN**

GLS

No.	Debits		No.	Credits	
101	Cash	$ 2,400	154	Accumulated Depreciation	$ 2,000
112	Accounts Receivable	4,250	201	Accounts Payable	2,600
126	Supplies	1,800	209	Unearned Service Revenue	1,200
153	Store Equipment	12,000	212	Salaries Payable	700
			301	V. Morelli, Capital	13,950
		$20,450			$20,450

During November the following summary transactions were completed.

Nov. 8 Paid $1,700 for salaries due employees, of which $700 is for October salaries.
10 Received $3,420 cash from customers on account.
12 Received $3,100 cash for services performed in November.
15 Purchased store equipment on account $2,000.
17 Purchased supplies on account $700.
20 Paid creditors on account $2,700.
22 Paid November rent $400.
25 Paid salaries $1,700.
27 Performed services on account and billed customers for services provided $900.
29 Received $600 from customers for future service.

Adjustment data consist of:

1. Supplies on hand $1,200.
2. Accrued salaries payable $400.
3. Depreciation for the month is $200.
4. Unearned service revenue of $1,250 is earned.

Instructions

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

(d) Trial balance $24,350

(f) Adj. trial balance $24,950
(g) Net income $250; Ending capital $14,200
Total assets $17,750

PROBLEMS: SET C

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

CONTINUING COOKIE CHRONICLE

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

CCC3 It is the end of November and Natalie has been in touch with her grandmother. Her grandmother asked Natalie how well things went in her first month of business. Natalie, too, would like to know if she has been profitable or not during November. Natalie realizes that in order to determine Cookie Creations' income, she must first make adjustments.

Go to the book's companion website, **www.wiley.com/college/weygandt**, *to see the completion of this problem.*

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

AN PEPSICO

Financial Reporting Problem: PepsiCo, Inc.

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

Instructions

(a) Using the consolidated financial statements and related information, identify items that may result in adjusting entries for prepayments.
(b) Using the consolidated financial statements and related information, identify items that may result in adjusting entries for accruals.
(c) Using the Selected Financial Data and 5-Year Summary, what has been the trend since 2003 for net income?

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

AN PEPSICO

BYP3-2 PepsiCo's financial statements are presented in Appendix A. Financial statements for The Coca-Cola Company are presented in Appendix B.

Instructions

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

(a) Net increase (decrease) in property, plant, and equipment (net) from 2006 to 2007.
(b) Increase (decrease) in selling, general, and administrative expenses from 2006 to 2007.
(c) Increase (decrease) in long-term debt (obligations) from 2006 to 2007.
(d) Increase (decrease) in net income from 2006 to 2007.
(e) Increase (decrease) in cash and cash equivalents from 2006 to 2007.

Exploring the Web

AN

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

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

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

Instructions

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

CRITICAL THINKING

Decision Making Across the Organization

BYP3-4 Happy Camper Park was organized on April 1, 2009, by Amaya Berge. Amaya is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Amaya prepared the following income statement for the quarter that ended March 31, 2010.

S

HAPPY CAMPER PARK
Income Statement
For the Quarter Ended March 31, 2010

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

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

You first look at the trial balance. In addition to the account balances reported above in the income statement, the ledger contains the following additional selected balances at March 31, 2010.

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

You then make inquiries and discover the following.

1. Rental revenues include advanced rentals for summer occupancy $15,000.
2. There were $1,700 of supplies on hand at March 31.
3. Prepaid insurance resulted from the payment of a one-year policy on January 1, 2010.
4. The mail on April 1, 2010, brought the following bills: advertising for week of March 24, $110; repairs made March 10, $260; and utilities, $180.
5. There are four employees, who receive wages totaling $300 per day. At March 31, 2 days' wages have been incurred but not paid.
6. The note payable is a 3-month, 10% note dated January 1, 2010.

Instructions

With the class divided into groups, answer the following.

(a) Prepare a correct income statement for the quarter ended March 31, 2010.
(b) Explain to Amaya the generally accepted accounting principles that she did not recognize in preparing her income statement and their effect on her results.

(a) Net income $26,550
(b) Effect on result is $22,750

Communication Activity

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

C

Instructions

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

Ethics Case

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

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

Instructions

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

"All About You" Activity

BYP3-7 Companies must report or disclose in their financial statements information about all liabilities, including potential liabilities related to environmental clean-up. There are many situations in which you will be asked to provide personal financial information about your assets, liabilities, revenue, and expenses. Sometimes you will face difficult decisions regarding what to disclose and how to disclose it.

Instructions

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

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

Answers to Insight and Accounting Across the Organization Questions

p. 98 How Long Will "The Force" Be with Us?

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

Q: What if the expenses are recognized over a period that is *longer than* that used for revenues?

A: *If the expenses are recognized over a period that is longer than that used for revenues, earnings will be overstated during the early years and understated in later years. In either case, management and stockholders could be misled.*

p. 106 Turning Gift Cards into Revenue

Q: Suppose that Robert Jones purchases a $100 gift card at Best Buy on December 24, 2010, and gives it to his wife, Devon, on December 25, 2010. On January 3, 2011, Devon uses the card to purchase $100 worth of CDs. When do you think Best Buy should recognize revenue, and why?

A: *According to the revenue recognition principle, companies should recognize revenue when earned. In this case revenue is not earned until Best Buy provides the goods. Thus, when Best Buy receives cash in exchange for the gift card on December 24, 2010, it should recognize a liability, Unearned Revenue, for $100. On January 3, 2011, when Devon Jones exchanges the card for merchandise, Best Buy should recognize revenue and eliminate $100 from the balance in the Unearned Revenue account.*

Answers to Self-Study Questions

1. c **2.** c **3.** d **4.** a **5.** d **6.** d **7.** c **8.** c **9.** a **10.** c **11.** a **12.** b **13.** b **14.** c ***15.** a

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.