CHAPTER 3
THE ADJUSTING PROCESS

DISCUSSION QUESTIONS

1. **a.** Under cash-basis accounting, revenues are reported in the period in which cash is received and expenses are reported in the period in which cash is paid.

b. Under accrual-basis accounting, revenues are reported in the period in which they are earned and expenses are reported in the same period as the revenues to which they relate.

2. The matching concept is related to the accrual basis of accounting.

3. Adjusting entries are needed at the end of an accounting period to bring the ledger up to date.

4. Adjusting entries bring the ledger up to date as a normal part of the accounting cycle. Correcting entries correct errors in the ledger.

5. Four different categories of adjusting entries include prepaid expenses (deferred expenses), unearned revenues (deferred revenues), accrued expenses (accrued liabilities), and accrued revenues (accrued assets).

6. Statement (a): Increases the balance of a revenue account.

7. Statement (b): Increases the balance of an expense account.

8. Yes, because every adjusting entry affects expenses or revenues.

9. **a.** The rights acquired represent an asset.

b. The justification for debiting Rent Expense is that when the ledger is summarized in a trial balance at the end of the month and statements are prepared, the rent will have become an expense. Hence, no adjusting entry will be necessary.

10. **a.** The portion of the cost of a fixed asset deducted from revenue of the period is debited to Depreciation Expense. It represents the cost of the fixed asset that has been expensed in generating revenue during the period. The reduction in the fixed asset account is recorded by a credit to Accumulated Depreciation rather than to the fixed asset account. The use of the contra asset account facilitates the presentation of original cost and accumulated depreciation on the balance sheet.

b. Depreciation Expense—debit balance; Accumulated Depreciation—credit balance.

c. No. It is not customary for the balances of the two accounts to be equal in amount.

d. Depreciation Expense appears on the income statement; Accumulated Depreciation appears on the balance sheet.

PRACTICE EXERCISES

PE 3-1A

a. No
b. No
c. Yes
d. No
e. No
f. Yes

PE 3-1B

a. Yes
b. No
c. No
d. Yes
e. Yes
f. Yes

PE 3-2A

a. (2) Unearned revenue
b. (3) Accrued revenue
c. (4) Accrued expense
d. (1) Prepaid expense

PE 3-2B

a. (2) Unearned revenue
b. (1) Prepaid expense
c. (3) Accrued revenue
d. (4) Accrued expense

PE 3-3A

Accounts Receivable	17,555	
Fees Earned		17,555
Accrued fees.		

PE 3-3B

Accounts Receivable	23,570	
Fees Earned		23,570
Accrued fees.		

PE 3-4A

Salaries Expense	23,000	
Salaries Payable		23,000
Accrued salaries [($27,600 ÷ 6 days) × 5 days].		

PE 3-4B

Salaries Expense	7,080	
Salaries Payable		7,080
Accrued salaries [($11,800 ÷ 5 days) × 3 days].		

PE 3-5A

Dec.	31	Unearned Rent	11,025	
		Rent Revenue		11,025
		Rent earned [($18,900 ÷ 12 months) × 7 months].		

PE 3-5B

Dec.	31	Unearned Fees	82,750	
		Fees Earned		82,750
		Fees earned ($272,500 – $189,750).		

PE 3-6A

Insurance Expense	15,500	
Prepaid Insurance		15,500
Insurance expired ($4,500 + $16,600 – $5,600).		

PE 3-6B

Supplies Expense	6,845	
Supplies		6,845
Supplies used ($3,375 + $6,450 – $2,980).		

PE 3-7A

Depreciation Expense	7,700	
Accumulated Depreciation—Equipment		7,700
Depreciation on equipment.		

PE 3-7B

Depreciation Expense	6,880	
Accumulated Depreciation—Equipment		6,880
Depreciation on equipment.		

PE 3-8A

a. **Revenues were understated by $6,600.**
b. **Expenses were understated by $10,400 ($1,400 + $9,000).**
c. **Net income was overstated by $3,800 ($10,400 – $6,600).**

PE 3-8B

a. **Revenues were understated by $44,500.**
b. **Expenses were understated by $13,100 ($5,800 + $7,300).**
c. **Net income was understated by $31,400 ($44,500 – $13,100).**

PE 3-9A

a. **The totals are equal even though the credit should have been to Wages Payable instead of Accounts Payable.**
b. **The totals are unequal. The credit total is higher by $27 ($1,152 – $1,125).**

PE 3-9B

a. **The totals are unequal. The debit total is higher by $900 ($9,800 – $8,900).**
b. **The totals are equal because the adjusting entry was omitted.**

PE 3-10A

a.

HEMLOCK COMPANY
Income Statements
For Years Ended December 31

	2019		2018	
	Amount	Percent	Amount	Percent
Fees earned	$725,000	100%	$615,000	100%
Operating expenses	435,000	60%	356,700	58%
Operating income	$290,000	40%	$258,300	42%

b. **An unfavorable trend of increasing operating expenses and decreasing operating income is indicated.**

PE 3-10B

a.

CORNEA COMPANY
Income Statements
For Years Ended December 31

	2019		2018	
	Amount	Percent	Amount	Percent
Fees earned	$1,640,000	100%	$1,300,000	100%
Operating expenses	869,200	53%	715,000	55%
Operating income	$ 770,800	47%	$ 585,000	45%

b. **A favorable trend of decreasing operating expenses and increasing operating income is indicated.**

EXERCISES

Ex. 3-1

1. **Accrued expense (b)**
2. **Unearned revenue (c)**
3. **Accrued revenue (a)**
4. **Prepaid expense (d)**
5. **Unearned revenue (c)**
6. **Prepaid expense (d)**
7. **Prepaid expense (d)**
8. **Accrued expense (b)**

Ex. 3-2

Account	Answer
Accounts Receivable……………………	Normally requires adjustment (AR).
Cash………………………………………	Does not normally require adjustment.
Harriet Kasun, Capital…………………	Does not normally require adjustment.
Interest Expense………………………	Normally requires adjustment (AE).
Interest Receivable……………………	Normally requires adjustment (AR).
Land………………………………………	Does not normally require adjustment.
Office Equipment………………………	Does not normally require adjustment.
Prepaid Rent……………………………	Normally requires adjustment (PE).
Supplies…………………………………	Normally requires adjustment (PE).
Unearned Fees…………………………	Normally requires adjustment (UR).
Wages Expense…………………………	Normally requires adjustment (AE).

Ex. 3-3

a.

Accounts Receivable	59,500	
Fees Earned		59,500
Accrued fees.		

b. **No. If the cash basis of accounting is used, revenues are recognized only when the cash is received. Therefore, earned but unbilled revenues would not be recognized in the accounts, and no adjusting entry would be necessary.**

Ex. 3-4

a. **Fees earned (or revenues) will be understated. Net income will be understated.**

b. **Accounts receivable (or assets) will be understated. Owner's equity (owner's capital account) will be understated.**

Ex. 3-5

a.

Salaries Expense	10,350	
Salaries Payable		10,350
Accrued salaries [($17,250 ÷ 5 days) × 3 days].		

b.

Salaries Expense	13,800	
Salaries Payable		13,800
Accrued salaries [($17,250 ÷ 5 days) × 4 days].		

Ex. 3-6

$66,075 ($73,250 – $7,175)

Ex. 3-7

a. **Salary expense (or expenses) will be understated. Net income will be overstated.**

b. **Salaries payable (or liabilities) will be understated. Owner's equity (owner's capital account) will be overstated.**

Ex. 3-8

a. **Salary expense (or expenses) will be overstated because two days of salaries that should have been included as October expenses are being recorded in November. Net income will be understated.**

b. **The balance sheet will be correct. This is because salaries payable has been paid, and the net income errors for October and November have offset each other. Thus, owner's equity (owner's capital account) is correct.**

Ex. 3-9

Unearned Fees	14,400	
Fees Earned		14,400
Fees earned ($18,000 – $3,600).		

Ex. 3-10

a. **Rent revenue (or revenues) will be understated. Net income will be understated.**

b. **Unearned rent (liabilities) will be overstated. Owner's equity (owner's capital account) at the end of the period will be understated.**

Ex. 3-11

Supplies Expense	3,970	
Supplies		3,970
Supplies used ($4,850 – $880).		

Ex. 3-12

$4,800 ($690 + $4,110)

Ex. 3-13

a. **Insurance expense (or expenses) will be understated. Net income will be overstated.**

b. **Prepaid insurance (or assets) will be overstated. Owner's equity (Owner's Capital) will be overstated.**

Ex. 3-14

a.

Insurance Expense	20,250	
Prepaid Insurance		20,250
Insurance expired.		

b.

Insurance Expense	20,250	
Prepaid Insurance		20,250
Insurance expired ($27,000 – $6,750).		

Ex. 3-15

a.

Insurance Expense	30,700	
Prepaid Insurance		30,700
Insurance expired ($3,000 + $32,500 – $4,800).		

b.

Insurance Expense	30,700	
Prepaid Insurance		30,700
Insurance expired.		

Ex. 3-16

a.

Unearned Fees	39,750	
Fees Earned		39,750
Unearned fees earned during year.		

b.

Accounts Receivable	24,650	
Fees Earned		24,650
Accrued fees earned.		

Ex. 3-17

a.

Dec.	31	Taxes Expense	12,320	
		Prepaid Taxes		12,320
		Prepaid taxes expired		
		[($18,480 ÷ 12 months) × 8 months].		
	31	Taxes Expense	45,000	
		Taxes Payable		45,000
		Accrued taxes.		

b. $57,320 ($12,320 + $45,000)

Ex. 3-18

Depreciation Expense	8,200	
Accumulated Depreciation—Equipment		8,200
Depreciation on equipment.		

Ex. 3-19

a. $1,075,000 ($3,150,000 – $2,075,000)

b. No. Depreciation is an allocation of the cost of the equipment to the periods benefiting from its use. It does not necessarily relate to value or loss of value.

Ex. 3-20

a. $13,011 million ($27,804 – $14,793)

b. No. Depreciation is an allocation method, not a valuation method. That is, depreciation allocates the cost of a fixed asset over its useful life. Depreciation does not attempt to measure market values, which may vary significantly from year to year.

Ex. 3-21

Income: $6,643 million ($3,197 + $3,446)

Ex. 3-22

a. $553 million overstated

b. 51.5% ($553 ÷ $1,073)

Ex. 3-23

	Error (a)		Error (b)	
	Over-stated	Under-stated	Over-stated	Under-stated
1. Revenue for the year would be	$ 0	$34,900	$ 0	$ 0
2. Expenses for the year would be	0	0	0	12,770
3. Net income for the year would be	0	34,900	12,770	0
4. Assets at July 31 would be	0	0	0	0
5. Liabilities at July 31 would be	34,900	0	0	12,770
6. Owner's equity at July 31 would be	0	34,900	12,770	0

Ex. 3-24

$218,530 ($196,400 + $34,900 – $12,770)

Ex. 3-25

a.	Dec.	31	Depreciation Expense	13,900	
			Accumulated Depreciation—Equipment		13,900
			Depreciation on equipment.		

b. (1) Depreciation expense would be understated. Net income would be overstated.

(2) Accumulated depreciation would be understated, and total assets would be overstated. Owner's equity (owner's capital account) would be overstated.

Ex. 3-26

1.

Accounts Receivable	**6**	
Fees Earned		**6**
Accrued fees earned.		

2.

Supplies Expense	**2**	
Supplies		**2**
Supplies used.		

3.

Insurance Expense	**12**	
Prepaid Insurance		**12**
Insurance expired.		

4.

Depreciation Expense	**4**	
Accumulated Depreciation—Equipment		**4**
Equipment depreciation.		

5.

Wages Expense	**2**	
Wages Payable		**2**
Accrued wages.		

Ex. 3-27

1. **The accountant debited Accounts Receivable for $5,000 but did not credit Laundry Revenue. This adjusting entry represents accrued laundry revenue.**
2. **The accountant debited rather than credited Laundry Supplies for $3,000.**
3. **The accountant credited the prepaid insurance account for $3,600, but debited the insurance expense account for only $600.**
4. **The accountant credited Laundry Equipment for the depreciation expense of $13,000 instead of crediting the accumulated depreciation account.**
5. **The accountant did not debit Wages Expense for $1,000.**

The corrected adjusted trial balance is shown below.

EVA'S LAUNDRY Adjusted Trial Balance May 31, 2019		
	Debit Balances	Credit Balances
Cash	7,500	
Accounts Receivable	23,250	
Laundry Supplies	750	
Prepaid Insurance	1,600	
Laundry Equipment	190,000	
Accumulated Depreciation—Laundry Equipment		61,000
Accounts Payable		9,600
Wages Payable		1,000
Eva Baldwin, Capital		110,300
Eva Baldwin, Drawing	28,775	
Laundry Revenue		187,100
Wages Expense	50,200	
Rent Expense	25,575	
Utilities Expense	18,500	
Depreciation Expense	13,000	
Laundry Supplies Expense	3,000	
Insurance Expense	3,600	
Miscellaneous Expense	3,250	
	369,000	369,000

Ex. 3-28

a.

AMAZON.COM, INC.
Operating Income Statements
For the Years Ended December 31
(in millions)

	Year 2		Year 1	
	Amount	Percent	Amount	Percent
Product sales	$70,080	78.8%	$60,903	81.8%
Service sales	18,908	21.2%	13,549	18.2%
Total sales	$88,988	100.0%	$74,452	100.0%
Cost of sales	$62,752	70.5%	$54,181	72.8%
Fulfillment	10,766	12.1%	8,585	11.5%
Marketing	4,332	4.9%	3,133	4.2%
Technology and content	9,275	10.4%	6,565	8.8%
General and administrative	1,552	1.7%	$ 1,129	1.5%
Other operating expense (income), net	133	0.2%	114	0.2%
Total operating expenses	$88,810	99.8%	$73,707	99.0%
Income from operations	$ 178	0.2%	$ 745	1.0%

b. The vertical analysis indicates that the income from operations declined from 1.0% to 0.2% of sales between the two years. Total expenses increased from 99.0% to 99.8% of total sales. This increase is explained by the increase in fulfillment (11.5% to 12.1%), marketing (4.2% to 4.9%), technology and content (8.8% to 10.4%), and general and administrative (1.5% to 1.7%) expenses. There was a sizable decrease in the cost of sales from 72.8% to 70.5% of total sales. However, this decrease was not sufficient to offset the increases in the other expenses; thus, total expenses increased and income from operations decreased as a percent of total sales between the two years. Management should investigate the reasons for the expense increases, paying special attention to technology and content.

Ex. 3-29

a. **Net income: $3,273 – $2,693 = $580 million**

$$\frac{\$580}{\$2,693} = 21.5\%$$

b. **Year 1:** $$\frac{\$2,693}{\$27,799} = 9.7\%$$

Year 2: $$\frac{\$3,273}{\$30,601} = 10.7\%$$

c. **Nike has increased net income between the two years by $580 million, or by 21.5%. This represents impressive earnings growth between the two years. Nike is able to accomplish this by growing sales and reducing expenses as a percent of sales between the two years.**

Ex. 3-30

a. **AT&T**

Revenues	$132,447	100.0%
Cost of services (expense)	60,611	45.8%
Selling and marketing expense	39,697	30.0%
Depreciation and other expenses	20,393	15.4%
Operating income	$ 11,746	8.8%

b. **Verizon**

Revenues	$127,079	100.0%
Cost of services (expense)	49,931	39.3%
Selling and marketing expense	41,016	32.3%
Depreciation and other expenses	16,533	13.0%
Operating income	$ 19,599	15.4%

c. **AT&T's operating income is 8.8% of revenues, while Verizon's operating income to revenues is 15.4%. Verizon appears to be more efficient in generating operating income from revenues. AT&T's cost of services is 45.8% of revenues, while Verizon's is over six percentage points less at 39.3% of revenues. This difference is a large contributor to Verizon's superior operating income-to-revenues efficiency. The other two expense items essentially cancel each other out in that the selling and marketing expenses are 30.0% of revenues for AT&T, while Verizon's are slightly larger at 32.3% of revenues. In contrast, the depreciation expense is 15.4% of revenues for AT&T and only 13.0% for Verizon. In summary, it appears that Verizon is able to generate more operating income per sales dollar, mostly because of a lower cost of services per sales dollar in comparison to AT&T.**

PROBLEMS

Prob. 3-1A

1.

Dec.	31	Supplies Expense	1,095	
		Supplies		1,095
		Supplies used ($1,375 – $280).		
	31	Unearned Rent	2,250	
		Rent Revenue		2,250
		Rent earned [($9,000 ÷ 4 months) × 1 month].		
	31	Wages Expense	3,220	
		Wages Payable		3,220
		Accrued wages.		
	31	Accounts Receivable	18,750	
		Fees Earned		18,750
		Accrued fees earned.		
	31	Depreciation Expense	2,900	
		Accumulated Depreciation—Office Equipment		2,900
		Depreciation expense.		

2. **Adjusting entries are a planned part of the accounting process to update the accounts. Correcting entries are not planned but arise only when necessary to correct errors.**

Prob. 3-2A

1.

July	31	Accounts Receivable	11,150	
		Fees Earned		11,150
		Accrued fees earned.		
	31	Supplies Expense	2,450	
		Supplies		2,450
		Supplies used ($3,350 – $900).		
	31	Rent Expense	6,000	
		Prepaid Rent		6,000
		Prepaid rent expired.		
	31	Depreciation Expense	8,950	
		Accumulated Depreciation—Equipment		8,950
		Equipment depreciation.		
	31	Unearned Fees	10,000	
		Fees Earned		10,000
		Fees earned ($12,000 – $2,000).		
	31	Wages Expense	4,840	
		Wages Payable		4,840
		Accrued wages.		

2. **Fees Earned would be understated by $11,150, Wages Expense would be understated by $4,840, and net income would be understated by $6,310 ($11,150 – $4,840).**

3. **Accounts Receivable would be understated by $11,150, total assets would be understated by $11,150, Wages Payable would be understated by $4,840, total liabilities would be understated by $4,840, owner's equity (Owner's Capital) would be understated by $6,310 ($11,150 – $4,840), and total liabilities and owner's equity would be understated by $11,150 ($6,310 + $4,840).**

4. **There is no effect on the "Net increase or decrease in cash" on the statement of cash flows because adjusting entries do not affect cash.**

Prob. 3-3A

1. a.

Accounts Receivable	7,380	
Fees Earned		7,380
Accrued fees earned.		

b.

Supplies Expense	13,425	
Supplies		13,425
Supplies used ($16,200 – $2,775).		

c.

Depreciation Expense	11,000	
Accumulated Depreciation—Equipment		11,000
Equipment depreciation.		

d.

Unearned Fees	16,500	
Fees Earned		16,500
Fees earned.		

e.

Wages Expense	3,880	
Wages Payable		3,880
Accrued wages.		

2.

Revenues	$294,750	
Expenses	226,350	($94,500 + $72,000 + $51,750 + $8,100)
Net Income	$ 68,400	

3.

Revenues	$318,630	($294,750 + $7,380 + $16,500)
Expenses	254,655	($226,350 + $13,425 + $11,000 + $3,880)
Net Income	$ 63,975	

4. The effect of the adjusting entries on Nancy Townes, Capital is the difference in net income in (2) and (3) of $4,425 ($68,400 – $63,975). The adjusting entries reduced net income by $4,425.

Prob. 3-4A

2019				
Nov.	**30**	**Supplies Expense**	**8,850**	
		Supplies		**8,850**
		Supplies used ($11,250 – $2,400).		
	30	**Insurance Expense**	**10,400**	
		Prepaid Insurance		**10,400**
		Insurance expired ($14,250 – $3,850).		
	30	**Depreciation Expense—Equipment**	**11,600**	
		Accumulated Depreciation—Equipment		**11,600**
		Equipment depreciation		
		($106,100 – $94,500).		
	30	**Depreciation Expense—Automobiles**	**7,300**	
		Accumulated Depreciation—Automobiles		**7,300**
		Automobile depreciation		
		($62,050 – $54,750).		
	30	**Utilities Expense**	**1,200**	
		Accounts Payable		**1,200**
		Accrued utilities expense		
		($26,130 – $24,930, or $14,100 – $12,900).		
	30	**Salary Expense**	**8,100**	
		Salaries Payable		**8,100**
		Accrued salaries ($525,000 – $516,900).		
	30	**Unearned Service Fees**	**9,000**	
		Service Fees Earned		**9,000**
		Service fees earned ($18,000 – $9,000, or		
		$742,800 – $733,800).		

Prob. 3-5A

1.

a.

Insurance Expense	6,600	
Prepaid Insurance		6,600
Insurance expired ($7,200 – $600).		

b.

Supplies Expense	1,305	
Supplies		1,305
Supplies used ($1,980 – $675).		

c.

Depreciation Expense—Building	12,000	
Accumulated Depreciation—Building		12,000
Building depreciation.		

d.

Depreciation Expense—Equipment	8,600	
Accumulated Depreciation—Equipment		8,600
Equipment depreciation.		

e.

Unearned Rent	4,500	
Rent Revenue		4,500
Rent revenue earned ($6,750 – $2,250).		

f.

Salaries and Wages Expense	2,800	
Salaries and Wages Payable		2,800
Accrued salaries and wages.		

g.

Accounts Receivable	10,050	
Fees Earned		10,050
Accrued fees earned.		

Prob. 3-5A (Concluded)

2.

PITMAN COMPANY
Adjusted Trial Balance
October 31, 2019

	Debit Balances	Credit Balances
Cash	7,500	
Accounts Receivable	48,450	
Prepaid Insurance	600	
Supplies	675	
Land	112,500	
Building	300,250	
Accumulated Depreciation—Building		99,550
Equipment	135,300	
Accumulated Depreciation—Equipment		106,550
Accounts Payable		12,150
Unearned Rent		2,250
Salaries and Wages Payable		2,800
Jan Pitman, Capital		371,000
Jan Pitman, Drawing	15,000	
Fees Earned		334,650
Rent Revenue		4,500
Salaries and Wages Expense	196,170	
Utilities Expense	42,375	
Advertising Expense	22,800	
Repairs Expense	17,250	
Depreciation Expense—Building	12,000	
Depreciation Expense—Equipment	8,600	
Insurance Expense	6,600	
Supplies Expense	1,305	
Miscellaneous Expense	6,075	
	933,450	933,450

Prob. 3-6A

1.

Apr.	30	Supplies Expense	2,750	
		Supplies		2,750
		Supplies used.		
	30	Accounts Receivable	23,700	
		Fees Earned		23,700
		Accrued fees earned.		
	30	Depreciation Expense	1,800	
		Accumulated Depreciation—Equipment		1,800
		Equipment depreciation.		
	30	Wages Expense	1,400	
		Wages Payable		1,400
		Accrued wages.		

2.

	Net Income	Total Assets	=	Total Liabilities	+	Total Owner's Equity
Reported amounts	$120,000	$750,000		$300,000		$450,000
Corrections:						
Supplies used	–2,750	–2,750		0		–2,750
Unbilled fees earned	+23,700	+23,700		0		+23,700
Equipment depreciation	–1,800	–1,800		0		–1,800
Accrued wages	–1,400	0		+1,400		–1,400
Corrected amounts	$137,750	$769,150		$301,400		$467,750

Prob. 3-1B

1.

May	31	Accounts Receivable	19,750	
		Fees Earned		19,750
		Accrued fees earned.		
	31	Supplies Expense	8,150	
		Supplies		8,150
		Supplies used ($12,300 – $4,150).		
	31	Wages Expense	2,700	
		Wages Payable		2,700
		Accrued wages.		
	31	Unearned Rent	3,000	
		Rent Revenue		3,000
		Rent earned ($9,000 ÷ 3 months).		
	31	Depreciation Expense	3,200	
		Accumulated Depreciation—Equipment		3,200
		Depreciation expense.		

2. Adjusting entries are a planned part of the accounting process to update the accounts. Correcting entries are not planned but arise only when necessary to correct errors.

Prob. 3-2B

1.

Nov.	30	Supplies Expense	2,620	
		Supplies		2,620
		Supplies used ($3,170 – $550).		
	30	Depreciation Expense	1,675	
		Accumulated Depreciation—Equipment		1,675
		Depreciation for year.		
	30	Rent Expense	8,500	
		Prepaid Rent		8,500
		Rent expired.		
	30	Wages Expense	2,000	
		Wages Payable		2,000
		Accrued wages.		
	30	Unearned Fees	6,000	
		Fees Earned		6,000
		Fees earned ($10,000 – $4,000).		
	30	Accounts Receivable	5,380	
		Fees Earned		5,380
		Accrued fees.		

2. Fees Earned would be understated by $6,000, Depreciation Expense would be understated by $1,675, and net income would be understated by $4,325 ($6,000 – $1,675).

3. Accumulated Depreciation—Equipment would be understated by $1,675, total assets would be overstated by $1,675, Unearned Fees would be overstated by $6,000, total liabilities would be overstated by $6,000, owner's equity (Owner's Capital) would be understated by $4,325 ($6,000 – $1,675), and total liabilities and owner's equity would be overstated by $1,675 ($6,000 – $4,325).

4. There is no effect on the "Net increase or decrease in cash" on the statement of cash flows because adjusting entries do not affect cash.

Prob. 3-3B

1.

2019				
Apr.	30	Supplies Expense	5,820	
		Supplies		5,820
		Supplies used ($7,200 – $1,380).		
	30	Accounts Receivable	3,900	
		Fees Earned		3,900
		Accrued fees earned.		
	30	Depreciation Expense	3,000	
		Accumulated Depreciation—Equipment		3,000
		Equipment depreciation.		
	30	Wages Expense	2,475	
		Wages Payable		2,475
		Accrued wages.		
	30	Unearned Fees	14,140	
		Fees Earned		14,140
		Fees earned.		

2.

Revenues…………………………	$305,800	
Expenses…………………………	261,800	($157,800 + $55,000 + $42,000 + $7,000)
Net Income………………………	$ 44,000	

3.

Revenues…………………………	$323,840	($305,800 + $3,900 + $14,140)
Expenses…………………………	273,095	($261,800 + $5,820 + $3,000 + $2,475)
Net Income………………………	$ 50,745	

4. The effect of the adjusting entries on John Bridger, Capital is the difference in net income in (3) and (2) of $6,745 ($50,745 – $44,000), which would increase John Bridger, Capital.

Prob. 3-4B

2019				
Mar.	**31**	**Supplies Expense**	**4,025**	
		Supplies		**4,025**
		Supplies used ($6,200 – $2,175).		
	31	**Insurance Expense**	**7,850**	
		Prepaid Insurance		**7,850**
		Insurance expired ($9,000 – $1,150).		
	31	**Depreciation Expense—Buildings**	**9,500**	
		Accumulated Depreciation—Buildings		**9,500**
		Depreciation ($61,000 – $51,500).		
	31	**Depreciation Expense—Trucks**	**5,000**	
		Accumulated Depreciation—Trucks		**5,000**
		Depreciation ($17,000 – $12,000).		
	31	**Utilities Expense**	**1,830**	
		Accounts Payable		**1,830**
		Accrued utilities expense		
		($8,750 – $6,920, or $8,030 – $6,200).		
	31	**Salary Expense**	**1,400**	
		Salaries Payable		**1,400**
		Accrued salaries ($81,400 – $80,000).		
	31	**Unearned Service Fees**	**6,650**	
		Service Fees Earned		**6,650**
		Service fees earned ($10,500 – $3,850, or		
		$169,330 – $162,680).		

Prob. 3-5B

1.

2019				
July	31	Depreciation Expense—Building	6,400	
		Accumulated Depreciation—Building		6,400
		Building depreciation.		
	31	Depreciation Expense—Equipment	2,800	
		Accumulated Depreciation—Equipment		2,800
		Equipment depreciation.		
	31	Salaries and Wages Expense	900	
		Salaries and Wages Payable		900
		Accrued salaries and wages.		
	31	Insurance Expense	4,500	
		Prepaid Insurance		4,500
		Insurance expired ($6,000 – $1,500).		
	31	Accounts Receivable	10,200	
		Fees Earned		10,200
		Accrued fees earned.		
	31	Supplies Expense	1,110	
		Supplies		1,110
		Supplies used ($1,725 – $615).		
	31	Unearned Rent	3,300	
		Rent Revenue		3,300
		Rent revenue earned ($3,600 – $300).		

Prob. 3-5B (Concluded)

2.

REECE FINANCIAL SERVICES CO. Adjusted Trial Balance July 31, 2019		
	Debit Balances	Credit Balances
Cash	10,200	
Accounts Receivable	44,950	
Prepaid Insurance	1,500	
Supplies	615	
Land	50,000	
Building	155,750	
Accumulated Depreciation—Building		69,250
Equipment	45,000	
Accumulated Depreciation—Equipment		20,450
Accounts Payable		3,750
Unearned Rent		300
Salaries and Wages Payable		900
Joni Reece, Capital		153,550
Joni Reece, Drawing	8,000	
Fees Earned		168,800
Rent Revenue		3,300
Salaries and Wages Expense	57,750	
Utilities Expense	14,100	
Advertising Expense	7,500	
Depreciation Expense—Building	6,400	
Repairs Expense	6,100	
Insurance Expense	4,500	
Depreciation Expense—Equipment	2,800	
Supplies Expense	1,110	
Miscellaneous Expense	4,025	
	420,300	420,300

Prob. 3-6B

1.

Aug.	31	Accounts Receivable	31,900	
		Fees Earned		31,900
		Accrued fees earned.		
	31	Depreciation Expense	7,500	
		Accumulated Depreciation—Equipment		7,500
		Equipment depreciation.		
	31	Wages Expense	5,200	
		Wages Payable		5,200
		Accrued wages.		
	31	Supplies Expense	3,000	
		Supplies		3,000
		Supplies used.		

2.

	Net Income	Total Assets	=	Total Liabilities	+	Total Owner's Equity
Reported amounts	$112,500	$650,000		$225,000		$425,000
Corrections:						
Unbilled fees earned	+31,900	+31,900		0		+31,900
Equipment depreciation	–7,500	–7,500		0		–7,500
Accrued wages	–5,200	0		+5,200		–5,200
Supplies used	–3,000	–3,000		0		–3,000
Corrected amounts	$128,700	$671,400		$230,200		$441,200

CONTINUING PROBLEM

1.

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Date		Description	Post. Ref.	Debit	Credit
2019		Adjusting Entries			
July	31	Accounts Receivable	12	1,400	
		Fees Earned	41		1,400
		Accrued fees earned (115 hrs. –			
		80 hrs.) × $40 = $1,400.			
	31	Supplies Expense	56	745	
		Supplies	14		745
		Supplies used ($1,020 – $275).			
	31	Insurance Expense	57	225	
		Prepaid Insurance	15		225
		Insurance expired ($2,700 ÷			
		12 months) = $225 per month.			
	31	Depreciation Expense	58	50	
		Accum. Depr.—Office Equipment	18		50
		Office equipment depreciation.			
	31	Unearned Revenue	23	3,600	
		Fees Earned	41		3,600
		Fees earned ($7,200 ÷ 2 months).			
	31	Wages Expense	50	140	
		Wages Payable	22		140
		Accrued wages.			

Continuing Problem (Continued)

2.

Account: Cash **Account No.** 11

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			3,920	
	1		1	5,000		8,920	
	1		1		1,750	7,170	
	1		1		2,700	4,470	
	2		1	1,000		5,470	
	3		1	7,200		12,670	
	3		1		250	12,420	
	4		1		900	11,520	
	8		1		200	11,320	
	11		1	1,000		12,320	
	13		1		700	11,620	
	14		1		1,200	10,420	
	16		2	2,000		12,420	
	21		2		620	11,800	
	22		2		800	11,000	
	23		2	750		11,750	
	27		2		915	10,835	
	28		2		1,200	9,635	
	29		2		540	9,095	
	30		2	500		9,595	
	31		2	3,000		12,595	
	31		2		1,400	11,195	
	31		2		1,250	9,945	

Account: Accounts Receivable **Account No.** 12

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			1,000	
	2		1		1,000	—	—
	23		2	1,750		1,750	
	30		2	1,000		2,750	
	31	Adjusting	3	1,400		4,150	

Continuing Problem (Continued)

Account: Supplies **Account No.** 14

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			170	
	18		2	850		1,020	
	31	Adjusting	3		745	275	

Account: Prepaid Insurance **Account No.** 15

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1		1	2,700		2,700	
	31	Adjusting	3		225	2,475	

Account: Office Equipment **Account No.** 17

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	5		1	7,500		7,500	

Account: Accumulated Depreciation—Office Equipment **Account No.** 18

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	31	Adjusting	3		50		50

Account: Accounts Payable **Account No.** 21

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓				250
	3		1	250		—	—
	5		1		7,500		7,500
	18		2		850		8,350

Account: Wages Payable **Account No.** 22

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	31	Adjusting	3		140		140

Continuing Problem (Continued)

Account: **Unearned Revenue** Account No. **23**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	3		1		7,200		7,200
	31	Adjusting	3	3,600			3,600

Account: **Peyton Smith, Capital** Account No. **31**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓				4,000
	1		1		5,000		9,000

Account: **Peyton Smith, Drawing** Account No. **32**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			500	
	31		2	1,250		1,750	

Account: **Fees Earned** Account No. **41**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓				6,200
	11		1		1,000		7,200
	16		2		2,000		9,200
	23		2		2,500		11,700
	30		2		1,500		13,200
	31		2		3,000		16,200
	31	Adjusting	3		1,400		17,600
	31	Adjusting	3		3,600		21,200

Continuing Problem (Continued)

Account: **Wages Expense** Account No. **50**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			400	
	14		1	1,200		1,600	
	28		2	1,200		2,800	
	31	Adjusting	3	140		2,940	

Account: **Office Rent Expense** Account No. **51**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			800	
	1		1	1,750		2,550	

Account: **Equipment Rent Expense** Account No. **52**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			675	
	13		1	700		1,375	

Account: **Utilities Expense** Account No. **53**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			300	
	27		2	915		1,215	

Account: **Music Expense** Account No. **54**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			1,590	
	21		2	620		2,210	
	31		2	1,400		3,610	

Continuing Problem (Continued)

Account: **Advertising Expense** Account No. **55**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			500	
	8		1	200		700	
	22		2	800		1,500	

Account: **Supplies Expense** Account No. **56**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			180	
	31	Adjusting	3	745		925	

Account: **Insurance Expense** Account No. **57**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	31	Adjusting	3	225		225	

Account: **Depreciation Expense** Account No. **58**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	31	Adjusting	3	50		50	

Account: **Miscellaneous Expense** Account No. **59**

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2019							
July	1	Balance	✓			415	
	4		1	900		1,315	
	29		2	540		1,855	

Continuing Problem (Concluded)

3.

PS MUSIC Adjusted Trial Balance July 31, 2019			
	Account No.	**Debit Balances**	**Credit Balances**
Cash	11	9,945	
Accounts Receivable	12	4,150	
Supplies	14	275	
Prepaid Insurance	15	2,475	
Office Equipment	17	7,500	
Accumulated Depreciation—Office Equipment	18		50
Accounts Payable	21		8,350
Wages Payable	22		140
Unearned Revenue	23		3,600
Peyton Smith, Capital	31		9,000
Peyton Smith, Drawing	32	1,750	
Fees Earned	41		21,200
Wages Expense	50	2,940	
Office Rent Expense	51	2,550	
Equipment Rent Expense	52	1,375	
Utilities Expense	53	1,215	
Music Expense	54	3,610	
Advertising Expense	55	1,500	
Supplies Expense	56	925	
Insurance Expense	57	225	
Depreciation Expense	58	50	
Miscellaneous Expense	59	1,855	
		42,340	42,340

CASES & PROJECTS

CP 3-1

1. **No. The accrual basis of accounting requires that revenues be reported in the period in which they are earned. When revenue is reported before it is earned, the revenues do not accurately reflect the revenues for the period. By knowingly recording an adjusting entry for more than the amount of revenue that was earned during the period, Chris is demonstrating a failure of individual character and is acting unethically.**

2. **The users of the financial information who rely upon this information will be affected, as the information will not be a faithful representation of the entity's economic activity.**

CP 3-2

It is acceptable for Daryl to prepare the financial statements for Squid Realty Co. on an accrual basis. The revision of the financial statements to include the accrual of the $30,000 commission as of December 28, 2018, would not be appropriate. Most real estate contracts include contingencies that can void the contract. Such contingencies include obtaining a loan, appraisals, environmental studies, and inspection results. In other words, Daryl can only be sure of earning the commission on January 5, 2019, when the attorney formally records the transfer of the property to the buyer, and Daryl may disclose the pending sale and related commission in a note to the financial statements. Indicating on the loan application to Free Spirit Bank that Squid Realty Co. has not been rejected previously for credit is unethical and unprofessional, and intentionally filing false loan documents is illegal.

CP 3-3

A sample solution based on Nike Inc.'s Form 10-K for the fiscal year ended May 31, 2015, follows:

1. **Footwear**
2. **3**
3. **$3,273 million in 2015; $2,693 million in 2014; $2,472 million in 2013**
4. **$30,601 million in 2015; $27,799 million in 2014; $25,313 million in 2013**
5. **Nike recognizes revenue when title passes and the risks and rewards of ownership have passed to the customer, based on the terms of sale. Title passes generally upon shipment or upon receipt by the customer depending on the country of the sale and the agreement with the customer. Retail store revenues are recorded at the time of sale.**
6. **The company's net income has increased from $2,472 million in 2013 to $3,273 million in 2015. This is a significant increase, reflecting significantly improved financial performance over the periods presented.**

CP 3-4

To: My Instructor
From: Ima Student
Re: Revenue Recognition of Ticket Sales at Delta Air Lines

Customers of Delta Air Lines typically purchase tickets for air travel several weeks prior to their scheduled flight and pay for their tickets using a credit card such as VISA or American Express. While the credit card company will remit payment to Delta shortly after the ticket is purchased, Delta will not record revenue from the ticket until after the air travel has taken place. This is because Delta does not earn the ticket revenue until it provides the required service. When Delta receives payment from the credit card company for an airplane ticket, Delta records a liability, called Unearned Revenue. After a customer uses the ticket for a flight, Delta records an adjusting entry to remove the liability and records revenue to reflect the fact that Delta has provided the service.

CP 3-5

a. There are several indications that adjusting entries were not recorded before the financial statements were prepared, including:

1. **All expenses on the income statement are identified as "paid" items and not as "expenses."**
2. **No expense is reported on the income statement for depreciation, and no accumulated depreciation is reported on the balance sheet.**
3. **No supplies, accounts payable, or wages payable are reported on the balance sheet.**

b. Likely accounts requiring adjustment include:

1. **Accumulated Depreciation—Truck for depreciation expense.**
2. **Supplies (paid) expense for supplies on hand.**
3. **Insurance (paid) expense for unexpired insurance.**
4. **Wages accrued.**
5. **Utilities accrued.**