CHAPTER 3

ADJUSTING THE ACCOUNTS

LEARNING OBJECTIVES

1. EXPLAIN THE TIME PERIOD ASSUMPTION.

2. EXPLAIN THE ACCRUAL BASIS OF ACCOUNTING.

3. EXPLAIN THE REASONS FOR ADJUSTING ENTRIES AND IDENTIFY THE MAJOR TYPES OF ADJUSTING ENTRIES.

4. PREPARE ADJUSTING ENTRIES FOR DEFERRALS.

5. PREPARE ADJUSTING ENTRIES FOR ACCRUALS.

6. DESCRIBE THE NATURE AND PURPOSE OF AN ADJUSTED TRIAL BALANCE.

*7. PREPARE ADJUSTING ENTRIES FOR THE ALTERNATIVE TREATMENT OF DEFERRALS.

*8. DISCUSS FINANCIAL REPORTING CONCEPTS.

CHAPTER REVIEW

Timing Issues

1. (L.O. 1) The **time period (or periodicity) assumption** assumes that the economic life of a business can be divided into artificial time periods.

2. Accounting time periods are generally a month, a quarter, or a year. An accounting time period that is one year in length is a **fiscal year.**

Accrual Basis of Accounting

3. (L.O. 2) The revenue recognition and expense recognition principles are used under the **accrual basis of accounting.** Under **cash basis accounting,** revenue is recorded only when cash is received and expenses are recorded only when paid.

4. Generally accepted accounting principles require accrual basis accounting rather than cash basis accounting because the cash basis of accounting often leads to misleading financial statements.

Revenue Recognition Principle

5. The **revenue recognition principle** requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

The Expense Recognition Principle

6. The **expense recognition principle** requires that efforts (expenses) be matched with results (revenues).

Adjusting Entries

7. (L.O. 3) Adjusting entries are made in order for:
   a. Revenues to be recorded in the period in which services are performed, and for expenses to be recognized in the period in which they are incurred.
   b. The revenue recognition and expense recognition principles are followed.

8. Adjusting entries are required every time financial statements are prepared. Adjusting entries can be classified as (a) **deferrals** (prepaid expenses or unearned revenues) or (b) **accruals** (accrued revenues or accrued expenses).

Deferrals

9. (L.O. 4) **Prepaid expenses** are expenses paid in cash before they are used or consumed.
   a. Prepaid expenses expire with the passage of time or through use and consumption.
   b. An **asset-expense account relationship** exists with prepaid expenses.
   c. Prior to adjustment, **assets are overstated** and **expenses are understated.**
   d. The adjusting entry results in a debit to an expense account and a credit to an asset account.
   e. Examples of prepaid expenses include supplies, insurance, and depreciation.
   f. To illustrate a prepaid adjusting entry, assume on October 1, Kubitz Company pays $2,400 cash to Sandy Insurance Co. for a one-year insurance policy effective October 1. The adjusting entry at October 31 is:

Insurance Expense ($2,400 X 1/12)..................................	200	
Prepaid Insurance		200

10. **Depreciation** is the process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner.
    a. The purchase of equipment or a building is viewed as a long-term prepayment of services and, therefore, is allocated in the same manner as other prepaid expenses.
    b. Depreciation is an estimate rather than a factual measurement of the cost that has expired.
    c. In recording depreciation, Depreciation Expense is debited and a contra asset account, Accumulated Depreciation—Equipment, is credited.
    d. In the balance sheet, Accumulated Depreciation is offset against the asset account. The difference between the cost of the asset and its related accumulated depreciation is referred to as the **book value** of the asset.
    e. To illustrate an adjusting entry for depreciation, assume Resch Co. purchases equipment for $6,000 cash on January 1, 2014. Assuming that annual depreciation is $1,200, the adjusting entry at December 31, 2014 is:

Depreciation Expense..	1,200	
Accumulated Depreciation—Equipment		1,200

11. **Unearned revenues** are cash received before services are performed.
    a. Unearned revenues are subsequently recognized by performing the service for a customer.
    b. A **liability-revenue account relationship** exists with unearned revenues.
    c. Prior to adjustment, **liabilities are overstated** and **revenues are understated.**
    d. The adjusting entry results in a debit to a liability account and a credit to a revenue account.
    e. Examples of unearned revenues include rent, magazine subscriptions, and customer deposits for future service.
    f. To illustrate an unearned revenue adjusting entry, assume on October 1, Schoen Co. receives $3,000 cash from a renter in payment of monthly rent for the period October through December. At October 31, the adjusting entry to record the rent earned in October is:

Unearned Rent Revenue...	1,000	
Rent Revenue ($3,000 X 1/3)		1,000

<u>Accruals</u>

12. (L.O. 5) **Accrued revenues** are revenues for services performed but not yet received in cash or recorded.
    a. Accrued revenues may accumulate with the passing of time as in the case of interest and rent, or through services performed but for which payment has not been collected.
    b. An **asset-revenue account relationship** exists with accrued revenues.
    c. Prior to adjustment, **both assets and revenues are understated.**
    d. The adjusting entry results in an increase (a debit) to an asset account and an increase (a credit) to a revenue account.
    e. To illustrate an accrued revenue adjusting entry, assume in October, Mayer, a dentist, performs $800 of services for patients for which payment has not been collected. The adjusting entry at October 31 is:

Accounts Receivable..	800	
Service Revenue		800

13. **Accrued expenses** are expenses incurred but not yet paid in cash or recorded.
    a. Accrued expenses result from the same causes as accrued revenues and include interest, rent, taxes, and salaries.
    b. A **liability-expense account relationship** exists with accrued expenses.
    c. Prior to adjustment, both **liabilities and expenses are understated.**
    d. The adjusting entry results in an increase (a debit) to an expense account and an increase (a credit) to a liability account.

e. To illustrate an accrued expense adjusting entry, assume Schwenk Company incurs salaries and wages of $4,000 during the last week of October that will be paid in November. The adjusting entry on October 31 is:

Salaries and Wages Expense	4,000	
Salaries and Wages Payable............................		4,000

14. Each adjusting entry affects one balance sheet account and one income statement account.

Adjusted Trial Balance

15. (L.O. 6) After all adjusting entries have been journalized and posted an **adjusted trial balance** is prepared. This trial balance shows the balances of all accounts, including those that have been adjusted, at the end of the accounting period.

16. The **purpose** of an adjusted trial balance is to prove the equality of the total debit balances and the total credit balances in the ledger after all adjustments have been made.

17. The accounts in the adjusted trial balance contain all data that are needed for the preparation of financial statements.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 3-1

(a) Prepaid Insurance—to recognize insurance expired during the period.

(b) Depreciation Expense—to account for the depreciation that has occurred on the asset during the period.

(c) Unearned Service Revenue—to record revenue earned for services performed.

(d) Interest Payable—to recognize interest accrued but unpaid on notes payable.

BRIEF EXERCISE 3-2

Item	(a) Type of Adjustment	(b) Account Balances before Adjustment
1.	Prepaid Expenses	Assets Overstated Expenses Understated
2.	Accrued Revenues	Assets Understated Revenues Understated
3.	Accrued Expenses	Expenses Understated Liabilities Understated

4.	Unearned Revenues	Liabilities Overstated Revenues Understated

BRIEF EXERCISE 3-3

Dec. 31	Supplies Expense..	4,200	
	Supplies ($6,700 – $2,500)............................		4,200

Supplies

	6,700	12/31	4,200
12/31 Bal.	2,500		

Supplies Expense

12/31	4,200	

BRIEF EXERCISE 3-4

Dec. 31	Depreciation Expense	4,000	
	Accumulated Depreciation—Equipment		4,000

Depreciation Expense

12/31	4,000		

Accum. Depreciation—Equipment

		12/31	4,000

Balance Sheet:

Equipment	$30,000	
Less: Accumulated Depreciation—Equipment	4,000	$26,000

BRIEF EXERCISE 3-5

July 1	Prepaid Insurance	14,400	
	Cash		14,400
Dec. 31	Insurance Expense [($14,400 ÷ 3) X 1/2]	2,400	
	Prepaid Insurance		2,400

Prepaid Insurance

7/1	14,400	12/31	2,400
12/31 Bal.	12,000		

Insurance Expense

12/31	2,400		

BRIEF EXERCISE 3-6

July 1	Cash	14,400	
	Unearned Service Revenue		14,400
Dec. 31	Unearned Service Revenue	2,400	
	Service Revenue		2,400

Unearned Service Revenue

12/31	2,400	7/1	14,400
		12/31 Bal.	12,000

Service Revenue

		12/31	2,400

BRIEF EXERCISE 3-7

1.	Dec. 31	Interest Expense	400	
		Interest Payable		400
2.	31	Accounts Receivable	1,900	
		Service Revenue		1,900
3.	31	Salaries and Wages Expense	900	
		Salaries and Wages Payable		900

BRIEF EXERCISE 3-8

Account	(a) Type of Adjustment	(b) Related Account
Accounts Receivable	Accrued Revenues	Service Revenue
Prepaid Insurance	Prepaid Expenses	Insurance Expense
Accum. Depr.—Equipment	Prepaid Expenses	Depreciation Expense
Interest Payable	Accrued Expenses	Interest Expense
Unearned Service Revenue	Unearned Revenues	Service Revenue

BRIEF EXERCISE 3-9

PARSONS COMPANY
Income Statement
For the Year Ended December 31, 2014

Revenues		
Service revenue		$37,000
Expenses		
Salaries and wages expense	$16,000	
Rent expense	4,000	
Insurance expense	2,000	
Supplies expense	1,500	
Depreciation expense	1,300	
Total expenses		24,800
Net income		$12,200

BRIEF EXERCISE 3-10

PARSONS COMPANY
Owner's Equity Statement
For the Year Ended December 31, 2014

Owner's capital, January 1	$15,600
Add: Net income	12,200
	27,800
Less: Drawings	7,000
Owner's capital, December 31	$20,800

*BRIEF EXERCISE 3-11

(a)	Apr. 30	Supplies	700	
		Supplies Expense		700
(b)	30	Service Revenue	3,000	
		Unearned Service Revenue		3,000

BRIEF EXERCISE 3-12

(a) Predictive value.
(b) Confirmatory value.
(c) Materiality.
(d) Complete.
(e) Free from error.
(f) Comparability.
(g) Verifiability.
(h) Timeliness.

BRIEF EXERCISE 3-13

(a) Relevant.
(b) Faithful representation.
(c) Consistency.

BRIEF EXERCISE 3-14

(a) 1. Predictive value.
(b) 2. Neutral.
(c) 3. Verifiable.
(d) 4. Timely.

BRIEF EXERCISE 3-15

(c)