

ADJUSTING ENTRIES

Key Topics to Know

Accounting Principles

- Matching Principle
 - States that revenue earned and the costs incurred to produce that revenue must be recorded in the same period
- Revenue Recognition Principle
 - States that revenue must be recognized (recorded) in the period in which it is earned

Accrual Basis Accounting

- Accrued revenues and accrued expenses
- Deferred revenues and deferred expenses
- Unbilled vs. unearned revenues
- Always have at least one income statement account (revenue or expense) and one balance sheet account (asset or liability)
- Never recorded for cash, dividends, capital stock or retained earnings

Journalizing adjusting entries

- Always have at least one income statement account (revenue or expense) and one balance sheet account (asset or liability)
- Never recorded for cash, dividends, capital stock or retained earnings
- Effects on the financial statements if adjusting entries are omitted.

Depreciation

- All long-lived assets are depreciated (reduced in value over time) except for land
- The decline in value is credited to a contra-asset account, accumulated depreciation
- Net Book Value = balance in the asset account - the balance in the related accumulated depreciation account

Adjusted Trial Balance:

- Starts with trial balance before adjustments
- Adds or deducts adjusting entries as appropriate
- Forms the basis for preparing financial statements

Practice Problems

Problem #1 – Classify Accruals and Deferrals

Each of the following items is either a **deferred expense** (prepaid expense), **deferred revenue** (unearned revenue), **accrued expense** (accrued liability) or **accrued revenue** (accrued asset).

- a) The supplies account is an example of a _____.
- b) Tuition received by a college is an example of _____.
- c) Wages earned by employees but not yet paid are an example of an _____.
- d) A two year premium paid on a fire insurance policy is a _____.
- e) Fees earned but not yet recorded are an example of an _____.
- f) Property taxes for the current year that are not due until February of the next year are _____.
- g) Subscription payments received in advance by a newspaper are _____.
- h) An electric bill for July that is not due until August 7 is an _____.

Required: Determine the proper classification for each item.

Problem #2 – Adjusting Entry for Supplies

The balance of the Supplies account before adjustment at the end of the year, is \$2,730. The amount of supplies on hand at the end of the year is \$260.

Required: Journalize the adjusting entry required

Problem #3 – Adjusting Entry for Unearned Fees

The balance of the Unearned Fees account before adjustment is \$7,300. The unearned fees at the end of the year are \$1,700.

- Required:
- a) Journalize the adjusting entry required.
 - b) If the adjusting entry for unearned fees was not made, which items on the income statement and/or the balance sheet will be overstated or understated?

Problem #4 – Adjusting Entry for Accrued Wages

D Company pays the office staff weekly on Friday. The weekly wages average \$3,000.

- Required: Journal the adjusting entry required if the accounting period ends on Wednesday.

Problem #5 – Effect of Omitting Adjusting Entry for Accrued wages

D Company pays the office staff weekly on Friday. The weekly wages average \$3,000. On Wednesday, December 31, there were wages earned but not yet paid.

- Required: Which items on the income statement and/or the balance sheet will be overstated or understated if wages are not accrued?

Problem #6 – Adjusting Entry for Depreciation

B Company purchased a new truck on January 1 for \$25,000. The depreciation for the year is \$5,000.

- Required:
- a) Journalize the adjusting entry for the depreciation for the year.
 - b) What is the book value of the truck on December 31?
 - c) If the adjusting entry for depreciation was not made, which items on the income statement and/or the balance sheet will be overstated or understated?

Problem #7 – Adjusting Entries

Selected account balances at December 31, before year-end adjustments, were:

	<u>Debits</u>	<u>Credits</u>
Cash	\$12,780	
Accounts Receivable	11,250	
Supplies	4,750	
Prepaid Insurance	2,700	
Office Equipment	42,500	
Accumulated Depreciation		\$8,250
Salaries and Wages Payable		
Unearned Fees		6,250
Fees Earned		89,750
Salaries and Wages Expense	29,420	
Depreciation Expense		
Supplies Expense		
Insurance Expense		

Data needed for year-end adjustments are as follows:

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|--|---------|
| 1. Unbilled fees at December 31 | \$3,650 |
| 2. Supplies on hand at December 31 | \$1,275 |
| 3. Insurance expired during the year | \$2,400 |
| 4. Depreciation of office equipment for the year | \$2,750 |
| 5. Unearned fees at December 31 | \$1,250 |
| 6. Salaries and wages earned but not paid at December 31 | \$1,150 |

Required: Journalize the adjusting entries required.

Multiple Choice Questions

1. The entry to record cash is paid for rent to cover the next year is
 - a) Debit Rent Expense, credit Cash.
 - b) Debit Prepaid Rent, credit Rent Expense.
 - c) Debit Prepaid Rent, credit Cash.
 - d) Debit Cash, credit Prepaid Rent.

2. A landlord should report rent collected in advance as a debit to Cash and a credit to:
 - a) A liability.
 - b) An asset other than Cash.
 - c) A revenue.
 - d) An owners' equity.

3. A customer purchased a drill press on November 14 on account. The drill press was delivered two weeks later. The customer paid for the drill press on December 5. When should the seller record the revenue for this transaction?
 - a) November.
 - b) December.
 - c) Evenly in each of the two months.
 - d) One-third in November and two-thirds in December.

4. The following information pertains to S Company:

May 1	Customer ordered an installation service to be performed on May 15
May 2	Customer paid cash for the installation
May 8	Sooner purchased the necessary supplies on account to complete the installation
May 15	Installation was started and completed
May 20	Sooner paid for the supplies

When would the company record the expense related to the supplies?

- a) May 2.
- b) May 8.
- c) May 15.
- d) May 20.

5. Consider the following events for B Company:
- | | |
|---------|--|
| June 1 | Purchased gasoline for \$200 on account |
| June 7 | Advertised lawn mowing for \$100 per lawn |
| June 9 | Signed up 8 customers and received \$800 in cash |
| June 12 | Mowed 8 lawns, using up all the gasoline purchased on June 1 |
| June 13 | Paid for the gasoline |
- Under accrual-basis accounting, what is the appropriate day to record the revenues related to lawn services?
- a) June 1.
b) June 7.
c) June 9.
d) June 12.
6. Which of the following is a possible adjusting journal entry?
- a) Debit Cash, credit Accounts Payable.
b) Debit Service Revenue, credit Cash.
c) Debit Salaries Expense, credit Salaries Payable.
d) Debit Utilities Expense, credit Retained Earnings.
7. Making insurance payments in advance is an example of:
- a) An accrued revenue.
b) An accrued expense.
c) An unearned revenue.
d) A prepaid expense.
8. An example of an adjusting entry would not include:
- a) Recording the use of office supplies.
b) Recording the expiration of prepaid insurance.
c) Recording unpaid salaries.
d) Paying salaries to company employees.
9. Adjusting entries:
- a) Often include the Cash account.
b) Usually are recorded at the beginning of the accounting period.
c) Always involve at least one income statement account and one balance sheet account.
d) Adjust the balance of revenue and expense accounts to zero.

10. The rented in an office building should report rent paid in advance as a credit to Cash and a debit to:
 - a) A liability.
 - b) An asset other than Cash.
 - c) A revenue.
 - d) An owners' equity.

11. An unearned revenue is:
 - a) Cash received from a customer after the service is performed
 - b) Cash received from a customer before the service is performed
 - c) Service performed for a customer before the payment is received
 - d) Service performed for a customer before the customer is billed

12. An unbilled revenue is:
 - a) Cash received from a customer after the service is billed
 - b) Cash received from a customer before the service is billed
 - c) Service performed for a customer before the payment is received
 - d) Service performed for a customer before the customer is billed

13. Adjusting Entries are
 - a) corrections of errors.
 - b) updating entries for previously unrecorded expenses or revenues.
 - c) not required.
 - d) will always affect cash.

14. If the prepaid expenses are not adjusted, assets on the balance sheet
 - a) will be overstated.
 - b) will be understated.
 - c) will not be affected.
 - d) may be either overstated or understated.

15. On January 1, A Company purchased an oven for \$2,000. The oven was expected to last five years and has no salvage value. The adjusting entry made on December 31, to record the depreciation of the oven for one year is:
 - a) Dr Depreciation expense 400 Cr Accumulated depreciation 400
 - b) Dr Depreciation expense 400 Cr Equipment 400
 - c) Dr Accumulated depreciation 400 Cr Depreciation expense 400
 - d) Dr Depreciation expense 500 Cr Accumulated depreciation 500

Solutions to Practice Problems

Problem #1 – Classify Accruals and Deferrals

- a) The supplies account is an example of a **deferred expense**.
- b) Tuition received by a college is an example of a **deferred revenue**.
- c) Wages earned by employees but not yet paid are an example of an **accrued expense**.
- d) A two year premium paid on a fire insurance policy is a **deferred expense or prepaid expense**.
- e) Fees earned but not yet recorded are an example of accrued **revenue**.
- f) Property taxes for 1998 that are not due until February, 1999 are **accrued expenses**.
- g) Subscription payments received in advance by a newspaper are **deferred revenue or unearned revenue**.
- h) The electric bill for July that is not due for payment until August 7 is an **accrued expense**.

Problem #2 – Adjusting Entry for Supplies

Supplies expense	2,470	
Supplies		2,470

Problem #3 – Adjusting Entry for Unearned Fees

- a) Adjusting entry required:

Unearned fees	5,600	
Fees earned		5,600

- b) If the above adjusting entry was not made
- revenue and net income on the income statement will be understated
 - on the balance sheet, liabilities will be overstated and both retained earnings and owner's equity will be understated.

Problem #4 – Adjusting Entry for Accrued Wages

Wages expense	1,800	
Wages payable		1,800

Problem #5 – Effect of Omitting Adjusting Entry for Accrued wages

If the adjusting entry for accrued wages was not made:

- Wages expense will be understated and net income will be overstated on the income statement
- Liabilities will be understated and both retained earnings and owner's equity will be overstated on the balance sheet.

Problem #6 – Adjusting Entry for Depreciation

a) The adjusting entry to record the depreciation:

Depreciation expense	5,000	
Accumulated depreciation		5,000

b) The book value of the truck on December 31 is \$20,000 (25,000 - 5,000)

c) If the adjusting entry for depreciation was not made:

- Depreciation expense will be understated and net income will be overstated on the income statement
- Assets will be overstated and owner's equity will be overstated on the balance sheet.

Problem #7 – Adjusting Entries

Adjusting entries required:

a.	Accounts Receivable	3,650	
	Fees earned		3,650
b.	Supplies Expense	3,475	
	Supplies		3,475
c.	Insurance Expense	2,400	
	Prepaid Insurance		2,400
d.	Depreciation Expense	2,750	
	Accumulated Depreciation		2,750
e.	Unearned Fees	5,000	
	Fees Earned		5,000
f.	Salaries and Wages Expense	1,150	
	Salaries and Wages Expense		1,150

Solutions to Multiple Choice Questions

- | | |
|-----|---|
| 1. | C |
| 2. | A |
| 3. | A |
| 4. | C |
| 5. | D |
| 6. | C |
| 7. | D |
| 8. | D |
| 9. | C |
| 10. | B |
| 11. | B |
| 12. | D |
| 13. | B |
| 14. | A |
| 15. | A |