

Chapter 3

The Adjusting Process

Study Guide

Do You Know...?

Learning Objective 1: Describe the nature of the adjusting process.

- The difference between accrual and cash basis of accounting? *(See exercises 1–3)*
- What kinds of accounts are affected by adjustments? *(See exercises 4–6)*
- How to determine if an account or transaction is for an accrued revenue, an accrued expense, an unearned revenue, or a prepaid expense? *(See exercises 7–9)*

Learning Objective 2: Prepare adjusting entries for accruals.

- How to calculate the amount of the adjustment needed for accrued revenues and accrued expenses? *(See exercises 10–15)*
- How to prepare the journal entry related to the adjustment? *(See exercises 10–15)*

Learning Objective 3: Prepare adjusting entries for deferrals.

- How to calculate the amount of the adjustment needed for unearned revenues and prepaid expenses? *(See exercises 16–21)*
- How to prepare the journal entry related to the adjustment? *(See exercises 16–21)*

Learning Objective 4: Prepare adjusting entries for depreciation.

- Which assets will be depreciated? *(See exercises 22–24)*
- How to prepare the journal entry to record depreciation expense for the period? *(See exercises 25–27)*
- How to find the net book value of equipment? *(See exercises 25–27)*
- How depreciable assets will be shown on the financial statements? *(See exercises 25–27)*

Learning Objective 5: Summarize the adjusting process.

- The impact on the financial statements if adjusting entries are not made? *(See exercises 28–30)*

Learning Objective 6: Prepare an adjusted trial balance.

- The effect of errors on the adjusted trial balance? *(See exercises 31–33)*

Learning Objective 7: Describe and illustrate the use of vertical analysis in evaluating a company's performance and financial condition.

- How to identify favorable and unfavorable trends in the financial statements?
(See exercises 34–36)

Fill-in-the-Blank Equations

1. _____ = Cost of asset – Accumulated depreciation
2. Beginning accumulated depreciation + _____ = Ending depreciation
3. Beginning supplies + Supplies bought – _____ = Ending supplies
4. Beginning prepaid expense + Additional payments – _____ = Ending prepaid expense

Exercises

1. Determine if each of the following descriptions relates to an accrual or a cash basis of accounting.
 - a. Company A records income when the payment is received from the customer.
 - b. Company B records an accrued expense at year-end for any expenses incurred but not paid.
 - c. When the customer buys an item and charges it to his account, Company C records it as sales revenue.
2. Determine whether each of the following is a characteristic of an accrual or a cash basis of accounting.
 - a. The company received payments for one-year magazine subscriptions throughout the year. On the balance sheet, the company records a liability for Unearned Revenue.
 - b. The corporation paid for a \$12,000, one-year insurance policy beginning in September. The income statement shows an Insurance Expense of \$12,000.
 - c. The firm sold goods for \$10,000 to customers and received payments of \$8,000 by year-end, with \$2,000 still in customer accounts. The company records Sales Revenue of \$8,000 on its income statement for these goods.

3. Do the following independent situations relate to an accrual or a cash basis of accounting?
 - a. Upon startup in July, the company paid for its rent for the upcoming year, but only expensed half of the amount paid on its income statement.
 - b. In January, the organization paid for cleaning services received in the previous period. The expense is recorded in January upon payment.
 - c. The corporation receives payment on the fifteenth of the month for its hourly services. When preparing financial statements, the accountant records a journal entry for Accrued Revenues.
4. Determine whether each of the following accounts would need to be adjusted at the end of the period.
 - a. Accumulated Depreciation
 - b. Unearned Rent Revenue
 - c. Cash
5. Determine whether each of the following accounts will require adjusting entries.
 - a. Owner Capital
 - b. Prepaid Insurance
 - c. Wages Payable
6. Does each of the following accounts need year-end adjusting entries?
 - a. Accrued Legal Revenue
 - b. Accounts Receivable
 - c. Land
7. Determine whether each of the following describes an accrued revenue, an accrued expense, an unearned revenue, or a prepaid expense.
 - a. A company makes payments on the fifteenth of every month to its lawyer for hourly services. At the end of the year, the company's board members and lawyer have met for a total of 20 hours owed to the lawyer since the last billing cycle.
 - b. A company receives payments during the year for a six-month or yearly subscription to its magazine. At the end of the year, some customers still have months left in their subscriptions.
 - c. On December 1, a company paid rent for a three-month lease on a storage building starting that day.

8. Do the following situations describe an accrued revenue, an accrued expense, an unearned revenue, or a prepaid expense?
- A company provided cleaning services for its clients at an hourly rate that will be paid the following month.
 - A business received payments throughout the year for membership contracts that expired within either six months or one year. At the end of the year, some contracts had not yet expired.
 - A firm paid its predetermined telephone bill for the next six months.
9. Is each of the following an accrued revenue, an accrued expense, an unearned revenue, or a prepaid expense?
- A manufacturer pays its employees on the first and third Friday of every month. By the end of the period, employees have worked four days since the last pay period.
 - An architect designs a building for a company, agreeing to bill at an hourly rate and receive payment upon completion. At the end of the year, the design is still in progress.
 - A firm pays in advance for monthly rental of a delivery truck.
- 10. Accrued Revenue** A law firm allows its clients to pay on the tenth of every month for services rendered rather than for each visit. Since the last billing cycle, the law firm provided 200 hours of services at \$80 per hour.
- Find the amount of accrued revenue the law firm should record at the end of the year.
 - Journalize the adjusting entry to record the asset for the accrued revenue.
- 11. Accrued Revenue** An electrical company provides services for a new building at a rate of \$50 per hour. Once completed, the owner of the building will pay for the total amount of hours worked. By the end of the year, the electrical company has worked 150 hours at the building and expects to finish the project after working an additional 50 hours in the next period.
- Calculate the accrued revenue the electrical company should record.
 - Journalize the adjusting entry to record the asset.

- 12. Accrued Revenue** By the end of the year, a CPA firm has provided a client with 30 hours of service to prepare a tax return. The client agrees to pay for hours performed monthly on the fifteenth of the following month. The CPA firm bills clients \$35 per hour.
- Calculate the accrued revenue the CPA firm should show in the year-end financial statements.
 - Record the journal entry to show the adjustment.
- 13. Accrued Expense** A business's lawyer charges \$60 per hour to meet with the board of directors. The business pays for the expense on the fifth of every month. By the end of the year, the board members and lawyer had met 51 hours since the last pay period.
- How much should the business record as an accrued legal expense at year-end?
 - Record the journal entry to make the adjustment.
- 14. Accrued Expense** A company pays its employees every other Friday, with daily wages of \$340, including weekends. The previous payday occurred on Friday, June 24.
- If the company's year ended June 30, what amount should the wages payable account on the balance sheet show?
 - Journalize the adjusting entry to record the payables accrued.
- 15. Accrued Expense** A company pays its telephone bill on the fifteenth of each month at a daily rate of \$15.
- Calculate the amount of Telephone Utilities Payable at December 31.
 - Journalize the adjusting entry to record the liability.
- 16. Unearned Revenue** A new gym begins business in November, offering a special for its membership plan of one year for \$240. During November, 12 people sign up for the plan starting December 1; during December, 20 people sign up for the plan starting December 15.
- Calculate the amount of the unearned revenue at year-end on December 31.
 - Journalize the adjusting entry to record the revenue.

- 17. Unearned Revenue** A rental company owns a building from which it leases out multiple offices. During the year, it received the following advance rental payments for one-year leases from separate tenants: \$24,000 in June, \$36,000 in August, and \$12,000 in October. The leases started the first of the month *following* the payment. Assume that these are the only advance rental payments received and that no adjusting entries were made during the year.
- Find the balance of the unearned rent revenue account at year-end on December 31. Also, find the amount of the adjustment needed at year-end.
 - Journalize the adjusting entry to record the revenue earned.
- 18. Unearned Revenue** A magazine company sells a one-year subscription for \$42 that will begin the month after the payment is received. During November, the company sells 200 subscriptions. The company did not sell any other subscriptions in the period.
- Find the adjustment needed at December 31 to record any revenue earned for the November subscriptions.
 - Journalize the adjusting entry to record the revenue.
- 19. Prepaid Expense** On June 1, Company A signed a rental agreement for a new building and paid \$24,000 in advance for the year of rent beginning the same day.
- Determine the amount of the adjustment that should be made on December 31, the year-end for the rent on this building.
 - Record the journal entry to show the adjustment.
- 20. Prepaid Expense** At the beginning of the quarter, a company had \$2,670 of supplies on hand. During the period, the company purchased \$500 worth of supplies. At the end of the year, on December 31, the supplies on hand are \$1,220.
- How much of an adjustment should the company make to show the use of the supplies?
 - Record the journal entry to make the adjustment.
- 21. Prepaid Expense** On December 15, Company B paid \$18,000 for a six-month insurance policy starting on that day.
- How much should Company B show as Insurance Expense for the year ended December 31? What will be the balance of Prepaid Insurance at the end of the year?
 - Record the journal entry to show the adjustment made on December 31.

- 22.** Determine whether each of the following assets will be depreciated.
- Building
 - Land
 - Inventory
- 23.** Determine whether each of the following assets will have a contra asset for Accumulated Depreciation.
- Equipment
 - Machinery
 - Notes Receivable
- 24.** Determine whether each of the following assets will require an adjusting entry for depreciation.
- Long-Term Investments
 - Delivery Van
 - Computers
- 25.** A piece of machinery that was purchased on July 1 has an original cost of \$10,000. The company takes an annual depreciation of \$1,500 a year.
- Record the depreciation expense for the third year.
 - Find the net book value of the machinery after the first year.
 - Find the net book value of the machinery after the third year.
 - Show how the machinery will be recorded on the balance sheet at the end of the third year.
- 26.** A company purchased a building for \$200,000 on January 1 of Year 1. At the beginning of the third year, the company has accumulated depreciation of \$25,000 for the building, with an annual depreciation expense of \$12,500.
- Record the depreciation expense for the third year.
 - Find the beginning and ending net book values of the building for the third year.
 - Show how the building will be recorded on the balance sheet at the end of the third year.

- 27.** After three years, a company has accumulated depreciation of \$9,000 on a piece of equipment. The company paid \$21,000 for the equipment and records a depreciation expense of \$3,000 per year.
- Record the depreciation expense for the fourth year.
 - Find the net book value for the piece of equipment at the beginning and ending of the fourth year.
 - Show how the equipment will be recorded on the balance sheet for the fourth year.
- 28.** If a company does not record each of the following adjusting entries, determine the impact on the financial statements (overstated or understated assets, liabilities, stockholders' equity, revenues, expenses, net income).
- The company fails to adjust Prepaid Insurance for the last period.
 - The accountant does not record an adjusting entry to Unearned Revenue to record revenue earned for the month of December.
 - The company fails to record an accrued expense.
- 29.** If a company does not record each of the following adjusting entries, determine the impact on the financial statements (overstated or understated assets, liabilities, stockholders' equity, revenues, expenses, net income).
- Recording an accrued revenue
 - Showing an adjustment to Prepaid Rent to record rent expense
 - Making the year-end adjustment to Unearned Membership Revenue recognizing revenue earned
- 30.** If a company does not record each of the following adjusting entries, determine the impact on the financial statements (overstated or understated assets, liabilities, stockholders' equity, revenues, expenses, net income).
- Record an entry for any legal expenses accrued.
 - Make an adjustment at year-end for utilities paid in advance at the beginning of the period.
 - Record the revenue for services performed but not yet paid for by customers.

- 31.** Will the following independent errors cause the debit or credit totals on the adjusted trial balance to be unequal? If so, by how much?
- a. The journal entry for Wages Expense was made for \$10,450 instead of \$10,550.
 - b. The journal entry to record sales is accidentally recorded as a \$500 debit to Cash, a \$450 debit to Accounts Receivable, and a \$5,000 credit to Sales Revenue.
 - c. To record depreciation for the year, a \$3,000 debit to Depreciation Expense and a \$3,000 credit to Machinery were made.
- 32.** By how much will the debit or credit totals be higher on the adjusted trial balance due to the following independent errors?
- a. The sale of goods was shown using a \$300 debit to Cash and a \$400 credit to Sales Revenue.
 - b. The entry to record accrued revenues was made by debiting Accounts Receivable for \$450 and crediting Accrued Legal Revenue for \$45.
 - c. When recording the interest expense, the accountant debited Interest Expense for \$890 and Interest Payable for \$800.
- 33.** Determine by how much, if at all, the adjusted trial balance will be incorrect due to the following independent errors.
- a. An adjusting entry for prepaid insurance debited the insurance payable account for \$1,200 and credited the prepaid insurance account for \$1,200.
 - b. A journal entry debited the utilities expense account for \$800 and credited the cash account for \$700.
 - c. While recording the accrued interest revenue, the accountant debited the interest receivable account for \$300 and credited the interest revenue account for \$30.

34. Identify any favorable and unfavorable trends in the following income statements by preparing a vertical analysis. (Round percentages to two decimal places.)

Becker Corporation		
Income Statements		
For the Years Ended December 31		
	Year 2	Year 1
Revenues	<u>\$394,000</u>	<u>\$212,500</u>
Operating expenses:		
Wages expense	\$ 79,000	\$ 65,000
Rent expense	19,000	18,000
Utilities expense	21,000	14,200
Interest expense	<u>7,500</u>	<u>7,800</u>
Total operating expenses	<u>\$126,500</u>	<u>\$105,000</u>
Net income	<u>\$267,500</u>	<u>\$107,500</u>

35. Identify any favorable and unfavorable trends in the following income statements by preparing a vertical analysis. (Round percentages to two decimal places.)

Red Corporation		
Income Statements		
For the Years Ended December 31		
	Year 2	Year 1
Revenues	<u>\$530,000</u>	<u>\$525,000</u>
Operating expenses:		
Wages expense	\$ 90,500	\$ 88,000
Rent expense	35,500	35,000
Utilities expense	7,750	7,750
Insurance expense	<u>15,000</u>	<u>12,000</u>
Total operating expenses	<u>\$148,750</u>	<u>\$142,750</u>
Net income	<u>\$381,250</u>	<u>\$382,250</u>

36. Identify any unfavorable and favorable trends in the following income statements by preparing a vertical analysis. (Round percentages to two decimal places.)

Apple Tree Corporation		
Income Statements		
For the Years Ended December 31		
	Year 2	Year 1
Revenues:		
Sales revenue	\$675,000	\$650,000
Rent revenue	<u>180,000</u>	<u>230,000</u>
Total revenues	<u>\$855,000</u>	<u>\$880,000</u>
Operating expenses:		
Wages expense	\$ 90,500	\$100,000
Rent expense	48,000	38,000
Utilities expense	9,000	8,700
Advertising expense	13,200	14,000
Insurance expense	<u>15,000</u>	<u>15,000</u>
Total operating expenses	<u>\$175,700</u>	<u>\$175,700</u>
Net income	<u>\$679,300</u>	<u>\$704,300</u>