

## CHAPTER 4: ACCRUAL ACCOUNTING CONCEPTS



Rudy Archuleta/Redux Pictures



### The Navigator

- ● Scan Learning Objectives
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- ● Work Using the Decision Toolkit
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- ● Complete Assignments
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## LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1 Explain the revenue recognition principle and the expense recognition principle.
- 2 Differentiate between the cash basis and the accrual basis of accounting.
- 3 Explain why adjusting entries are needed, 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 the adjusted trial balance.
- 7 Explain the purpose of closing entries.
- 8 Describe the required steps in the accounting cycle.
- 9 Understand the causes of differences between net income and net cash provided by operating activities.



## Feature Story: KEEPING TRACK OF GROUPONS

Who doesn't like buying things at a discount? That's why it's not surprising that three years after it started as a company, **Groupon** was estimated to be worth \$16 billion. This translates into an average increase in value of almost \$15 million per day.

Now consider that Groupon had previously been estimated to be worth even more than that. What happened? Well, accounting regulators and investors began to question the way that Groupon had accounted for some of its transactions. But if Groupon sells only coupons ("Groupons"), you're probably wondering how hard can it be to accurately account for that? It turns out that accounting for coupons is not as easy as you might think.

First, consider what happens when Groupon makes a sale. Suppose it sells a Groupon for \$30 for Highrise Hamburgers. When it receives the \$30 from the customer, it must turn over half of that amount (\$15) to Highrise Hamburgers. So should Groupon record revenue for the full \$30 or just \$15? Until recently, Groupon recorded the full \$30. But, in response to an SEC ruling on the issue, Groupon now records revenue of \$15 instead. Groupon also had to restate its previous financial statements. This restatement reduced annual revenue by \$312.9 million.

A second issue is a matter of timing. When should Groupon record this \$15 revenue? Should it record the revenue when it sells the Groupon, or must it wait until the customer uses the Groupon at Highrise Hamburgers? You can find the answer to this question in the notes to Groupon's financial statements. It recognizes the revenue once "the number

The accounting becomes even more complicated when you consider the company’s loyalty programs. Groupon offers free or discounted Groupons to its subscribers for doing things such as referring new customers or participating in promotions. These Groupons are to be used for future purchases, yet the company must record the expense at the time the customer receives the Groupon. The cost of these programs is huge for Groupon, so the timing of this expense can definitely affect its reported income.

The final kicker is that Groupon, like all other companies, must rely on many estimates in its financial reporting. For example, Groupon reports that “estimates are utilized for, but not limited to, stock-based compensation, income taxes, valuation of acquired goodwill and intangible assets, customer refunds, contingent liabilities and the depreciable lives of fixed assets.” It concludes by saying that “actual results could differ materially from those estimates.” So, next time you use a coupon, think about what that means for the company’s accountants!



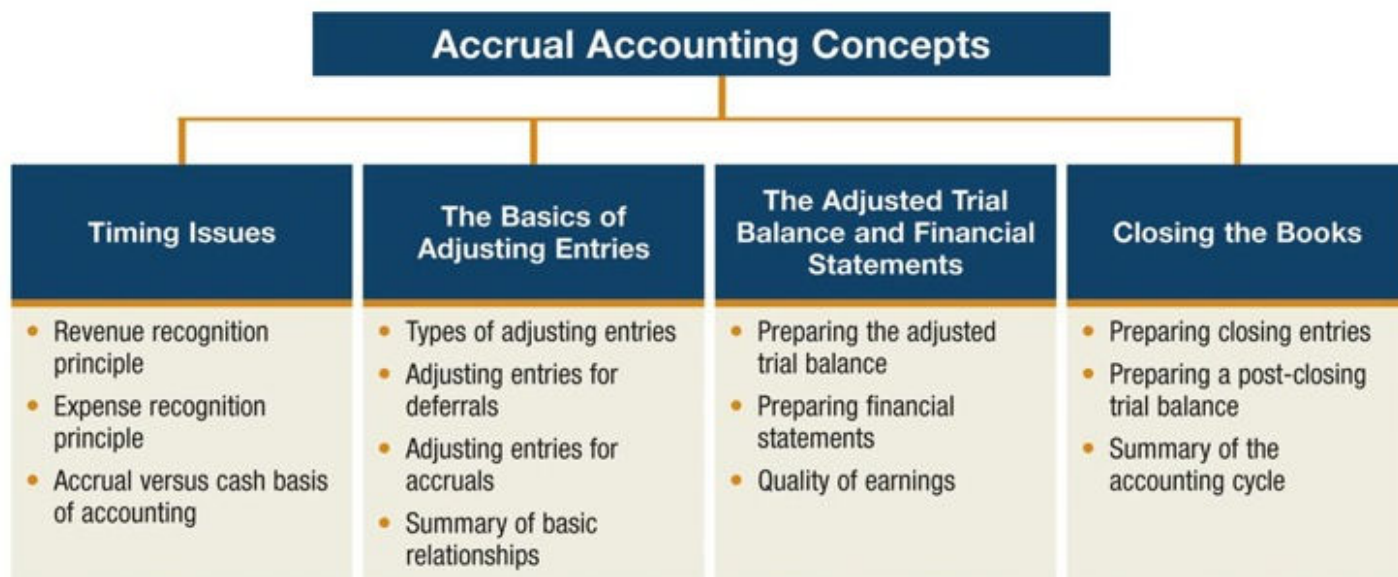
## INSIDE CHAPTER 4...

- **Reporting Revenue Accurately** ([p. 166](#))
- **Cashing In on Accrual Accounting** ([p. 167](#))
- **Turning Gift Cards into Revenue** ([p. 174](#))
- **Got Junk?** ([p. 180](#))
- **Cooking the Books?** ([p. 186](#))

## PREVIEW OF CHAPTER 4

As indicated in the Feature Story, making adjustments is necessary to avoid misstatement of revenues and expenses such as those at **Groupon**. In this chapter, we introduce you to the accrual accounting concepts that make such adjustments possible.

The organization and content of the chapter are as follows.





## Timing Issues

Most businesses need immediate feedback about how well they are doing. For example, management usually wants monthly reports on financial results, most large corporations are required to present quarterly and annual financial statements to stockholders, and the Internal Revenue Service requires all businesses to file annual tax returns.

**Accounting divides the economic life of a business into artificial time periods.** As indicated in [Chapter 2](#), this is the [periodicity assumption](#). Accounting time periods are generally a month, a quarter, or a year.

## LEARNING OBJECTIVE 1

Explain the revenue recognition principle and the expense recognition principle.

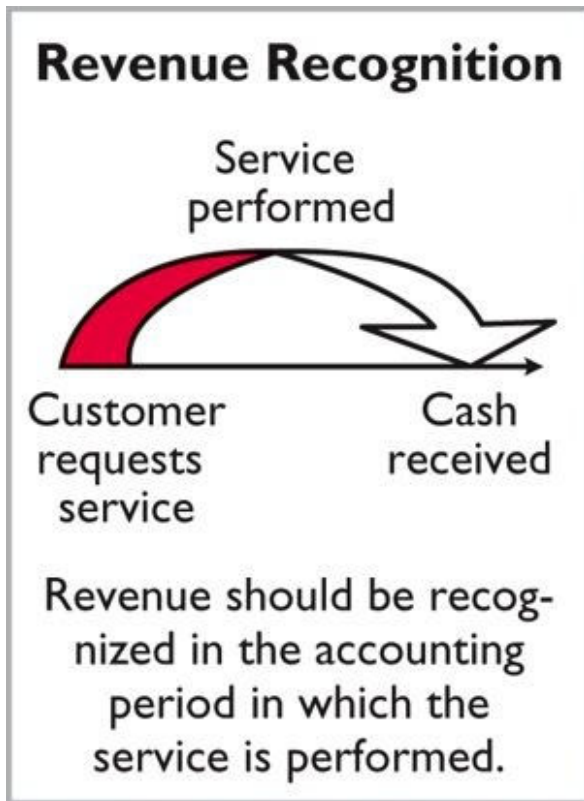
Many business transactions affect more than one of these arbitrary time periods. For example, a new building purchased by **Citigroup** or a new airplane purchased by **Delta Air Lines** will be used for many years. It doesn't make sense to expense the full cost of the building or the airplane at the time of purchase because each will be used for many subsequent periods. Instead, we determine the impact of each transaction on specific accounting periods.

## Helpful Hint

An accounting time period that is one year long is called a [fiscal year](#).

Determining the amount of revenues and expenses to report in a given accounting period can be difficult. Proper reporting requires an understanding of the nature of the company's business. Two principles are used as guidelines: the revenue recognition principle and the expense recognition principle.





## THE REVENUE RECOGNITION PRINCIPLE

When a company agrees to perform a service or sell a product to a customer, it has a performance obligation. The [revenue recognition principle](#) requires that companies recognize revenue in the accounting period **in which the performance obligation is satisfied**. To illustrate, assume Conrad Dry Cleaners 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, Conrad records revenue in June when it performs the service, not in July when it receives the cash. At June 30, Conrad would report a receivable on its balance sheet and revenue in its income statement for the service performed. The journal entries for June and July would be as follows.

|      |                     |     |     |
|------|---------------------|-----|-----|
| June | Accounts Receivable | xxx |     |
|      | Service Revenue     |     | xxx |
| July | Cash                | xxx |     |
|      | Accounts Receivable |     | xxx |

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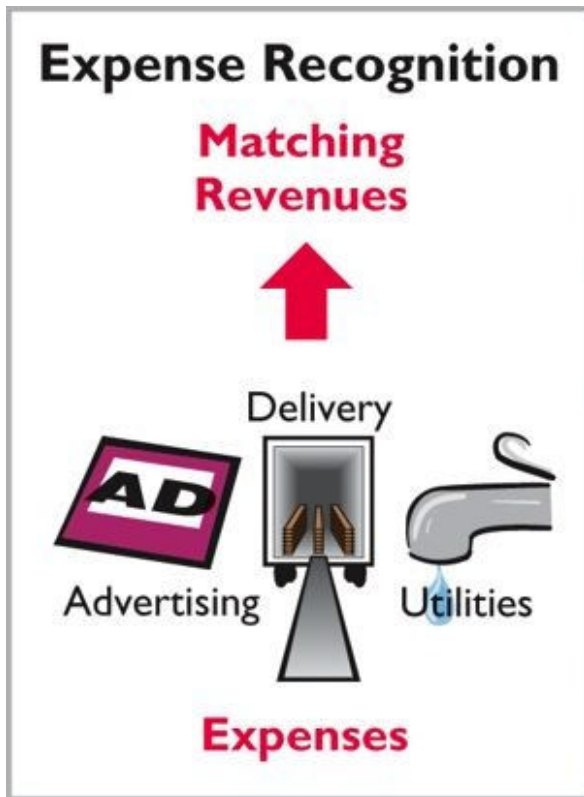


## DECISION TOOLKIT

| DECISION CHECKPOINTS                             | INFO NEEDED FOR DECISION                                | TOOL TO USE FOR DECISION                                                       | HOW TO EVALUATE RESULTS                                                                                                      |
|--------------------------------------------------|---------------------------------------------------------|--------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
| At what point should the company record revenue? | Need to understand the nature of the company's business | Record revenue in the period in which the performance obligation is satisfied. | Recognizing revenue too early overstates current period revenue; recognizing it too late understates current period revenue. |

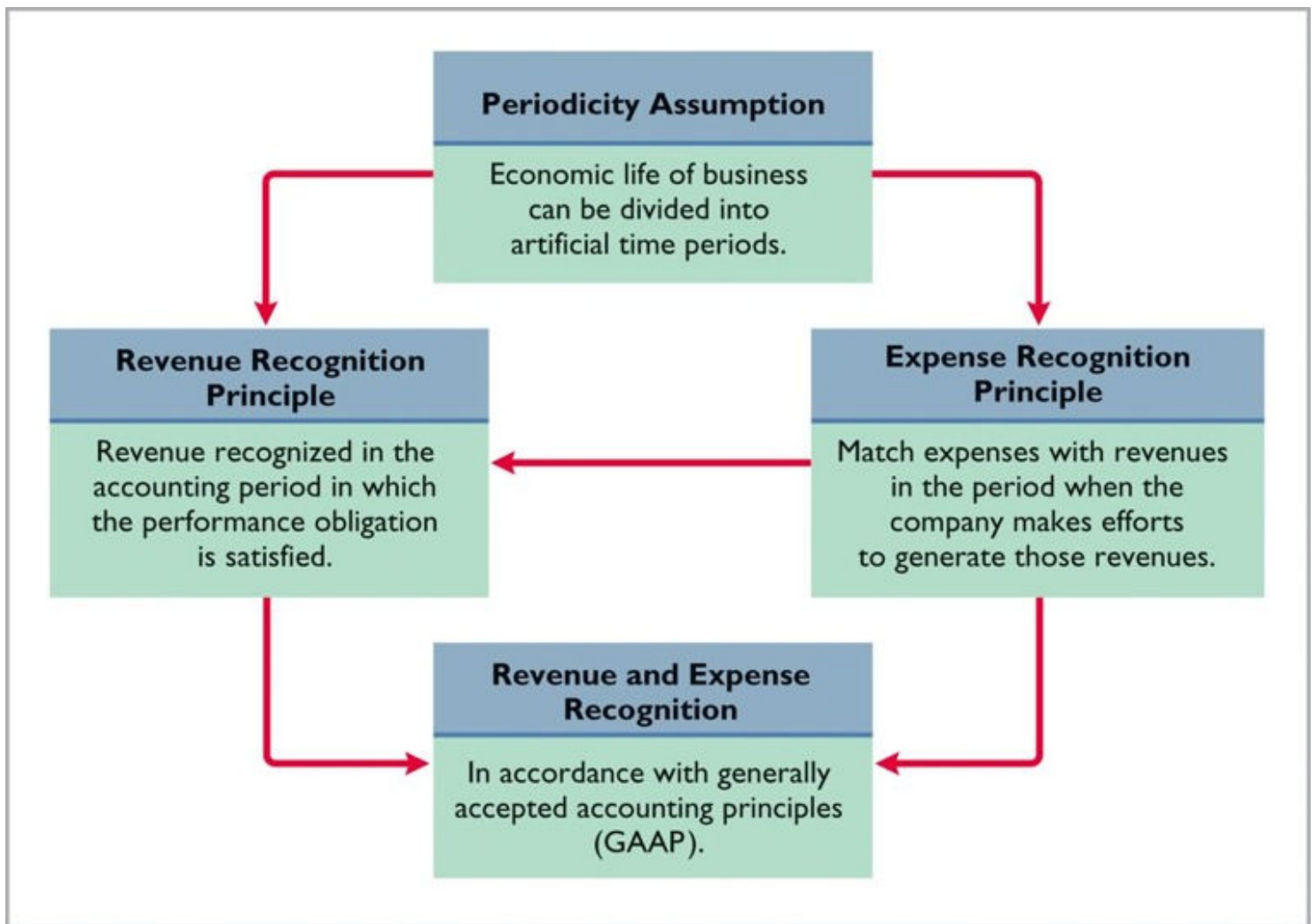
## THE EXPENSE RECOGNITION PRINCIPLE

In recognizing expenses, a simple rule is followed: “Let the expenses follow the revenues.” Thus, expense recognition is tied to revenue recognition. Applied to the preceding example, this means that the salary expense Conrad incurred in performing the cleaning service on June 30 should be reported in the same period in which it recognizes the service revenue. The critical issue in expense recognition is determining when the expense makes its contribution to revenue. This may or may not be the same period in which the expense is paid. If Conrad does not pay the salary incurred on June 30 until July, it would report salaries and wages payable on its June 30 balance sheet.



The practice of expense recognition is referred to as the [expense recognition principle](#) (often referred to as the [matching principle](#)). It dictates that efforts (expenses) be matched with results (revenues). [Illustration 4-1](#) shows these relationships.

### Illustration 4-1: GAAP relationships in revenue and expense recognition





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## DECISION TOOLKIT

| DECISION CHECKPOINTS                              | INFO NEEDED FOR DECISION                                | TOOL TO USE FOR DECISION                                                                         | HOW TO EVALUATE RESULTS                                                                                                         |
|---------------------------------------------------|---------------------------------------------------------|--------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|
| At what point should the company record expenses? | Need to understand the nature of the company's business | Expenses should “follow” revenues—that is, match the effort (expense) with the result (revenue). | Recognizing expenses too early overstates current period expense; recognizing them too late understates current period expense. |



### Investor Insight: Reporting Revenue Accurately

Until recently, electronics manufacturer **Apple** was required to spread the revenues from iPhone sales over the two-year period following the sale of the phone. Accounting standards required this because it was argued that Apple was obligated to provide software updates after the phone was sold. Therefore, since Apple had service obligations after the initial date of sale, it was forced to spread the revenue over a two-year period. However, since the company received full payment upfront, the cash flows from iPhones significantly exceeded the revenue reported from iPhone sales in each accounting period. It also meant that the rapid growth of iPhone sales was not fully reflected in the revenue amounts reported in Apple's income statement. A new accounting standard now enables Apple to report nearly all of its iPhone revenue at the point of sale. It was estimated that under the new rule revenues would have been about 17% higher and earnings per share almost 50% higher.



PhotoAlto/James Hardy/Getty Images, Inc.



In the past, why was it argued that Apple should spread the recognition of iPhone revenue over a two-year period, rather than recording it upfront? (See [page 224](#).)

## ACCRUAL VERSUS CASH BASIS OF ACCOUNTING

**Accrual-basis accounting** means that transactions that change a company's financial statements are recorded **in the periods in which the events occur**, even if cash was not exchanged. For example, using the accrual basis means that companies recognize revenues when they perform the services (the revenue recognition principle), even if cash was not received. Likewise, under the accrual basis, companies recognize expenses when incurred (the expense recognition principle), even if cash was not paid.

## LEARNING OBJECTIVE 2

Differentiate between the cash basis and the accrual basis of accounting.

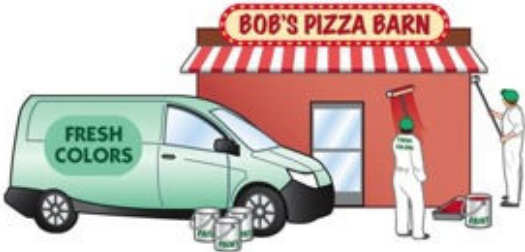
An alternative to the accrual basis is the cash basis. Under **cash-basis accounting**, companies record revenue when they receive cash. They record an expense when they pay out cash. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails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

## International Note

**Illustration 4-2** compares accrual-based numbers and cash-based numbers. Suppose that Fresh Colors paints a large building in 2013. In 2013, it incurs and pays total expenses (salaries and paint costs) of \$50,000. It bills the customer \$80,000 but does not receive payment until 2014. On an accrual basis, Fresh Colors reports \$80,000 of revenue during 2013 because that is when it performed the service. The company matches expenses of \$50,000 to the \$80,000 of revenue. Thus, 2013 net income is  $\$30,000 (\$80,000 - \$50,000)$ . The \$30,000 of net income reported for 2013 indicates the profitability of Fresh Colors' efforts during that period.

If Fresh Colors were to use cash-basis accounting, it would report \$50,000 of expenses in 2013 and \$80,000 of revenues during 2014. As shown in **Illustration 4-2**, it would report a loss of \$50,000 in 2013 and would report net income of \$80,000 in 2014. Clearly, the cash-basis measures are misleading because the financial performance of the company would be misstated for both 2013 and 2014.

## Illustration 4-2: Accrual-versus cash-basis accounting

|               | 2013                                                                                                                                                   | 2014                                                                                                                                          |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|----------|---------|---------------|------------|------------|--------------------------------------------------------------------------------------------------------------------------------------------------|---------|----------|---------|----------|------------|----------|
| Activity      | <div></div> <p>Purchased paint, painted building, paid employees</p> | <div></div> <p>Received payment for work done in 2013</p> |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Accrual basis | <table><tr><td>Revenue</td><td>\$80,000</td></tr><tr><td>Expense</td><td><u>50,000</u></td></tr><tr><td>Net income</td><td>\$30,000</td></tr></table>  | Revenue                                                                                                                                       | \$80,000 | Expense | <u>50,000</u> | Net income | \$30,000   | <table><tr><td>Revenue</td><td>\$ 0</td></tr><tr><td>Expense</td><td><u>0</u></td></tr><tr><td>Net income</td><td>\$ 0</td></tr></table>         | Revenue | \$ 0     | Expense | <u>0</u> | Net income | \$ 0     |
| Revenue       | \$80,000                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Expense       | <u>50,000</u>                                                                                                                                          |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Net income    | \$30,000                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Revenue       | \$ 0                                                                                                                                                   |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Expense       | <u>0</u>                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Net income    | \$ 0                                                                                                                                                   |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Cash basis    | <table><tr><td>Revenue</td><td>\$ 0</td></tr><tr><td>Expense</td><td><u>50,000</u></td></tr><tr><td>Net loss</td><td>\$(50,000)</td></tr></table>      | Revenue                                                                                                                                       | \$ 0     | Expense | <u>50,000</u> | Net loss   | \$(50,000) | <table><tr><td>Revenue</td><td>\$80,000</td></tr><tr><td>Expense</td><td><u>0</u></td></tr><tr><td>Net income</td><td>\$80,000</td></tr></table> | Revenue | \$80,000 | Expense | <u>0</u> | Net income | \$80,000 |
| Revenue       | \$ 0                                                                                                                                                   |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Expense       | <u>50,000</u>                                                                                                                                          |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Net loss      | \$(50,000)                                                                                                                                             |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Revenue       | \$80,000                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Expense       | <u>0</u>                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |
| Net income    | \$80,000                                                                                                                                               |                                                                                                                                               |          |         |               |            |            |                                                                                                                                                  |         |          |         |          |            |          |



## International Insight: Cashing In on Accrual Accounting

The Chinese government, like most governments, uses cash accounting. It is therefore interesting that for about \$38 billion of expenditures in a recent budget projection, the Chinese government used accrual accounting instead of cash accounting. It decided to expense the amount in the year in which it was originally allocated rather than when the payments would be made. Why did it do this? It enabled the government to keep its projected budget deficit below a 3% threshold. While it was able to keep its projected shortfall below 3%, China did suffer some criticism for its inconsistent accounting. Critics charge that this inconsistent treatment reduces the transparency of China's accounting information. That is, it is not easy for outsiders to accurately evaluate what is really going on.



Günay Mutlu/iStockphoto

Source: Andrew Batson, “China Altered Budget Accounting to Reduce Deficit Figure,” *Wall Street Journal Online* (March 15, 2010).



Accrual accounting is often considered superior to cash accounting. Why, then, were some people critical of China’s use of accrual accounting in this instance? (See [page 224](#).)

## The Basics of Adjusting Entries

In order for revenues to be recorded in the period in which the performance obligations are satisfied, and for expenses to be recognized in the period in which they are incurred, companies make adjusting entries. [Adjusting entries ensure that the revenue recognition and expense recognition principles are followed.](#)

## LEARNING OBJECTIVE 3

Explain why adjusting entries are needed, and identify the major types of adjusting entries.

Adjusting entries are necessary because the **trial balance**—the first pulling together 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. Examples are the use of supplies and the earning of wages by employees.
- 2. Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions. Examples are charges related to the use of buildings and equipment, rent, and insurance.
- 3. Some items may be unrecorded. An example is a utility service bill that will not be received until the next accounting period.

**Adjusting entries are required every time a company prepares financial statements.** The company analyzes each account in the trial balance to determine whether it is complete and up-to-date for financial statement purposes. **Every adjusting entry will include one income statement account and one balance sheet account.**

Adjusting entries are classified as either deferrals or accruals. As [Illustration 4-3](#) shows, each of these classes has two subcategories.

## Illustration 4-3: Categories of adjusting entries

### Deferrals:

- 1. **Prepaid expenses:** Expenses paid in cash before they are used or consumed.
- 2. **Unearned revenues:** Cash received before services are performed.

### Accruals:

- 1. **Accrued revenues:** Revenues for services performed but not yet received in cash or recorded.
- 2. **Accrued expenses:** Expenses incurred but not yet paid in cash or recorded.

Subsequent sections give examples of each type of adjustment. Each example is based on the October 31 trial balance of Sierra Corporation from [Chapter 3](#). It is reproduced in [Illustration 4-4](#). Note that Retained Earnings has been added to this trial balance with a zero balance. We will explain its use later.

## Illustration 4-4: Trial balance



### SIERRA CORPORATION

#### Trial Balance

October 31, 2014

|                   | <u>Debit</u> | <u>Credit</u> |
|-------------------|--------------|---------------|
| Cash              | \$15,200     |               |
| Supplies          | 2,500        |               |
| Prepaid Insurance | 600          |               |
| Equipment         | 5,000        |               |
| Notes Payable     |              | \$ 5,000      |
| Accounts Payable  |              | 2,500         |





## SIERRA CORPORATION

### Trial Balance

October 31, 2014

|                            |            |             |
|----------------------------|------------|-------------|
| Unearned Service Revenue   | 1,200      |             |
| Common Stock               | 10,000     |             |
| Retained Earnings          | 0          |             |
| Dividends                  | 500        |             |
| Service Revenue            | 10,000     |             |
| Salaries and Wages Expense | 4,000      |             |
| Rent Expense               | <u>900</u> | <u>    </u> |
|                            | \$28,700   | \$28,700    |

We assume that Sierra Corporation uses an accounting period of one month. Thus, monthly adjusting entries are made. The entries are dated October 31.

## ADJUSTING ENTRIES FOR DEFERRALS

To defer means to postpone or delay. Deferrals are costs or revenues that are recognized at a date later than the point when cash was originally exchanged. Companies make adjusting entries for deferred expenses to record the portion that was incurred during the period. Companies also make adjusting entries for deferred revenues to record services performed during the period. The two types of deferrals are prepaid expenses and unearned revenues.

## LEARNING OBJECTIVE 4

Prepare adjusting entries for deferrals.

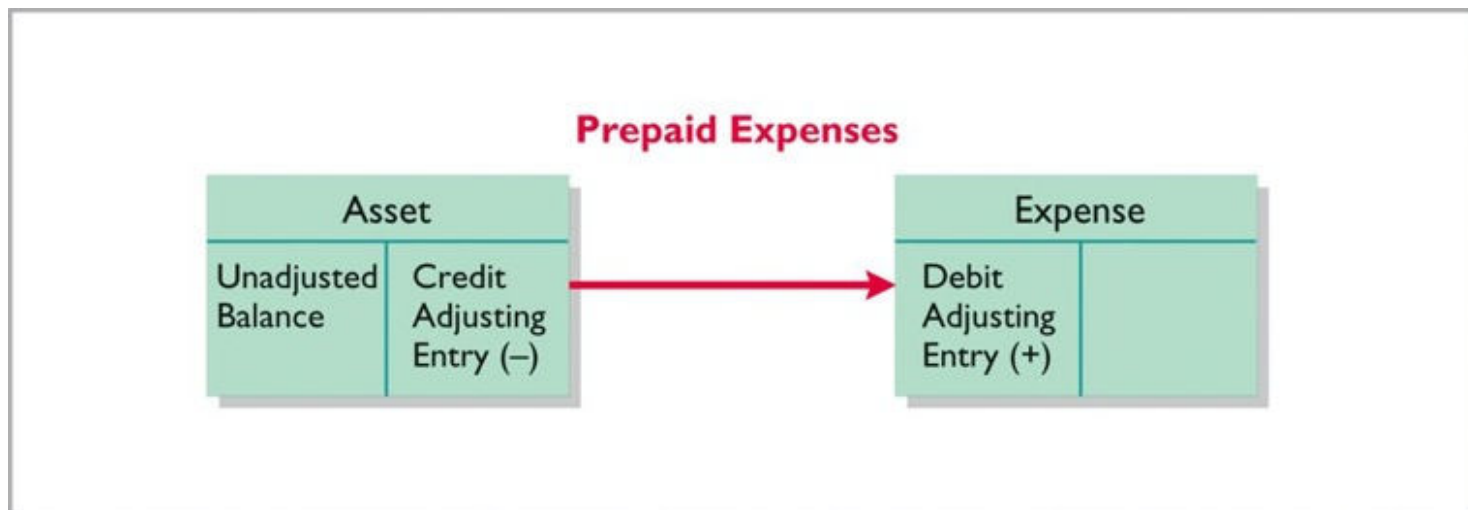
### Prepaid Expenses

Companies record payments of expenses that will benefit more than one accounting period as assets. These [prepaid expenses](#) or [prepayments](#) are expenses paid in cash before they are used or consumed. When expenses are prepaid,

**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 entries, which would be impractical and unnecessary. Accordingly, companies postpone the recognition of such cost expirations until they prepare financial statements. At each statement date, they make adjusting entries to record the expenses applicable to the current accounting period and to show the remaining amounts in the asset accounts.

Prior to adjustment, assets are overstated and expenses are understated. Therefore, as shown in [Illustration 4-5](#), **an adjusting entry for prepaid expenses results in an increase (a debit) to an expense account and a decrease (a credit) to an asset account.**

## Illustration 4-5: Adjusting entries for prepaid expenses



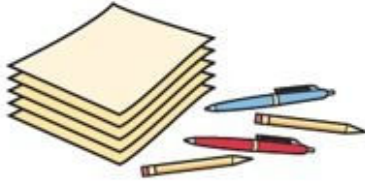
Let's look in more detail at some specific types of prepaid expenses, beginning with supplies.

## SUPPLIES.

The purchase of supplies, such as paper and envelopes, results in an increase (a debit) to an asset account. During the accounting period, the company uses supplies. Rather than record supplies expense as the supplies are used, companies recognize supplies expense at the **end** of the accounting period. At the end of the accounting period, the company counts the remaining supplies. The difference between the unadjusted balance in the Supplies (asset) account and the actual cost of supplies on hand represents the supplies used (an expense) for that period.

## Supplies

Oct. 5



Supplies purchased;  
record asset



Oct. 31

Supplies used;  
record supplies expense

Recall from [Chapter 3](#) that Sierra Corporation purchased supplies costing \$2,500 on October 5. Sierra recorded the purchase by increasing (debiting) the asset Supplies. This account shows a balance of \$2,500 in the October 31 trial balance. A physical count of the inventory 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  $\$1,500 (\$2,500 - \$1,000)$ . This use of supplies decreases an asset, Supplies. It also decreases stockholders' equity by increasing an expense account, Supplies Expense. This is shown in [Illustration 4-6](#).

### Illustration 4-6: Adjustment for supplies

| Basic Analysis        | The expense Supplies Expense is increased \$1,500; the asset Supplies is decreased \$1,500.                                                                                                                                                      |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|----------|------------------------------------------------------------------------------------------------------------------------------|--------|-------|---------|------------|---------|------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|------------------|--|---------|------------|---------|------------|
| Equation Analysis     | (1)                                                                                                                                                                                                                                              | $\begin{array}{r} \text{Assets} \\ \text{Supplies} \\ -\$1,500 \end{array}$ | =        | $\begin{array}{r} \text{Liabilities} \\ + \\ \text{Stockholders' Equity} \\ \text{Supplies Expense} \\ -\$1,500 \end{array}$ |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Debit–Credit Analysis | Debits increase expenses: debit Supplies Expense \$1,500.<br>Credits decrease assets: credit Supplies \$1,500.                                                                                                                                   |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Journal Entry         | Oct. 31                                                                                                                                                                                                                                          | Supplies Expense<br>Supplies<br>(To record supplies used)                   | 1,500    | 1,500                                                                                                                        |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Posting               | <table border="1"> <thead> <tr> <th colspan="2">Supplies</th> </tr> </thead> <tbody> <tr> <td>Oct. 5</td> <td>2,500</td> </tr> <tr> <td>Oct. 31</td> <td>Adj. 1,500</td> </tr> <tr> <td>Oct. 31</td> <td>Bal. 1,000</td> </tr> </tbody> </table> |                                                                             | Supplies |                                                                                                                              | Oct. 5 | 2,500 | Oct. 31 | Adj. 1,500 | Oct. 31 | Bal. 1,000 | <table border="1"> <thead> <tr> <th colspan="2">Supplies Expense</th> </tr> </thead> <tbody> <tr> <td>Oct. 31</td> <td>Adj. 1,500</td> </tr> <tr> <td>Oct. 31</td> <td>Bal. 1,500</td> </tr> </tbody> </table> |  | Supplies Expense |  | Oct. 31 | Adj. 1,500 | Oct. 31 | Bal. 1,500 |
| Supplies              |                                                                                                                                                                                                                                                  |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Oct. 5                | 2,500                                                                                                                                                                                                                                            |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Oct. 31               | Adj. 1,500                                                                                                                                                                                                                                       |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Oct. 31               | Bal. 1,000                                                                                                                                                                                                                                       |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Supplies Expense      |                                                                                                                                                                                                                                                  |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Oct. 31               | Adj. 1,500                                                                                                                                                                                                                                       |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |
| Oct. 31               | Bal. 1,500                                                                                                                                                                                                                                       |                                                                             |          |                                                                                                                              |        |       |         |            |         |            |                                                                                                                                                                                                                |  |                  |  |         |            |         |            |

## Helpful Hint

Due to their nature, adjusting entries have **no effect** on cash flows. As a result, we do not show the cash flow effects as we did in [Chapter 3](#).

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

## Insurance

Oct. 4



Insurance purchased;  
record asset

| Insurance Policy    |               |               |              |
|---------------------|---------------|---------------|--------------|
| Oct<br>\$50         | Nov<br>\$50   | Dec<br>\$50   | Jan<br>\$50  |
| Feb<br>\$50         | March<br>\$50 | April<br>\$50 | May<br>\$50  |
| June<br>\$50        | July<br>\$50  | Aug<br>\$50   | Sept<br>\$50 |
| <b>1 YEAR \$600</b> |               |               |              |

Oct. 31

Insurance expired;  
record insurance expense

## INSURANCE.

Companies purchase insurance to protect themselves from losses due to fire, theft, and unforeseen events. Insurance must be paid in advance, often for more than one year. The cost of insurance (premiums) paid in advance is recorded as an increase (debit) in the asset account Prepaid Insurance. At the financial statement date, companies increase (debit) Insurance Expense and decrease (credit) Prepaid Insurance for the cost of insurance that has expired during the period.

On October 4, Sierra Corporation paid \$600 for a one-year fire insurance policy. Coverage began on October 1. Sierra recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of \$600 in the October 31 trial balance. Insurance of  $\$50(\$600 \div 12)$  expires each month. The expiration of prepaid insurance decreases an asset, Prepaid Insurance. It also decreases stockholders' equity by increasing an expense account, Insurance Expense.

As shown in [Illustration 4-7](#), the asset Prepaid Insurance shows a balance of \$550, which represents the unexpired cost for the remaining 11 months of coverage. At the same time, the balance in Insurance Expense equals the insurance cost that expired in October. If Sierra does not make this adjustment, October expenses are understated by \$50 and net



## Illustration 4-7: Adjustment for insurance

Basic  
Analysis

The expense Insurance Expense is increased \$50; the asset Prepaid Insurance is decreased \$50.

Equation  
Analysis

(2) 

|                          |   |                    |   |                             |
|--------------------------|---|--------------------|---|-----------------------------|
| <u>Assets</u>            | = | <u>Liabilities</u> | + | <u>Stockholders' Equity</u> |
| <u>Prepaid Insurance</u> | = |                    |   | <u>Insurance Expense</u>    |
| -\$50                    |   |                    |   | -\$50                       |

Debit-Credit  
Analysis

Debits increase expenses: debit Insurance Expense \$50.  
Credits decrease assets: credit Prepaid Insurance \$50.

Journal  
Entry

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

Posting

| Prepaid Insurance |          |         |         | Insurance Expense |         |
|-------------------|----------|---------|---------|-------------------|---------|
| Oct. 4            | 600      | Oct. 31 | Adj. 50 | Oct. 31           | Adj. 50 |
| Oct. 31           | Bal. 550 |         |         | Oct. 31           | Bal. 50 |

## DEPRECIATION.

A company typically owns a variety of assets that have long lives, such as buildings, equipment, and motor vehicles. The period of service is referred to as the [useful life](#) of the asset. Because a building is expected to provide service for many years, it is recorded as an asset, rather than an expense, on the date it is acquired. As explained in [Chapter 2](#), companies record such assets **at cost**, as required by the historical cost principle. To follow the expense recognition principle, companies allocate a portion of this cost 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.

### *Need for adjustment.*

The acquisition of long-lived assets is essentially a long-term prepayment for the use of an asset. An adjusting entry for depreciation is needed to recognize the cost that has been used (an expense) during the period and to report the unused cost (an asset) at the end of the period. One very important point to understand: **Depreciation is an allocation concept, not a valuation concept.** That is, depreciation **allocates an asset's cost to the periods in which it is used.** Depreciation does not attempt to report the actual change in the value of the asset.

## Depreciation

Oct. 2



Equipment purchased;  
record asset

| Equipment                 |               |               |              |
|---------------------------|---------------|---------------|--------------|
| Oct<br>\$40               | Nov<br>\$40   | Dec<br>\$40   | Jan<br>\$40  |
| Feb<br>\$40               | March<br>\$40 | April<br>\$40 | May<br>\$40  |
| June<br>\$40              | July<br>\$40  | Aug<br>\$40   | Sept<br>\$40 |
| Depreciation = \$480/year |               |               |              |

Oct. 31

Depreciation recognized;  
record depreciation expense

For Sierra Corporation, assume that depreciation on the equipment is \$480 a year, or \$40 per month. As shown in [Illustration 4-8 \(page 172\)](#), rather than decrease (credit) the asset account directly, Sierra instead credits Accumulated Depreciation—Equipment. Accumulated Depreciation is called a [contra asset account](#). Such an account is offset against an asset account on the balance sheet. Thus, the Accumulated Depreciation—Equipment account offsets the asset Equipment. This account keeps track of the total amount of depreciation expense taken over the life of the asset. To keep the accounting equation in balance, Sierra decreases stockholders' equity by increasing an expense account, Depreciation Expense.

The balance in the Accumulated Depreciation—Equipment account will increase \$40 each month, and the balance in Equipment remains \$5,000.

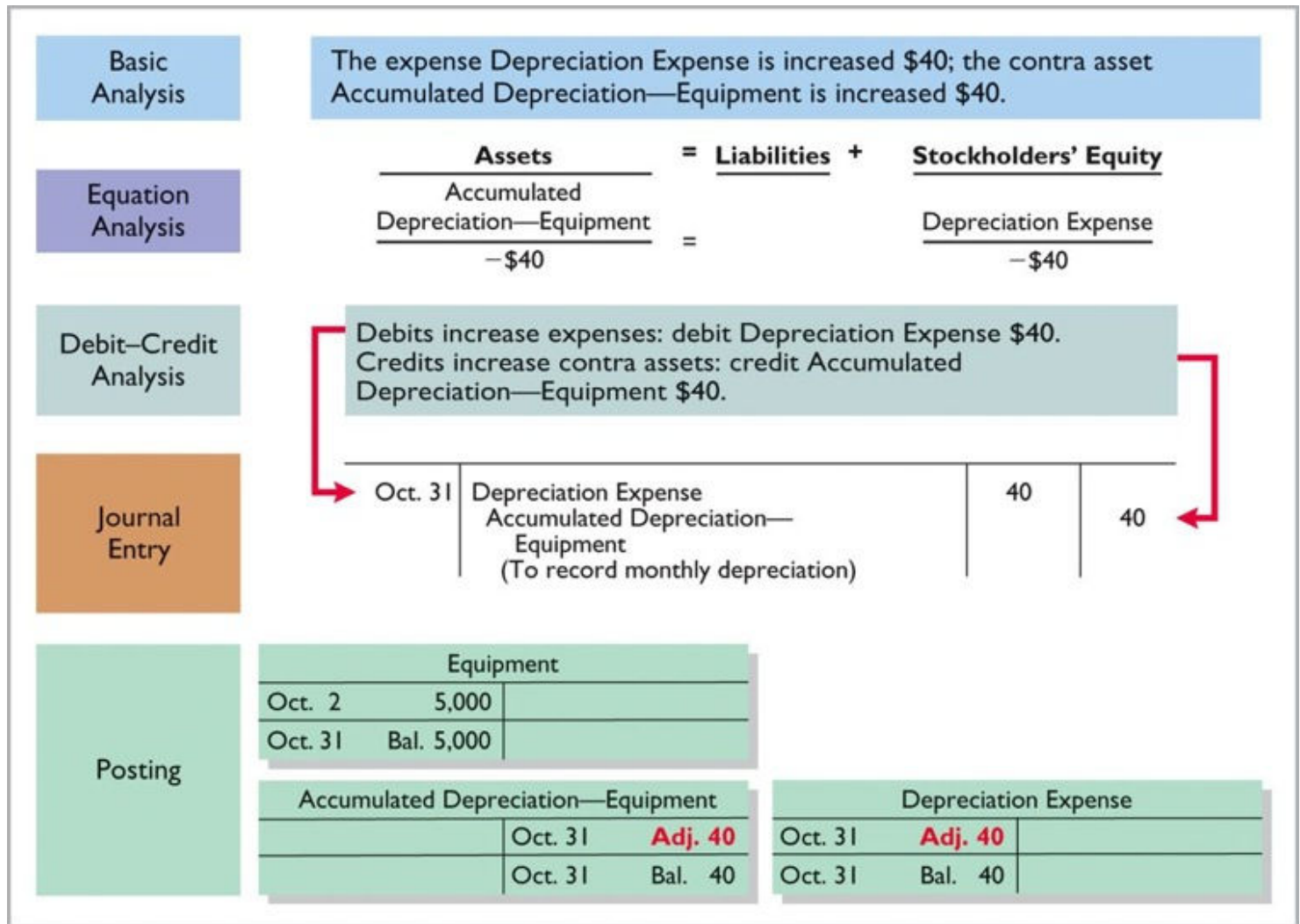
## Helpful Hint

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

## Statement presentation.

As noted above, Accumulated Depreciation—Equipment is a contra-asset account. It is offset against Equipment on the balance sheet. The normal balance of a contra-asset account is a credit. A theoretical alternative to using a contra-asset account would be to decrease (credit) the asset account by the amount of depreciation each period. But using 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. Thus, in the balance sheet, Sierra deducts Accumulated Depreciation—Equipment from the related asset account, as shown in [Illustration 4-9](#).

## Illustration 4-8: Adjustment for depreciation



## Illustration 4-9: Balance sheet presentation of accumulated depreciation

|                                          |                |
|------------------------------------------|----------------|
| Equipment                                | \$ 5,000       |
| Less: Accumulated depreciation—equipment | <u>40</u>      |
|                                          | <b>\$4,960</b> |

**Book value** is the difference between the cost of any depreciable asset and its related accumulated depreciation. In [Illustration 4-9](#), the book value of the equipment at the balance sheet date is \$4,960. The book value and the fair value

## Alternative Terminology

Book value is also referred to as *carrying value*.

Depreciation expense identifies the portion of an asset’s cost that expired during the period (in this case, in October). The accounting equation shows that without this adjusting entry, total assets, total stockholders’ equity, and net income are overstated by \$40 and depreciation expense is understated by \$40.

[Illustration 4-10](#) summarizes the accounting for prepaid expenses.

## Illustration 4-10: 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.<br>Expenses understated. | Dr. Expenses Cr. Assets<br>or Contra Assets |

## Unearned Revenues

Companies record cash received before services are performed by increasing (crediting) a liability account called [unearned revenues](#). In other words, the company has a performance obligation to transfer a service to one of its customers. Items like rent, magazine subscriptions, and customer deposits for future service may result in unearned revenues. Airlines such as **United**, **American**, and **Delta**, for instance, treat receipts from the sale of tickets as unearned revenue until the flight service is provided.

## Unearned Revenues

Oct. 2



Cash is received in advance;  
liability is recorded



Oct. 31

Some service has been  
performed; some revenue  
is recorded

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without publisher's prior permission. Violators will be prosecuted.

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

When a company receives payment for services to be performed in a future accounting period, it increases (credits) an unearned revenue account. Unearned revenue is a liability account used to recognize the obligation that exists. The company subsequently recognizes revenues when it performs the service. During the accounting period, it is not practical to make daily entries as the company performs services. Instead, the company delays recognition of revenue until the adjustment process. The company then makes an adjusting entry to record the revenue for services performed during the period and to show the liability that remains at the end of the accounting period. Prior to adjustment, liabilities are typically overstated and revenues are understated. Therefore, as shown in [Illustration 4-11](#), 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 4-11: Adjusting entries for unearned revenues



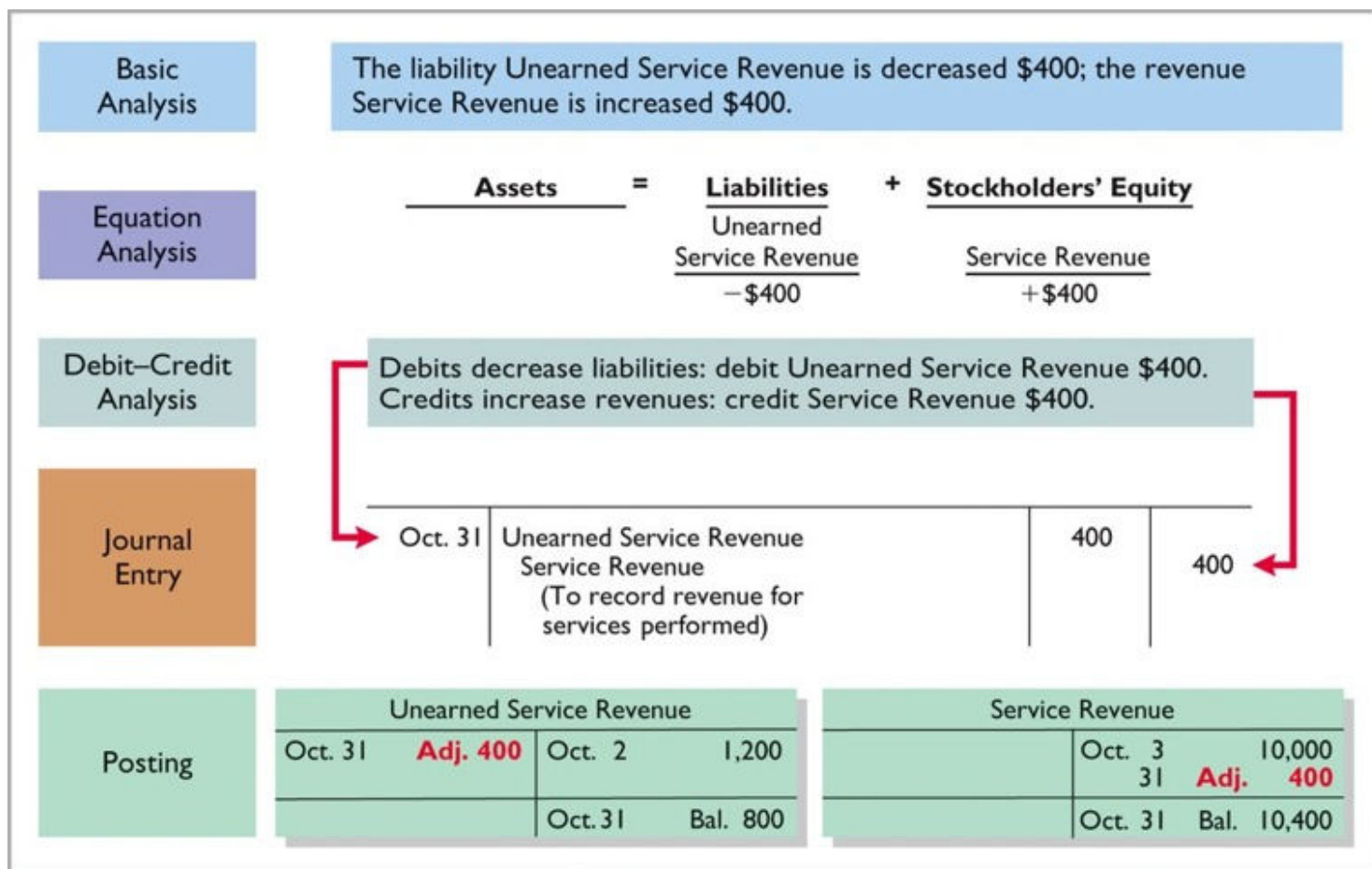
## Unearned Revenues



Sierra Corporation received \$1,200 on October 2 from R. Knox for guide services for multi-day trips expected to be completed by December 31. Sierra credited the payment to Unearned Service Revenue. This liability account shows a balance of \$1,200 in the October 31 trial balance. From an evaluation of the service Sierra performed for Knox during October, the company determines that it should recognize \$400 of revenue in October. The liability (Unearned Service Revenue) is therefore decreased and stockholders' equity (Service Revenue) is increased.

As shown in [Illustration 4-12 \(page 174\)](#), the liability Unearned Service Revenue now shows a balance of \$800. That amount represents the remaining guide services expected to be performed in the future. Service Revenue shows total revenue for October of \$10,400. **Without this adjustment, revenues and net income are understated by \$400 in the income statement. Moreover, liabilities are overstated and stockholders' equity is understated by \$400 on the October 31 balance sheet.**

### Illustration 4-12: Service revenue accounts after adjustment



[Illustration 4-13](#) summarizes the accounting for unearned revenues.

## Illustration 4-13: 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 are now recognized as revenue for services performed. | Liabilities overstated. Revenues understated. | Dr. Liabilities<br>Cr. Revenues |



## Accounting Across the Organization: Turning Gift Cards into Revenue

Those of you who are marketing majors (and even most of you who are not) know that gift cards are among the hottest marketing 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.

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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 exercised? How should expired gift cards be accounted for? In a recent balance sheet, **Best Buy** reported unearned revenue related to gift cards of \$479 million.

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



Suppose that Robert Jones purchases a \$100 gift card at Best Buy on December 24, 2013, and gives it to his wife, Mary Jones, on December 25, 2013. On January 3, 2014, Mary uses the card to purchase \$100 worth of CDs. When do you think Best Buy should recognize revenue and why? (See [page 224](#).)



## ADJUSTING ENTRIES FOR DEFERRALS

The ledger of Hammond, Inc., on March 31, 2014, includes these selected accounts before adjusting entries are prepared.

|                                    | <u>Debit</u> | <u>Credit</u> |
|------------------------------------|--------------|---------------|
| Prepaid Insurance                  | \$ 3,600     |               |
| Supplies                           | 2,800        |               |
| Equipment                          | 25,000       |               |
| Accumulated Depreciation—Equipment |              | \$5,000       |
| Unearned Service 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 equipment depreciates \$200 a month.
- 4. During March, services were performed for one-half of the unearned service revenue.

Prepare the adjusting entries for the month of March.

### Action Plan

- ● Make adjusting entries at the end of the period for revenues recognized and expenses incurred in the period.
- ● Don't forget to make adjusting entries for deferrals. Failure to adjust for deferrals leads to overstatement of the asset or liability and understatement of the related expense or revenue.



### Solution

|                      |     |     |
|----------------------|-----|-----|
| 1. Insurance Expense | 100 |     |
| Prepaid Insurance    |     | 100 |

2. Supplies Expense 2,000

Supplies 2,000

(To record supplies used)

3. Depreciation Expense 200

Accumulated Depreciation—Equipment 200

(To record monthly depreciation)

4. Unearned Service Revenue 4,600

Service Revenue 4,600

(To record revenue for services performed)

Related exercise material: [BE4-4](#), [BE4-5](#), [BE4-6](#), [BE4-7](#), and  [4-1](#).

## ADJUSTING ENTRIES FOR ACCRUALS

The second category of adjusting entries is **accruals**. Prior to an accrual adjustment, the revenue account (and the related asset account) or the expense account (and the related liability account) are understated. Thus, the adjusting entry for accruals will **increase both a balance sheet and an income statement account**.

## LEARNING OBJECTIVE 5

Prepare adjusting entries for accruals.

### Accrued Revenues

Revenues for services performed 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. These are unrecorded because the earning of interest does not involve daily transactions. Companies do not record interest revenue on a daily basis because it is often impractical to do so. Accrued revenues also may result from services that have been performed but not yet billed nor collected, as in the case of commissions and fees. These may be unrecorded because only a portion of the total service has been performed and the clients won't be billed until the service has been completed.



## Accrued Revenues



Revenue and receivable  
are recorded for  
unbilled services

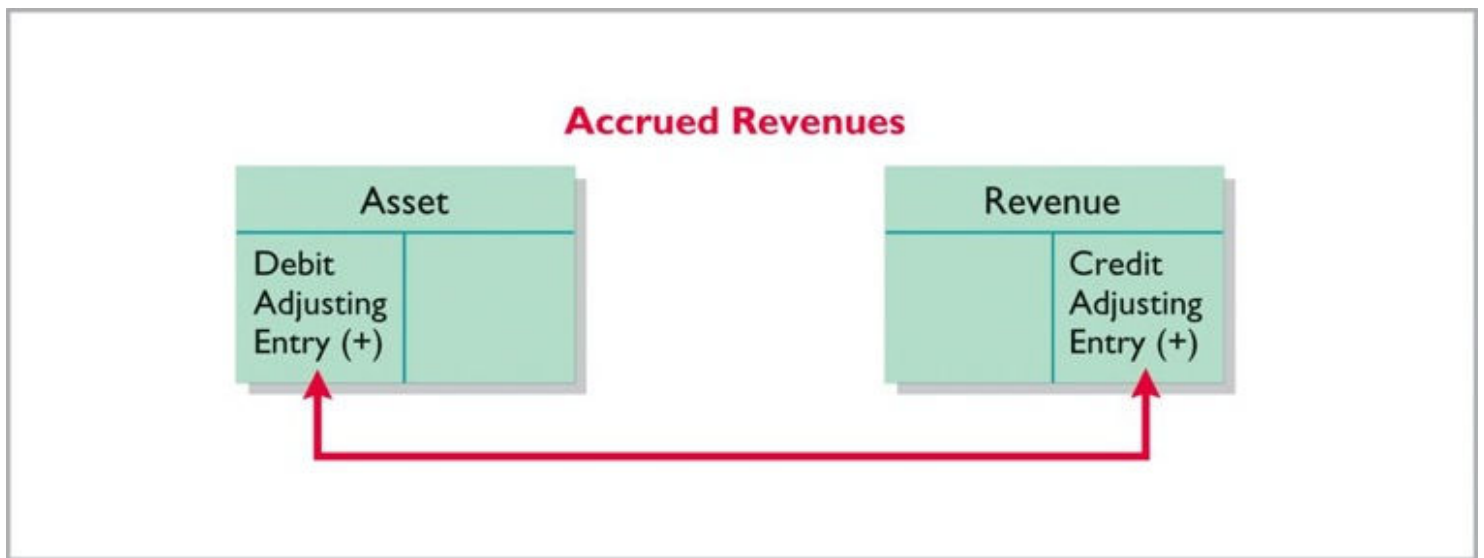
Nov. 10



Cash is received;  
receivable is reduced

An adjusting entry records the receivable that exists at the balance sheet date and the revenue for the services performed during the period. Prior to adjustment, both assets and revenues are understated. As shown in [Illustration 4-14 \(page 176\)](#), an adjusting entry for accrued revenues results in an increase (a debit) to an asset account and an increase (a credit) to a revenue account.

### Illustration 4-14: Adjusting entries for accrued revenues

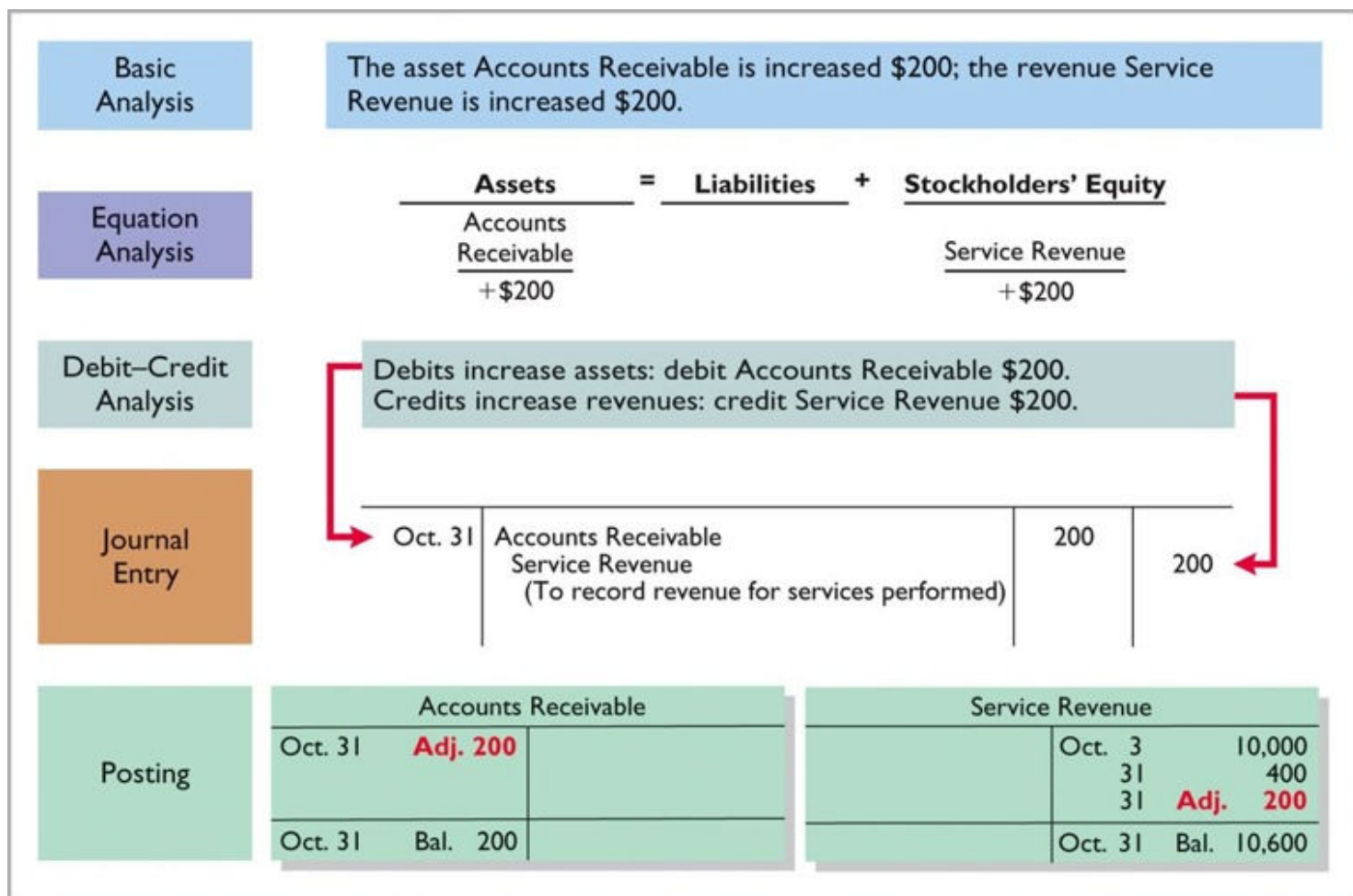


In October, Sierra Corporation performed guide services worth \$200 that were not billed to clients on or before October 31. Because these services are not billed, they are not recorded. The accrual of unrecorded service revenue increases an asset account, Accounts Receivable. It also increases stockholders' equity by increasing a revenue account, Service Revenue, as shown in [Illustration 4-15](#).

### Helpful Hint

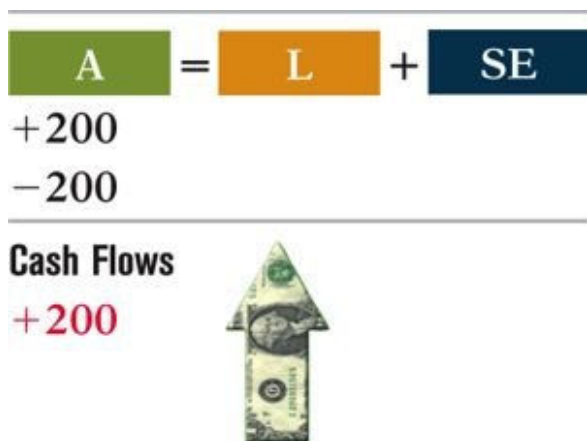
For accruals, there may have been no prior entry, and the accounts requiring adjustment may both have zero balances prior to adjustment.

### Illustration 4-15: Adjustment for accrued revenue



The asset Accounts Receivable shows that clients owe Sierra \$200 at the balance sheet date. The balance of \$10,600 in Service Revenue represents the total revenue for services Sierra performed during the month (\$10,000 + \$400 + \$200). **Without the adjusting entry, assets and stockholders' equity on the balance sheet and revenues and net income on the income statement are understated.**

**Equation analyses** summarize the effects of transactions on the three elements of the accounting equation, as well as the effect on cash flows.



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

Nov. 10    Cash

200

(To record cash collected on account)

The company records the collection of the receivables by a debit (increase) to Cash and a credit (decrease) to Accounts Receivable.

Illustration 4-16 summarizes the accounting for accrued revenues.

### Illustration 4-16: Accounting for accrued revenues

## ACCOUNTING FOR ACCRUED REVENUES

| Examples                 | Reason for Adjustment                                        | Accounts Before Adjustment                | Adjusting Entry            |
|--------------------------|--------------------------------------------------------------|-------------------------------------------|----------------------------|
| Interest, rent, services | Services performed but not yet received in cash or recorded. | Assets understated. Revenues understated. | Dr. Assets<br>Cr. Revenues |

## Accrued Expenses

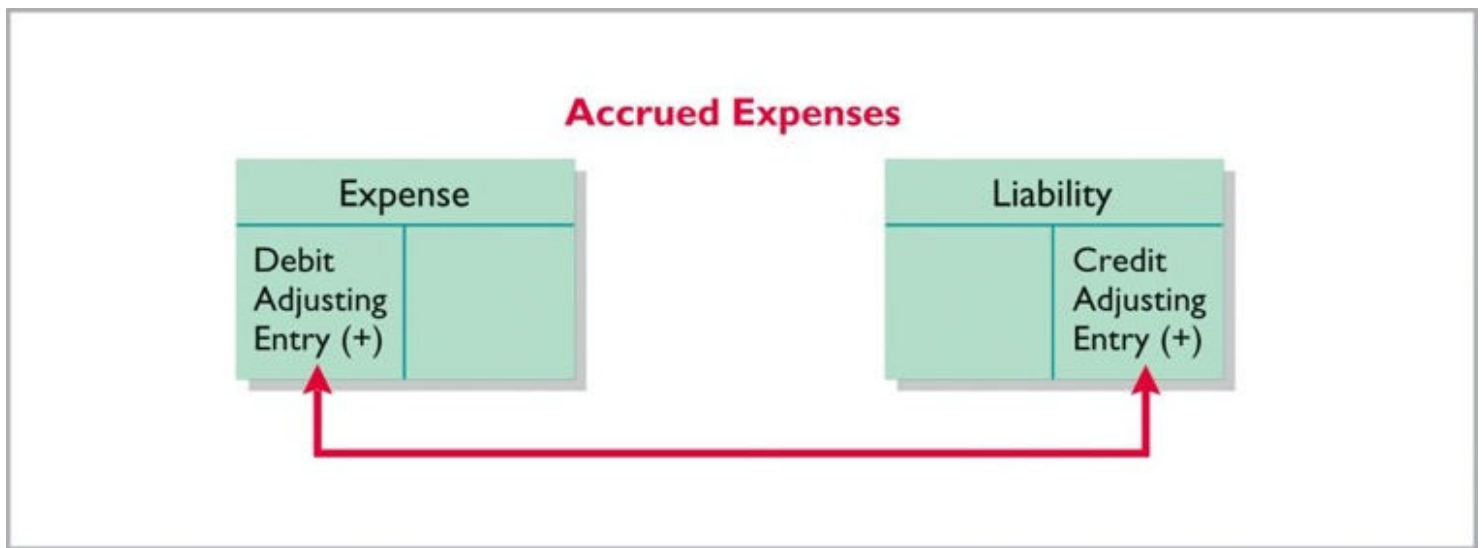
Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Interest, taxes, utilities, and salaries are common examples of accrued expenses.

## 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 this improper accounting apparently was the desire to meet earnings targets.

Companies make adjustments for accrued expenses to record the obligations that exist at the balance sheet date and to recognize the expenses that apply to the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore, **an adjusting entry for accrued expenses results in an increase (a debit) to an expense account and an increase (a credit) to a liability account.**

### Illustration 4-17: Adjusting entries for accrued expenses



Let's look in more detail at some specific types of accrued expenses, beginning with accrued interest.

## ACCRUED INTEREST.

Sierra Corporation signed a three-month note payable in the amount of \$5,000 on October 1. The note requires Sierra to pay interest at an annual rate of 12%.

The amount of the interest recorded is determined by three factors: (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 Sierra, the total

interest due on the \$5,000 note at its maturity date three months in the future is  $\$150(\$5,000 \times 12\% \times \frac{3}{12})$ , or \$50 for one month. [Illustration 4-18](#) shows the formula for computing interest and its application to Sierra Corporation for the month of October.

### Illustration 4-18: Formula for computing interest

**Face Value of Note** × **Annual Interest Rate** × **Time in Terms of One Year** = **Interest**

\$5,000 × 12% ×  $\frac{1}{12}$  = **\$50**

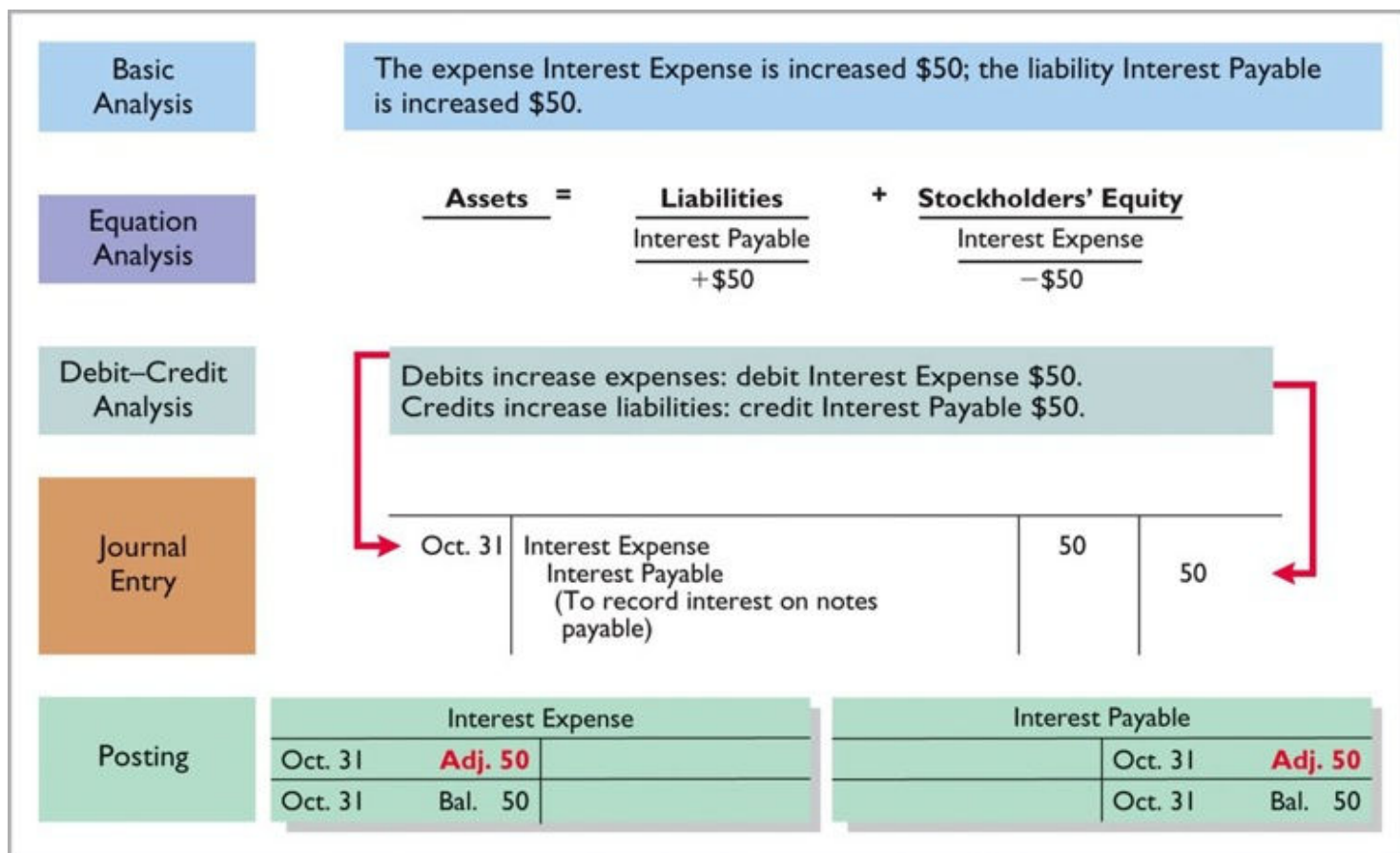
## Helpful Hint

In computing interest, we express the time period as a fraction of a year.

As [Illustration 4-19](#) shows, the accrual of interest at October 31 increases a liability account, Interest Payable. It also decreases stockholders' equity by increasing an expense account, Interest Expense.

### Illustration 4-19: Adjustment for accrued interest



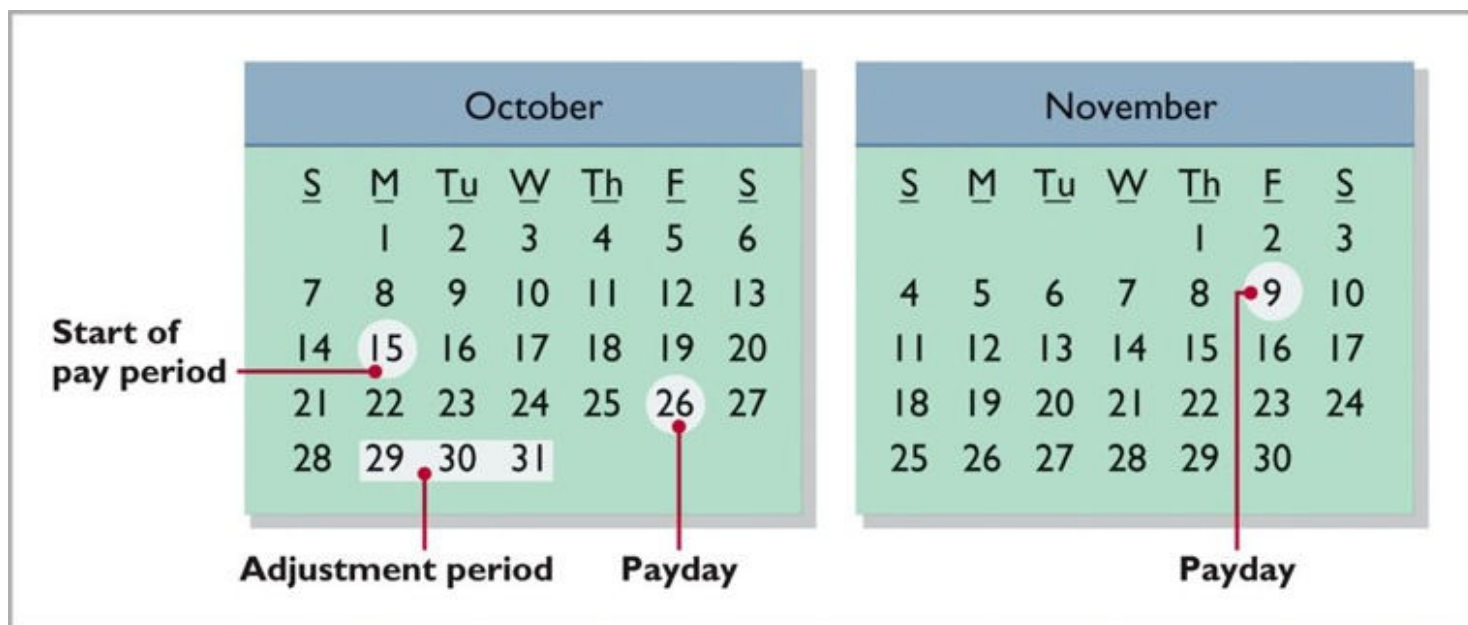


Interest Expense shows the interest charges for the month of October. Interest Payable shows the amount of interest the company owes at the statement date. Sierra will not pay the interest until the note comes due at the end of three months. Companies use the Interest Payable account, instead of crediting Notes Payable, to disclose the two different 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 stockholders' equity are overstated.**

## ACCRUED SALARIES.

Companies pay for some types of expenses, such as employee salaries and wages, after the services have been performed. Sierra paid salaries on October 26 for its employees' first two weeks of work; the next payment of salaries will not occur until November 9. As [Illustration 4-20](#) shows, three working days remain in October (October 29–31).

### Illustration 4-20: Calendar showing Sierra Corporation's pay periods



At October 31, the salaries for these three days represent an accrued expense and a related liability to Sierra. 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). This accrual increases a liability, Salaries and Wages Payable. It also decreases stockholders' equity by increasing an expense account, Salaries and Wages Expense, as shown in [Illustration 4-21](#).

## Illustration 4-21: Adjustment for accrued salaries

| Basic Analysis             | The expense Salaries and Wages Expense is increased \$1,200; the liability account Salaries and Wages Payable is decreased \$1,200.                                                                                              |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
|----------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|----------------------------|--|---------|------------------------------------------------------------------------------------------|-------|------------|---------|------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|--|----------------------------|--|---------|------------|---------|------------|
| Equation Analysis          | $\begin{array}{rcl} \text{Assets} & = & \text{Liabilities} + \text{Stockholders' Equity} \\ & & \text{Salaries and Wages Payable} + \text{Salaries and Wages Expense} \\ & & +\$1,200 \qquad \qquad \qquad -\$1,200 \end{array}$ |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Debit–Credit Analysis      | Debits increase expenses: debit Salaries and Wages Expense \$1,200.<br>Credits increase liabilities: credit Salaries and Wages Payable \$1,200.                                                                                  |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Journal Entry              | <table><tr><td>Oct. 31</td><td>Salaries and Wages Expense<br/>Salaries and Wages Payable<br/>(To record accrued salaries)</td><td>1,200</td><td>1,200</td></tr></table>                                                          |       |                            |  | Oct. 31 | Salaries and Wages Expense<br>Salaries and Wages Payable<br>(To record accrued salaries) | 1,200 | 1,200      |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Oct. 31                    | Salaries and Wages Expense<br>Salaries and Wages Payable<br>(To record accrued salaries)                                                                                                                                         | 1,200 | 1,200                      |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Posting                    | <table><tr><th colspan="2">Salaries and Wages Expense</th></tr><tr><td>Oct. 26</td><td>4,000</td></tr><tr><td>31</td><td>Adj. 1,200</td></tr><tr><td>Oct. 31</td><td>Bal. 5,200</td></tr></table>                                |       | Salaries and Wages Expense |  | Oct. 26 | 4,000                                                                                    | 31    | Adj. 1,200 | Oct. 31 | Bal. 5,200 | <table><tr><th colspan="2">Salaries and Wages Payable</th></tr><tr><td>Oct. 31</td><td>Adj. 1,200</td></tr><tr><td>Oct. 31</td><td>Bal. 1,200</td></tr></table> |  | Salaries and Wages Payable |  | Oct. 31 | Adj. 1,200 | Oct. 31 | Bal. 1,200 |
| Salaries and Wages Expense |                                                                                                                                                                                                                                  |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Oct. 26                    | 4,000                                                                                                                                                                                                                            |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| 31                         | Adj. 1,200                                                                                                                                                                                                                       |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Oct. 31                    | Bal. 5,200                                                                                                                                                                                                                       |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Salaries and Wages Payable |                                                                                                                                                                                                                                  |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Oct. 31                    | Adj. 1,200                                                                                                                                                                                                                       |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |
| Oct. 31                    | Bal. 1,200                                                                                                                                                                                                                       |       |                            |  |         |                                                                                          |       |            |         |            |                                                                                                                                                                 |  |                            |  |         |            |         |            |

After Nov. 9, the balance of Salaries and Wages Payable is \$5,200 (13 days × \$400). Only the net part of this expense for October 6 has been transmitted without publisher's prior permission. Violators will be prosecuted.

Salaries and Wages Payable of \$1,200 is the amount of the liability for salaries Sierra owes as of October 31. **Without the \$1,200 adjustment for salaries, Sierra's expenses are understated \$1,200 and its liabilities are understated \$1,200.**

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

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

This entry eliminates the liability for Salaries and Wages Payable that Sierra recorded in the October 31 adjusting entry, and it records the proper amount of Salaries and Wages Expense for the period between November 1 and November 9.

[Illustration 4-22](#) summarizes the accounting for accrued expenses.

## Illustration 4-22: 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<br>Cr. Liabilities |



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## People, Planet, and Profit Insight: Got Junk?

Do you have an old computer or two in your garage? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete **each day**. Yet, in a recent year, only 11% of computers were recycled. It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.





What accounting issue might this cause for companies? (See [page 225](#).)

## ***Do it!:* ADJUSTING ENTRIES FOR ACCRUALS**

Micro Computer Services Inc. began operations on August 1, 2014. At the end of August 2014, management attempted to prepare monthly financial statements. The following information relates to August.

- 1. At August 31, the company owed its employees \$800 in salaries that will be paid on September 1.
- 2. On August 1, the company borrowed \$30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
- 3. Revenue for services performed but unrecorded for August totaled \$1,100.

Prepare the adjusting entries needed at August 31, 2014.

### **Action Plan**

- ● Make adjusting entries at the end of the period to recognize revenue for services performed and for expenses incurred.
- ● 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 and Wages Expense 800

Salaries and Wages Payable 800

(To record accrued salaries)

2. Interest Expense 250

Interest Payable 250

(To record accrued interest:  $\$30,000 \times 10\% \times \frac{1}{12} = \$250$ )

Service Revenue 1,100

(To record revenue for services performed)

Related exercise material: [BE4-8](#),  [4-2](#), [E4-8](#), [E4-9](#), [E4-10](#), and [E4-11](#).

## SUMMARY OF BASIC RELATIONSHIPS

[Illustration 4-23](#) summarizes the four basic types of adjusting entries. Take some time to study and analyze the adjusting entries. Be sure to note that **each adjusting entry affects one balance sheet account and one income statement account**.

### Illustration 4-23: Summary of adjusting entries

| <u>Type of Adjustment</u> | <u>Accounts Before Adjustment</u> | <u>Adjusting Entry</u> |
|---------------------------|-----------------------------------|------------------------|
| Prepaid expenses          | Assets overstated.                | Dr. Expenses           |
|                           | Expenses understated.             | Cr. Assets or          |
|                           |                                   | Contra Assets          |
| Unearned revenues         | Liabilities overstated.           | Dr. Liabilities        |
|                           | Revenues understated.             | Cr. Revenues           |
| Accrued revenues          | Assets understated.               | Dr. Assets             |
|                           | Revenues understated.             | Cr. Revenues           |
| Accrued expenses          | Expenses understated.             | Dr. Expenses           |
|                           | Liabilities understated.          | Cr. Liabilities        |

[Illustrations 4-24](#) and [4-25](#) show the journalizing and posting of adjusting entries for Sierra Corporation on October 31. When reviewing the general ledger in [Illustration 4-25](#), note that for learning purposes we have highlighted the adjustments in color.



**Illustration 4-24: General journal showing adjusting entries**  
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**GENERAL JOURNAL**

| Date    | Account Titles and Explanation             | Debit | Credit |
|---------|--------------------------------------------|-------|--------|
| 2014    | <u>Adjusting Entries</u>                   |       |        |
| Oct. 31 | Supplies Expense                           | 1,500 |        |
|         | Supplies                                   |       | 1,500  |
|         | (To record supplies used)                  |       |        |
| 31      | Insurance Expense                          | 50    |        |
|         | Prepaid Insurance                          |       | 50     |
|         | (To record insurance expired)              |       |        |
| 31      | Depreciation Expense                       | 40    |        |
|         | Accumulated Depreciation—Equipment         |       | 40     |
|         | (To record monthly depreciation)           |       |        |
| 31      | Unearned Service Revenue                   | 400   |        |
|         | Service Revenue                            |       | 400    |
|         | (To record revenue for services performed) |       |        |
| 31      | Accounts Receivable                        | 200   |        |
|         | Service Revenue                            |       | 200    |

**GENERAL JOURNAL**

| Date | Account Titles and Explanation | Debit | Credit |
|------|--------------------------------|-------|--------|
|------|--------------------------------|-------|--------|

(To record revenue for services performed)

|    |                  |    |    |
|----|------------------|----|----|
| 31 | Interest Expense | 50 |    |
|    | Interest Payable |    | 50 |

(To record interest on notes payable)

|    |                            |       |       |
|----|----------------------------|-------|-------|
| 31 | Salaries and Wages Expense | 1,200 |       |
|    | Salaries and Wages Payable |       | 1,200 |

(To record accrued salaries)

**Illustration 4-25: General ledger after adjustments**

**GENERAL LEDGER**

**Cash**

|        |        |        |       |
|--------|--------|--------|-------|
| Oct. 1 | 10,000 | Oct. 2 | 5,000 |
|        |        |        |       |
| 1      | 5,000  | 3      | 900   |
|        |        |        |       |
| 2      | 1,200  | 4      | 600   |
|        |        |        |       |
| 3      | 10,000 | 20     | 500   |
|        |        |        |       |
|        |        | 26     | 4,000 |

**GENERAL LEDGER**

Oct. 31 Bal. 15,200

**Accounts Receivable**

Oct. 31 **200**

Oct. 31 Bal. 200

**Supplies**

Oct. 5 2,500      Oct. 31 **1,500**

Oct. 31 Bal. 1,000

**Prepaid Insurance**

Oct. 4 600      Oct. 31 **50**

Oct. 31 Bal. 550

**Equipment**

Oct. 2 5,000

Oct. 31 Bal. 5,000

**Accumulated Depreciation—Equipment**

Oct. 31 **40**

Oct. 31 Bal. 40

## **GENERAL LEDGER**

### **Notes Payable**

Oct. 1    5,000

Oct. 31   Bal. 5,000

### **Accounts Payable**

Oct. 5    2,500

Oct. 31   Bal. 2,500

### **Interest Payable**

Oct. 31   **50**

Oct. 31   Bal. 50

### **Unearned Service Revenue**

Oct. 31   **400**                      Oct. 2    1,200

Oct. 31   Bal. 800

### **Salaries and Wages Payable**

Oct. 31   **1,200**

Oct. 31   Bal. 1,200

### **Common Stock**

**GENERAL LEDGER**

Oct. 1    10,000

Oct. 31   Bal. 10,000

**Retained Earnings**

Oct. 31   Bal. 0

**Dividends**

Oct. 20   500

Oct. 31   Bal. 500

**Service Revenue**

Oct. 3    10,000

31        **400**

31        **200**

Oct. 31   Bal. 10,600

**Salaries and Wages Expense**

Oct. 26   4,000

31   **1,200**

Oct. 31   Bal. 5,200

## **GENERAL LEDGER**

### **Supplies Expense**

Oct. 31 **1,500**

Oct. 31 Bal. 1,500

### **Rent Expense**

Oct. 3 900

Oct. 31 Bal. 900

### **Insurance Expense**

Oct. 31 **50**

Oct. 31 Bal. 50

### **Interest Expense**

Oct. 31 **50**

Oct. 31 Bal. 50

### **Depreciation Expense**

Oct. 31 **40**

Oct. 31 Bal. 40

## **The Adjusted Trial Balance and Financial Statements**



After a company has journalized and posted all adjusting entries, it prepares another trial balance from the ledger accounts. This trial balance is called an **adjusted trial balance**. It shows the balances of all accounts, including those adjusted, at the end of the accounting period. 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. Because the accounts contain all data needed for financial statements, the adjusted trial balance is the **primary basis for the preparation of financial statements**.

## LEARNING OBJECTIVE 6

Describe the nature and purpose of the adjusted trial balance.

## PREPARING THE ADJUSTED TRIAL BALANCE

[Illustration 4-26](#) presents the adjusted trial balance for Sierra Corporation prepared from the ledger accounts in [Illustration 4-25](#). The amounts affected by the adjusting entries are highlighted in color.

### Illustration 4-26: Adjusted trial balance



#### SIERRA CORPORATION

#### Adjusted Trial Balance

October 31, 2014

|                                    | <u>Dr.</u> | <u>Cr.</u> |
|------------------------------------|------------|------------|
| Cash                               | \$ 15,200  |            |
| Accounts Receivable                | 200        |            |
| Supplies                           | 1,000      |            |
| Prepaid Insurance                  | 550        |            |
| Equipment                          | 5,000      |            |
| Accumulated Depreciation—Equipment |            | \$ 40      |
| Notes Payable                      |            | 5,000      |
| Accounts Payable                   |            | 2,500      |



## SIERRA CORPORATION

### Adjusted Trial Balance

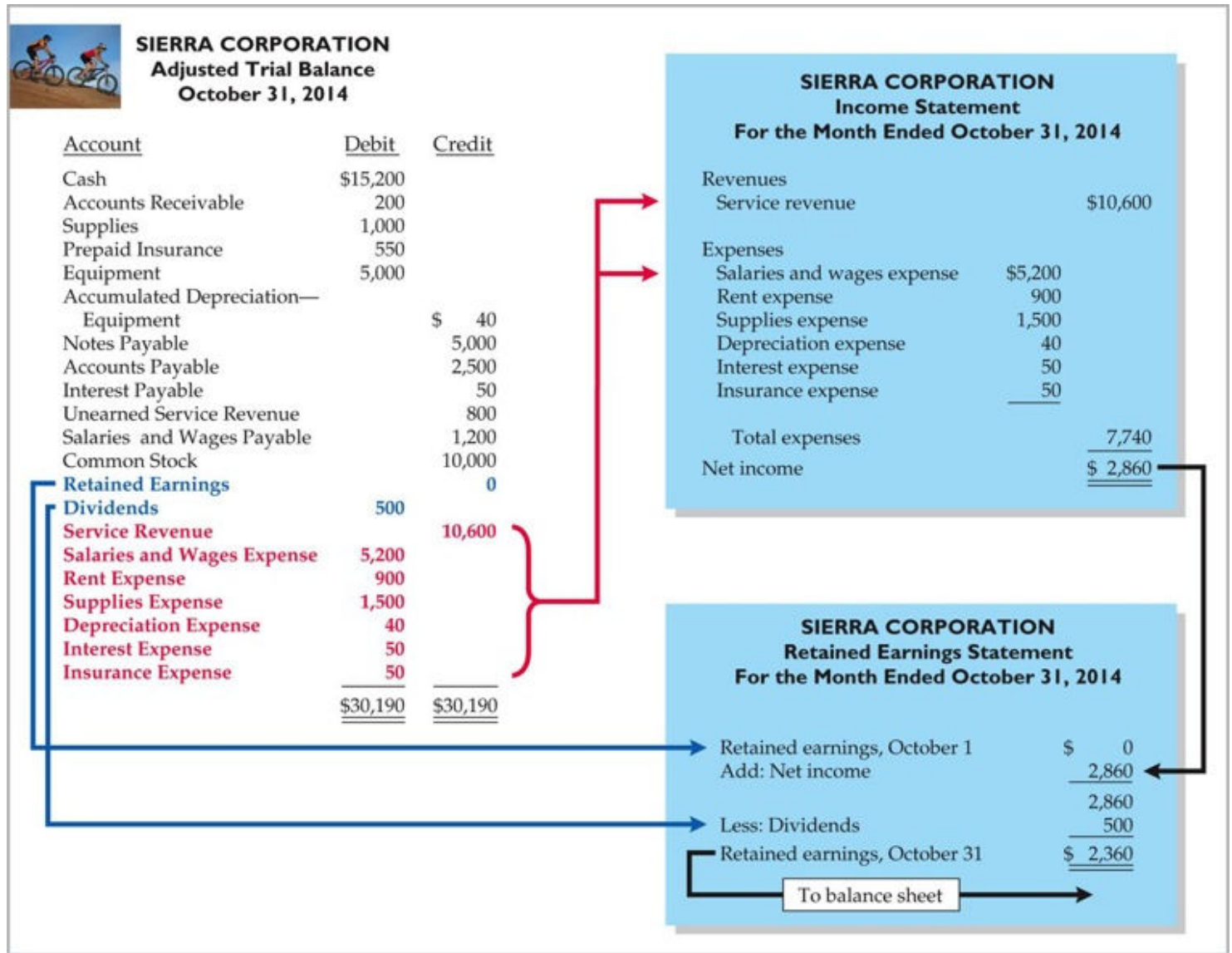
October 31, 2014

|                            |                 |        |                   |
|----------------------------|-----------------|--------|-------------------|
| Interest Payable           |                 | 50     |                   |
| Unearned Service Revenue   |                 | 800    |                   |
| Salaries and Wages Payable |                 | 1,200  |                   |
| Common Stock               |                 | 10,000 |                   |
| Retained Earnings          |                 | 0      |                   |
| Dividends                  | 500             |        |                   |
| Service Revenue            |                 | 10,600 |                   |
| Salaries and Wages Expense | 5,200           |        |                   |
| Supplies Expense           | 1,500           |        |                   |
| Rent Expense               | 900             |        |                   |
| Insurance Expense          | 50              |        |                   |
| Interest Expense           | 50              |        |                   |
| Depreciation Expense       | <u>40</u>       |        | <u>          </u> |
|                            | <b>\$30,190</b> |        | <b>\$30,190</b>   |

## PREPARING FINANCIAL STATEMENTS

Companies can prepare financial statements directly from an adjusted trial balance. Illustrations 4-27 and 4-28 (page 185) present the relationships between the data in the adjusted trial balance of Sierra Corporation and the corresponding financial statements. As Illustration 4-27 shows, companies prepare the income statement from the revenue and expense accounts. Similarly, they derive the retained earnings statement from the Retained Earnings account, Dividends account, and the net income (or net loss) shown in the income statement. As Illustration 4-28 shows, companies then prepare the balance sheet from the asset, liability, and stockholders' equity accounts. They obtain the amount reported for retained earnings on the balance sheet from the ending balance in the retained earnings statement.

## Illustration 4-27: Preparation of the income statement and retained earnings statement from the adjusted trial balance



## Illustration 4-28: Preparation of the balance sheet from the adjusted trial balance



## SIERRA CORPORATION Adjusted Trial Balance October 31, 2014

| Account                            | Debit           | Credit          |
|------------------------------------|-----------------|-----------------|
| Cash                               | \$15,200        |                 |
| Accounts Receivable                | 200             |                 |
| Supplies                           | 1,000           |                 |
| Prepaid Insurance                  | 550             |                 |
| Equipment                          | 5,000           |                 |
| Accumulated Depreciation—Equipment |                 | \$ 40           |
| Notes Payable                      |                 | 5,000           |
| Accounts Payable                   |                 | 2,500           |
| Interest Payable                   |                 | 50              |
| Unearned Service Revenue           |                 | 800             |
| Salaries and Wages Payable         |                 | 1,200           |
| Common Stock                       |                 | 10,000          |
| Retained Earnings                  |                 | 0               |
| Dividends                          | 500             |                 |
| Service Revenue                    |                 | 10,600          |
| Salaries and Wages Expense         | 5,200           |                 |
| Supplies Expense                   | 1,500           |                 |
| Rent Expense                       | 900             |                 |
| Insurance Expense                  | 50              |                 |
| Interest Expense                   | 50              |                 |
| Depreciation Expense               | 40              |                 |
|                                    | <u>\$30,190</u> | <u>\$30,190</u> |

## SIERRA CORPORATION Balance Sheet October 31, 2014

| Assets                                     |                 |
|--------------------------------------------|-----------------|
| Cash                                       | \$15,200        |
| Accounts receivable                        | 200             |
| Supplies                                   | 1,000           |
| Prepaid insurance                          | 550             |
| Equipment                                  | 5,000           |
| Less: Accumulated depreciation—equipment   | 40              |
| Total assets                               | <u>\$21,910</u> |
| Liabilities and Stockholders' Equity       |                 |
| Liabilities                                |                 |
| Notes payable                              | \$ 5,000        |
| Accounts payable                           | 2,500           |
| Salaries and wages payable                 | 1,200           |
| Unearned service revenue                   | 800             |
| Interest payable                           | 50              |
| Total liabilities                          | \$ 9,550        |
| Stockholders' equity                       |                 |
| Common stock                               | 10,000          |
| Retained earnings                          | 2,360           |
| Total stockholders' equity                 | <u>12,360</u>   |
| Total liabilities and stockholders' equity | <u>\$21,910</u> |

Balance at Oct. 31 from retained earnings statement in Illustration 4-27

## QUALITY OF EARNINGS

“Did you make your numbers today?” is a question asked often in both large and small businesses. Companies and employees are continually under pressure to “make the numbers”—that is, to have earnings that are in line with expectations. Therefore, it is not surprising that many companies practice earnings management. **Earnings management** is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. The quality of earnings is greatly affected when a company manages earnings up or down to meet some targeted earnings number. A company that has a high **quality of earnings** provides full and transparent information that will not confuse or mislead users of the financial statements. A company with questionable quality of earnings may mislead investors and creditors, who believe they are relying on relevant and reliable information. As a result, investors and creditors lose confidence in financial reporting, and it becomes difficult for our capital markets to work efficiently.

Companies manage earnings in a variety of ways. One way is through the use of **one-time items** to prop up earnings numbers. For example, **ConAgra Foods** recorded a nonrecurring gain from the sale of **Pilgrim's Pride** stock for \$186 million to help meet an earnings projection for the quarter.

Another way is to **inflate revenue** numbers in the short-run to the detriment of the long-run. For example, **Bristol-Myers Squibb** provided sales incentives to its wholesalers to encourage them to buy products at the end of the quarter (often referred to as channel-stuffing). As a result Bristol-Myers was able to meet its sales projections. The problem was that the wholesalers could not sell that amount of merchandise and ended up returning it to Bristol-Myers. The result was that Bristol-Myers had to restate its income numbers.



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## Ethics Insight: Cooking the Books?

Allegations of abuse of the revenue recognition principle have become all too common in recent years. For example, it was alleged that **Krispy Kreme** sometimes doubled the number of doughnuts shipped to wholesale customers at the end of a quarter to boost quarterly results. The customers shipped the unsold doughnuts back after the beginning of the next quarter for a refund. Conversely, **Computer Associates International** was accused of backdating sales—that is, reporting a sale in one quarter that did not actually occur until the beginning of the following quarter in order to achieve the previous quarter's sales targets.



© Dean Turner/iStockphoto



What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues? (See [page 225](#).)

Companies also manage earnings through **improper adjusting entries**. Regulators investigated **Xerox** for accusations that it was booking too much revenue upfront on multi-year contract sales. Financial executives at **Office Max** resigned amid accusations that the company was recognizing rebates from its vendors too early and therefore overstating revenue. Finally, **WorldCom's** abuse of adjusting entries to meet its net income targets is unsurpassed. It used adjusting entries to increase net income by reclassifying liabilities as revenue and reclassifying expenses as



## International Note

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 to meet strict internal control requirements. Some U.S. companies believe that this gives foreign firms an unfair advantage because developing and maintaining internal controls can be very expensive.

The good news is that, as a result of investor pressure as well as the **Sarbanes-Oxley Act**, many companies are trying to improve the quality of their financial reporting. For example, hotel operator **Marriott** is now providing detailed information on the write-offs it has on loan guarantees it gives hotels. **General Electric** has decided to provide more detail on its revenues and operating profits for individual businesses it owns. **IBM** is attempting to provide a better breakdown of its earnings. At the same time, regulators are taking a tough stand on the issue of quality of earnings. For example, one regulator noted that companies may be required to restate their financials every single time that they account for any transaction that had no legitimate purpose but was done solely for an accounting purpose, such as to smooth net income.

## *Do it!:* TRIAL BALANCE

Skolnick Co. was organized on April 1, 2014. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below.

|                            | <u>Debit</u> |                                    | <u>Credit</u> |
|----------------------------|--------------|------------------------------------|---------------|
| 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 and Wages Payable         | 400           |
| Equipment                  | 15,000       | Interest Payable                   | 50            |
| Dividends                  | 600          | Unearned Rent Revenue              | 500           |
| Salaries and Wages Expense | 9,400        | Common Stock                       | 14,000        |
| Rent Expense               | 1,500        | Retained Earning                   | 0             |
| Depreciation Expense       | 850          | Service Revenue                    | 14,200        |



|                   | <u>Debit</u> |              | <u>Credit</u> |
|-------------------|--------------|--------------|---------------|
| Supplies Expense  | 200          | Rent Revenue | 800           |
| Utilities Expense | 510          |              |               |
| Interest Expense  | <u>50</u>    |              | <u>    </u>   |
|                   | \$37,310     |              | \$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, 2014, for Skolnick Co.
- (c) Determine the balance in Retained Earnings at June 30, 2014.

## Action Plan

- ● In an adjusted trial balance, all asset, liability, revenue, and expense accounts are properly stated.
- ● To determine the ending balance in Retained Earnings, add net income and subtract dividends.



## Solution

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

### Revenues

|                 |            |          |
|-----------------|------------|----------|
| Service revenue | \$14,200   |          |
| Rent revenue    | <u>800</u> |          |
| Total revenues  |            | \$15,000 |

### Expenses

|                      |               |
|----------------------|---------------|
| Rent expense         | 1,500         |
| Depreciation expense | 850           |
| Utilities expense    | 510           |
| Supplies expense     | 200           |
| Interest expense     | <u>50</u>     |
| Total expenses       | <u>12,510</u> |
| 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       |
| Supplies                                 | 1,000      | Unearned rent revenue      | 500         |
| Prepaid rent                             | 900        | Salaries and wages payable | 400         |
| Equipment                                | \$15,000   | Interest payable           | 50          |
| Less: Accumulated depreciation—equipment | <u>850</u> |                            | <u>    </u> |
| Total assets                             | \$23,350   | Total liabilities          | \$7,460     |

- (c)

| Assets                     |       | Liabilities |  |
|----------------------------|-------|-------------|--|
| Retained earnings, April 1 | \$ 0  |             |  |
| Add: Net income            | 2,490 |             |  |

Retained earnings, June 30      \$1,890

Related exercise material: [BE4-9](#), [BE4-10](#), [BE4-11](#), [BE4-12](#),  [4-3](#), [E4-12](#), [E4-13](#), [E4-15](#), and [E4-16](#).

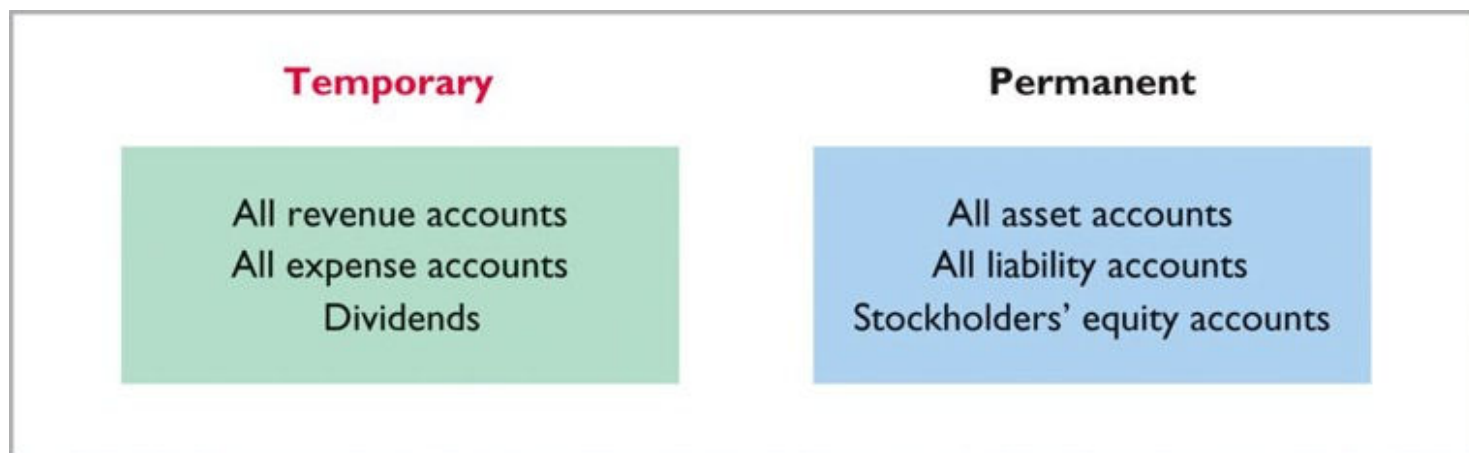
## Closing the Books

In previous chapters, you learned that revenue and expense accounts and the Dividends account are subdivisions of retained earnings, which is reported in the stockholders' equity section of the balance sheet. Because revenues, expenses, and dividends relate only to a given accounting period, they are considered [temporary accounts](#). In contrast, all balance sheet accounts are considered [permanent accounts](#) because their balances are carried forward into future accounting periods. [Illustration 4-29](#) identifies the accounts in each category.

## LEARNING OBJECTIVE 7

Explain the purpose of closing entries.

### Illustration 4-29: Temporary versus permanent accounts



## PREPARING CLOSING ENTRIES

At the end of the accounting period, companies transfer the temporary account balances to the permanent stockholders' equity account—Retained Earnings—through the preparation of closing entries. [Closing entries](#) transfer net income (or net loss) and dividends to Retained Earnings, so the balance in Retained Earnings agrees with the retained earnings statement. For example, in the adjusted trial balance in [Illustration 4-24 \(page 181\)](#), Retained Earnings has a balance of zero. Prior to the closing entries, the balance in Retained Earnings is its beginning-of-the-period balance. (For Sierra, this is zero because it is Sierra's first month of operations.)

## Alternative Terminology

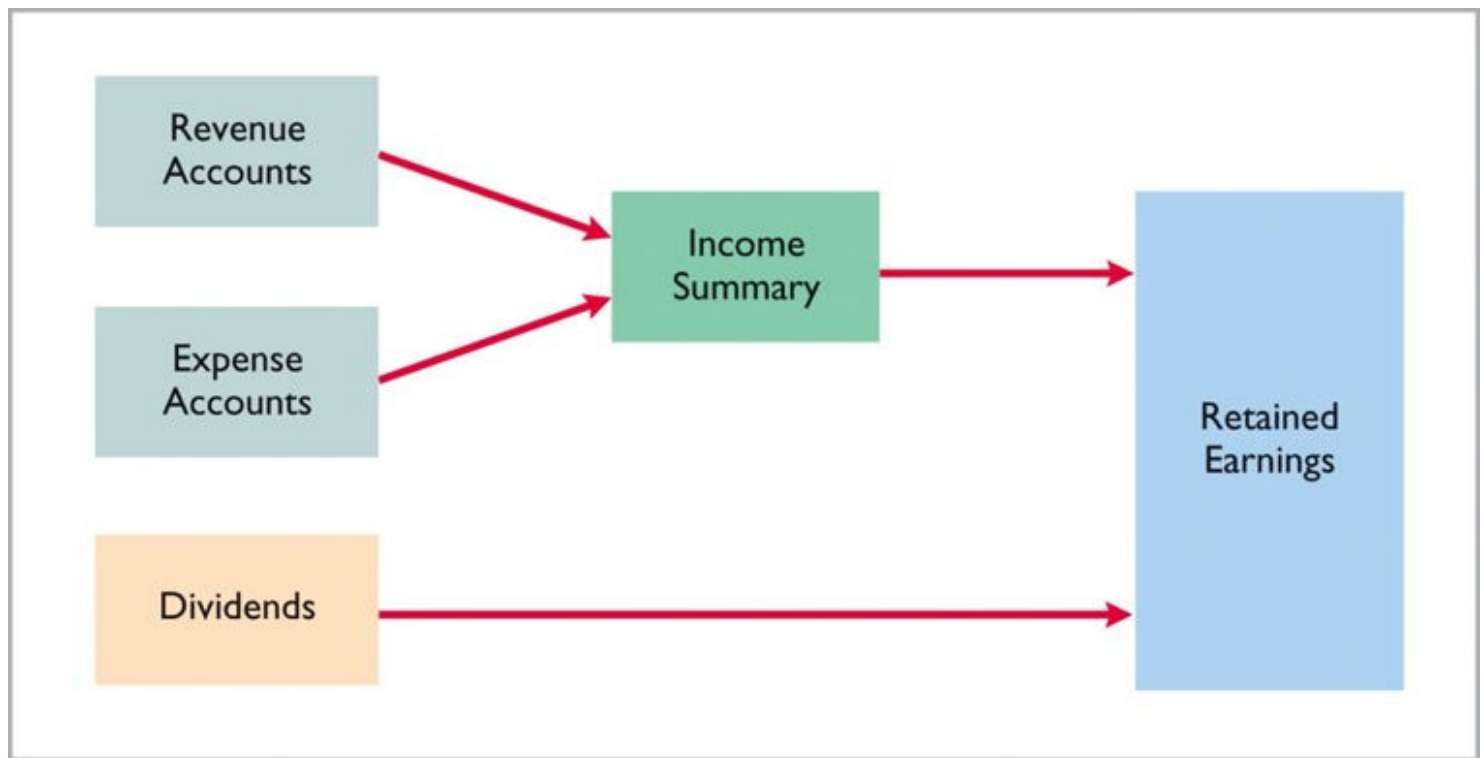
Temporary accounts are sometimes called *nominal accounts*, and permanent accounts are sometimes called *real accounts*.

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In addition to updating Retained Earnings to its correct ending balance, closing entries produce a **zero balance in each temporary account**. As a result, these accounts are ready to accumulate data about revenues, expenses, and dividends that occur in the next accounting period. **Permanent accounts are not closed.**

When companies prepare closing entries, they could close each income statement account directly to Retained Earnings. However, to do so would result in excessive detail in the Retained Earnings account. Instead, companies close the revenue and expense accounts to another temporary account, **Income Summary**. The balance in Income Summary is the net income or loss for the year. Income Summary is then closed, which transfers the net income or net loss from this account to Retained Earnings. [Illustration 4-30](#) depicts the closing process. While it still takes the average large company seven days to close, some companies such as **Cisco** employ technology that allows them to do a so-called “virtual close” almost instantaneously any time during the year. Besides dramatically reducing the cost of closing, the virtual close provides companies with accurate data for decision-making whenever they desire it.

### Illustration 4-30: The closing process



[Illustration 4-31](#) shows the closing entries for Sierra Corporation. [Illustration 4-32](#) ([page 190](#)) diagrams the posting process for Sierra Corporation’s closing entries.

### Illustration 4-31: Closing entries journalized

#### GENERAL JOURNAL

| Date                          | Account Titles and Explanation | Debit | Credit |
|-------------------------------|--------------------------------|-------|--------|
| <b><u>Closing Entries</u></b> |                                |       |        |
| 2014                          | (1)                            |       |        |

**GENERAL JOURNAL**

| <b>Date</b> | <b>Account Titles and Explanation</b> | <b>Debit</b> | <b>Credit</b> |
|-------------|---------------------------------------|--------------|---------------|
| Oct. 31     | Service Revenue                       | 10,600       |               |
|             | Income Summary                        |              | 10,600        |
|             | (To close revenue account)            |              |               |
|             | (2)                                   |              |               |
| 31          | Income Summary                        | 7,740        |               |
|             | Salaries and Wages Expense            |              | 5,200         |
|             | Supplies Expense                      |              | 1,500         |
|             | Rent Expense                          |              | 900           |
|             | Insurance Expense                     |              | 50            |
|             | Interest Expense                      |              | 50            |
|             | Depreciation Expense                  |              | 40            |
|             | (To close expense accounts)           |              |               |
|             | (3)                                   |              |               |
| 31          | Income Summary                        | 2,860        |               |
|             | Retained Earnings                     |              | 2,860         |

## GENERAL JOURNAL

| Date | Account Titles and Explanation | Debit | Credit |
|------|--------------------------------|-------|--------|
|------|--------------------------------|-------|--------|

(To close net income to retained earnings)

(4)

|    |                   |     |  |
|----|-------------------|-----|--|
| 31 | Retained Earnings | 500 |  |
|----|-------------------|-----|--|

|  |           |  |     |
|--|-----------|--|-----|
|  | Dividends |  | 500 |
|--|-----------|--|-----|

(To close dividends to retained earnings)

## Helpful Hint

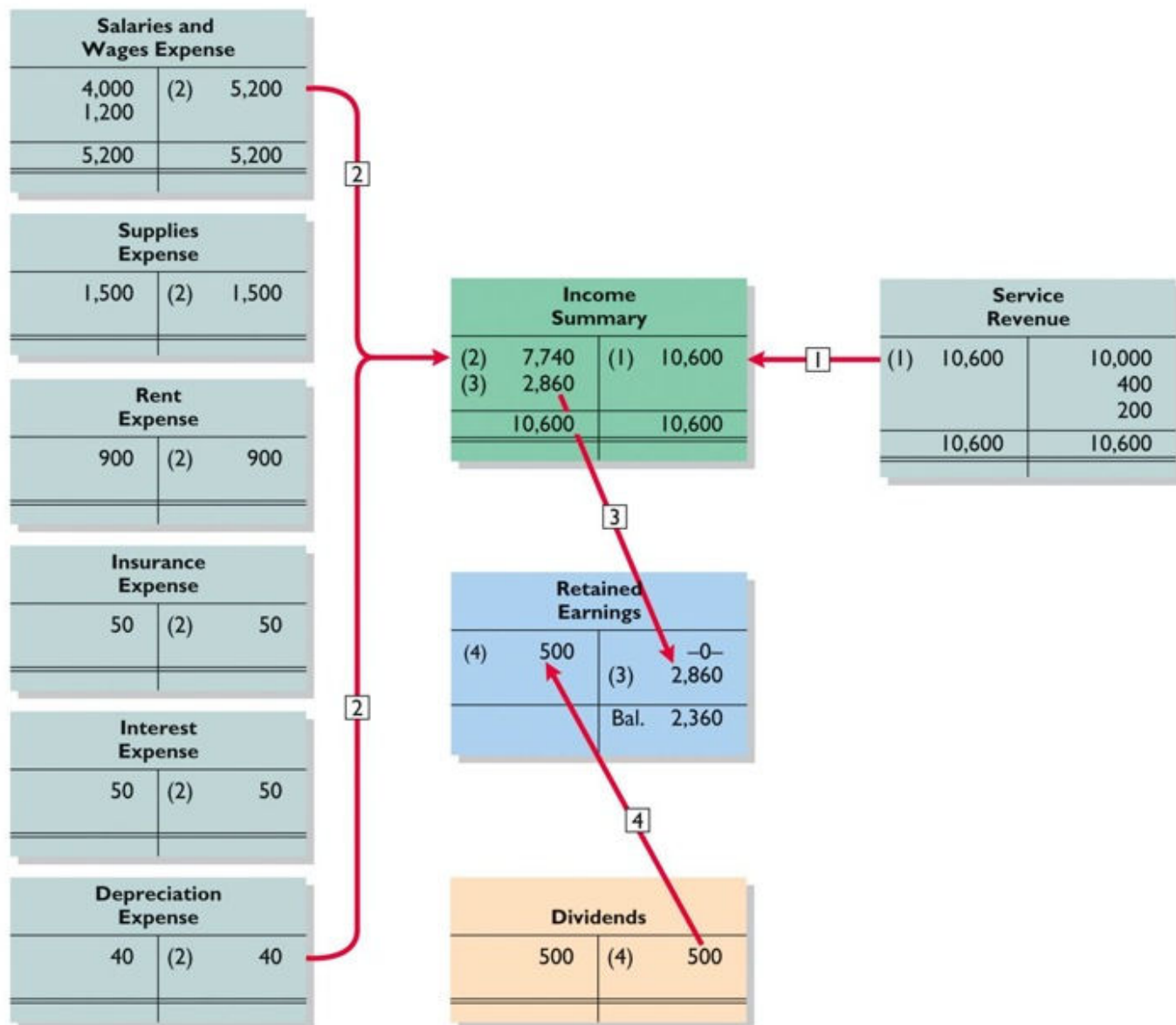
Income Summary is a very descriptive title: Companies close total revenues to Income Summary and total expenses to Income Summary. The balance in Income Summary in this case is net income of \$2,860.

## PREPARING A POST-CLOSING TRIAL BALANCE

After a company journalizes and posts all closing entries, it prepares another trial balance, called a [post-closing trial balance](#), from the ledger. A post-closing trial balance is a list of all permanent accounts and their balances after closing entries are journalized and posted. **The purpose of this trial balance is to prove the equality of the total debit balances and total credit balances of the permanent account balances that the company carries forward into the next accounting period.** Since all temporary accounts will have zero balances, **the post-closing trial balance will contain only permanent—balance sheet—accounts.**

## Illustration 4-32: Posting of closing entries





## Do it!: CLOSING ENTRIES

After making entries to close its revenue and expense accounts to Income Summary, Hancock Company has the following balances.

Dividends                \$15,000

Retained Earnings    42,000

Income Summary     18,000 (credit balance)

Prepare the remaining closing entries at December 31.

- Close Income Summary to Retained Earnings.
- Close Dividends to Retained Earnings.



## Solution

|         |                                            |        |        |
|---------|--------------------------------------------|--------|--------|
| Dec. 31 | Income Summary                             | 18,000 |        |
|         | Retained Earnings                          |        | 18,000 |
|         | (To close net income to retained earnings) |        |        |
| 31      | Retained Earnings                          | 15,000 |        |
|         | Dividends                                  |        | 15,000 |
|         | (To close dividends to retained earnings)  |        |        |

Related exercise material: [BE4-13](#), [BE4-14](#),  [4-4](#), [E4-14](#), and [E4-18](#).

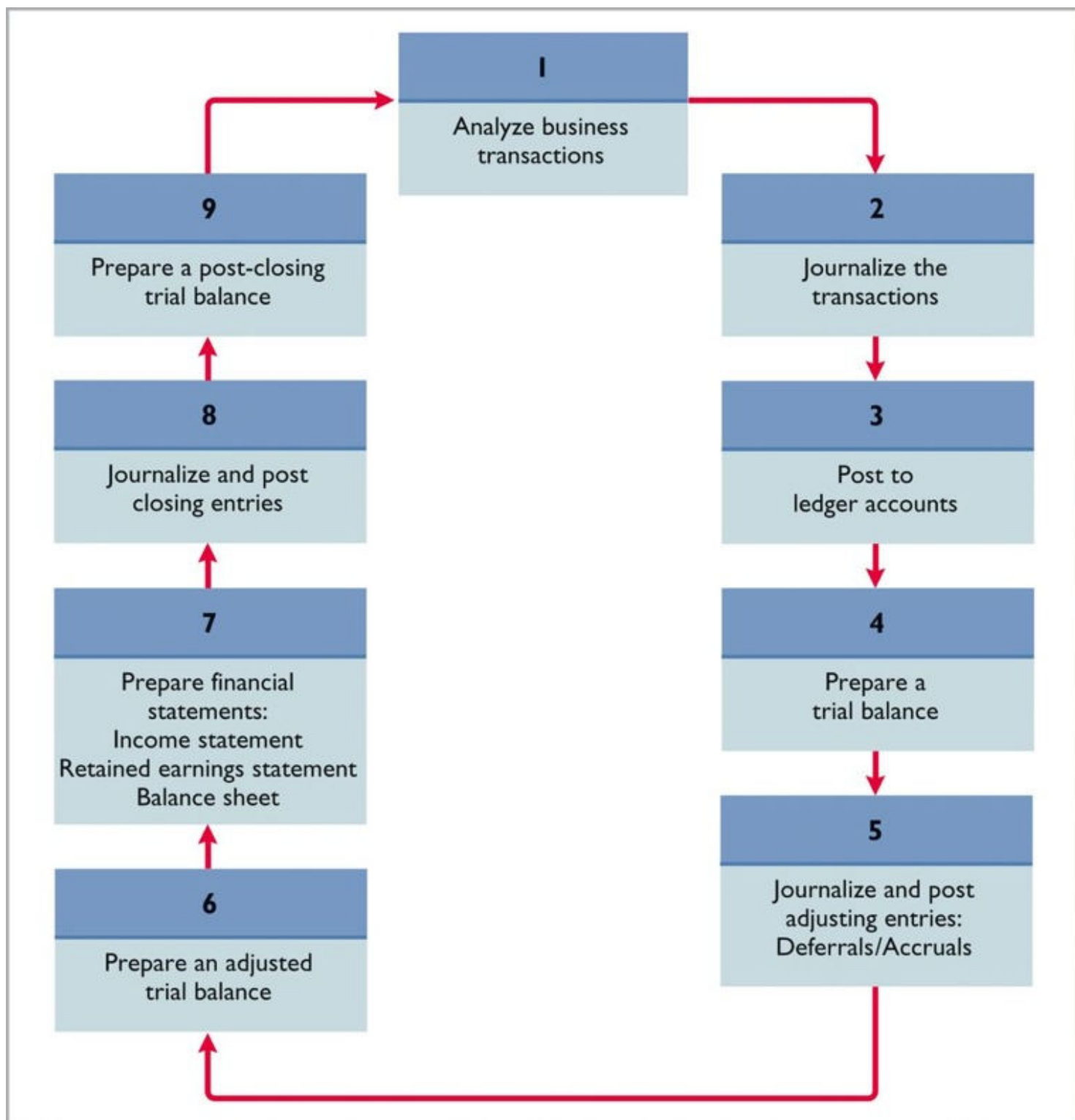
## SUMMARY OF THE ACCOUNTING CYCLE

[Illustration 4-33](#) shows the required steps in the accounting cycle. You can see that the cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. Companies perform the steps in the cycle in sequence and repeat them in each accounting period.

## LEARNING OBJECTIVE 8

Describe the required steps in the accounting cycle.

### Illustration 4-33: Required steps in the accounting cycle



Steps 1–3 may occur daily during the accounting period, as explained in [Chapter 3](#). Companies perform Steps 4–7 on a periodic basis, such as monthly, quarterly, or annually. Steps 8 and 9, closing entries and a post-closing trial balance, usually take place only at the end of a company’s **annual** accounting period.

## Helpful Hint

Some companies reverse certain adjusting entries at the beginning of a new accounting period. The company makes a [reversing entry](#) at the beginning of the next accounting period. This entry is the exact opposite of the adjusting entry made in the previous period.

In this chapter, you learned that adjusting entries are used to adjust numbers that would otherwise be stated on a cash basis. Sierra Corporation's income statement ([Illustration 4-27, page 184](#)) shows net income of \$2,860. The statement of cash flows reports a form of cash-basis income referred to as "Net cash provided by operating activities." For example, [Illustration 1-8 \(page 15\)](#), which shows a statement of cash flows, reports net cash provided by operating activities of \$5,700 for Sierra. Net income and net cash provided by operating activities often differ. The difference for Sierra is \$2,840 (\$5,700 – \$2,860). The following summary shows the causes of this difference of \$2,840.

## LEARNING OBJECTIVE 9

Understand the causes of differences between net income and net cash provided by operating activities.

|                                                            | Computation of Net Cash Provided by of<br>Operating Activities | Computation of Net<br>Income |
|------------------------------------------------------------|----------------------------------------------------------------|------------------------------|
| (1) Cash received in advance from customer                 | \$ 1,200                                                       | \$ 0                         |
| (2) Cash received from customers for services performed    | 10,000                                                         | 10,000                       |
| (3) Services performed for cash received previously in (1) | 0                                                              | 400                          |
| (4) Services performed on account                          | 0                                                              | 200                          |
| (5) Payment of rent                                        | (900)                                                          | (900)                        |
| (6) Purchase of insurance                                  | (600)                                                          | 0                            |
| (7) Payment of employee salaries                           | (4,000)                                                        | (4,000)                      |
| (8) Use of supplies                                        | 0                                                              | (1,500)                      |
| (9) Use of insurance                                       | 0                                                              | (50)                         |
| (10) Depreciation                                          | 0                                                              | (40)                         |
| (11) Interest cost incurred, but not paid                  | 0                                                              | (50)                         |

|                                      | Computation of Net Cash Provided by of<br>Operating Activities | Computation of Net<br>Income |
|--------------------------------------|----------------------------------------------------------------|------------------------------|
|                                      |                                                                |                              |
| (12) Salaries incurred, but not paid | <u>0</u>                                                       | <u>(1,200)</u>               |
|                                      | \$ 5,700                                                       | \$ 2,860                     |

For each item included in the computation of net cash provided by operating activities, confirm that cash was either received or paid. For each item in the income statement, confirm that revenue should be recorded because a performance obligation has been satisfied (even when cash was not received) or that an expense was incurred (even when cash was not paid).



THE DECISION TOOLKIT

USING

Humana Corporation provides managed health care services to approximately 7 million people. Headquartered in Louisville, Kentucky, it has over 13,700 employees in 15 states and Puerto Rico. Suppose that the information shown in the trial balance was taken from Humana’s 2014 financial records.



HUMANA CORPORATION

Adjusted Trial Balance

December 31, 2014

(in millions)

| <u>Account</u>                     | <u>Dr.</u> | <u>Cr.</u> |
|------------------------------------|------------|------------|
| Cash                               | \$ 1,613   |            |
| Debt Investments (current)         | 6,190      |            |
| Accounts Receivable                | 824        |            |
| Other Current Assets               | 626        |            |
| Equipment                          | 2,402      |            |
| Accumulated Depreciation—Equipment |            | \$ 1,723   |
| Stock Investments (noncurrent)     | 1,307      |            |
| Goodwill                           | 1,993      |            |
| Other Long-Term Assets             | 921        |            |
| Benefits Payable                   |            | 3,222      |
| Accounts Payable                   |            | 1,308      |
| Other Current Liabilities          |            | 730        |
| Notes Payable (noncurrent)         |            | 3,117      |





## HUMANA CORPORATION

### Adjusted Trial Balance

December 31, 2014

(in millions)

|                                     |            |             |
|-------------------------------------|------------|-------------|
| Common Stock                        | 1,690      |             |
| Dividends                           | 0          |             |
| Retained Earnings                   | 3,046      |             |
| Revenues                            | 30,960     |             |
| Medical Cost Expense                | 24,775     |             |
| Selling and Administrative Expenses | 4,227      |             |
| Depreciation Expense                | 250        |             |
| Interest Expense                    | 106        |             |
| Income Tax Expense                  | <u>562</u> | <u>    </u> |
|                                     | \$45,796   | \$45,796    |

### Instructions

From the trial balance, prepare an income statement, retained earnings statement, and classified balance sheet. **Be sure to prepare them in that order since each statement depends on information determined in the preceding statement.**

### Solution

**HUMANA CORPORATION**



**Income Statement**

**For the Year Ended December 31, 2014**

**(in millions)**

|                                     |            |               |
|-------------------------------------|------------|---------------|
| Revenues                            |            | \$30,960      |
| Medical cost expense                | \$24,775   |               |
| Selling and administrative expenses | 4,227      |               |
| Depreciation expense                | 250        |               |
| Interest expense                    | 106        |               |
| Income tax expense                  | <u>562</u> | <u>29,920</u> |
| Net income                          |            | \$ 1,040      |

**HUMANA CORPORATION**



**Retained Earnings Statement**

**For the Year Ended December 31, 2014**

**(in millions)**

|                             |          |
|-----------------------------|----------|
| Beginning retained earnings | \$3,046  |
| Add: Net income             | 1,040    |
| Less: Dividends             | <u>0</u> |
| Ending retained earnings    | \$4,086  |

HUMANA CORPORATION



Balance Sheet

December 31, 2014

(in millions)

Assets

Current assets

|                      |            |          |
|----------------------|------------|----------|
| Cash                 | \$1,613    |          |
| Debt investments     | 6,190      |          |
| Accounts receivable  | 824        |          |
| Other current assets | <u>626</u> |          |
| Total current assets |            | \$ 9,253 |

Long-term investments

|                   |       |
|-------------------|-------|
| Stock investments | 1,307 |
|-------------------|-------|

Property, plant, and equipment

|                                    |              |     |
|------------------------------------|--------------|-----|
| Equipment                          | 2,402        |     |
| Accumulated depreciation—equipment | <u>1,723</u> | 679 |

Intangible assets

|          |       |
|----------|-------|
| Goodwill | 1,993 |
|----------|-------|

HUMANA CORPORATION



Balance Sheet

December 31, 2014

(in millions)

|                        |            |
|------------------------|------------|
| Other long-term assets | <u>921</u> |
| Total assets           | \$14,153   |

**Liabilities and Stockholders' Equity**

Liabilities

Current liabilities

|                           |            |
|---------------------------|------------|
| Accounts payable          | \$1,308    |
| Benefits payable          | 3,222      |
| Other current liabilities | <u>730</u> |
| Total current liabilities | \$ 5,260   |

Long-term liabilities

|                   |              |
|-------------------|--------------|
| Notes payable     | <u>3,117</u> |
| Total liabilities | 8,377        |

Stockholders' equity

|              |       |
|--------------|-------|
| Common stock | 1,690 |
|--------------|-------|

## HUMANA CORPORATION



### Balance Sheet

December 31, 2014

(in millions)

|                                            |              |
|--------------------------------------------|--------------|
| Retained earnings                          | <u>4.086</u> |
| Total stockholders' equity                 | <u>5.776</u> |
| Total liabilities and stockholders' equity | \$14,153     |



## Summary of Learning Objectives

- **1 Explain the revenue recognition principle and the expense recognition principle.** The revenue recognition principle dictates that companies recognize revenue when a performance obligation has been satisfied. The expense recognition principle dictates that companies recognize expenses in the period when the company makes efforts to generate those revenues.
- **2 Differentiate between the cash basis and the accrual basis of accounting.** Under the cash basis, companies record events only in the periods in which the company receives or pays cash. Accrual-based accounting means that companies record, in the periods in which the events occur, events that change a company's financial statements even if cash has not been exchanged.
- **3 Explain why adjusting entries are needed, and identify the major types of adjusting entries.** Companies make adjusting entries at the end of an accounting period. These entries ensure that companies record revenues in the period in which the performance obligation is satisfied and that companies recognize expenses in the period in which they are incurred. The major types of adjusting entries are prepaid expenses, unearned revenues, accrued revenues, and accrued expenses.
- **4 Prepare adjusting entries for deferrals.** Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals at the statement date to record the portion of the deferred item that represents the expense incurred or the revenue for services performed in the current accounting period.
- **5 Prepare adjusting entries for accruals.** Accruals are either accrued revenues or accrued expenses. Adjusting entries for accruals record revenues for services performed and expenses incurred in the current accounting period that have not been recognized through daily entries.
- **6 Describe the nature and purpose of the adjusted trial balance.** An adjusted trial balance is a trial balance that shows the balances of all accounts, including those that have been adjusted, at the end of an accounting period. The purpose of an adjusted trial balance is to show the effects of all financial events that have occurred during the accounting period.
- **7 Explain the purpose of closing entries.** One purpose of closing entries is to transfer net income or net loss for the period to Retained Earnings. A second purpose is to “zero-out” all temporary accounts (revenue

accounts, expense accounts, and Dividends) so that they start each new period with a zero balance. To accomplish this, companies "close" all temporary accounts at the end of an accounting period. They make separate entries to close revenues and expenses to Income Summary, Income Summary to Retained Earnings, and Dividends to Retained Earnings. Only temporary accounts are closed.

- **8 Describe the required steps in the accounting cycle.** The required steps in the accounting cycle are (a) analyze business transactions, (b) journalize the transactions, (c) post to ledger accounts, (d) prepare a trial balance, (e) journalize and post adjusting entries, (f) prepare an adjusted trial balance, (g) prepare financial statements, (h) journalize and post closing entries, and (i) prepare a post-closing trial balance.
- **9 Understand the causes of differences between net income and net cash provided by operating activities.** Net income is based on accrual accounting, which relies on the adjustment process. Net cash provided by operating activities is determined by adding cash received from operating the business and subtracting cash expended during operations.



## DECISION TOOLKIT *A SUMMARY*

| DECISION CHECKPOINTS                             | INFO NEEDED FOR DECISION                                | TOOL TO USE FOR DECISION                                                       | HOW TO EVALUATE RESULTS                                                                                                      |
|--------------------------------------------------|---------------------------------------------------------|--------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
| At what point should the company record revenue? | Need to understand the nature of the company's business | Record revenue in the period in which the performance obligation is satisfied. | Recognizing revenue too early overstates current period revenue; recognizing it too late understates current period revenue. |

| DECISION CHECKPOINTS                              | INFO NEEDED FOR DECISION                                | TOOL TO USE FOR DECISION                                                                         | HOW TO EVALUATE RESULTS                                                                                                         |
|---------------------------------------------------|---------------------------------------------------------|--------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|
| At what point should the company record expenses? | Need to understand the nature of the company's business | Expenses should “follow” revenues—that is, match the effort (expense) with the result (revenue). | Recognizing expenses too early overstates current period expense; recognizing them too late understates current period expense. |

## Appendix 4A: Adjusting Entries in an Automated World—Using a Worksheet

In the previous discussion, we used T-accounts and trial balances to arrive at the amounts used to prepare financial statements. Accountants frequently use a device known as a worksheet to determine these amounts. A [worksheet](#) is a multiple-column form that may be used in the adjustment process and in preparing financial statements. Accountants can prepare worksheets manually, but today most use computer spreadsheets.

### LEARNING OBJECTIVE 10

Describe the purpose and the basic form of a worksheet.

As its name suggests, the worksheet is a working tool for the accountant. **A worksheet is not a permanent accounting record**; it is neither a journal nor a part of the general ledger. The worksheet is merely a supplemental device used to make it easier to prepare adjusting entries and the financial statements. Small companies with relatively few accounts and adjustments may not need a worksheet. In large companies with numerous accounts and many adjustments, a worksheet is almost indispensable.

[Illustration 4A-1](#) ([page 196](#)) shows the basic form and procedures for preparing a worksheet. Note the headings: The worksheet starts with two columns for the Trial Balance. The next two columns record all Adjustments. Next is the Adjusted Trial Balance. The last two sets of columns correspond to the Income Statement and the Balance Sheet. All items listed in the Adjusted Trial Balance columns are included in either the Income Statement or the Balance Sheet columns.

### Summary of Learning Objective for Appendix 4A

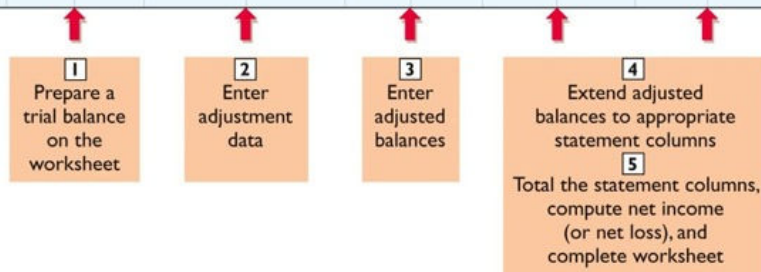
- **10 Describe the purpose and the basic form of a worksheet.** The worksheet is a device to make it easier to prepare adjusting entries and the financial statements. Companies often prepare a worksheet using a computer spreadsheet. The sets of columns of the worksheet are, from left to right, the unadjusted trial balance, adjustments, adjusted trial balance, income statement, and balance sheet.

### Illustration 4A-1: Form and procedure for a worksheet



Sierra Corporation.xls

| HomeInsertPage LayoutFormulasDataReviewView |                            |                                      |        |             |           |                        |        |                  |        |               |        |
|---------------------------------------------|----------------------------|--------------------------------------|--------|-------------|-----------|------------------------|--------|------------------|--------|---------------|--------|
| P18                                         | fx                         |                                      |        |             |           |                        |        |                  |        |               |        |
|                                             | A                          | B                                    | C      | D           | E         | F                      | G      | H                | I      | J             | K      |
| 1                                           |                            |                                      |        |             |           |                        |        |                  |        |               |        |
| 2                                           |                            | SIERRA CORPORATION                   |        |             |           |                        |        |                  |        |               |        |
| 3                                           |                            | Worksheet                            |        |             |           |                        |        |                  |        |               |        |
| 4                                           |                            | For the Month Ended October 31, 2014 |        |             |           |                        |        |                  |        |               |        |
| 5                                           |                            |                                      |        |             |           |                        |        |                  |        |               |        |
| 6                                           |                            | Trial Balance                        |        | Adjustments |           | Adjusted Trial Balance |        | Income Statement |        | Balance Sheet |        |
| 7                                           | Account Titles             | Dr.                                  | Cr.    | Dr.         | Cr.       | Dr.                    | Cr.    | Dr.              | Cr.    | Dr.           | Cr.    |
| 8                                           | Cash                       | 15,200                               |        |             |           | 15,200                 |        |                  |        | 15,200        |        |
| 9                                           | Supplies                   | 2,500                                |        |             | (a) 1,500 | 1,000                  |        |                  |        | 1,000         |        |
| 10                                          | Prepaid Insurance          | 600                                  |        |             | (b) 50    | 550                    |        |                  |        | 550           |        |
| 11                                          | Equipment                  | 5,000                                |        |             |           | 5,000                  |        |                  |        | 5,000         |        |
| 12                                          | Notes Payable              |                                      | 5,000  |             |           |                        | 5,000  |                  |        |               | 5,000  |
| 13                                          | Accounts Payable           |                                      | 2,500  |             |           |                        | 2,500  |                  |        |               | 2,500  |
| 14                                          | Unearned Service Revenue   |                                      | 1,200  | (d) 400     |           |                        | 800    |                  |        |               | 800    |
| 15                                          | Common Stock               |                                      | 10,000 |             |           |                        | 10,000 |                  |        |               | 10,000 |
| 16                                          | Retained Earnings          |                                      | -0-    |             |           |                        | -0-    |                  |        |               | -0-    |
| 17                                          | Dividends                  | 500                                  |        |             |           | 500                    |        |                  |        | 500           |        |
| 18                                          | Service Revenue            |                                      | 10,000 |             | (d) 400   |                        | 10,600 |                  | 10,600 |               |        |
| 19                                          |                            |                                      |        |             | (e) 200   |                        |        |                  |        |               |        |
| 20                                          | Salaries and Wages Expense | 4,000                                |        | (g) 1,200   |           | 5,200                  |        | 5,200            |        |               |        |
| 21                                          | Rent Expense               | 900                                  |        |             |           | 900                    |        | 900              |        |               |        |
| 22                                          | Totals                     | 28,700                               | 28,700 |             |           |                        |        |                  |        |               |        |
| 23                                          |                            |                                      |        |             |           |                        |        |                  |        |               |        |
| 24                                          | Supplies Expense           |                                      |        | (a) 1,500   |           | 1,500                  |        | 1,500            |        |               |        |
| 25                                          | Insurance Expense          |                                      |        | (b) 50      |           | 50                     |        | 50               |        |               |        |
| 26                                          | Accum. Depreciation—       |                                      |        |             |           |                        |        |                  |        |               |        |
| 27                                          | Equipment                  |                                      |        |             | (c) 40    |                        | 40     |                  |        |               | 40     |
| 28                                          | Depreciation Expense       |                                      |        | (c) 40      |           | 40                     |        | 40               |        |               |        |
| 29                                          | Interest Expense           |                                      |        | (f) 50      |           | 50                     |        | 50               |        |               |        |
| 30                                          | Accounts Receivable        |                                      |        | (e) 200     |           | 200                    |        |                  |        | 200           |        |
| 31                                          | Interest Payable           |                                      |        |             | (f) 50    |                        | 50     |                  |        |               | 50     |
| 32                                          | Salaries and Wages Payable |                                      |        |             | (g) 1,200 |                        | 1,200  |                  |        |               | 1,200  |
| 33                                          | Totals                     |                                      |        | 3,440       | 3,440     | 30,190                 | 30,190 | 7,740            | 10,600 | 22,450        | 19,590 |
| 34                                          |                            |                                      |        |             |           |                        |        |                  |        |               |        |
| 35                                          | Net Income                 |                                      |        |             |           |                        |        | 2,860            |        |               | 2,860  |
| 36                                          | Totals                     |                                      |        |             |           |                        |        | 10,600           | 10,600 | 22,450        | 22,450 |



## Glossary

### Accrual-basis accounting

(p. 166) Accounting basis in which companies record, in the periods in which the events occur, transactions that change a company's financial statements, even if cash was not exchanged.

### Accrued expenses

(p. 177) Expenses incurred but not yet paid in cash or recorded.

Accrued revenues

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(p. 175) Revenues for services performed but not yet received in cash or recorded.

Adjusted trial balance

(p. 183) A list of accounts and their balances after all adjustments have been made.

Adjusting entries

(p. 167) Entries made at the end of an accounting period to ensure that the revenue recognition and expense recognition principles are followed.

Book value

(p. 172) The difference between the cost of a depreciable asset and its related accumulated depreciation.

Cash-basis accounting

(p. 166) Accounting basis in which a company records revenue only when it receives cash and an expense only when it pays cash.

Closing entries

(p. 188) Entries at the end of an accounting period to transfer the balances of temporary accounts to a permanent stockholders' equity account, Retained Earnings.

Contra asset account

(p. 171) An account that is offset against an asset account on the balance sheet.

Depreciation

(p. 171) The process of allocating the cost of an asset to expense over its useful life.

Earnings management

(p. 185) The planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income.

Expense recognition principle (matching principle)

(p. 165) The principle that matches expenses with revenues in the period when the company makes efforts to generate those revenues.

Fiscal year

(p. 164, in margin) An accounting period that is one year long.

Income Summary

(p. 188) A temporary account used in closing revenue and expense accounts.

Periodicity assumption

(p. 164) An assumption that the economic life of a business can be divided into artificial time periods.

Permanent accounts

(p. 188) Balance sheet accounts whose balances are carried forward to the next accounting period.

(p. 189) A list of permanent accounts and their balances after a company has journalized and posted closing entries.

#### Prepaid expenses (prepayments)

(p. 169) Expenses paid in cash before they are used or consumed.

#### Quality of earnings

(p. 185) Indicates the level of full and transparent information that a company provides to users of its financial statements.

#### Revenue recognition principle

(p. 164) The principle that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

#### Reversing entry

(p. 191, in margin) An entry made at the beginning of the next accounting period; the exact opposite of the adjusting entry made in the previous period.

#### Temporary accounts

(p. 188) Revenue, expense, and dividend accounts whose balances a company transfers to Retained Earnings at the end of an accounting period.

#### Unearned revenues

(p. 173) Cash received and a liability recorded before services are performed.

#### Useful life

(p. 171) The length of service of a productive asset.

#### Worksheet

(p. 195) A multiple-column form that companies may use in the adjustment process and in preparing financial statements.

## Comprehensive



Terry Thomas and a group of investors incorporate the Green Thumb Lawn Care Corporation 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   |

Service Revenue 1,800

Analysis reveals the following additional data pertaining to these accounts.

- 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, 6% note.
- 4. Seven customers paid for the company's 6-month lawn service package of \$600 beginning in April. These customers received the first month of services in April.
- 5. Lawn services performed for other customers but not billed 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



#### GENERAL JOURNAL

| Date                     | Account Titles and Explanation                                     | Debit | Credit |
|--------------------------|--------------------------------------------------------------------|-------|--------|
| <u>Adjusting Entries</u> |                                                                    |       |        |
| Apr.<br>30               | Insurance Expense                                                  | 150   |        |
|                          | Prepaid Insurance                                                  |       | 150    |
|                          | (To record insurance expired: $\$3,600 \div 24 = \$150$ per month) |       |        |
| 30                       | Depreciation Expense                                               | 500   |        |
|                          | Accumulated Depreciation—Equipment                                 |       | 500    |

## GENERAL JOURNAL

| Date | Account Titles and Explanation                                                                             | Debit | Credit |
|------|------------------------------------------------------------------------------------------------------------|-------|--------|
|      | (To record monthly depreciation)                                                                           |       |        |
| 30   | Interest Expense                                                                                           | 100   |        |
|      | Interest Payable                                                                                           |       | 100    |
|      | (To accrue interest on notes payable: $\$20,000 \times 6\% \times \frac{1}{12} = \$100$ )                  |       |        |
| 30   | Unearned Service Revenue                                                                                   | 700   |        |
|      | Service Revenue                                                                                            |       | 700    |
|      | (To record revenue for services performed: $\$600 \div 6 = \$100$ ; $\$100$ per month $\times 7 = \$700$ ) |       |        |
| 30   | Accounts Receivable                                                                                        | 1,500 |        |
|      | Service Revenue                                                                                            |       | 1,500  |
|      | (To accrue revenue for services performed)                                                                 |       |        |



- Self-Test, Brief Exercises, Exercises, Problem Set A, and many more resources are available for practice in WileyPLUS.

*Note:* All Questions, Exercises, and Problems marked with an asterisk relate to material in the appendix to the chapter.

## Self-Test Questions

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Answers are on [page 225](#).

1.

What is the periodicity assumption?

(LO 1)

- (a) Companies should recognize revenue in the accounting period in which services are performed.
- (b) Companies should match expenses 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.

2.

Which principle dictates that efforts (expenses) be recorded with accomplishments (revenues)?

(LO 1)

- (a) Expense recognition principle.
- (b) Historical cost principle.
- (c) Periodicity principle.
- (d) Revenue recognition principle.

3.



Which one of these statements about the accrual basis of accounting is **false**?

(LO 2)

- (a) Companies record events that change their financial statements in the period in which events occur, even if cash was not exchanged.
- (b) Companies recognize revenue in the period in which the performance obligation is satisfied.
- (c) This basis is in accord with generally accepted accounting principles.
- (d) Companies record revenue only when they receive cash, and record expense only when they pay out cash.

4.

Adjusting entries are made to ensure that:

(LO 3)

- (a) expenses are recognized in the period in which they are incurred.
- (b) revenues are recorded in the period in which the performance obligation is satisfied.
- (c) balance sheet and income statement accounts have correct balances at the end of an accounting period.
- (d) All of the above.

5.

Each of the following is a major type (or category) of adjusting entry **except**:

(LO 4, 5)

- (a) prepaid expenses.
- (b) accrued revenues.

6.

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:

(LO 4)

- (a)

|                  |     |     |
|------------------|-----|-----|
| Supplies         | 600 |     |
| Supplies Expense |     | 600 |

- (b)

|                  |     |     |
|------------------|-----|-----|
| Supplies         | 750 |     |
| Supplies Expense |     | 750 |

- (c)

|                  |     |     |
|------------------|-----|-----|
| Supplies Expense | 750 |     |
| Supplies         |     | 750 |

- (d)

|                  |     |     |
|------------------|-----|-----|
| Supplies Expense | 600 |     |
| Supplies         |     | 600 |

7.

Adjustments for unearned revenues:

(LO 4)

- (a) decrease liabilities and increase revenues.
- (b) increase liabilities and increase revenues.
- (c) increase assets and increase revenues.
- (d) decrease revenues and decrease assets.

8.

Adjustments for prepaid expenses:

(LO 4)

- (a) decrease assets and increase revenues.



9.

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:

(LO 4)

- (a)

|                                          |       |       |
|------------------------------------------|-------|-------|
| Depreciation Expense                     | 1,000 |       |
| Accumulated Depreciation—Queenan Company |       | 1,000 |

- (b)

|                      |       |       |
|----------------------|-------|-------|
| Depreciation Expense | 1,000 |       |
| Equipment            |       | 1,000 |

- (c)

|                                    |       |       |
|------------------------------------|-------|-------|
| Depreciation Expense               | 1,000 |       |
| Accumulated Depreciation—Equipment |       | 1,000 |

- (d)

|                                    |       |       |
|------------------------------------|-------|-------|
| Equipment Expense                  | 1,000 |       |
| Accumulated Depreciation—Equipment |       | 1,000 |

10.

Adjustments for accrued revenues:

(LO 5)

- (a) increase assets and increase liabilities.
- (b) increase assets and increase revenues.
- (c) decrease assets and decrease revenues.
- (d) decrease liabilities and increase revenues.

11.

Colleen Mooney earned a salary of \$400 for the last week of September. She will be paid on October 1. The adjusting entry for Colleen's employer at September 30 is:

(LO 5)

Salaries and Wages Expense 400

Salaries and Wages Payable 400

- (c)

Salaries and Wages Expense 400

Cash 400

- (d)

Salaries and Wages Payable 400

Cash 400

12.

Which statement is **incorrect** concerning the adjusted trial balance?

(LO 6)

- (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 does not list temporary accounts.
- (d) The company prepares the adjusted trial balance after it has journalized and posted the adjusting entries.

13.

Which account will have a zero balance after a company has journalized and posted closing entries?

(LO 7)

- (a) Service Revenue.
- (b) Supplies.
- (c) Prepaid Insurance.
- (d) Accumulated Depreciation.

14.

Which types of accounts will appear in the post-closing trial balance?

(LO 7)

- (a) Permanent accounts.
- (b) Temporary accounts.
- (c) Expense accounts.
- (d) None of the above.

**15. PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.** All of the following are required steps in the accounting cycle **except**:

(LO 8)

- (a) journalizing and posting closing entries.
- (b) preparing an adjusted trial balance.
- (c) preparing a post-closing trial balance.
- (d) reversing entries.

Go to the book's companion website, [www.wiley.com/college/kimmel](http://www.wiley.com/college/kimmel), to access additional Self-Test Questions.



## Questions

1.

- (a) How does the periodicity assumption affect an accountant's analysis of accounting transactions?
- (b) Explain the term fiscal year.

2.

Identify and state two generally accepted accounting principles that relate to adjusting the accounts.

3.

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

4.

 In completing the engagement in [Question 3](#), Milner pays no costs in March, \$2,500 in April, and \$2,200 in May (incurred in April). How much expense should the firm deduct from revenues in the month when it recognizes the revenue? Why?

5.

"The historical cost principle of accounting requires adjusting entries." Do you agree? Explain.

6.

Why may the financial information in an unadjusted trial balance not be up-to-date and complete?

7.

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

8.

What types of accounts does a company debit and credit in a prepaid expense adjusting entry?

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9. “Depreciation is a process of valuation that results in the reporting of the fair value of the asset.” Do you agree? Explain.

10.

Explain the differences between depreciation expense and accumulated depreciation.

11.

Remington Company purchased equipment for \$15,000. By the current balance sheet date, the company had depreciated \$7,000. Indicate the balance sheet presentation of the data.

12.

What types of accounts are debited and credited in an unearned revenue adjusting entry?

13.

Ace Technologies provides maintenance service for computers and office equipment for companies throughout the Northeast. The sales manager is elated because she closed a \$300,000, three-year maintenance contract on December 29, 2013, two days before the company's year-end. “Now we will hit this year's net income target for sure,” she crowed. The customer is required to pay \$100,000 on December 29 (the day the deal was closed). Two more payments of \$100,000 each are also required on December 29, 2014 and 2015. Discuss the effect that this event will have on the company's financial statements.

14.

ValuMart, a large national retail chain, is nearing its fiscal year-end. It appears that the company is not going to hit its revenue and net income targets. The company's marketing manager, Steve Edmiston, suggests running a promotion selling \$50 gift cards for \$45. He believes that this would be very popular and would enable the company to meet its targets for revenue and net income. What do you think of this idea?

15.

 A company fails to recognize revenue for services performed but not yet received. Which of the following types of 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.

16.

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

17.

 A company makes an accrued revenue adjusting entry for \$780 and an accrued expense adjusting entry for \$510. How much was net income understated or overstated prior to these entries? Explain.

18.

On January 9, a company pays \$6,200 for salaries, of which \$1,100 was reported as Salaries and Wages Payable on December 31. Give the entry to record the payment.

**19. PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.** 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.

- (a) Assets are understated.