

3

The Adjusting Process

Learning Objectives/Success Keys

- 1 Differentiate between accrual and cash-basis accounting
- 2 Define and apply the accounting period concept, revenue, and matching principles
- 3 Explain why adjusting entries are needed
- 4 Journalize and post adjusting entries
- 5 Explain the purpose of and prepare an adjusted trial balance
- 6 Prepare the financial statements from the adjusted trial balance

Chapter 1 introduced you to the accounting equation and the financial statements. Chapter 2 brought T-accounts, debits, credits, and the trial balance. You are now ready for the next step in the accounting cycle.

Sherman Lawn Service and Greg's Groovy Tunes have well-oiled accounting systems. At the end of each period, Hannah Sherman and Greg Moore need to measure their

- Operating performance
- Financial position

Chapter 3 continues the accounting cycle by showing how to update the accounts at the end of the period. The process is called *adjusting the books* and it requires special journal entries called *adjusting entries*.

Study this material carefully. It applies to small businesses like Greg's Groovy Tunes and Smart Touch Learning and to giant companies such as eBay and ExxonMobil. It also applies to the business you may operate someday.

Accountants have concepts and principles to guide their work. Chief among these are the following:

- Accrual accounting versus cash-basis accounting
- The accounting period



- The revenue principle
- The matching principle

In this chapter, we apply these principles to Smart Touch Learning for the month of April. ExxonMobil, eBay, and all other companies follow the same principles.

Accrual Accounting Versus Cash-Basis Accounting

1 Differentiate between accrual and cash-basis accounting

There are two ways to do accounting:

- **Accrual accounting** records the effect of each transaction as it occurs—that is, revenues are recorded when earned and expenses are recorded when incurred. Most businesses use the accrual basis as covered in this book.
- **Cash-basis accounting** records only cash receipts and cash payments. It ignores receivables, payables, and depreciation. Only very small businesses use the cash basis of accounting.

Suppose Smart Touch Learning purchased \$200 of office supplies on account on May 15, 2010, and paid the account in full on June 3, 2010. On the accrual basis, the business records this transaction as follows:

May 15	Office supplies (A+)	200	
	Accounts payable (L+)		200
	<i>Purchased supplies on account.</i>		
Jun 3	Accounts payable (L-)	200	
	Cash (A-)		200
	<i>Paid on account.</i>		

In contrast, cash-basis accounting ignores this transaction on May 15 because the business paid no cash. The cash basis records only cash receipts and cash payments. *In the cash basis,*

- Cash receipts are treated as revenues.
- Cash payments are treated as expenses.

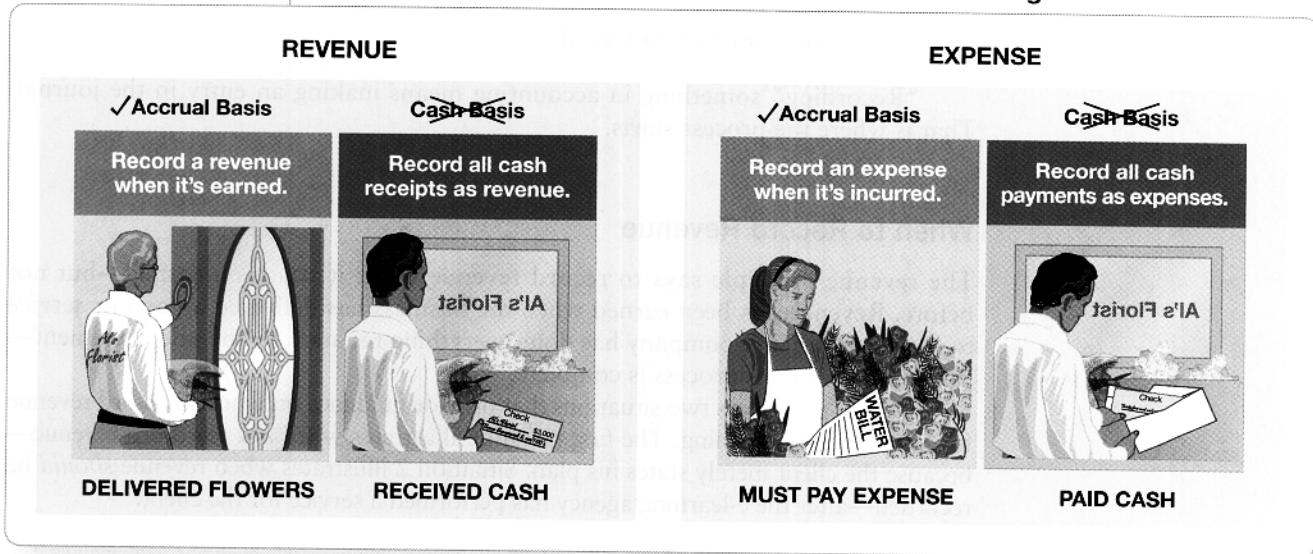
Under the cash basis, Smart Touch Learning would record each cash payment as an expense. So for our office supplies example, the company would recognize the cash basis expense on June 3, 2010, because that is the date that cash was paid. This is faulty accounting because the business acquired supplies, which are assets.

Now let us see how differently the accrual basis and the cash basis account for a revenue. Suppose Smart Touch Learning performed service and earned revenue on May 20, 2010, but did not collect cash until June 5, 2010. Under the accrual basis, the business records \$1,000 of revenue on account on May 20 as follows:

May 20	Accounts receivable (A+)	1,000	
	Service revenue (R+)		1,000
	<i>Earned revenue on account.</i>		
Jun 5	Cash (A+)	1,000	
	Accounts receivable (A-)		1,000
	<i>Received on account.</i>		

Under the cash basis, the business would record no revenue until the cash receipt, which in this case would be on June 5. As a result, cash-basis accounting never reports accounts receivable from customers. In this case, cash-basis accounting actually shows the revenue in the wrong accounting period (June). Revenue should be recorded when it is earned (May), and that is how the accrual basis operates.

Exhibit 3-1 illustrates the difference between the accrual basis and the cash basis for a florist. Keep in mind that the accrual basis is the correct way to do accounting.

EXHIBIT 3-1**Accrual Accounting Versus Cash-Basis Accounting****Stop & Think...**

Most of us think in terms of cash. Did our bank balance go up or down? This is in essence what the cash basis measures—changes in the cash balance. But consider your job. When do you actually earn your salary—when you go to work or when you get paid? When you go to work you earn. That is when you accrue revenue under the accrual basis—not when you get paid by your employer.

Other Accounting Principles

The Accounting Period

Smart Touch Learning will know with 100% certainty how well it has operated only if the company sells the assets, pays the liabilities, and gives any leftover cash to the owner. This process of going out of business is called **liquidation**. For obvious reasons, it is not practical to measure income this way. Because businesses need periodic reports on their affairs, accountants slice time into small segments and prepare financial statements for specific periods, such as a month, quarter, or year.

The basic accounting period is one year, and all businesses prepare annual financial statements. For most companies, the annual accounting period runs the calendar year from January 1 through December 31. Other companies use a *fiscal year*, which ends on a date other than December 31. The year-end date is usually the low point in business activity for the year. Retailers are a notable example. For

- 2 Define and apply the accounting period concept, revenue, and matching principles

instance, Wal-Mart, JCPenney, and most other retailers use a fiscal year that ends on January 31 because their low point comes about a month after Christmas.

Companies also prepare financial statements for *interim* periods, such as monthly, quarterly, and semiannually. Most of our discussions are based on an annual accounting period, but everything can be applied to interim periods as well.

The Revenue Principle

The revenue principle tells accountants

- When to record revenue—that is, when to make a journal entry for a revenue
- The *amount* of revenue to record

“Recording” something in accounting means making an entry in the journal. That is where the process starts.

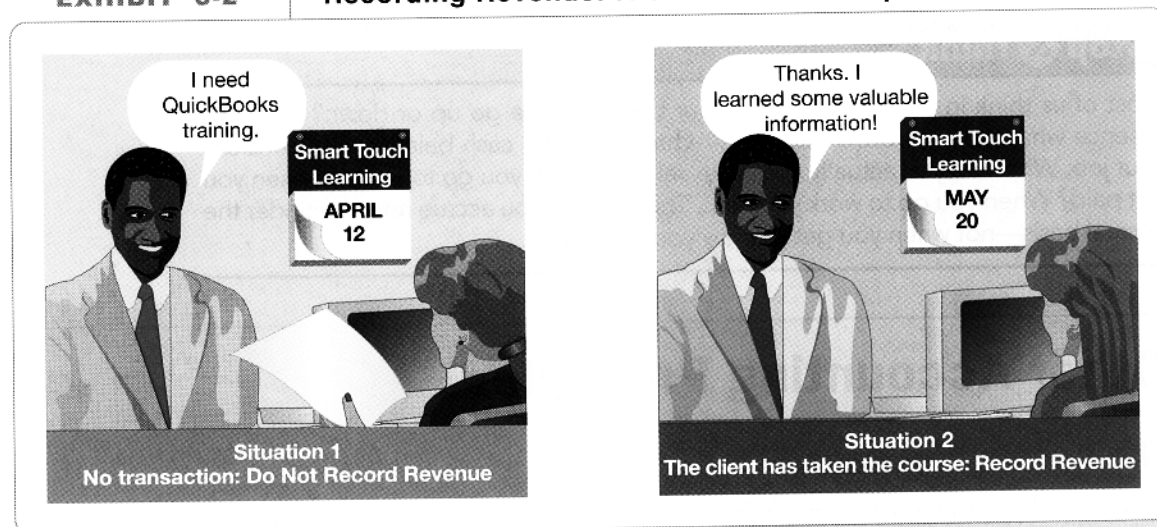
When to Record Revenue

The revenue principle says to record revenue when it has been earned—but not before. Revenue has been earned when the business has delivered a good or service to the customer. The company has done everything required by the sale agreement—that is, the earnings process is complete.

Exhibit 3-2 shows two situations that provide guidance on when to record revenue for Smart Touch Learning. The first situation illustrates when *not* to record revenue—because the client merely states his plan. Situation 2 illustrates when revenue *should* be recorded—after the e-learning agency has performed a service for the client.

EXHIBIT 3-2

Recording Revenue: The Revenue Principle



The Amount of Revenue to Record

Record revenue for the actual value of the item or service transferred to the customer. Suppose that in order to obtain a new client, Sheena Bright performs e-learning services for the cut-rate price of \$100. Ordinarily, the business would have charged \$200 for this service. How much revenue should the business record? The answer is \$100 because that was the value of this particular transaction. Sheena Bright did not charge \$200, so that is not the amount of revenue. Smart Touch charged only \$100, so it records \$100 of revenue.

The Matching Principle

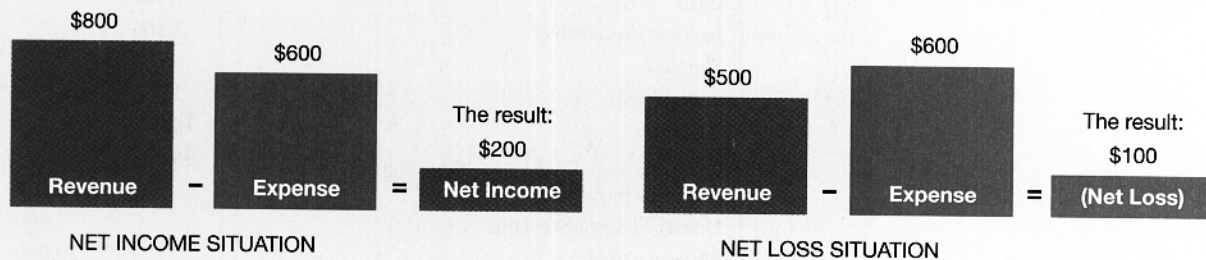
The **matching principle** guides accounting for expenses. Recall that expenses—such as salaries, rent, utilities, and advertising—are assets used up and liabilities incurred in order to earn revenue. The matching principle

1. Measures all the expenses incurred during the period
2. Matches the expenses against the revenues of the period

To match expenses against revenues means to subtract expenses incurred during one month from revenues earned during that same month. The goal is to compute net income or net loss. Exhibit 3-3 illustrates the matching principle.

EXHIBIT 3-3 Recording Expenses: The Matching Principle

Matching expense against revenue means to subtract the expense from the revenue. The goal is to measure net income (loss).



There is a natural link between some expenses and revenues. For example, Smart Touch Learning pays a commission to the employee who sells the e-learning agency's services. Other expenses are not so easy to link to sales. For example, Smart Touch Learning's monthly rent expense occurs regardless of the revenues earned that month. The matching principle tells us to identify those expenses with a particular period, such as a month or a year. The business will record rent expense each month based on the rental agreement. Smart Touch also pays a monthly salary to its employee.

How does Smart Touch Learning bring its accounts up to date for the financial statements? To address this question, accountants use the time-period concept.

The Time-Period Concept

Owners need periodic reports on their businesses. The **time-period concept** ensures that information is reported often. To measure income, companies update their accounts at the end of each period.

Let us look at Smart Touch Learning for an example of an expense accrual. On May 31, the business recorded salary expense of \$900 that it owed the employee at the end of the month. Smart Touch's accrual entry was

May 31	Salary expense (E+)	900	
	Salary payable (L+)		900
	<i>Accrued salary expense.</i>		

This entry assigns the salary expense to May because that was the month when the employee worked for the company. Without this entry, May's expenses would be understated, and net income would be overstated. The accrual entry also records the liability

owed at May 31. Without this entry, total liabilities would be understated. The remainder of the chapter shows how to adjust the accounts and bring the books up to date.

Why We Adjust the Accounts

3 Explain why adjusting entries are needed

At the end of the period, the accountant prepares the financial statements. The end-of-period process begins with the trial balance. Exhibit 3-4 is the trial balance of Smart Touch Learning at May 31, 2010.

EXHIBIT 3-4 Unadjusted Trial Balance

SMART TOUCH LEARNING Unadjusted Trial Balance May 31, 2010			
	Cash	\$ 4,800	
	Accounts receivable	2,200	
	Supplies	700	
	Prepaid rent	3,000	
	Furniture	18,000	
	Building	48,000	
	Accounts payable		\$18,200
	Unearned service revenue		600
	Notes payable		20,000
	Sheena Bright, Capital		33,200
	Sheena Bright, Withdrawals	1,000	
	Service revenue		7,000
	Salary expense	900	
	Utilities expense	400	
	Total	\$79,000	\$79,000

This *unadjusted trial balance* lists the revenues and expenses of the e-learning agency for May. But these amounts are incomplete because they omit various revenue and expense transactions. That is why the trial balance is *unadjusted*. Usually, however, we refer to it simply as the trial balance, without the label “unadjusted.”

Accrual accounting requires adjusting entries at the end of the period. We must have correct balances for the financial statements. To see why, consider the Supplies account in Exhibit 3-4.

Smart Touch Learning uses supplies during the month. This reduces the supplies on hand and creates an expense. It is a waste of time to record supplies expense every time supplies are used. But by the end of the month, some of the \$700 of Supplies on the unadjusted trial balance (Exhibit 3-4) have probably been used. So how does Sheena Bright account for the supplies expense? She must adjust the accounts at May 31.

Adjusting entries assign revenues to the period when they are earned and expenses to the period when they are incurred. Adjusting entries also update the asset and liability accounts. Adjustments are needed to properly measure two things:

1. Net income (loss) on the income statement and
2. Assets and liabilities on the balance sheet.

This end-of-period process is called *making the adjustments* or *adjusting the books*. Remember the following three facts about adjusting entries:

1. Adjusting entries never involve cash.
2. Adjusting entries either
 - a. Increase revenue earned (Revenue credit) or
 - b. Increase an expense (Expense debit)
3. The word “accrued” means you must journalize whatever amount you are being told about. (This will be explained further in an example later in the chapter.)

Two Categories of Adjusting Entries

The two basic categories of adjustments are *prepaids* and *accruals*. In a *prepaid* adjustment, the cash payment occurs before an expense is recorded. *Accrual* adjustments are the opposite. An accrual records an expense before the cash payment.

Adjusting entries fall into five types:

1. Prepaid expenses
2. Depreciation
3. Accrued expenses
4. Accrued revenues
5. Unearned revenues

The focus of this chapter is on learning how to account for these five types of adjusting entries.

4 Journalize and post adjusting entries

Prepaid Expenses

Prepaid expenses are advance payments of expenses. For example, McDonald's, the restaurant chain, makes prepayments for rent, insurance, and supplies. Prepaid expenses are assets, rather than expenses. When the prepayment is used up, the used portion of the asset becomes an expense via an adjusting journal entry.

Prepaid Rent

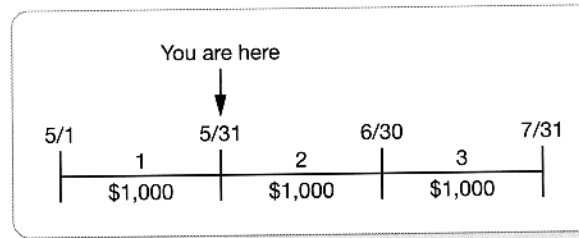
Landlords require tenants to pay rent in advance. This prepayment creates an asset for the renter. Suppose Smart Touch Learning prepays three months' office rent on May 1, 2010. If the lease specifies a monthly rental of \$1,000, the entry to record the payment is

May 1	Prepaid rent (\$1,000 × 3) (A+)	3,000	
	Cash (A-)		3,000
	<i>Paid rent in advance.</i>		

After posting, Prepaid rent has a \$3,000 debit balance.

ASSETS	
Prepaid rent	
May 1	3,000

The trial balance at May 31, 2010, lists Prepaid rent with a debit balance of \$3,000 (Exhibit 3-4). Throughout May, Prepaid rent maintains this balance. But \$3,000 is *not* the amount of Prepaid rent for the balance sheet at May 31. Why?



At May 31, Prepaid rent should be decreased for the amount that has been used up. The used-up portion is one month of the three months prepaid, or one-third of the prepayment. Recall that an asset that has expired is an *expense*. The adjusting entry transfers \$1,000 ($\$3,000 \times 1/3$) from the Prepaid rent to Rent expense. The adjusting entry is

a.	May 31	Rent expense ($\$3,000 \times 1/3$) (E+)	1,000	
		Prepaid rent (A-)		1,000
		<i>To record rent expense.</i>		

After posting, Prepaid rent and Rent expense show correct ending balances:

ASSETS				EXPENSES			
Prepaid rent				Rent expense			
May 1	3,000	May 31	1,000	May 31	1,000		
Bal	2,000			Bal	1,000		

Correct asset amount:	→	Total accounted for:	←	Correct expense amount:
\$2,000		\$3,000		\$1,000

The Prepaid rent is an example of an asset that was overstated prior to posting the adjusting entry. Notice that the ending balance in Prepaid rent is now \$2,000. Prepaid rent is an asset account. For Smart Touch, it should contain only two more months of rent on May 31 (for June and July). \$1,000 rent per month times two months equals the \$2,000 Prepaid rent balance.

The same analysis applies to the prepayment of three months of insurance. The only difference is in the account titles. Prepaid insurance would be used instead of Prepaid rent and Insurance expense would be used instead of Rent expense. In a computerized system, the adjusting entry can be programmed to recur automatically each accounting period.

Appendix 3A shows an alternative treatment of prepaid expenses. The end result on the financial statements is the same as illustrated here.

Supplies

Supplies are accounted for as prepaid expenses. On May 2, Sheena Bright paid \$500 for office supplies.

May 2	Supplies (A+)	500	
	Cash (A-)		500
	<i>Paid cash for supplies.</i>		

The May 31 trial balance, therefore, still lists Supplies with a \$700 debit balance, as shown in Exhibit 3-4. But Bright's May 31 balance sheet should *not* report supplies of \$700. Why not?

During May, the e-learning agency used supplies to conduct business. The cost of the supplies used becomes *supplies expense*. To measure supplies expense, Bright counts the supplies on hand at the end of May. This is the amount of the asset still owned by the business. Assume that supplies costing \$600 remain at May 31. Use the supplies T-account to determine the value of the supplies that were used:

ASSETS			EXPENSES		
Supplies			Supplies expense		
May 2	500				
May 15	200	Supplies Used ???		???	
Bal	600		Bal	???	

So, we can solve for the supplies used as

$$\begin{aligned}\text{Beginning Supplies} - \text{Supplies Used} &= \text{Ending Supplies} \\ \$700 (500 + 200) - \text{Supplies Used} &= \$600 \\ \text{Supplies Used} &= \$100\end{aligned}$$

The May 31 adjusting entry updates Supplies and records Supplies expense for May as follows:

b.	May 31	Supplies expense (\$700 - \$600) (E+)	100	
		Supplies (A-)		100
		<i>To record supplies expense.</i>		

After posting, Supplies and Supplies expense hold correct ending balances:

ASSETS			EXPENSES		
Supplies			Supplies expense		
May 2	500				
May 15	200	May 31 100	May 31	100	
Bal	600		Bal	100	

The Supplies account then enters June with a \$600 balance, and the adjustment process is repeated each month. Supplies is another example of an asset that was overstated at \$700 on the trial balance prior to posting the adjusting entry. That entry then reflected the correct balance of Supplies on May 31 of \$600.

Depreciation

Plant assets are long-lived tangible assets used in the operation of a business. Examples include land, buildings, equipment, and furniture. As a business uses the assets, their value and usefulness decline. The decline in usefulness of a plant asset is an expense, and accountants systematically spread the asset's cost over its useful life. The allocation of a plant asset's cost to expense is called **depreciation**. Land is the exception. We record no depreciation for land, as its value typically does not decline with use.

Similarity to Prepaid Expenses

The concept of accounting for plant assets is the same as for a prepaid expense. The major difference is the length of time it takes for the asset to be used up. Prepaid expenses usually expire within a year, while plant assets remain useful for several years. Let us review an example for Smart Touch Learning. On May 3 Smart Touch Learning purchased furniture for \$18,000 and made the following journal entry:

May 3	Furniture (A+)	18,000	
	Cash (A-)		18,000
	<i>Purchased furniture.</i>		

After posting, the Furniture account has an \$18,000 balance:

ASSETS	
Furniture	
May 3	18,000

Sheena Bright believes the furniture will remain useful for five years and then be worthless. One way to compute depreciation is to divide the cost of the asset (\$18,000) by its expected useful life (five years). So, the depreciation for each month is \$300 ($\$18,000 / 5 \text{ years} = \$3,600 / 12 \text{ months} = \300 per month). Depreciation expense for May is recorded by the following entry:

c.	May 31	Depreciation expense—furniture (E+)	300	
		Accumulated depreciation—furniture (CA+)		300
		<i>To record depreciation on furniture.</i>		

The Accumulated Depreciation Account

Accumulated depreciation, rather than Furniture, is credited because it is helpful to keep the original cost in the Furniture account. Managers can then refer to the Furniture account to see how much the asset actually cost them. This information may help decide how much to pay for new furniture. The Accumulated depreciation account holds the sum of all the depreciation recorded for the asset and that total increases over time.

Accumulated depreciation is a contra asset, which means that it is an asset account with a normal credit balance. A **contra account** has two main characteristics:

- A contra account is paired with and follows its related account.
- A contra account's normal balance (debit or credit) is the opposite of the balance of the related account.

For example, Accumulated depreciation is the contra account that follows Furniture. Furniture has a debit balance, so Accumulated depreciation, a contra asset, has a credit balance.

A business may have a separate Accumulated depreciation account for each depreciable asset. If Smart Touch Learning has both a building and a furniture account, it may have two accounts: Accumulated depreciation—building, and Accumulated depreciation—furniture. However, small companies often have only one Accumulated depreciation account for all their assets.

After posting the depreciation, the accounts appear as follows:

ASSETS				EXPENSES	
NORMAL ASSET		CONTRA ASSET		Depreciation	
Furniture		Accumulated depreciation—furniture		expense—furniture	
May 3	18,000		May 31	300	
Bal	18,000		Bal	300	

Book Value

The balance sheet reports both Furniture and Accumulated depreciation. Because it is a contra account, Accumulated depreciation is subtracted from Furniture. The resulting net amount (cost minus accumulated depreciation) of a plant asset is called its **book value**. For Smart Touch Learning's Furniture, the book value is

Book value of plant assets:	
Furniture	\$18,000
Less: Accumulated depreciation	(300)
Book value of the furniture	\$17,700

The book value represents costs (life) invested in the asset that the business has not yet used (expensed).

Suppose the e-learning agency also owns a building that cost \$48,000, with monthly depreciation of \$200. The following entry would record depreciation for May:

d.	May 31	Depreciation expense—building (E+)	200	
		Accumulated depreciation—building (CA+)		200
		<i>To record depreciation on building.</i>		

The May 31 balance sheet would report plant assets as shown in Exhibit 3-5.

EXHIBIT 3-5 Plant Assets on the Balance Sheet of Smart Touch Learning (May 31)

Plant Assets			
Furniture	\$18,000		
Less: Accumulated depreciation	(300)		\$17,700
Building	\$48,000		
Less: Accumulated depreciation	(200)		47,800
Plant assets, net			\$65,500

Accrued Expenses

Businesses often incur expenses before paying for them. The term **accrued expense** refers to an expense of this type. Consider an employee's salary. The salary expense grows as the employee works, so the expense is said to *accrue*. Another accrued expense is interest expense on a note payable. Interest accrues as time passes on the note. An accrued expense always creates a liability.

Companies do not make weekly journal entries to accrue expenses. Instead they wait until the end of the period. They make an adjusting entry to bring each expense (and the related liability) up to date for the financial statements.

Remember that prepaids and accruals are opposites.

- A *prepaid expense* is paid first and expensed later.
- An *accrued expense* is expensed first and paid later.

Now let us see how to account for accrued expenses.

Accruing Salary Expense

Suppose Smart Touch pays its employee a monthly salary of \$1,800, half on the 15th and half on the first day of the next month. Here is a calendar for May and June with the two paydayes circled:

May 2010						
Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
Apr 25	26	27	28	29	30	May 1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31	Jun 1	2	3	4	5

During May, Sheena Bright paid the first half-month salary on Saturday, May 15, and made this entry:

May 15	Salary expense (E+)	900	
	Cash (A-)		900
	<i>To pay salary.</i>		

After posting, Salary expense shows the following balance:

EXPENSES	
Salary expense	
May 15	900

The trial balance at May 31 (Exhibit 3-4) includes Salary expense, with a debit balance of \$900. This is Smart Touch's salary expense for the first half of May. The second payment of \$900 will occur on June 1, so the business must accrue salary expense for the second half of May. At May 31, Smart Touch makes the following adjusting entry:

e.	May 31	Salary expense (E+)	900	
		Salary payable (L+)		900
		<i>To accrue salary expense.</i>		

After posting, both Salary expense and Salary payable are up to date:

EXPENSES	
Salary expense	
May 15	900
May 31	900
Bal	1,800

LIABILITIES	
Salary payable	
May 31	900
Bal	900

Salary expense holds a full month's salary, and Salary payable shows the liability owed at May 31. This is an example of a liability that was understated before the adjusting entry was made.

Accruing Interest Expense

Borrowing money creates a liability for a Note payable. If, on May 1, 2010, Smart Touch borrows \$20,000 from the bank after signing a one-year note payable, the entry to record the note on May 1, 2010, is

May 1	Cash (A+)	20,000	
	Note payable (L+)		20,000
	<i>Borrowed money.</i>		

Interest on this note is payable one year later, on May 1, 2011. On May 31, 2010, the company must make an adjusting entry to record the interest expense that has accrued for the month of May. Assume one month's interest expense on this note is \$100. Your May 31 adjusting entry to accrue interest expense is

f.	May 31	Interest expense (E+)	100	
		Interest payable (L+)		100
		<i>To accrue interest expense.</i>		

This is another example of a liability that was understated before the adjusting entry was made. After posting, Interest expense and Interest payable have the following balances:

EXPENSES			LIABILITIES		
Interest expense			Interest payable		
May 31	100			May 31	100
Bal	100			Bal	100

Accrued Revenues

As we have just seen, expenses can occur before a company makes a cash payment for them, which creates an accrued expense. Similarly, businesses can earn revenue before they receive the cash. This calls for an **accrued revenue**, which is a revenue that has been earned but not yet collected in cash.

Assume that Smart Touch Learning is hired on May 15 to perform e-learning services for the **University of West Florida**. Under this agreement, Smart Touch will earn \$800 monthly. During May, Smart Touch will earn half a month's fee, \$400, for work May 16 through May 31. On May 31, Smart Touch makes the following adjusting entry to accrue the revenue earned during May 16 through 31:

g.	May 31	Accounts receivable (\$800 × 1/2) (A+)	400	
		Service revenue (R+)		400
		<i>To accrue service revenue.</i>		

The unadjusted trial balance in Exhibit 3-4 shows that Accounts receivable has an unadjusted balance of \$2,200. Service revenue's unadjusted balance is \$7,000 from the regular May activity. (Detailed entries for May transactions are not shown. Only adjusting entries are shown.) The adjustment updates both accounts.

ASSETS			REVENUES		
Accounts receivable			Service revenue		
	2,200			7,000	
May 31	400		May 31	400	
Bal	2,600		Bal	7,400	

Without the adjustment, Smart Touch's financial statements would understate both an asset, Accounts receivable, and a revenue, Service revenue.

Now we turn to the final category of adjusting entries.

Unearned Revenues

Some businesses collect cash from customers in advance of performing work. Receiving cash before earning it creates a liability to perform work in the future called **unearned revenue**. The company owes a product or a service to the customer, or it owes the customer his or her money back. Only after completing the job will the business *earn* the revenue. Because of this delay, unearned revenue is also called **deferred revenue**.

Suppose, for example, a law firm engages Smart Touch Learning to provide ethics e-learning services, agreeing to pay \$600 monthly, beginning immediately.

Sheena Bright collects the first amount on May 21. Smart Touch records the cash receipt and a liability as follows:

May 21	Cash (A+)		600	
	Unearned service revenue (L+)			600
	<i>Collected revenue in advance.</i>			

Now the liability account, Unearned service revenue, shows that Smart Touch owes \$600.

LIABILITIES

Unearned service revenue	
May 21	600

Unearned service revenue is a liability because the company owes a service to a client in the future.

The May 31 trial balance (Exhibit 3-4) lists Unearned service revenue with a \$600 credit balance. During the last 10 days of the month—May 21 through May 31—Smart Touch will *earn* approximately one-third (10 days divided by 30 days) of the \$600, or \$200. Therefore, Smart Touch makes the following adjusting entry to record earning \$200 of revenue:

h.	May 31	Unearned service revenue ($\$600 \times 1/3$) (L-)	200	
		Service revenue (R+)		200
		<i>To record service revenue that was collected in advance.</i>		

This adjusting entry shifts \$200 from liability to revenue. Service revenue increases by \$200, and Unearned service revenue decreases by \$200. Now both accounts are up-to-date at May 31:

LIABILITIES

Unearned service revenue			
May 31	200	May 21	600
		Bal	400

REVENUES

Service revenue	
	7,000
May 31	400
May 31	200
Bal	7,600

This is an example of a liability that was overstated prior to posting the adjusting journal entry. Remember this key point:

An unearned revenue is a liability, not a revenue.

An unearned revenue to one company is a prepaid expense to the company that paid in advance. Consider the law firm in the preceding example. The law firm had prepaid e-learning expense—an asset. Smart Touch Learning had unearned service revenue—a liability.

Exhibit 3-6 summarizes the timing of prepaid and accrual adjustments. Study the exhibit from left to right, and then move down. Appendix 3A shows an alternative treatment for unearned revenues.

EXHIBIT 3-6 Prepaid and Accrual Adjustments
PREPAIDS – Cash transaction comes first.

Prepaid Expenses	<i>Pay expense in advance and record an asset.</i>			
	Prepaid rent (A+)	XXX		
	Cash (A-)		XXX	

Unearned Revenues	<i>Receive cash in advance and record a liability.</i>			
	Cash (A+)	XXX		
	Unearned service revenue (L+)		XXX	

ACCRUALS – Cash transaction comes later.

Accrued Expenses	<i>Accrue an expense first.</i>			
	Salary expense (E+)	XXX		
	Salary payable (L+)		XXX	

Accrued Revenues	<i>Accrue a revenue first.</i>			
	Interest receivable (A+)	XXX		
	Interest revenue (R+)		XXX	

Source: The authors thank Darrel Davis and Alfonso Oddo for suggesting this exhibit.

<i>Record the expense later.</i>				
Rent expense (E+)		XXX		
Prepaid rent (A-)			XXX	

<i>Record the revenue later.</i>				
Unearned service revenue (L-)		XXX		
Service revenue (R+)			XXX	

<i>Pay the liability later.</i>				
Salary payable (L-)		XXX		
Cash (A-)			XXX	

<i>Collect cash later.</i>				
Cash (A+)		XXX		
Interest receivable (A-)			XXX	

Summary of the Adjusting Process

The adjusting process has two purposes:

1. To measure net income or net loss on the *income statement*. Every adjustment affects a *revenue* or an *expense*.
2. To update the *balance sheet*. Every adjustment affects an *asset* or a *liability*.

Exhibit 3-7 summarizes the effects of the various adjusting entries.

EXHIBIT 3-7

Summary of Adjusting Entries

Category of Adjusting Entry	Debit	Credit
Prepaid expense	Expense	Asset
Depreciation	Expense	Contra asset
Accrued expense	Expense	Liability
Accrued revenue	Asset	Revenue
Unearned revenue	Liability	Revenue

Source: Adapted from material provided by Beverly Terry.

Exhibit 3-8 on the following page summarizes the adjusting entries of Smart Touch Learning at May 31.

The adjustments are keyed by letter.

- Panel A gives the data for each adjustment.
- Panel B shows the adjusting entries.
- Panel C gives the accounts after posting.

Stop & Think...

Look at the eight adjusting entries in Exhibit 3-8. Notice that only the last two adjusting entries, (g) and (h), increased revenues. On the other hand, six of the eight adjusting entries increased expenses. So, when in doubt about an adjustment, most likely it will be an adjusting entry that increases (debits) an expense account.

EXHIBIT 3-8

Journalizing and Posting the Adjusting Entries of Smart Touch Learning

PANEL A—Information for Adjustments at May 31, 2010

- | | |
|--------------------------------------|--|
| a. Prepaid rent expired, \$1,000. | f. Accrued interest on note, \$100. |
| b. Supplies expense, \$100. | g. Accrued service revenue, \$400. |
| c. Depreciation on furniture, \$300. | h. Service revenue that was collected in advance and now has been earned, \$200. |
| d. Depreciation on building, \$200. | |
| e. Accrued salary expense, \$900. | |

PANEL B—Adjusting Entries

a.	Rent expense (E+)	1,000	
	Prepaid rent (A-)		1,000
	<i>To record rent expense.</i>		
b.	Supplies expense (E+)	100	
	Supplies (A-)		100
	<i>To record supplies used.</i>		
c.	Depreciation expense—furniture (E+)	300	
	Accumulated depreciation—furniture (CA+)		300
	<i>To record depreciation on furniture.</i>		
d.	Depreciation expense—building (E+)	200	
	Accumulated depreciation—building (CA+)		200
	<i>To record depreciation on building.</i>		
e.	Salary expense (E+)	900	
	Salary payable (L+)		900
	<i>To accrue salary expense.</i>		
f.	Interest expense (E+)	100	
	Interest payable (L+)		100
	<i>To accrue interest expense.</i>		
g.	Accounts receivable (A+)	400	
	Service revenue (R+)		400
	<i>To accrue service revenue.</i>		
h.	Unearned service revenue (L-)	200	
	Service revenue (R+)		200
	<i>To record revenue that was collected in advance.</i>		

PANEL C—Ledger Accounts

Assets		Liabilities		Owner's Equity		Expenses	
Cash		Accounts payable		Sheena Bright, Capital		Rent expense	
Bal	4,800	Bal	18,200	Bal	33,200	(a)	1,000
						Bal	1,000
Prepaid rent		Salary payable		Sheena Bright, Withdrawals		Salary expense	
3,000	(a) 1,000	(c)	900	Bal	1,000	900	
Bal	2,000	Bal	900			(e)	900
Furniture		Unearned service revenue		Revenue		Bal	1,800
Bal	18,000	(h)	200	Service revenue	7,000		
Accounts receivable		Bal	400	(g)	400		
2,200				(h)	200		
(g)	400			Bal	7,600		
Bal	2,600	Interest payable		Supplies expense			
Supplies		(f)	100	(b)	100		
700	(b) 100	Notes payable		Bal	100		
Bal	600	Bal	20,000				
Accumulated depreciation—furniture		Accumulated depreciation—building		Depreciation expense—furniture			
(c)	300	(d)	200	(c)	300		
Bal	300			Bal	300		
Building				Utilities expense			
Bal	48,000			Bal	400		
				Depreciation expense—building			
				(d)	200		
				Interest expense			
				(f)	100		

The Adjusted Trial Balance

- 5** Explain the purpose of and prepare an adjusted trial balance

This chapter began with the *unadjusted* trial balance (Exhibit 3-4). After the adjustments, the accounts appear as shown in Exhibit 3-8, Panel C. A useful step in preparing the financial statements is to list the accounts, along with their adjusted balances, on an **adjusted trial balance**. Exhibit 3-9 shows how to prepare the adjusted trial balance.

EXHIBIT 3-9

Preparation of Adjusted Trial Balance

SMART TOUCH LEARNING Preparation of Adjusted Trial Balance May 31, 2010						
	Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	4,800				4,800	
Accounts receivable	2,200		(g) 400		2,600	
Supplies	700			(b) 100	600	
Prepaid rent	3,000			(a) 1,000	2,000	
Furniture	18,000				18,000	
Building	48,000				48,000	
Accumulated depreciation—furniture				(c) 300		300
Accumulated depreciation—building				(d) 200		200
Accounts payable		18,200				18,200
Salary payable				(e) 900		900
Interest payable				(f) 100		100
Unearned service revenue		600	(h) 200			400
Notes payable		20,000				20,000
Sheena Bright, Capital		33,200				33,200
Sheena Bright, Withdrawals	1,000				1,000	
Service revenue		7,000		(g) 400 (h) 200		7,600
Rent expense			(a) 1,000		1,000	
Salary expense	900		(e) 900		1,800	
Supplies expense			(b) 100		100	
Depreciation expense—furniture			(c) 300		300	
Depreciation expense—building			(d) 200		200	
Interest expense			(f) 100		100	
Utilities expense	400				400	
	79,000	79,000	3,200	3,200	80,900	80,900

Balance Sheet
(Exhibit 3-12)

Statement of
Owner's Equity
(Exhibit 3-11)

Income
Statement
(Exhibit 3-10)

Exhibit 3-9 is a *work sheet*. We will continue this work sheet in Chapter 4. For now, simply note how clear this format is. The Account Titles and the Trial Balance are copied directly from the trial balance in Exhibit 3-4. The two Adjustments columns show the adjusting journal entries from Exhibit 3-8.

The Adjusted Trial Balance columns give the adjusted account balances. Each amount in these columns is computed by combining the trial balance amounts plus or minus the adjustments. For example, Accounts receivable starts with a debit balance of \$2,200. Adding the \$400 debit from adjustment (g) gives Accounts receivable an adjusted balance of \$2,600. Supplies begins with a debit balance of \$700. After the \$100 credit adjustment, Supplies has a \$600 balance. More than one entry

may affect a single account. Service revenue, for example, has two adjustments, (g) and (h), and both increased the Service revenue balance.

The Financial Statements

The May financial statements of Smart Touch Learning can be prepared from the adjusted trial balance in Exhibit 3-9. In the right margin, we see how the accounts are distributed to the financial statements. As always,

6 Prepare the financial statements from the adjusted trial balance

- the income statement (Exhibit 3-10) reports revenues and expenses.
- the statement of owner's equity (Exhibit 3-11) shows why the owner's capital changed during the period.
- the balance sheet (Exhibit 3-12) reports assets, liabilities, and owner's equity.

Preparing the Statements

The financial statements should be prepared in the following order:

1. Income statement—to determine net income or net loss
2. Statement of owner's equity—which needs net income or net loss from the income statement to compute ending capital
3. Balance sheet—which needs the amount of ending capital to achieve its balancing feature

All financial statements include the following elements:

Heading

- Name of the entity—such as Smart Touch Learning
- Title of the statement—income statement, statement of owner's equity, or balance sheet
- Date, or period, covered by the statement—May 31, 2010, or Month Ended May 30, 2010

Body of the statement

The income statement should list expenses in descending order by amount, as shown in Exhibit 3-10.

Relationships Among the Financial Statements

The arrows in Exhibits 3-10, 3-11, and 3-12 on the following page show how the financial statements relate to each other.

1. Net income from the income statement increases capital. A net loss decreases capital.
2. Ending capital from the statement of owner's equity goes to the balance sheet and makes total liabilities plus owner's equity equal total assets, satisfying the accounting equation.

To solidify your understanding of these relationships, trace net income from the income statement to the statement of owner's equity. Then trace ending capital to the balance sheet.

EXHIBIT 3-10**Preparing the Income Statement
from the Adjusted Trial Balance**

SMART TOUCH LEARNING			
Income Statement			
Month Ended May 31, 2010			
Revenue:			
Service revenue			\$7,600
Expenses:			
Salary expense	\$1,800		
Rent expense	1,000		
Utilities expense	400		
Depreciation expense—furniture	300		
Depreciation expense—building	200		
Interest expense	100		
Supplies expense	100		
Total expenses			3,900
Net income			<u>\$3,700</u>

EXHIBIT 3-11**Preparing the Statement
of Owner's Equity from
the Adjusted Trial Balance**

SMART TOUCH LEARNING	
Statement of Owner's Equity	
Month Ended May 31, 2010	
Sheena Bright, Capital, May 1, 2010	\$33,200
Add: Net income	3,700
	<u>36,900</u>
Less: Owner withdrawals	(1,000)
Sheena Bright, Capital, May 31, 2010	<u>\$35,900</u>

EXHIBIT 3-12**Preparing the Balance Sheet from the
Adjusted Trial Balance**

SMART TOUCH LEARNING			
Balance Sheet			
May 31, 2010			
Assets		Liabilities	
Cash	\$ 4,800	Accounts payable	\$18,200
Accounts receivable	2,600	Salary payable	900
Supplies	600	Interest payable	100
Prepaid rent	2,000	Unearned service revenue	400
Furniture	\$18,000	Notes payable	20,000
Less: Accumulated depreciation—furniture	-300	Total liabilities	<u>39,600</u>
Building	48,000		
Less: Accumulated depreciation—building	-200		
Total assets	<u>\$75,500</u>	Owner's Equity	
		Sheena Bright, Capital	<u>35,900</u>
		Total liabilities and owner's equity	<u>\$75,500</u>

Ethical Issues in Accrual Accounting

Like all areas of business, accounting poses ethical challenges. Accountants must be honest in their work. Only with complete and accurate information can people make wise decisions. Let us look at an example.

Smart Touch Learning has done well as a business and wishes to open another office. Assume the company needs to borrow \$30,000.

Suppose the e-learning agency understated expenses in order to inflate net income on the income statement. A banker could be tricked into lending the company money. Then if the business could not pay the loan, the bank would lose—all because the banker relied on incorrect accounting information.

Accrual accounting provides opportunities for unethical behavior. For example, a dishonest businessperson could easily overlook depreciation expense at the end of the year. Failing to record depreciation would overstate net income and paint a more favorable picture of the company's financial position. It is important for accountants to prepare accurate and complete financial statements because other people rely on the data for their decisions.

Decision Guidelines

THE ACCOUNTING PROCESS

Take the role of Hannah Sherman who owns Sherman Lawn Service. Assume it is now the end of the first year, and Sherman wants to know where the business stands financially. The Decision Guidelines give a map of the accounting process to help Sherman manage the business.

Decision	Guidelines
• Which basis of accounting better measures business income?	<i>Accrual basis</i> , because it provides more complete reports of operating performance and financial position
• How to measure revenues?	Revenue principle—Record revenues only after they are earned
• How to measure expenses?	Matching principle—Subtract expenses from revenues in order to measure net income
• Where to start with the measurement of income at the end of the period?	Unadjusted trial balance, usually referred to simply as the <i>trial balance</i>
• How to update the accounts for the financial statements?	<i>Adjusting entries</i> at the end of the period
• What are the categories of adjusting entries?	<div>Prepaid expenses Accrued revenues</div> <div>Depreciation of plant assets Unearned revenues</div> <div>Accrued expenses</div>
• How do the adjusting entries differ from other journal entries?	<ol style="list-style-type: none"> 1. Adjusting entries are made only at the end of the period. 2. Adjusting entries never affect cash. 3. All adjusting entries debit or credit <ul style="list-style-type: none"> • At least one <i>income statement</i> account (a revenue or an expense), and • At least one <i>balance sheet</i> account (an asset or a liability)
• Where are the accounts with their adjusted balances summarized?	<i>Adjusted trial balance</i> , which aids preparation of the financial statements

Summary Problem

The trial balance of Super Employment Services pertains to December 31, 2011, the end of Super's annual accounting period. Data needed for the adjusting entries include the following:

- Supplies on hand at year-end, \$200.
- Depreciation on furniture, \$2,000.
- Depreciation on building, \$1,000.
- Salaries owed but not yet paid, \$500.
- Accrued service revenue, \$1,300.
- \$3,000 of the unearned service revenue has been earned.

Requirements

- Open the ledger accounts with their unadjusted balances as shown for Accounts receivable:

Accounts receivable	
5,000	

- Journalize Super's adjusting entries at December 31, 2011. Key entries by letter, as in Exhibit 3-8.
- Post the adjusting entries.
- Write the trial balance on a work sheet, enter the adjusting entries, and prepare an adjusted trial balance, as shown in Exhibit 3-9.
- Prepare the income statement, the statement of owner's equity, and the balance sheet. Draw arrows linking the three financial statements.

SUPER EMPLOYMENT SERVICES Trial Balance December 31, 2011			
Account Title	Balance		
	Debit	Credit	
Cash	\$ 6,000		
Accounts receivable	5,000		
Supplies	1,000		
Furniture	10,000		
Accumulated depreciation—furniture		\$ 4,000	
Building	50,000		
Accumulated depreciation—building		30,000	
Accounts payable		2,000	
Salary payable			
Unearned service revenue		8,000	
Dan Mudge, Capital		12,000	
Dan Mudge, Withdrawals	25,000		
Service revenue		60,000	
Salary expense	16,000		
Supplies expense			
Depreciation expense—furniture			
Depreciation expense—building			
Advertising expense	3,000		
Total	\$116,000	\$116,000	

Solution

Requirements 1 and 3

ASSETS

Cash	
Bal	6,000
<hr/>	
Accounts receivable	
5,000	
(e) 1,300	
Bal	6,300
<hr/>	
Supplies	
1,000	(a) 800
Bal	200
<hr/>	
Furniture	
Bal	10,000
<hr/>	
Accumulated depreciation—furniture	
	4,000
(b) 2,000	
Bal	6,000
<hr/>	

Building	
Bal	50,000
<hr/>	
Accumulated depreciation—building	
	30,000
(c) 1,000	
Bal	31,000
<hr/>	

LIABILITIES

Accounts payable	
	Bal 2,000
<hr/>	
Salary payable	
(d) 500	
Bal	500
<hr/>	
Unearned service revenue	
(f) 3,000	8,000
Bal	5,000
<hr/>	

OWNER'S EQUITY

Dan Mudge, Capital	
	Bal 12,000
<hr/>	
Dan Mudge, Withdrawals	
Bal	25,000
<hr/>	

EXPENSES	
Salary expense	
16,000	
(d) 500	
Bal	16,500
<hr/>	

Supplies expense	
(a) 800	
Bal	800
<hr/>	

Depreciation expense—furniture	
(b) 2,000	
Bal	2,000
<hr/>	

Depreciation expense—building	
(c) 1,000	
Bal	1,000
<hr/>	

Advertising expense	
Bal	3,000
<hr/>	

REVENUE

Service revenue	
	60,000
(e) 1,300	
(f) 3,000	
Bal	64,300
<hr/>	

Requirement 2

	2011			
a.	Dec 31	Supplies expense (\$1,000 – \$200) (E+)	800	
		Supplies (A–)		800
		<i>To record supplies used.</i>		
b.	31	Depreciation expense—furniture (E+)	2,000	
		Accumulated depreciation—furniture (CA+)		2,000
		<i>To record depreciation expense on furniture.</i>		
c.	31	Depreciation expense—building (E+)	1,000	
		Accumulated depreciation—building (CA+)		1,000
		<i>To record depreciation expense on building.</i>		
d.	31	Salary expense (E+)	500	
		Salary payable (L+)		500
		<i>To accrue salary expense.</i>		
e.	31	Accounts receivable (A+)	1,300	
		Service revenue (R+)		1,300
		<i>To accrue service revenue.</i>		
f.	31	Unearned service revenue (L–)	3,000	
		Service revenue (R+)		3,000
		<i>To record service revenue that was collected in advance.</i>		

Requirement 4

SUPER EMPLOYMENT SERVICES Preparation of Adjusted Trial Balance December 31, 2011

Account Title	Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	6,000				6,000	
Accounts receivable	5,000		(e) 1,300		6,300	
Supplies	1,000			(a) 800	200	
Furniture	10,000				10,000	
Accumulated depreciation—furniture		4,000		(b) 2,000		6,000
Building	50,000				50,000	
Accumulated depreciation—building		30,000		(c) 1,000		31,000
Accounts payable		2,000				2,000
Salary payable				(d) 500		500
Unearned service revenue		8,000	(f) 3,000			5,000
Dan Mudge, Capital		12,000				12,000
Dan Mudge, Withdrawals	25,000				25,000	
Service revenue		60,000		(e) 1,300 (f) 3,000		64,300
Salary expense	16,000		(d) 500		16,500	
Supplies expense			(a) 800		800	
Depreciation expense—furniture			(b) 2,000		2,000	
Depreciation expense—building			(c) 1,000		1,000	
Advertising expense	3,000				3,000	
Total	116,000	116,000	8,600	8,600	120,800	120,800

Requirement 5

SUPER EMPLOYMENT SERVICES			
Income Statement			
Year Ended December 31, 2011			
Revenue:			
Service revenue			\$64,300
Expenses:			
Salary expense	\$16,500		
Advertising expense	3,000		
Depreciation expense—furniture	2,000		
Depreciation expense—building	1,000		
Supplies expense	800		
Total expenses		23,300	
Net income			<u>\$41,000</u>

SUPER EMPLOYMENT SERVICES	
Statement of Owner's Equity	
Year Ended December 31, 2011	
Dan Mudge, Capital, January 1, 2011	\$ 12,000
Add: Net income	41,000
	53,000
Less: Owner withdrawals	(25,000)
Dan Mudge, Capital, December 31, 2011	<u>\$ 28,000</u>

SUPER EMPLOYMENT SERVICES			
Balance Sheet			
December 31, 2011			
Assets		Liabilities	
Cash	\$ 6,000	Accounts payable	\$ 2,000
Accounts receivable	6,300	Salary payable	500
Supplies	200	Unearned service revenue	5,000
Furniture	\$10,000	Total liabilities	7,500
Less: Accumulated depreciation—furniture	(6,000)		
	4,000		
Building	50,000		
Less: Accumulated depreciation—building	(31,000)		
	19,000		
Total assets	<u>\$35,500</u>		
		Owner's Equity	
		Dan Mudge, Capital	28,000
		Total liabilities and owner's equity	<u>\$35,500</u>

Review *The Adjusting Process*

■ Accounting Vocabulary

Accrual Accounting (p. 134)

Accounting that records the impact of a business event as it occurs regardless of whether the transaction affected cash.

Accrued Expense (p. 144)

An expense that the business has incurred but not yet paid.

Accrued Revenue (p. 146)

A revenue that has been earned but not yet collected in cash.

Accumulated Depreciation (p. 142)

The sum of all depreciation expense recorded to date for an asset.

Adjusted Trial Balance (p. 152)

A list of all the accounts with their adjusted balances.

Adjusting Entries (p. 138)

Entries made at the end of the period to assign revenues to the period in which they are earned and expenses to the period in which they are incurred. Adjusting entries help measure the period's income and bring the related asset and liability accounts to correct balances for the financial statements.

Book Value (of a plant asset) (p. 143)

The asset's cost minus accumulated depreciation.

Cash-Basis Accounting (p. 134)

Accounting that records transactions only when cash is received or paid.

Contra Account (p. 142)

An account that always has a companion account and whose normal balance is opposite that of the companion account.

Deferred Revenue (p. 146)

A liability created when a business collects cash from customers in advance of doing work. Also called **unearned revenue**.

Depreciation (p. 142)

The allocation of a plant asset's cost to expense over its useful life.

Liquidation (p. 135)

The process of going out of business by selling all the assets, paying all the liabilities, and giving any leftover cash to the owner.

Matching Principle (p. 137)

Guide to accounting for expenses. Identify all expenses incurred during the period, measure the expenses, and match them against the revenues earned during that same time period.

Plant Assets (p. 142)

Long-lived tangible assets—such as land, buildings, and equipment—used in the operation of a business.

Revenue Principle (p. 136)

The basis for recording revenues; tells accountants when to record revenue and the amount of revenue to record.

Time-Period Concept (p. 137)

Ensures that information is reported at regular intervals.

Unearned Revenue (p. 146)

A liability created when a business collects cash from customers in advance of doing work. Also called **deferred revenue**.

■ Quick Check

1. What are the distinctive features of accrual accounting and cash-basis accounting?
 - a. Cash-basis accounting records all transactions.
 - b. Accrual accounting is superior because it provides more information.
 - c. Accrual accounting records only receivables, payables, and depreciation.
 - d. All the above are true.
2. The revenue principle says
 - a. Measure revenues and expenses in order to compute net income
 - b. Divide time into annual periods to measure revenue properly
 - c. Record revenue only after you have earned it
 - d. Record revenue after you receive cash
3. Adjusting the accounts is the process of
 - a. Recording transactions as they occur during the period
 - b. Zeroing out account balances to prepare for the next period
 - c. Subtracting expenses from revenues to measure net income
 - d. Updating the accounts at the end of the period

4. Which types of adjusting entries are natural opposites?
 - a. Expenses and revenues
 - b. Net income and net loss
 - c. Prepaids and depreciation
 - d. Prepaids and accruals
5. Assume that the weekly payroll of Off the Runway Boutique is \$390. December 31, end of the year, falls on Monday, and Off the Runway will pay its employee on Friday for the full week. What adjusting entry will Off the Runway make on Monday, December 31? (Use five days as a full work week.)
 - a.

Salary payable	390	
Salary expense		390
 - b.

Salary expense	78	
Salary payable		78
 - c.

Salary expense	312	
Cash		312
 - d. No adjustment is needed because the company will pay the payroll on Friday.
6. Hercules Workout World gains a client who prepays \$630 for a package of six physical training sessions. Hercules Workout World collects the \$630 in advance and will provide the training later. After two training sessions, what should Hercules Workout World report on its income statement?
 - a. Unearned service revenue of \$210
 - b. Service revenue of \$210
 - c. Cash of \$420
 - d. Service revenue of \$630
7. Assume you prepay Hercules Workout World for a package of six physical training sessions. Which type of account should you have in your records?
 - a. Prepaid expense
 - b. Accrued expense
 - c. Accrued revenue
 - d. Unearned revenue
8. Unearned revenue is always a(an)
 - a. Asset
 - b. Liability
 - c. Revenue
 - d. Owner's equity because you collected the cash in advance
9. The adjusted trial balance shows
 - a. Amounts ready for the financial statements
 - b. Amounts that may be out of balance
 - c. Assets, liabilities, and owner's equity only
 - d. Revenues and expenses only

10. Accounting data flow from the
 - a. Balance sheet to the income statement
 - b. Statement of owner's equity to the balance sheet
 - c. Income statement to the statement of owner's equity
 - d. Both b and c are correct

Answers are given after Apply Your Knowledge (p. 189).

Assess Your Progress

■ Short Exercises

S3-1 (L.OBJ. 1) Comparing accrual and cash basis accounting [5 min]

Suppose you work summers house-sitting for people while they are away on vacation. Most of your customers pay you immediately after you finish a job. A few ask you to send them a bill. It is now June 30 and you have collected \$600 from cash-paying customers. Your remaining customers owe you \$1,400.

Requirements

1. How much service revenue would you have under the
 - a. cash basis?
 - b. accrual basis?
2. Which method of accounting provides more information about your house-sitting business?

S3-2 (L.OBJ. 1) Comparing accrual and cash basis accounting [5 min]

The Michelle Cook Law Firm uses a client database. Suppose Michelle Cook paid \$5,000 for a computer.

Requirements

1. Describe how the business should account for the \$5,000 expenditure under
 - a. the cash basis.
 - b. the accrual basis.
2. State why the accrual basis is more realistic for this situation.

S3-3 (L.OBJ. 2) Applying the revenue principle [5 min]

Arizona Magazine sells annual subscriptions for the 12 monthly magazines mailed out each year. The company collects cash in advance and then mails out the magazines to subscribers each month.

Requirement

1. Apply the revenue principle to determine
 - a. when *Arizona Magazine* should record revenue for this situation.
 - b. the amount of revenue *Arizona Magazine* should record for the magazines mailed out January through March.

S3-4 (L.OBJ. 2) Applying the matching principle [5 min]

Suppose on January 1 you prepaid apartment rent of \$4,200 for the full year.

Requirement

1. At September 30, what are your two account balances for this situation?

S3-5 (L.OBJ. 3) Identifying types of adjusting entries [5 min]

On April 1 your company prepaid six months of rent, \$4,800.

Requirement

1. What type of adjusting entry is this?

Note: Short Exercise 3-6 should be used only after completing Short Exercise 3-5.

S3-6 (L.OBJ. 4) Journalizing adjusting entries [5 min]

Consider the facts presented in Short Exercise 3-5.

Requirements

1. Prepare the journal entry for the April 1 payment.
2. Prepare the adjusting entry required at April 30.
3. Post to the two accounts involved and show their balances at April 30.

S3-7 (L.OBJ. 4) Posting adjusting entries [5 min]

On December 1 your company paid cash of \$51,300 for computers that are expected to remain useful for four years. At the end of four years, the value of the computers is expected to be zero, so depreciation is \$12,825 per year.

Requirements

1. Post the purchase of December 1 and the depreciation on December 31 to T-accounts for the following accounts: Computer equipment, Accumulated depreciation-Computer equipment, and Depreciation expense-Computer equipment. Show their balances at December 31. (Assume that the journal entries have been completed.)
2. What is the computer equipment's book value on December 31?

S3-8 (L.OBJ. 4) Accruing interest expense and posting to T-accounts [10 min]

Harris Travel borrowed \$48,000 on September 1, 2011, by signing a one-year note payable to Street One Bank. Harris interest expense for the remainder of the fiscal year (September through November) is \$888.

Requirements

1. Make the adjusting entry to accrue interest expense at November 30, 2011. Date the entry and include its explanation.
2. Post to the T-accounts of the two accounts affected by the adjustment.

S3-9 (L.OBJ. 4) Accounting for unearned revenues [5–10 min]

Modern Magazine collects cash from subscribers in advance and then mails the magazines to subscribers over a one-year period.

Requirements

1. Journalize the entry to record the original receipt of \$100,000 cash.
2. Journalize the adjusting entry that *Modern Magazine* makes to record the earning of \$5,000 of subscription revenue that was collected in advance. Include an explanation for the entry.

S3-10 (L.OBJ. 5) Preparing an adjusted trial balance [10 min]

A Cut Above Hair Stylists has begun the preparation of its adjusted trial balance as follows:

A CUT ABOVE HAIR STYLISTS Preparation of Adjusted Trial Balance December 31, 2010						
Account	Trial Balance		Adjustments		Adjusted Trial Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	600					
Supplies	800					
Equipment	16,200					
Accumulated depreciation		1,100				
Accounts payable		500				
Interest payable						
Note payable		2,900				
Tim Adams, Capital		5,300				
Service revenue		13,000				
Rent expense	4,800					
Supplies expense						
Depreciation expense						
Interest expense	400					
Total	22,800	22,800				

Year-end data includes the following:

- Supplies on hand, \$200
- Depreciation, \$1,100
- Accrued interest expense, \$400

Requirement

- Complete A Cut Above's adjusted trial balance. Key each adjustment by letter.

Note: Short Exercise 3-11 and 3-12 should be used only after completing Short Exercise 3-10.

S3-11 (L.OBJ. 6) Preparing an income statement [10–15 min]

Refer to the data in Short Exercise 3-10.

Requirement

- Compute A Cut Above's net income for the year ended December 31, 2010.

S3-12 (L.OBJ. 6) Preparing a balance sheet [5 min]

Refer to the data in Short Exercise 3-10.

Requirement

- Compute A Cut Above's total assets at December 31, 2010.