Introduction to Business Accounting

Chapter 7 - Adjusting Entries

WORKBOOK

Slide 1

Adjusting Entries – Prepaid Expenses

Situation: You have created an Unadjusted Trial Balance for the period ending March 31, 2015. You know that Maintenance Supplies have been used during the month. You complete an inventory (count) of the supplies which reveals that there is currently $275 remaining.

You calculate the amount used by subtracting the ending balance from the balance at the beginning of the period:

Maintenance supplies available during March	$700
Maintenance supplies value on March 31	($275)
Supplies used during March (which is the adjustment amount required)	$425

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Adjusting Entries – Prepaid Expenses

The adjusting journal entry would be as follows:

XYZ Journal – Page 11					
Date		Description	Post. Ref.	Debit	Credit
March	31	Maintenance Supplies Expense Maintenance Supplies Maintenance supplies used in March.	88 14	425	 425

Accounting Equation Impact

Assets		=	Liabilities	+	Owner's Equity	
Maintenance Supplies					Maintenance Supplies Expense	
Balance 700					Balance 0	
	March 31 425				March 31 425	
Adj. Bal. 275					Adj. Bal. 425	

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Adjusting Entries – Prepaid Expenses

Account Ending Balance After Adjustment

XYZ Maintenance Supplies - 14							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Opening Balance				700	
		Month Closing Balance				700	
March	31	Adjusting Entry	11		425		425
		Adjusted Closing Balance				275	

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Adjusting Entries – Prepaid Expenses

Account Ending Balance After Adjustment

XYZ Maintenance Supplies Expense - 88							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Opening Balance				0	
		Month Closing Balance				0	
March	31	Adjusting Entry	11	425		425	
		Adjusted Closing Balance				425	

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Impact of Adjusting Entries

The impact of not adjusting maintenance supplies is as follows:

- Expenses are understated by $475
- Assets, Net Income and Owner's Equity are overstated by $475

Income Statement	Amount of Misstatement
Revenues correctly stated	$X,XXX
Expenses understated by	(475)
Net income overstated by	475

Balance Sheet	Amount of Misstatement
Assets overstated by	$475
Liabilities correctly stated	$X,XXX
Owner's equity overstated by	475
Total liabilities and owner's equity overstated by	475

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Adjusting Entries – Unearned Revenues

Situation: You have created an Unadjusted Trial Balance for the period ending March 31, 2015. Your tenant is required to pay 3 months rent in advance every quarter. To you this is Unearned Rent but will become Rental Income each month as earned. Your first rental payment of $30,000 is received on March 1. At the end of March you have earned one months rent.

- Your worksheet shows the following:

Unearned Rent prepayed by tenant on March 1	$30,000
Amount of rent earned on March 31 (the adjustment amount required)	$10,000

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Adjusting Entries – Unearned Revenues

The entry to record the original prepayment for three months rent.

XYZ Journal – Page 2					
Date		Description	Post. Ref.	Debit	Credit
March	1	Cash Unearned Rent Prepaid (3 months) building rent paid.	14 44	30,000	 30,000

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Adjusting Entries – Unearned Revenues

The adjusting journal entry would be as follows:

XYZ Journal – Page 11					
Date		Description	Post. Ref.	Debit	Credit
March	31	Unearned Rent Rent Revenue Collected building rent for March.	44 72	10,000	 10,000

Accounting System Impact

Assets	=	Liabilities	+	Owner's Equity
		Unearned Rent		Rent Revenue
		Balance 30,000		Balance 0
		March 31 10,000		March 31 / March 31 10,000
		Adj. Bal. 20,000		

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Adjusting Entries – Unearned Revenues

Account Ending Balance After Adjustment

XYZ Unearned Rent - 44							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Opening Balance					0
March	1		2		30,000		30,000
		Month Closing Balance					30,000
March	31	Adjusting Entry	11	10,000			20,000
		Adjusted Closing Balance					20,000

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Adjusting Entries – Unearned Revenues

Account Ending Balance After Adjustment

XYZ Rent Revenue - 72							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Opening Balance					0
		Month Closing Balance					0
March	31	Adjusting Entry	11		10,000		10,000
		Adjusted Closing Balance					10,000

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Adjusting Process – Affected Accounts

Failure to record the one month's earned rental revenue would result in:

Revenues and Owner's Equity would be understated by $10,000
Liabilities would be overstated by $10,000

Income Statement	Amount of Misstatement
Revenues understated by	($10,000)
Expenses correctly stated	$XXX
Net income understated by	($10,000)

Balance Sheet	Amount of Misstatement
Assets correctly stated	$XXX
Liabilities overstated by	$10,000
Owner's equity understated by	($10,000)
Total liabilities and owner's correctly stated	$XXX

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Adjusting Entries – Accrued Revenues

Situation: XYZ provides landscaping services to clients but does not bill until the work is 100% complete. As of March 31, you have completed half the job and earned $8,000 of services, which will be billed on April 2.

Your worksheet shows the following:

Total services performed for clients in March	$8,000
Total services already billed in March	$10,000

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Journal Entry– Accrued Revenues

The adjusting journal entry would be as follows:

XYZ Journal – Page 11					
Date		Description	Post. Ref.	Debit	Credit
March	31	Accounts Receivable Fees Earned Accrued fees for March.	12 70	8,000	 8,000

Accounting System Impact

Assets		=	Liabilities		+	Owner's Equity	
Accounts Receivable						Fees Earned	
Balance 0							Balance 10,000
March 31 8,000							March 31 8,000
Adj. Bal. 8,000							Adj. Bal. 18,000

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Posting Accounts – Accrued Revenues

XYZ Accounts Receivable - 12							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Month Closing Balance				0	
March	31	Adjusting Entry	11	8,000		8,000	
		Adjusted Closing Balance				8,000	

XYZ Fees Earned Account - 70							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
March	17		6		10,000		10,000
		Monthly Closing Balance					10,000
March	31	Adjusting Entry	11		8,000		18,000
		Adjusted Closing Balance					18,000

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Adjusting Entries – Accrued Revenues

The impact on financial statements of not accruing the revenue is as follows:

Revenues, Net Income, Owner's Equity and Assets would all be understated by $8,000.

Income Statement	Amount of Misstatement
Revenues understated by	($8,000)
Expenses correctly stated	$XXX
Net income understated by	($8,000)

Balance Sheet	Amount of Misstatement
Assets understated by	($8,000)
Liabilities correctly stated	$XXX
Owner's equity understated by	($8,000)
Total liabilities and owner's understated by	($8,000)

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Adjusting Entries – Accrued Expenses

Situation: XYZ pays wages monthly on the 1st day of each month. On March 31, it owes employees wages for the month of March.

Your worksheet shows the following:

Wages earned by March 31	$13,250
Wages paid for March	$0

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Journal Entry– Accrued Expenses

The adjusting journal entry would be as follows:

XYZ Journal – Page 11					
Date		Description	Post. Ref.	Debit	Credit
March	31	Wages Expense Wages Payable Accrued wages for March.	80 40	13,250	 13,250

Accounting System Impact

(of the above transaction)

Assets		=	Liabilities		+	Owner's Equity	
			Wages Payable			Wages Expense	
				Balance 0		Balance 24,500	
				March 31 13,250		March 31 13,250	
						Adj. Bal. 37,750	

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Posting Accounts– Accrued Expenses

Account Ending Balance After Adjustment

XYZ Wages Expense- 80							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Month Closing Balance				24,500	
March	31	Adjusting Entry	11	13,250		13,250	
		Adjusted Closing Balance				37,750	

The 24,500 shown above is from the payment for wages made on February and March 1 for wages accrued in the prior months.

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Posting Entries – Accrued Expenses

Account Ending Balance After Adjustment

XYZ Wages Payable- 42							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
March	1	Reversing Entry	2	14,500			0
		Monthly Closing Balance					0
March	31	Adjusting Entry	11		13,250		13,250
		Adjusted Closing Balance					13,250

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Adjusting Entries – Accrued Expenses

The impact on financial statements of not accruing wage expense is as follows:

Expenses and Liabilities are understated by $13,250, while Net Income and Owner's Equity would be overstated by $13,250.

Income Statement	Amount of Misstatement
Revenues correctly stated	$XXX
Expenses understated by	($13,250)
Net income overstated by	$13,250

Balance Sheet	Amount of Misstatement
Assets correctly stated	$XXX
Liabilities understated by	($13,250)
Owner's equity overstated by	$13,250
Total liabilities and owner's correctly stated	$XXX

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Adjusting Entries – Depreciation Expense

When making an adjusting entry to a Fixed Asset, the Fixed Asset account is not credited (decreased). Instead, we use a Contra-Asset account to reduce the value of the asset.

We do this because it is better information for investors and creditors to see how much of an asset has been used up when both are the asset and depreciation are reported on the Balance Sheet.

Example:

Computers	*$10,000*
Less Accumulated Depreciation	*($9,500)*
Net Asset Value	*$500*

From the above information, a creditor can see that the company will likely need to buy new computers soon. This will have an impact on whether they want to lend money to the company.

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Adjusting Entries – Depreciation Expense

Depreciation expense is recorded on the Income Statement but a Contra-Asset account entitled Accumulated Depreciation is credited (increased) on the balance sheet.

Situation: XYZ uses a straight line depreciation to determine that the building it purchased 5 months ago and rents to others depreciates at the rate of $1,000 per month.

Your worksheet shows the following:

Value of building on March 31	$80,000
Depreciation for March	$1.000

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Journal Entry – Depreciation Expense

The adjusting journal entry would be as follows:

XYZ Journal – Page 11					
Date		Description	Post. Ref.	Debit	Credit
March	31	Depreciation Expense Accumulated Depreciation – Rental Building Depreciation on Rental Building in March.	84 19	1 000	 1 000

Accounting System Impact

Assets		=	Liabilities		+	Owner's Equity	
Accumulated Depr. - Buildings						Depreciation Expense	
	March 31 1,000					March 31 1,000	
	Adj. Bal. 1,000					Adj. Bal. 1,000	

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Posting Accounts – Depreciation Expense

XYZ Depreciation Expense - 84							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Month Closing Balance				2,000	
March	31	Adjusting Entry	11	1,000		1,000	
		Adjusted Closing Balance				3,000	

XYZ Accumulated Depreciation – Buildings - 19							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Monthly Closing Balance					5,000
March	31	Adjusting Entry	11		1,000		1,000
		Adjusted Closing Balance					6,000

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Posting Accounts– Depreciation Expense

The Buildings ending balance remains unchanged after adjustment.

XYZ Buildings - 18							
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
		Monthly Closing Balance				80,000	

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Book Value of a Fixed Asset

Book Value of an asset is the difference between the original cost of the asset and the balance of the associated contra account (Accumulated Depreciation).

The following shows the book value calculation of the rental building.

Book Value of Building = Cost – Accumulated Depreciation

Book Value of Building = $80,000 - $6,000

Book Value of Building = $74,000

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Adjusting Entries – Depreciation Expense

The impact on financial statements of not accruing wage expense is as follows:

Expenses are understated by $1,000, while Net Income, Assets and Owner's Equity would be overstated by $1,000.

Income Statement	Amount of Misstatement
Revenues correctly stated	$XXX
Expenses understated by	($1,000)
Net income overstated by	$1,000

Balance Sheet	Amount of Misstatement
Assets overstated by	$1,000
Liabilities correctly stated	$XXX
Owner's equity overstated by	$1,000
Total liabilities and owner's overstated by	$1,000

Questions and Answers

Review Questions:

1. True or False: Adjusting entries ensure that all revenues earned and applicable expenses are recorded each month.
    A. True
    B. False

2. True or False: Depreciation expense is a contra-asset account that offsets the original value of an asset on the balance sheet.
    A. True
    B. False

3. If Accrued Revenue is not recorded, what is the impact to the financial statements?
    A. Net Income is understated
    B. Assets are understated
    C. Owner's equity is understated
    D. All of the above

4. What is the effect on the financial statements if prepaid subscription expense is not adjusted?
    A. Net Income is overstated
    B. Revenue is understated
    C. Owner's equity is understated
    D. None of the above

5. True or False: Unearned revenue is adjusted by debiting the Unearned Rent account and crediting Rental Revenue.
    A. True
    B. False

Answer Key:

1. A
   True. Adjusting entries ensure that all revenues earned and applicable expenses are recorded each month.

2. B
   False. Accumulated Depreciation is a contra-asset account that offsets the original value of an asset on the balance sheet.

3. D
   If Accrued Revenue is not recorded, then Net Income, assets, and owner's equity are all understated.

4. A
   Net Income is overstated, expenses are understated, assets are overstated and equity is overstated.

5. A
   True. Unearned revenue is adjusted by debiting the Unearned Rent account and crediting Rental Revenue.