HOW TO ADJUST ACCOUNTS

In analysing adjustments at the end of the period, there are three steps:

Step 1 **Ask: Was revenue earned or an expense incurred that is not yet recorded?** If the answer is YES, credit the revenue account or debit the expense account in the adjusting entry.

Step 2 **Ask: Was the related cash received or paid in the past or will it be received or paid in the future?**

If cash **was received** in the past (creating a deferred revenue [liability] account in the past) → Reduce the liability account (usually Unearned Revenue) that was recorded when cash was received because some or all of the liability has been earned since then. If cash **will be received** in the future → Increase the receivable account (such as Interest Receivable or Rent Receivable) to record what is owed by others to the company (creates an accrued revenue).

If cash **was paid** in the past (creating a prepaid expense account [asset] in the past) → Reduce the asset account (such as Supplies or Prepaid Expenses) that was recorded in the past because some or the entire asset has been used since then.

If cash **will be paid** in the future → Increase the payable account (such as Interest Payable or Wages Payable) to record what is owed by the company to others (creates an accrued expense).

Step 3 **Compute the amount of revenue earned or expense incurred.** Sometimes the amount is given or known, sometimes it must be computed, and sometimes it must be estimated.

COMPREHENSIVE REVIEW QUESTIONS

**Question One**

The trial balance for Terrific Lawn on April 30, 2010, based on the unadjusted balances is as follows:

|  |  |  |
| --- | --- | --- |
|  | DR | CR |
| Cash | 5032 |  |
| Accounts Receivable | 1700 |  |
| Notes Receivable | 0 |  |
| Prepaid Expenses | 300 |  |
| Equipment | 4600 |  |
| Accumulated Depreciation |  | 0 |
| Land | 3750 |  |
| Accounts Payable |  | 220 |
| Wages Payable |  | 0 |
| Utilities Payable |  | 0 |
| Notes Payable |  | 3700 |
| Interest Payable |  | 0 |
| Income Tax Payable |  | 0 |
| Unearned Revenue |  | 1600 |
| Contributed Capital |  | 9000 |
| Retained Earnings |  | 0 |
| Mowing Revenue |  | 5200 |
| Interest revenue |  | 12 |
| Wages Expense | 3900 |  |
| Fuel Expense | 410 |  |
| Insurance Expense | 0 |  |
| Utilities Expense | 0 |  |
| Depreciation Expense | 0 |  |
| Interest Expense | 40 |  |
| Income Tax Expense | 0 |  |
|  | **19,732** | **19,732** |

Additional information follows:

a. One-fourth of the Ksh.1,600 cash received from the city at the beginning of April for future mowing service has been earned in April. The Ksh.1,600 in Unearned Revenues represents four months of service (April through July).

b. Insurance costing Ksh.300 providing coverage for six months (April through September) paid by Terrific Lawn at the beginning of April has been partially used in April.

c. Mowers, edgers, rakes, and hand tools (equipment) have been used in April to generate revenues. The company estimates Ksh.300 in depreciation each year.

d. Wages have been paid through April 28. Employees worked the last two days of April and will be paid in May. Wages accrue at Ksh.200 per day.

e. An extra telephone line was installed in April at an estimated cost of Ksh.52, including hook-up and usage charges. The bill will be received and paid in May.

f. Interest accrues on the outstanding notes payable at an annual rate of 12 percent. The Ksh.3,700 in principal has been outstanding all month.

g. The estimated income tax rate for Terrific Lawn is 35 percent.

**Required:**

1. Using the three-step process outlined in this chapter, (1) determine if a revenue was earned or an expense incurred that needs to be recorded for the period, (2) determine whether cash was or will be received or paid, and (3) compute the amount. Prepare the adjusting journal entries for April.

2. Prepare an adjusted trial balance.

3. Prepare an income statement, statement of stockholders’ equity, and balance sheet from the amounts in the adjusted trial balance. Include earnings per share on the income statement. The company issued 1,500 shares.

4. Prepare the closing entry for April 30, 2010.

**Question two**

Compute the company’s net profit margin for the month.

Ellis, Inc., a small service company, keeps its records without the help of an accountant. After much effort, an outside accountant prepared the following unadjusted trial balance as of the end of the annual accounting period, December 31, 2012:

|  |  |  |
| --- | --- | --- |
|  | DR | CR |
| Cash | 46000 |  |
| Accounts Receivable | 10400 |  |
| Supplies | 640 |  |
| Prepaid Insurance | 800 |  |
| Service Trucks | 16000 |  |
| Accumulated Deppreciation |  | 9600 |
| Other Assets | 8960 |  |
| Account Payable |  | 2400 |
| Wages payable |  |  |
| Income Taxes Payable |  |  |
| Note Payable (3 years, 10% interest due each December 31) |  | 16000 |
| Contributed Capital (5000 shares outstanding) |  | 20560 |
| Retained Earnings |  | 6000 |
| Service Revenue |  | 61600 |
| Remaining Expenses (Excludes income tax) | 33360 |  |
| Income tax expense |  |  |
|  | 116,160 | 116,160 |

Data not yet recorded at December 31, 2011, included:

a. The supplies count on December 31, 2011, reflected Ksh.240 remaining supplies on hand to be used in 2012.

b. Insurance expired during 2011, Ksh.400.

c. Depreciation expense for 2011, Ksh.4,200.

d. Wages earned by employees not yet paid on December 31, 2011, Ksh.720.

e. Income tax expense, Ksh.5,880.

Required:

1. Record the 2011 adjusting entries.

2. Prepare an income statement and a classified balance sheet that include the effects of the preceding five transactions.