Sydney Institute of Business and Technology

ACTG100 Accounting A

Student Workbook Answers

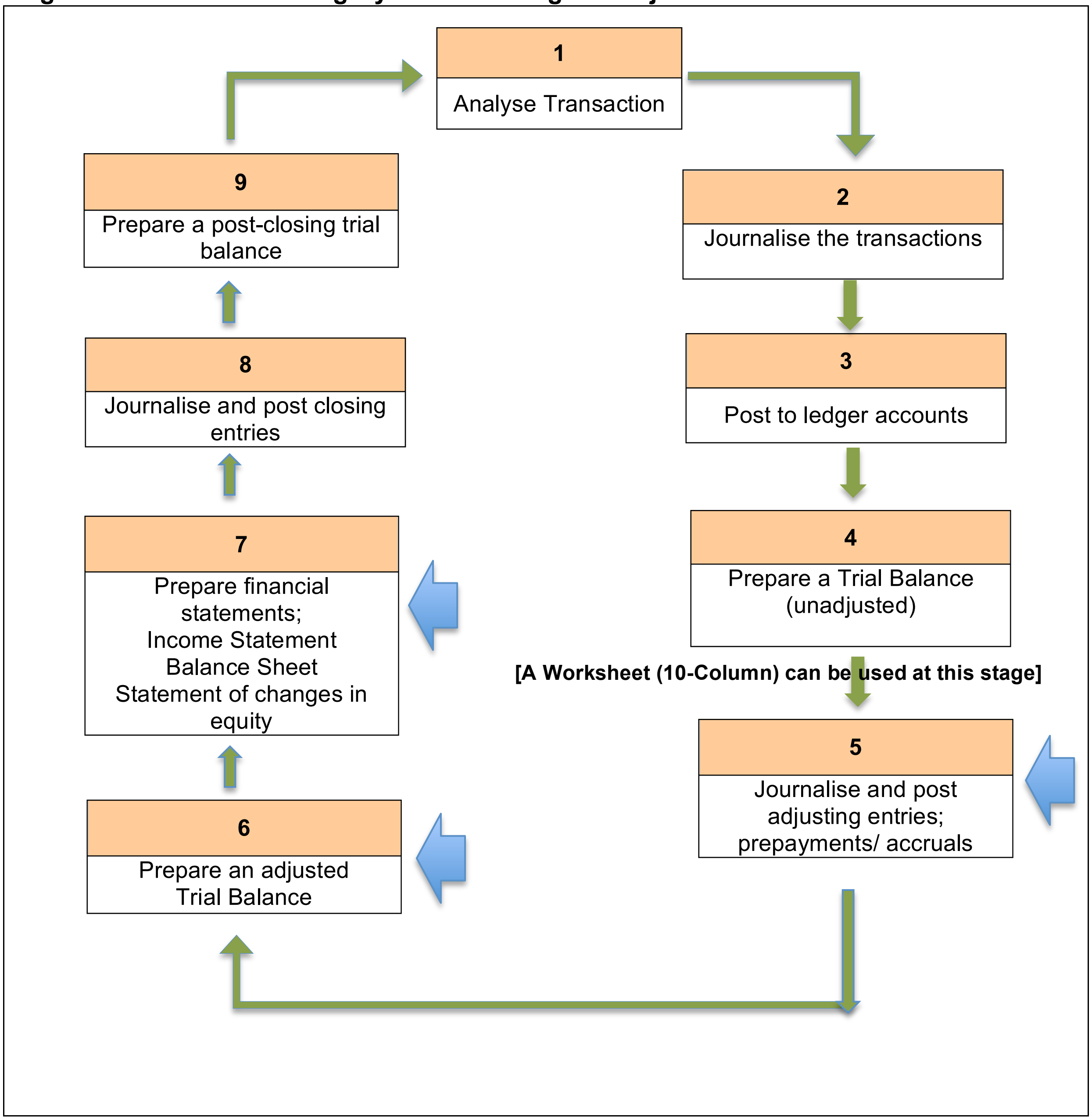
Lecture and Tutorial

Week 5: Adjustments (Part 2) Completing the Accounting Cycle

Updated March 2016

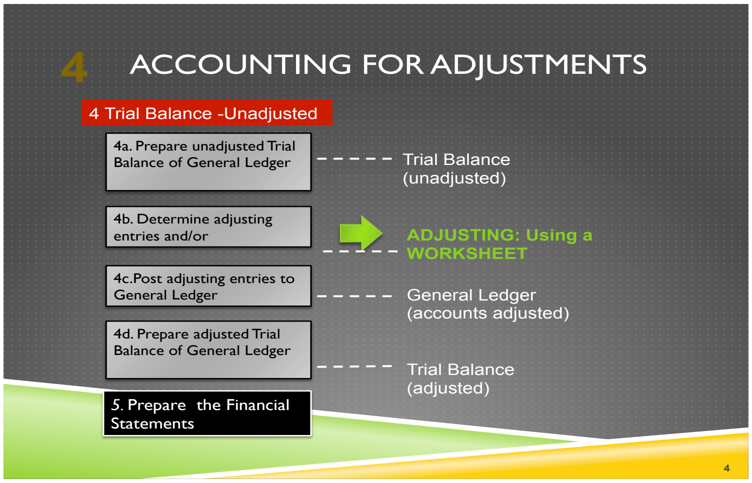
The Accounting Cycle: Learning about the Adjustment Process

Figure 5.0: The Accounting Cycle Illustrating the Adjustment Process



Symbols & Legends	Details
	Steps 5, 6 & 7: The process of Adjusting Entries comes after preparing the unadjusted Trial Balance

ACTG 100 Lecture Week 5: Adjusting Entries Revisited



Adjusting entries can be classified as either prepayments or accruals:

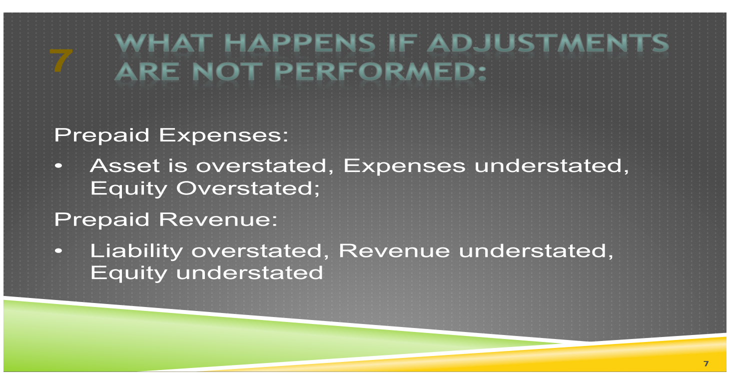
Prepayments

1. Prepaid expenses: amounts paid in cash and recorded as assets until the economic benefits are used or consumed. It will then be expensed.
2. Prepaid Revenue: Cash advance received from customers. A liability is also recorded until the services are performed or the goods provided. It will then be recorded as income earned.

Accruals

1. Accrued revenues: amounts not yet received and not yet recorded for which the goods or services have been provided. It will be recorded as income earned but not received.
2. Accrued expenses: amounts not yet paid and not yet recorded for which the consumption of economic benefit has occurred. It will be recorded as an expense that has not been paid.

Effects on the Financial Statement items if adjusting is not done:



Prepayments

In order to record **all** income and expenses in the correct[1] accounting period, adjusting entries are made at the end of the accounting period. They record the **portion** of the prepayments that represents an *expense* (income) for the current accounting year. ***Failure*** to adjust for the prepayment would lead to an overstatement of the *asset* (liability) and a related understatement of the *expense* (revenue). To illustrate what happens:

Effects on Financial Statements if adjusting entries are not performed: Prepayments

- Prepaid Expenses: Asset is overstated, Expenses understated, Equity Overstated
- Prepaid Revenue: Liability overstated, Revenue understated, Equity understated

Exercise 5.0	**Failure to adjust for a Prepaid Expense**

Prepaid Expenses:

Prepaid Insurance for 1-year purchased on 1st Jan (recorded as an asset with 12months of future economic benefit) has expired over Jan, Feb, Mar, Apr, May Jun and must now be expensed on balance date 30 Jun 2016:

Problem: Failure to adjust a prepaid expense will cause the financial statement to be:

Before adjustment

Asset overstated (B/S)
Expense understated (I/S)

A = L + E

Asset =	Liabilities +	Equity
Overstated		Overstated (as expense is understated)

Before adjustment	**Adjusting journal**	**Accruals Matching Principle (after adjustment)**
Prepaid expense has expired :	**Dr Expense**	To correct the understatement
	Cr Prepaid Expense	To correct the overstatement

[1] Income in the accounting period when earned, matched by expenses incurred in the same accounting period as the income recorded.

Prepaid Expenses: depreciation (STUDENTS HAVE THE ANSWERS)

As time passes, fixed assets other than land lose their capacity to provide useful services. To account for this decrease in usefulness, the cost of fixed assets is systematically allocated to expense through a process called depreciation.

<table>
<tr><td colspan="3">Building (a long lived asset with future economic benefit) is adjusted for depreciation expense on balance date to record the portion of expired economic benefit.</td></tr>
<tr><td colspan="3">Problem: Failure to adjust depreciation for a non-current asset

<u>Before adjustment</u> :

Asset overstated (B/S)
Expense understated (I/S)

A = L + E
<table><tr><td>Asset =</td><td>Liabilities +</td><td>Equity</td></tr><tr><td>Overstated</td><td></td><td>Overstated (as expense is understated)</td></tr></table></td></tr>
<tr><td>Before adjustment</td><td>Adjusting journal</td><td>Accruals Matching Principle (after adjustment)</td></tr>
<tr><td>Asset has decreased in usefulness :</td><td>Dr Depreciation Expense
Cr Accum Depreciation
(contra asset account)</td><td>To correct the <u>understatement</u>

To correct the asset <u>*overstatement</u></td></tr>
</table>

* accumulated depreciation is a contra-asset account. With the passage of time this results in the non-current asset having a carrying cost lower that the original cost of purchase.

Exercise 5.1	**Failure to adjust for a Prepaid Revenue**

Prepaid Revenue:

<table>
<tr><td>Received cash payment in advance for a promise to provide services in the future (liability until services is provided). Example: Adele was paid $6,000 in April to provide design services for the 3 months covering Apr, May & June. In Apr the journal entry was:

Dr Cash at Bank (A+) $6,000

Cr Unearned Revenue (L+) $6,000

On balance date 30 June 2016, all three months design is recognised as Services Revenue. The liability Unearned Revenue will need to be adjusted.</td></tr>
<tr><td>Problem: Failure to adjust an unearned revenue (prepaid revenue)

<u>Before adjustment</u> :

Liabilities overstated (B/S)
Revenue understated (I/S)

Dr A = L + E Cr
<table><tr><td>Asset =</td><td>Liabilities +</td><td>Equity</td></tr><tr><td></td><td>Overstated</td><td>Understated (as income is understated)</td></tr></table></td></tr>
</table>

Before Adjustment		Adjusting journal	Accruals Matching Principle (after adjustment)
Services are now provided/performed	:	**Dr Unearned Revenue** **Cr Service Revenue**	To correct the overstatement To correct the understatement

Caution: Unearned revenue (liability) is adjusted to reduce the amount that is now recognised as Service Revenue (income earned after providing the service or delivering the goods).

This has nothing to do with the payment in cash that was received in advance. That is cash the bank received and recorded earlier (cash at bank is not involved in the balance date adjustment).

Accruals:

Adjusting entries for accruals are required to record revenues and expenses for the accounting period that have **not been recognised** through daily entries. An adjusting entry for accruals will increase account balances in **both** the Balance Sheet and the Income Statement.

Effects on Financial Statements if adjusting entries are not performed: Accruals

- Accrued Expenses: Expenses & Liability understated, Equity overstated
- Accrued Revenue: Asset & Income is understated, Equity understated

Exercise 5.2	Failure to adjust for an Accrued Expense

Accrued Expenses:

Adele has not recorded that she owes (liabilities) wages to her part-time assistant for helping out in the business in the current accounting period (expenses).

Problem: Failure to adjust an accrued expense

Effect on the financial statements if **no** adjustment

A = L + E

Before adjustment

Liabilities understated (B/S)
Expense understated (I/S)

Asset =	Liabilities +	Equity
	Understated	Overstated (as expense is understated)

Before Adjustment		Adjusting journal	Accruals Matching Principle (after adjustment)
Expenses incurred needs to be recorded	:	**Dr Expense** **Cr Payable** **(to accrue for expenses)**	To correct the understatement To correct the understatement

Exercise 5.3	Failure to adjust for an Accrued Revenue

Accrued Revenue:

The Nursery owes Adele (accounts receivable) Commission of 5% of sales revenue (income) to Adele for introducing a client.

Problem: Failure to adjust a accrued revenue

Effect on the financial statements if no adjustment

A = L + E

Before adjustment	:	Asset =	Liabilities +	Equity
Asset understated (B/S) Income understated (I/S)		Understated		Understated (as income is understated)

Before Adjustment		Adjusting journal	Accruals Matching Principle (after adjustment)
Income earned needs to be recorded	:	**Dr Receivable account**	To correct the understatement
		Cr Revenue account	To correct the understatement
		(to accrue for revenue)	

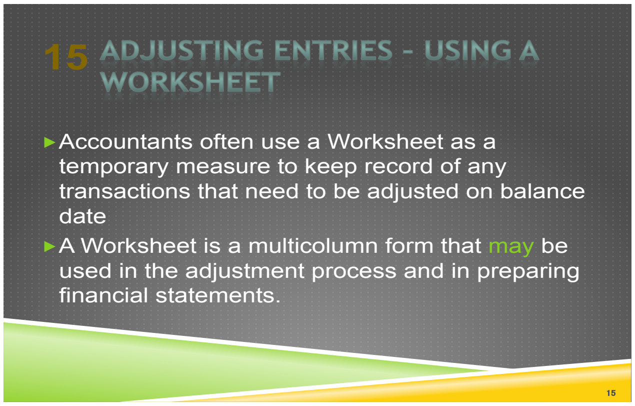
Figure 5.1: Accounting basis and the adjusting process: Balance Date Adjustment

(source: Hongren's 8E[2], p127)

Decision	Guidelines
• Which basis of accounting better measures business income?	Accruals basis, as it provides more complete reports of operating performance and financial position.
• How does a business measure income?	Profit recognition principle – record income only after they are earned.
• How does a business measure expenses?	Matching principle – record expenses in the same time period and activity that relates to the revenue recorded.
• Where does a business start with the measurement of profit at the end of the period?	Unadjusted trial balance.
• How does a business update the trial balance for the financial statements?	Adjusting entries at the end of the period on balance date.
• What are the categories of adjusting entries?	Prepaid expenses Depreciation Accrued expenses Accrued Revenue Unearned Revenue
• How do the adjusting entries *differ* from other journal entries?	1. Adjusting entries are made only at the end of the period on balance date. 2. Adjusting entries never affect the cash account. 3. All adjusting entries debit or credit: • At least one income statement account (a revenue or an expense), and • At least one balance sheet account (an asset or a liability)
• Where are the accounts with their adjusting balances summarised?	Adjusting trial balance for which is used to prepare the financial statements.

[2] Nobles, Mattison, Matsumara, Best, Frazer, Tan, Willett, *Hongren's Financial Accounting, 8E,* Pearson 2014.

The use of a Worksheet during interim reporting.[3]



Accountants often use a Worksheet as a temporary measure to keep record of *many* transactions that need to be adjusted on balance date

The worksheet functions as a *separate* spreadsheet to gather information needed to adjust the accounts, prepare an adjusted trial balance and to prepare financial statements. It is a multicolumn form[4] that *may be used* in the **adjustment process** and in **preparing financial statements.** It is **not** a permanent accounting record: it is neither a journal nor a part of the general ledger.

The worksheet is popular and is especially useful when financial statements are required more often (by management) for internal reporting (e.g. monthly, quarterly or semi-annually) and also to gather all the information required to be journalized on the last day of the financial year (or balance date).

In small businesses that have relatively few accounts and adjustments, a worksheet may not be needed. Worksheets are almost indispensable (cannot do without) in large businesses with numerous accounts and many adjustments.

WORKSHEET USEFULNESS:

- It assembles in one place all the information needed to adjust the accounts and prepare the financial statements;
- It helps in the preparation of interim financial statements for internal use when adjusting and closing entries are not required in the financial statement records;
- It contains the information needed to close off the income and expense accounts (temporary accounts) at the end of the period when completing the Closing Entries.
- The Worksheet does not replace the financial statements; it is simply a tool used to gather and organise the information needed to complete these steps of the accounting cycle.

[3] Source: SIBT Lecture 5 Semester 3 2015.

[4] or a spreadsheet generated under a computer accounting environment

Adjusting Trial Balance[5]

Adjusted Trial Balance:

After adjusting entries are recorded in the general journal, they need to be posted to the ledger accounts so that an ***Adjusted Trial Balance*** can be prepared.

Financial statements are prepared from the adjusted trial balance.

Exercise 5.4	**Adjusting entries, using a Worksheet for adjustments, Statement of Changes in Equity**

Required:

A. Enter the adjustments below into the Worksheet, and complete the worksheet for Asha's Orchids (Ignore GST).

B. Prepare a fully classified Balance Sheet in the narrative format for Asha's Orchids as at 30 June 2016 and a Statement of Changes in Equity for the year ending 30 June 2016.

5 Source: SIBT Lecture 5 Semester 3 2015.

A.

Business Transaction

1. Accrued service revenue $3,600

2. Depreciation on Motor Vehicle $5,000

3. Wages owing to staff but unpaid as at 30 June $2,000

4. Prepaid advertising expired $1,000

5. Supplies on hand at 30 June $2,780. The beginning balance of supplies was $6,780.

6. Cash of $12,000 had been received in advance and was recorded correctly as Unearned Revenue. By 30 June, 50% has been earned.

A. Adjusting Journal Entries on balance date 30 June 2016: **(provided as reference)**

Date	Details	Debit	Credit
30 June	Accounts Receivable	3,600	
[1]	Services Revenue		3,600
	(To accrue services revenue)		
30 June	Depreciation Expense – Motor Vehicle	5,000	
[2]	Accum Depn – Motor Vehicle		5,000
	(To depreciate motor vehicle)		
30 June	Wages Expense	2,000	
[3]	Wages Payable		2,000
	(To accrue wages expense)		
30 June	Advertising Expense	1,000	
[4]	Prepaid Advertising		1,000
	(To adjust for Advertising expense)		
30 June	Supplies Expense	4,000	
[5]	Supplies		4,000
	(To adjust for Supplies consumed)		
30 June	Unearned Revenue	6,000	
[6]	Services Revenue		6,000
	(To adjust for Service Revenue)		

Asha's Orchids - Worksheet										
For the year ended 30 June 2016										
	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
Account Title	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
Cash at Bank	57 420				57 420				57 420	
Accounts receivable	6 880		3 600		10 480				10 480	
GST Outlays	200				200				200	
Prepaid Advertising	2 400			1 000	1 400				1 400	
Supplies	6 780			4 000	2 780				2 780	
Land	50 000				50 000				50 000	
Motor Vehicle	65 200				65 200				65 200	
Accum depreciation – M.V		5 680		5 000		10 680				10 680
Accounts payable		6 200				6 200				6 200
Wages payable		1 000		2 000		3 000				3 000
GST Collections		500				500				500
Unearned revenue		12 000	6 000			6 000				6 000
Mortgage Payable		50 000				50 000				50 000
Asha Capital		110 060				110 060				110 060
Asha, Drawings	6 000				6 000				6 000	
Service revenue		14 600		3 600 6 000		24 200		24 200		
Depreciation expense - MV			5 000		5 000		5 000			
Wages expense	3 200		2 000		5 200		5 200			
Telephone expense	400				400		400			
Advertising expense	600		1 000		1 600		1 600			
Supplies expense	960		4 000		4 960		4 960			
	200 040	200 040	21 600	21 600	210 640	210 640	17 160	24 200	193 480	186 440
NET PROFIT							7 040			7 040
TOTAL							24 200	24 200	193 480	193 480

B. Balance Sheet for Asha's Orchids prepared from a multicolumn Worksheet

Asha's Orchids
Balance Sheet
As at 30 June 2016

Current Assets		
Cash at Bank		$57 420
Accounts receivable		10 480
Supplies		2 780
Prepaid Advertising		1 400
		72 080
Non-Current Assets		
Land		50 000
Motor Vehicle	65 200	
Less: Accumulated depreciation	(10 680)	54 520
		104 520
TOTAL ASSETS		176 600
Current Liabilities		
Accounts payable		6 200
Wages payables		3 000
Unearned revenue		6 000
GST payable		300
		15 500
Non-Current Liabilities		
Mortgage payable		50 000
TOTAL LIABILITIES		65 500
NET ASSETS		111 100
EQUITY		
Asha, Capital		111 100

Exercise 5.4 (con't)	Adjusting entries, using a Worksheet for adjustments, Statement of Changes in Equity

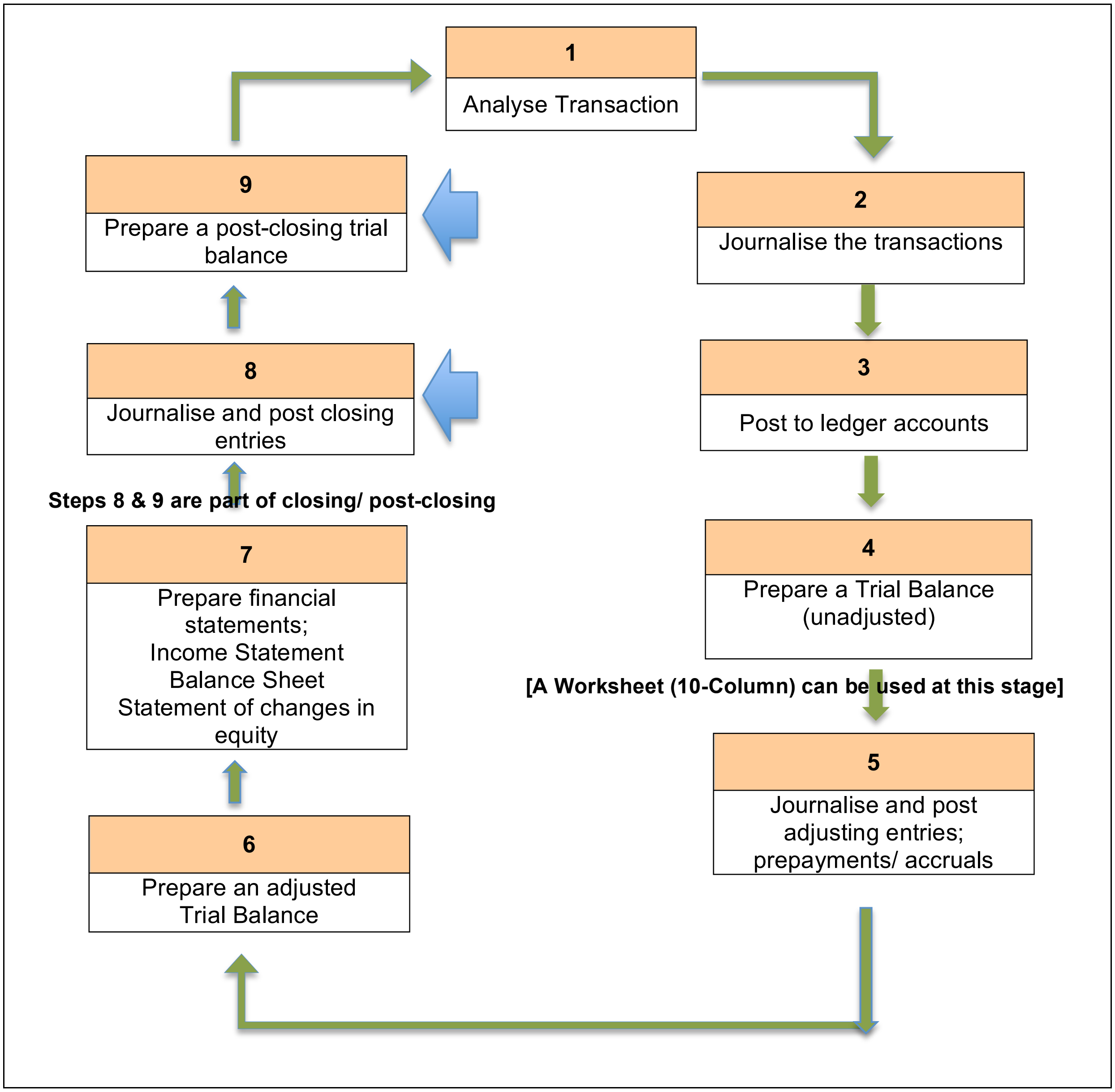
B .

Asha's Orchids
Statement of Changes in Equity
For the year ended 30 June 2016

Asha, Capital – 1 July 2015		**110 060**
Add:	Profit	**7 040**
		117 100
Less:	Drawings	**6 000**
Asha, Capital – 30 June 2016		**111 100**

Closing the Books at the end of the Accounting Cycle

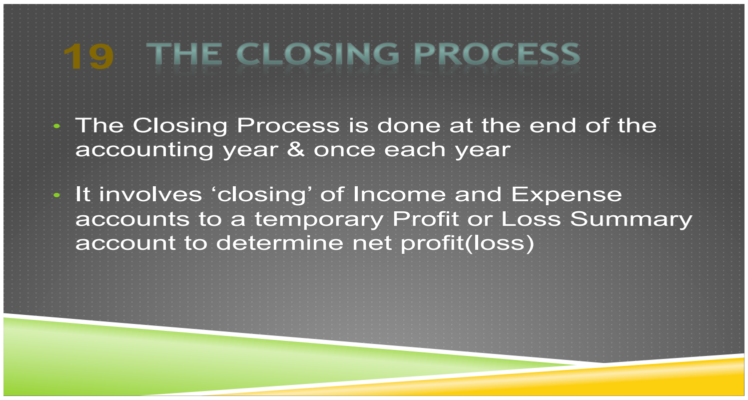
Figure 5.2: Closing/Post closing within the Accounting Cycle



<u>The steps in the accounting cycle is performed in sequence and are repeated in each accounting period:</u>

Steps 1 to 3: may occur daily during the accounting period.
Steps 4 to 7: are performed on a periodic basis, such as monthly, semi-annually (6-monthly) or annually. The Worksheet is used to record events to be *adjusted*.
Steps 8 & 9: closing entries and a post-closing trial balance, are usually only at the end of a business's financial year.

The Closing process



The Accounting Cycle typically lasts for one fiscal year. In Australia, the **fiscal year** or more commonly, "**financial year**" begins on 1 July and ends on 30 June of the following year (e.g. The financial year ended 30 June 2018 is from 1 July 2017 to 30 June 2018).

At the end of each financial year the accounts created for income, expenses and drawings will need to be journalized back to the equity account in order to determine the effect on changes to the equity account (i.e. how well the 1-year performance of the business and drawings has impacted on the owner's overall 'wealth'). This process is known as the **closing** of books.

Remember that the **Income Statement** *(Statement of Financial Performance)* reports income and expenses for a **single** financial year. As income, expenses and drawings relate to only one financial year period, they are considered **temporary** accounts. In contrast all statement of financial position accounts (i.e. Balance Sheet items) are considered permanent accounts because the balance is carried forward into future accounting periods:

Temporary	Permanent
All income accounts	All asset accounts
All expenses accounts	All liability accounts
Drawings	Equity accounts

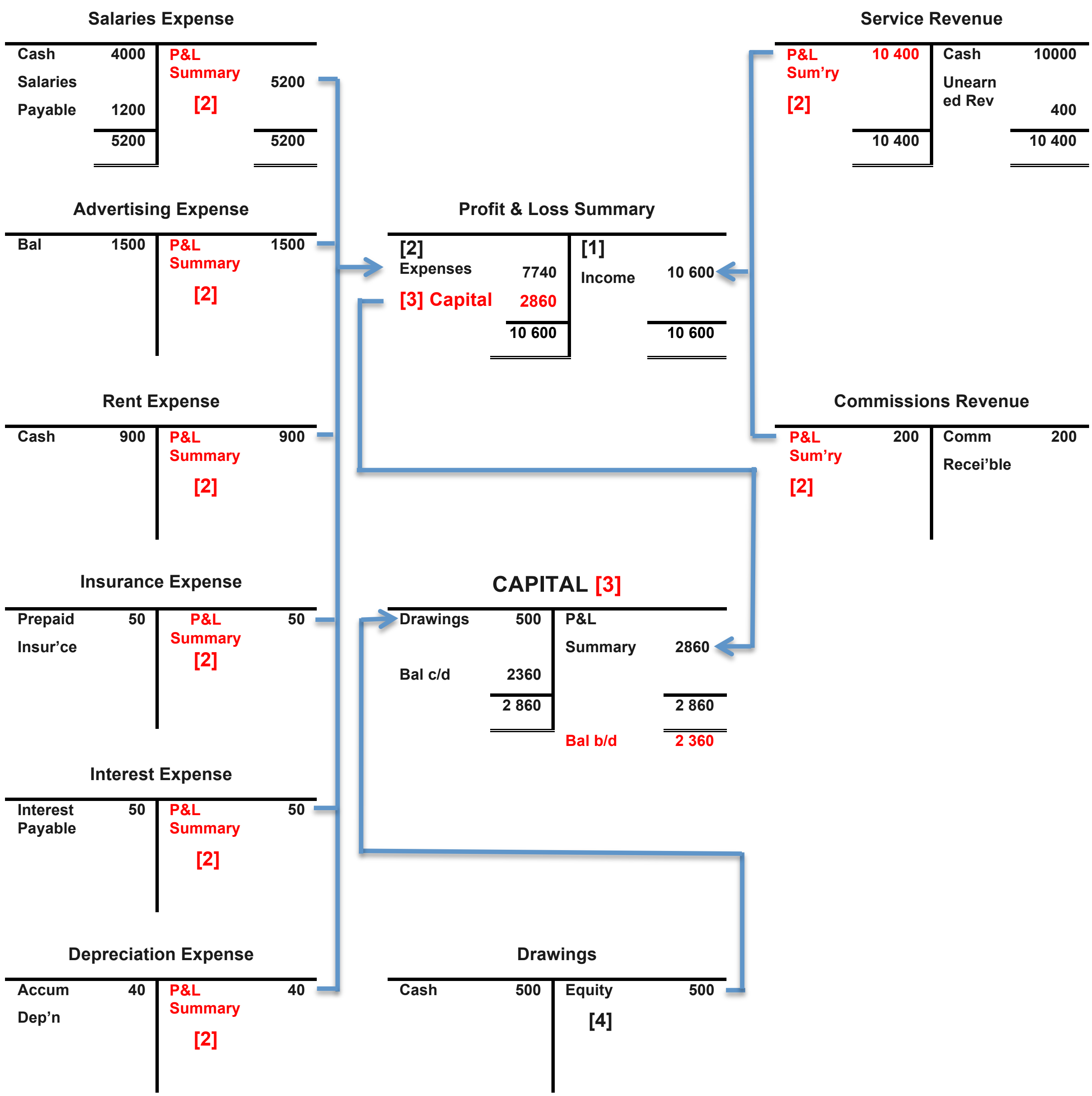
Statement of Financial Performance

Statement of Financial Position

Preparing Closing Entries: Illustration

To prepare for the *next* financial year, all income and expense accounts are 'closed' by transferring their end-of-year balance to a special ***temporary*** account, the *Profit & Loss Summary.* Closing or clearing reduces the balance in each account to ***zero*** and this helps prepare the accounts for the *next* accounting period.

Figure 5.3: Illustrating the Posting of Closing Entries



Closing entries journalized: (follow the trial provided above in Figure 5.2)

	General Journal: Closing entries		
Date	Details	Debit	Credit
30 June	Service Revenue	10 400	
[1]	Commissions Revenue	200	
	P & L Summary		10 600
	(To close income accounts)		
30 June	P & L Summary	7 740	
[2]	Salaries expense		5 200
	Advertising expense		1 500
	Rent expense		900
	Insurance expense		50
	Interest expense		50
	Depreciation expense		40
	(To close expense accounts)		
30 June	P & L Summary	2 860	
[3]	Capital		
	(To close profit/loss to capital)		
30 June	Capital	500	
[4]	Drawings		500
	(To close drawings to Capital)		

Recall that income increases and expense decreases the Equity account. However, these accounts are recorded *separate from* the Balance Sheet (A=L+E). To determine how profit (loss) ***changes equity*** the calculated profit (loss) in the temporary Profit or Loss Summary will be 'closed' and transferred to the Equity (Capital) account. This again uses the 'zero' double-entry system.

"Zero-rizing" an account applies the double-entry debit & credit system. Any account with a debit balance will be 'credited' by the same amount and transferred "out" to the Profit or Loss Summary account. Similarly, an account with a credit balance will be 'debited'. In the closing process, the temporary Profit or Loss Summary is ***used*** to calculate profit (loss) for the financial year. Total income (revenues) is closed to the P&L Summary, total expenses are closed to the P&L Summary, and the balance in the P&L Summary is a Profit or Loss.

Post Closing Trial Balance

After all closing entries are journalized and posted another trial balance called a post-closing trial balance is prepared from the ledger (Step 9). A post-closing trial balance is a list of all ***permanent accounts*** and their balances after closing entries are journalized. The purpose of this trial balance is to prove the sum of the debit balances equals the sum of the credit balances that are carried forward into the next accounting period. A few key points:

- Explain the purpose of closing entries:

  One purpose of closing entries is to transfer the results of operations for the year to the Profit & Loss Summary. Additionally it creates nil (zero) balances in all temporary accounts (income accounts, expense accounts and drawings), ready for the start of the next financial year. To accomplish this, all temporary accounts are closed at the end of the financial year. Separate entries are made to close income and expenses to the P&L Summary. Then the P&L Summary to Equity and, Drawings to Equity. Only the temporary accounts are closed.

- The required steps in the accounting cycle are:

  (a) analyse business transactions,

  (b) journalise the transactions,

  (c) post to ledger accounts,

  (d) prepare an unadjusted trial balance,

  (e) journalise and post adjusting entries,

  (f) prepare an adjusted trial balance,

  (g) prepare financial statements,

  (h) journalise and post closing entries, and

  (i) prepare a post-closing trial balance

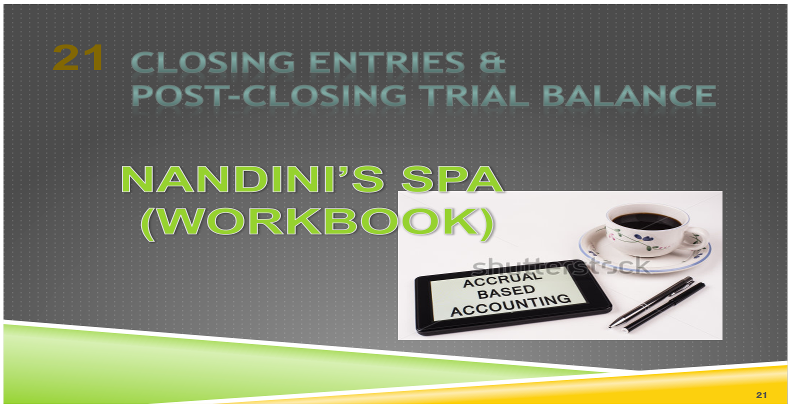
- There are three Trial-Balances created in the Accounting cycle:

  There are three Trial Balances along the Accounting Cycle - the unadjusted trial balance, the adjusted trial balance and the post-closing trial balance. Each have a specific purpose:

  1. Unadjusted Trial Balance provides a preliminary check on the accuracy of the posting process (debits and credits) from the journals to the ledger accounts.
  2. Adjusted Trial Balance prepared only at the end of the accounting period and includes the balances of all general ledger accounts after the adjusting entries have been posted to the accounts.
  3. Post Closing Trial Balance is prepared at the end of the accounting period after all closing entries have been posted to the accounts and the account balances determined.

Exercise 5.5	Nandini's Spa: Post-closing journal, post-closing trial balance and Statement of Changes in Equity

[Sibt Sem 3 2015 Lect 6 p63-65]



CURRENT ASSETS

NON-CURRENT ASSETS

CURRENT LIABILITY

EQUITY

TEMPORARY ACCOUNTS:
Drawings
Income
Expenses

Nandini's SPA Adjusted Trial Balance As at 30 June 2017		
	Debits	**Credits**
Cash at Bank	36,000	
Accounts Receivable	15,400	
Prepaid Rent	3,600	
Furniture	82,400	
Accum. Furniture		18,000
Accounts Payable		26,000
Wages Payable		2,280
Capital		86,800
DRAWINGS	12,000	
Service Revenue		87,000
Advertising expense	22,280	
Rent expense	17,400	
Wages expense	12,800	
Depn expense Furniture	18,000	
	219,880	**219,880**

Summary of the Closing Process:

1. Close income accounts to the P&L Summary account;
2. Close expense accounts to the P&L Summary account;
3. Close the P&L Summary account to the Capital account;
4. Close Drawings account to the Capital account

Required:
Using the adjusted trial balance above, prepare the closing entries for Nandini's Spa, a post-closing balance at 30 June 2017 and a Statement of Changes in Equity.

Exercise 5.5 (con't)	Nandini's Spa: Preparing the Closing Entries

ANSWERS:

Date	Details	Debit	Credit
30 June	Service revenue	87,000	
	P&L Summary		
	(Close revenue account)		
30 June	P&L Summary	70,480	
	Advertising expense		22,280
	Rent expense		17,400
	Wages expense		12,800
	Depreciation exp Furniture		18,000
	(Close expense account)		
30 June	P&L Summary	16,520	
	Capital		16,520
	(Transfer profit to capital account)		
30 June	Capital	12,000	
	Drawings		12,000
	(Close drawings to capital account)		

Exercise 5.5 (con't)	Nandini's Spa: the Post-Closing Trial Balance

[SIBT S3 2015 LECT 6 p65]

Answers

NOTE: Post-Closing has **no** P&L Items + Drawings

Nandini's SPA
Post-Closing Trial Balance
As at 30 June 2017

		Debits	Credits
CURRENT ASSETS	Cash at Bank	36,000	
	Accounts Receivable	15,400	
	Prepaid Rent	3,600	
NON-CURRENT ASSETS	Furniture	82,400	
	Accum Dep'n - Furniture		18,000
CURRENT LIABILITY	Accounts Payable		26,000
	Wages Payable		2,280
EQUITY	Capital***		91,120
		137,400	**137,400**

Exercise 5.3 (con't)	Nandini's Spa: Statement of Changes in Equity

Answers:

Nandini's Spa
Statement of Changes in Equity
For the year ended 30 June 2017

	Capital – 1 July 2016		$86 600
	Add: Profit		**16 520**
			103 120
	Less: Drawings		**12 000**
	Capital – 30 June 2017		$91 120

~~~End of Lecture~~~
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Tutorial

Week 5

HOMEWORK (REVISION WEEK 5) from Textbook HEM

DISCUSSION QUESTION SOLUTIONS

DEFERRALS: are expenses paid in advance (prepayments) or revenues received in advance (unearned revenue). They are referred to as 'Prepayments' in Lectures.

1. *During the year, the publishers of* Fishing for the Family*, a monthly magazine, received cash for a 3-year magazine subscription. A credit was made to the Unearned Subscriptions Revenue account.*

(a) Is the required adjusting entry made at the end of the period an example of accrual or a prepayment (deferral)?

(b) What types of accounts will be affected by the required adjusting entry?

(c) What effect will omission of the adjusting entry have on profit and on the statement of financial position?

Answers:

(a) Prepayments (Deferral)

(b) Unearned Subscriptions Revenue, a liability account, will be debited and Subscriptions Revenue, a revenue account, will be credited in relation to subscriptions for the number of magazines already published.

(c) Profit will be understated as the suitable amount of revenue has not been recognised in an adjusting entry. Liabilities will be overstated, and equity will be understated in the statement of financial position.

EXERCISE SOLUTIONS

Exercise 4.3 Cash versus accrual accounting

1. During March, Thuy Bui's business performed services for a specific customer for which the fee was $9000. Payment was received in the following April.

(a) Was the revenue earned in March or April?
(b) What account should be debited in (i) March and (ii) April?

2. During the month a business received $160 000 in cash and paid out $120 000 in cash. Does this indicate that the business earned $40 000 during the month? Explain.

3. Gorajek Sole Traders purchased a 3-year insurance contract on 1 March. The business debited the entire cost of $12 000 to Insurance Expense. The financial year ends on 30 June. Under the accrual system, what is the correct expense for the current year, and what entry would be made to correct the accounts? Under the cash basis of accounting, what is the correct expense and the correct adjusting entry (if any)?

ANSWERS:

1. (a) The revenue was earned in March

(b) (i) In March:
Debit – Accounts Receivable
Credit – Sales

(ii) In April:
Debit – Cash at Bank
Credit – Accounts Receivable

2. The increase of $40 000 in cash does not necessarily indicate that a similar amount of profit was earned. Many other assets may have increased or decreased; and liabilities and capital also may have increased or decreased.

3. As $12 000 is the cost of a three year contract, the cost for one year is one-third or $4000. As the contract was taken out on 1 March, and the end of the reporting period is 30 June, only 4 months have been used in the current year. Hence, assuming equal usage of advertising services across all months, the correct expense for the current year is 4/12 of $4000 = $1333.

The adjusting entry to be recorded on 30 June is:

Prepaid Insurance	Dr	10 667	
Insurance Expense	Cr		10 667

Under the cash basis of accounting the correct expense for the current year would be $12 000, and no adjusting entry would have been recorded at the end of the period.

Exercise 4.5 Journalising adjusting entries

Calvin's Cleaning has employed you to investigate whether any accrual entries are needed in the business. On completion of your investigation on 30 June, you have discovered that the following items need attention:

1. Unearned cleaning services revenue now earned, $3200.
2. Depreciation not recorded, $12 000.
3. Employee salaries owed but not recorded, $6400.
4. Prepaid insurance expired, $1200.
5. Interest revenue accrued but not recorded, $1600.

Required

A. Prepare the adjusting entries for items 1 to 5 at 30 June, the end of the accounting period.
B. Suppose the adjusting entries in requirement A were not made. Calculate the total overstatement or understatement of profit as a result of the omission of these adjustments.

A.

Calvin's Cleaning: General Journal

Date	Particulars	Debit	Credit
30 June	Unearned Security Services Revenue	3 200	
[1]	Security Services Revenue		3 200
	(Precollected revenue now earned)		
30 June	Depreciation Expense	12 000	
[2]	Accumulated Depreciation		12 000
	(Depreciation expense for the period)		
30 June	Salary Expense	6 400	
[3]	Salaries Payable		6 400
	(Salaries incurred but not yet paid)		
30 June	Insurance Expense	1 200	
[4]	Prepaid Insurance		1 200
	(Prepaid insurance expired)		
30 June	Interest Receivable	1 600	
[5]	Interest Revenue		1 600
	(Interest revenue accrued)		

B. Profit would have been overstated as a result of expenses not being recorded ($12 000 + $6400 + $1200 = $19 600) and understated as a result of total revenues not being recorded ($3200 + $1600 = $4800). The net overstatement of profit is therefore $19 600 – $4800 = $14 800.

Exercise 4.15 Adjusting entries and effect on financial statements

In the first column of the schedule presented below are the condensed financial statements for Melvin Motor vehicle Rentals before adjusting entries were made. The following items were not reflected in the statements:

1. *Rental revenue earned but not collected or recorded, $1500.*
2. *Depreciation on vehicles not recorded, $14 500.*
3. *Wages earned by employees but not paid at year-end, $5600.*
4. *The company requires the first-day rental in advance as a deposit for making a reservation. The deposit is either deducted from the total rental charges or is forfeited. During the last week of June, deposits earned were not recorded as revenue, $990.*

Required

A. *Prepare the necessary adjusting entries in general journal form.*

B. *Determine the effects of the adjustments on the financial statements by completing the schedule presented.*

C. *1. Did profit increase or decrease? By how much?*
2. What was the effect of the adjusting entries on total assets? total liabilities? total equity?

A.

MELVIN MOTOR VEHICLE RENTALS
General Journal

	Particulars	Debit	Credit
1.	Accounts Receivable	1 500	
	Rental Revenue		1 500
	(Rent revenue earned)		
2.	Depreciation Expense – Vehicles	14 500	
	Accum. Dep'n – Vehicles		14 500
	(Depreciation on vehicles)		
3.	Wages Expense	5 600	
	Wages Payable		5 600
	(Wages owing to employees)		
4.	Unearned Rental Revenue	990	
	Rental Revenue		990
	(Rent deposits in advance earned)		

B.

MELVIN MOTORVEHICLE RENTALS
Financial Statements

	Unadjusted balances	Adjustments	Adjusted balances
Income statement			
Rental revenue	$255 600	+ 1 500	
		+ 990	$258 090
Expenses:			
Depreciation expense	—	+ 14 500	14 500
Insurance expense	46 800		46 800
Wages expense	140 000	+ 5 600	145 600
General expenses	24 000		24 000
Profit	$44 800		$27 190
Statement of changes in equity			
Beginning capital	$90 000		$90 000
Add: Profit	44 800		27 190
Less: Drawings	(72 000)		(72 000)
Ending capital	$62 800		$45 190
Balance sheet/Statement of financial position			
Cash at bank	$46 800		$46 800
Accounts receivable	—	+ 1 500	1 500
Other receivables	10 800		10 800
Vehicles	124 000		124 000
Less: Accum. depreciation	(38 000)	+ 14 500	(52 500)
	$143 600		$130 600
Wages payable	—	+ 5 600	5 600
Unearned rental revenue	7 200	– 990	6 210
Loan payable	73 600		73 600
Melvin Mazarati, Capital	62 800		45 190
	$143 600		$130 600

C. 1. Profit decreased by $17 610 ($44 800 – $27 190).
2. Total assets decreased by $13 000 ($143 600 – $130 600).
Total liabilities increased by $4610 ($85 410 – $80 800).
Total equity decreased by $17 610 ($62 800 – $45 190).