**Accounting for Transactions – Adjustments Part 1) – Week 4 Solutions**

Discussion Question

*Q3. 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.*

1. *Is the required adjusting entry made at the end of the period an example of accrual or a deferral?*
2. *What types of accounts will be affected by the required adjusting entry?*
3. *What effect will omission of the adjusting entry have on profit and on the statement of financial position?*

(a) 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 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)?*

1. (a) The revenue was earned in March

(b)(i) In March:

Debit – Accounts Receivable

Credit – Sales

1. In April:

Debit – Cash at Bank

Credit – Accounts Receivable

1. 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.
2. 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***

1. *Prepare the adjusting entries for items 1 to 5 at 30 June, the end of the accounting period.*
2. *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

|  |  |  |  |
| --- | --- | --- | --- |
| 1. | Unearned Security Services Revenue | 3 200 |  |
|  | Security Services Revenue |  | 3 200 |
|  | Precollected revenue now earned. |  |  |
|  |  |  |  |
| 2. | Depreciation Expense | 12 000 |  |
|  | Accumulated Depreciation |  | 12 000 |
|  | Depreciation expense for the period. |  |  |
| 3. | Salary Expense | 6 400 |  |
|  | Salaries Payable |  | 6 400 |
|  | Salaries incurred but not yet paid. |  |  |
|  |  |  |  |
| 4. | Insurance Expense | 1 200 |  |
|  | Prepaid Insurance |  | 1 200 |
|  | Prepaid insurance expired. |  |  |
|  |  |  |  |
| 5. | Interest Receivable | 1 600 |  |
|  | 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 Motorvehicle 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.*

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | MELVIN MOTORVEHICLE RENTALS  Financial Statements | | | | | | |  |
|  |  | Unadjusted balances | | | Adjustment | | Adjusted balances |  |
|  | Income statement  Rental revenue  Expenses:  Depreciation expense  Insurance expense  Wages expense  General expenses | $ | 255 600    —  46 800  140 000     24 000 |  |  | |  |  |
|  | Profit | $ | 44 800 |  |  | |  |  |
|  | Statement of changes in equity  Beginning capital  Add: Profit  Less: Drawings | $ | 90 000  44 800    (72 000) |  |  | |  |  |
|  | Ending capital | $ | 62 800 |  |  | |  |  |
|  | Balance sheet  Cash at bank  Accounts receivable  Other receivables  Vehicles  Less: Accumulated depreciation | $ | 46 800  —  10 800  124 000    (38 000) |  |  | |  |  |
|  |  | $ | 143 600 |  |  |  |  |  |
|  | Wages payable  Unearned rental revenue  Loan payable  Melvin Maserati, Capital | $ | —  7 200  73 600     62 800 |  |  | |  |  |
|  |  | $ | 143 600 |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |

***Required***

1. *Prepare the necessary adjusting entries in general journal form.*
2. *Determine the effects of the adjustments on the financial statements by completing the schedule presented.*
3. *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 MOTORVEHICLE 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. Depreciation – 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).