**Chapter 3 Homework**

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| --- | --- | --- | --- |
| K: / 4 | T: / 4 | A: / 4 | C: / 4 |

**To Be Handed In:**

**Questions: 2, 3, 9, 19**

**Wave Accounting / MirzaBooks: P3-9A**

2. Identify and describe two generally accepted accounting principles that relate to adjusting the accounts.

Two of the most important principles to adjusting accounts are the revenue recognition and matching principles. The revenue recognition principle states that revenue should be recognized when it is earned, and not necessarily when cash is received. This principle is crucial for the accrual basis of accounting to work correctly, as this principle facilitates a business’ ability to record a transaction and increase their revenue without having received any cash. It ensures a more accurate portrayal of the revenue and assets on financial documents such as the income statement and balance sheet, respectively. The matching period states that the revenue of a period must be evaluated and matched against expenses of the same period. This ensures that when analyzing financial documents, the business’ ability to generate revenue is offset against its expenses to more accurately portray the business’ ability to produce value for stakeholders. To more closely adhere to the matching principle, businesses perform several activities to more accurately depict their expenses through adjusting entries.

3. Pierce Dussault, a lawyer, accepts a legal engagement in March, performs the work in April, and is paid in May. If Dussault’s law firm prepares monthly financial statements, when should it recognize revenue from this engagement? Why?

Dussault performing legal services in April but not being paid immediately is effectively equivalent to Dussault performing his services on account. In March, a transaction has not occurred since Dussault’s client has not paid and Dussault performed any legal duties. Therefore, there are no journal entries regarding this engagement in March. Since Dussault performs legal services in April, he produces revenue in April, as the revenue recognition principle states that the revenue must be recorded as soon as it is earned, and the client becomes an accounts receivable. The journalized transaction would debit accounts receivable and credit service revenue. This would lead to an increase in assets, revenue, and – by extension - overall owner’s equity, which would appear on the balance sheet and income statement. In May, Dussault is paid for his service in April, which is effectively equivalent to the client paying what they owe as part of their accounts receivable account. As such, the business’ bank account is debited, and their accounts receivable is credited. This would not change the overall value of the assets from this engagement from April but would change the amount in the business’ bank account, leading to a change on the balance sheet.

9. Distinguish among the three categories of adjusting entries, and identify the types of adjustments applicable to each category.

The three categories of adjusting entries are prepayments, accruals, estimates. Prepayment adjusting entries include prepaid expenses and unearned revenue, in which the business pays for an expense or is paid for revenue ahead of time. Prepaid expenses are first recorded as assets before they are used, after which they are appropriately recorded as an expense. For example, prepaid insurance is first treated as an asset and is debited while the expense is credited. Over the course of several months, the business will expense a portion of the prepaid insurance into an insurance expense to more closely adhere to the revenue recognition and matching principles, as well as to report legitimate higher expenses. Unearned revenue may be used when an airline has customers buy tickets before they fly. When the customer buys a ticket, the airline receives cash, but hasn’t yet provided a service. Unearned revenue is first treated as a liability before its value increases revenue, so cash is debited, and unearned revenue is credited. Once the customer flies, the airline can convert some, if not all, of the unearned revenue into revenue by debiting unearned revenue and crediting revenue.

Accrual adjustments are performed when the business either earns revenue or incurs an expense but has not paid or been paid. An adjusting entry for accrued revenue would look like selling a good or service on account as the business has not received payment yet, so an account such as accounts receivable may be debited and revenue would be credited. Accrued revenues may increase over time but not be billed / collected and performing these adjustment entries helps to increase overall assets and revenue to produce a more accurate image of the business on financial documents. An adjusting entry for accrued expenses would look like buying a good or service on account since expense is debited and an account such as accounts payable is credited. Moreover, accrued expenses help increase liabilities and expenses to portray a more accurate image of the business on financial documents.

A widely adopted and systematic approach for adjusting entries for estimates is amortization. It is the process in which businesses can expense a portion of their assets in the asset’s useful life to more accurately reflect the business’ assets. The process aims to define how much revenue an asset generates each period in comparison to its cost. Both the asset’s useful life and salvage value (how much value each asset retains from each period) are estimated, leading the value an asset is expensed to be an estimate of how much revenue the asset produced in a period. Moreover, businesses use amortization to legitimately report greater expenses and more closely adhere to the matching principle, as there is now a more accurate depiction of the business’ expenses.

19. Explain the difference between amortization expense and accumulated amortization.

Amortization expense is an expense account that holds the value expensed from an asset for the current fiscal period. Accumulated amortization is a contra-asset account since it is an asset account with a normal balance of credit. It holds a sum of the amortization expense for the period and appears on the balance sheet to be subtracted from the total assets. Accumulated amortization helps produce a more accurate depiction of a long-term asset as subtracting it from the asset’s value produces an estimated remaining value of the asset, which is likely to be more accurate to an asset’s theoretical true value.

P3 – 9A:

1. Journalize the adjusting entries at June 30th, 2003
2. Prepare a ledger. Enter the trial balance amounts and post the adjusting entries.
3. Prepare an adjusted trial balance at June 30, 2003

Journal:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Atlantic Tours | | | |
| **JOURNAL** | | | | |
|  | Dhrumil Patel | | Mr. Mirza | |
|  |  |  |  |  |
| # | **A/C #** | **Accounts** | **$ Amount** | |
|  |  |  | **DR** | **CR** |
| 30 | 5400 | 5400 (Insurance expense) | 600 |  |
|  | 1054 | 1054 (Prepaid Insurance) |  | 600 |
|  |  |  |  |  |
|  | 5154 | 5154 (Amortization expense - office furniture) | 50 |  |
|  | 1605 | 1605 (Acc amortization - Office furniture / equipment) |  | 50 |
|  |  |  |  |  |
|  | 5151 | 5151 (Amortization expense - automobiles) | 2300 |  |
|  | 1602 | 1602 (Acc amortization - Automobiles) |  | 2300 |
|  |  |  |  |  |
|  | 5450 | 5450 (Interest expense) | 300 |  |
|  | 2202 | 2202 (Notes payable) |  | 300 |
|  |  |  |  |  |
|  | 1000 | 1000 (Bank) | 15000 |  |
|  | 4003 | 4003 (Fees earned) |  | 6000 |
|  | 2100 | 2100 (Unearned Revenue) |  | 9000 |
|  |  |  |  |  |
|  | 5650 | 5650 (Salaries and wages expense) | 1200 |  |
|  | 2204 | 2204 (Salaries Payable) |  | 1200 |
|  |  |  |  |  |
|  | 1020 | 1020 (Accounts receivable) | 1200 |  |
|  | 4002 | 4002 (Service revenue) |  | 1200 |
|  |  |  |  |  |
|  | 5100 | 5100 (Advertising Expense) | 500 |  |
|  | 2200 | 2200 (Accounts Payable) |  | 500 |

Balance Sheet:

|  |  |  |
| --- | --- | --- |
| Dhrumil Patel | | Mr. Mirza |
|  |  |  |
| **Atlantic Tours** | | |
| **BALANCE SHEET** | | |
| **AS AT June 30th, 2003** | | |
|  |  |  |
|  |  | **2003** |
|  |  | **$** |
| **ASSETS** |  |  |
| Current |  |  |
|  | Cash | 18,000 |
|  | Accounts receivable | 1,200 |
|  | Prepaids | 6,600 |
|  |  | 25,800 |
|  |  |  |
| Long-term |  |  |
|  | Property, plant, and equipment | 141,800 |
|  | Accumulated amortization - PPE | (2,350) |
|  |  | 139,450 |
|  |  |  |
|  |  | $ 165,250 |
|  |  |  |
| **LIABILITIES** |  |  |
| Current |  |  |
|  | Unearned revenue | 24,000 |
|  | Accounts payable | 500 |
|  | Notes payable | 62,300 |
|  | Salaries payable | 1,200 |
|  |  | 88,000 |
|  |  |  |
| Long-term |  |  |
|  |  | 88,000 |
|  |  |  |
| **OWNER'S EQUITY** |  |  |
|  | Owner's capital | 70,000 |
|  | Net income | 7,250 |
|  |  | 77,250 |
|  |  |  |
|  |  | $ 165,250 |

Income Statement:

|  |  |  |  |
| --- | --- | --- | --- |
| Dhrumil Patel | | | Mr. Mirza |
|  |  |  |  |
| **Atlantic Tours** | | | |
| **INCOME STATEMENT** | | | |
| **FOR THE YEAR ENDING June 30th, 2003** | | | |
|  |  |  |  |
|  |  |  | **2003** |
|  |  |  | **$** |
| Revenue |  |  |  |
|  | Revenue |  | 23,100 |
|  |  |  | $ 23,100 |
|  |  |  |  |
| Cost of goods sold |  |  |  |
|  |  |  |  |
| Gross profit |  |  | 23,100 |
|  |  |  |  |
| Operating expenses |  |  |  |
|  | Advertising |  | 1,300 |
|  | Amortization |  | 2,350 |
|  | Automobile expenses |  | 1,100 |
|  | Insurance expense |  | 600 |
|  | Interest |  | 300 |
|  | Salaries expense |  | 10,200 |
|  |  |  | 15,850 |
|  |  |  |  |
| Income before income taxes |  |  | 7,250 |
|  |  |  |  |
|  |  |  |  |
| Net income for the year |  |  | $ 7,250 |

**Note: use templates where needed**