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Module 3

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Instructions:

Click on any of the underlined titles in the table of contents to be directed to that section of the module. Click on the <**back**> symbol to return to the table of contents.

Video Lectures

Because seeing and hearing is sometimes better than just reading, I have prepared two video lectures for this module. After you read through the sections below, click here to play or to download the videos:

Adjusting Entries, Part 1: ***http://youtu.be/u3ODNjiNNBA***
Adjusting Entries, Part 2: ***http://youtu.be/-XhzRKZRIGQ***

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Module 3 Summary

I. Importance of the Income Statement

A. *Profitability* is a key concern for investors and managers. As we learned in the previous modules, accountants measure profitability by determining the *net income* (or *net loss*) during some time period (a month, quarter, year, etc.). This is then reported to investors and to business insiders on the company's *income statement*.

B. Net income or loss is equal to the difference between *revenues* and *expenses*. Therefore, in order to measure the amount of income or loss accurately, it is critical that we be able to accurately measure the amount of revenue that has been earned and the amount of expense that has been incurred during the period.

C. Because profitability is such a big concern, you can be sure that many complicated accounting rules regarding the way we measure revenues and expenses are contained in GAAP. (And that just leads to more job security and higher rates of pay for accountants!) ☺

D. Let's begin by examining a fundamental timing issue regarding the way revenues and expenses are recorded during an accounting period.

II. Accrual Basis, Cash Basis, and Adjusting Entries

A. Under GAAP, companies are required to report accounting information on an ***accrual basis***, as opposed to a ***cash basis***. *Accrual basis accounting* rules tell us that revenues are to be recorded when they have been *earned* (whether payment has been received or not), and expenses are to be recorded when they have been *incurred* (whether paid or not). This is the type of accounting we have been practicing all along in our tutorials.

B. Under ***cash basis*** accounting, revenues are only recorded when cash is received, and expenses are only recorded when cash has been paid. *Cash basis accounting* is "checkbook accounting." Whenever cash is received and entered as a deposit in the checkbook, it is also entered in one of the company's revenue accounts. Whenever a check is written and recorded in the checkbook (even if it is being written to buy equipment or a building), it is also entered in an expense account. In a pure cash basis accounting system, there is only one asset – cash!

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C. Cash basis accounting is simple and many small businesses use it. However, it is not acceptable under GAAP.

> ***More about cash basis…***
> *Students are usually puzzled when they hear that cash basis accounting is not allowed under GAAP, but that many small businesses still use it. What happens to the owners of these businesses? Do the "accounting police" come and arrest them?*
>
> *GAAP rules are not laws that have to be followed, so cash basis users can breathe a sigh of relief. There are laws that require large corporations (those that sell their stock to the public) to follow GAAP, but they do not apply to sole proprietorships or partnerships.*
>
> *Even through a non-incorporated business can legally operate on a cash basis, it may be wiser to go with accrual basis accounting. For one thing, cash basis creates distortions that may make it appear that the business is profitable when it actually isn't. This can mislead the owner/manager and might result in some poor management decisions. For another, the bank may not feel comfortable basing a loan decision on a business' cash-basis financial statements because of the distortions it can create. We will examine these problems in more depth a little later on, but we should conclude that the owner of the business certainly ought to be concerned about the flaws that are associated with cash basis accounting!*
>
> *A final note about cash basis accounting. Under cash basis, there will never be a need to make adjusting entries (explained below). By definition, revenues and expenses are only recorded in cash basis accounting systems when cash is collected or paid. Adjusting entries are made to record expenses or revenues that have not been paid or collected, and so would never be required in a cash basis accounting system.*

D. We are following GAAP in our tutorials, so we have been applying ***accrual basis*** accounting rules in all of our tutorials. When accrual basis accounting is used, ***adjusting entries*** will inevitably be required at the end of the accounting period. This will be necessary because we can be certain that some of the revenues that were earned and some of the expenses that were incurred will not have been recorded.

1. Why were these revenues and expenses not recorded? Did we just overlook them? No, nothing was overlooked. *The accountant was simply waiting until the end of the period to make the entries, because it was not convenient or even feasible to make them any earlier*.

> ***Here's what we mean…***
> *Wages expense is incurred each minute that an employee works for the business, and supplies expense is incurred each time a paper clip is used. But no one would try to record the wages expenses on a minute-by-minute basis, or the supplies expense paper clip by paper clip. Instead, the accountant waits, and then records the accumulated expenses as adjusting entries at the end of the period.*

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> *The same thing happens with revenues that are earned as services are provided. We would not leave our work on a customer's job every five minutes to go and record five minutes' worth of revenues!*
>
> *Therefore, at the end of the accounting period, some of the revenue and expense account balances on the trial balance will be incomplete. The accountant determines how much revenue has been earned but not recorded, and how much has been incurred in supplies and wages and other expenses that still need to be recorded. He or she then journalizes the adjusting entries that are necessary to bring their balances up to date.*

2. Let's summarize these points:

   - Adjusting entries will definitely be required if the company is using an accrual-basis accounting system.
   - The adjusting entries are necessary in order to record all the revenues that have been earned and all the expenses that have been incurred so that they can be reported accurately on the period's income statement.
   - If adjusting entries are omitted, the revenues, expenses and net income (or loss) reported on the income statement will be incorrect.

E. Adjusting entries may be classified into two general types, and we will examine each type thoroughly in the sections below. The two types are:

1. Adjustments to recognize ***deferred revenues and expenses***.
2. Adjustments to recognize ***accrued revenues and expenses***.

III. Adjustments to Recognize Deferred Expense Items.

A. In the case of "deferred expense items," cash was paid by the company at some time in the past, and, because the payment provided future benefits to the company, an asset account was debited. Examples would include the purchase of supplies and equipment, or payments for rent or insurance (the *prepaid expense*s described in Module 2).

Since an asset account is debited at the time of payment, and not an expense account, the recording of any expense is ***deferred*** (or put off) until later, after the asset begins to be used in the business and begins to lose its ability to provide future benefits to the company. Only after this

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happens is an expense really incurred, and at that time the bookkeeper will need to record it.

a. As we stated above, supplies represent a deferred expense item. They are assets when they are first purchased, but they become expenses as the supplies are used up. When this happens, the bookkeeper will need to record a decrease in the Supplies asset account (a credit entry), and an increase in the Supplies Expense account (a debit entry). If you recall, this was one of the entries that was made in the Module 1 example and practice problem.

b. Other assets that would represent deferred expense items are payments for insurance coverage (debited to an asset account called *Prepaid Insurance*) or payment of rent in advance (*Prepaid Rent*). These accounts are "prepaid expense" asset accounts.

B. **Accounting for Prepaid Expense Assets**

1. ***Prepaid expenses*** are asset accounts that have not been discussed previously. Recall that assets represent things the business owns that will benefit the business in the future. Supplies, equipment, buildings and any other assets that are used up in operating the business really do represent "prepaid" expenses, though we do not call them by that title. However, they are assets that are purchased and paid for in advance of being used, and so they do represent an item that has been "prepaid" and that will become expense later on as they are used up.

2. The two new "prepaid expense" asset accounts introduced here are ***Prepaid Rent*** and ***Prepaid Insurance***. If rent is paid for the coming year or if an insurance policy is acquired that provides a year's coverage, assets are being purchased that will provide benefits to the business through the coming year. After the year has passed all the benefit these assets provide will have been consumed, at which point the assets will have become expenses. At the time of their purchase, though, none of the benefit will have expired so two asset accounts, *Prepaid Rent* and *Prepaid Insurance*, will be debited.

Video Lecture

The video below pertains to making adjusting entries for deferred expense and revenue items. After you read through the sections below, click here to play or to download the video:

Adjusting Entries, Part 1: ***http://youtu.be/u3ODNjiNNBA***

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C. Over time and through use, the benefits these assets provide expires and the asset is used up (either completely or partially). This will not be recorded minute by minute as the expense is incurred, so it will be necessary to periodically stop and *adjust* these asset account balances, reducing them and recording an expense.

D. *The adjusting entry for any deferred expense items is almost always the same*. Some asset account is credited (decreased) and one of the expense accounts is debited (increased):

? Expense	***$ X***	
? Asset		***$ X***

1. In the case of supplies, the entry will be:

Supplies Expense	***$ X***	
Supplies		***$ X***

2. In the case of insurance and rent, the entries will be:

Insurance Expense	***$ X***	
Prepaid Insurance		***$ X***
Rent Expense	***$ X***	
Prepaid Rent		***$ X***

E. ***Long-lasting assets*** (buildings, equipment, trucks and so on) are also deferred expense items. Like supplies, insurance and rent, these assets become expense over time as they lose their ability to benefit the business. However, they are different from supplies, prepaid insurance and prepaid rent in three important ways:

1. These assets do not disappear as they are used in the course of business operations. Instead they wear out, or ***depreciate***, over time.

2. "Wear" is difficult to measure, so we cannot determine the amount of the expense with much precision and we will have to *estimate* the expense amount.

3. We have to change the form of the adjusting entry we make when we record depreciation expense, since *we cannot credit the asset account directly*. This is because of the Cost Principle (see the discussion below). To solve this problem

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we will have to break the asset into two “pieces” and use two different accounts for each long-term asset!

Here’s what we mean…
This discussion will clarify the three points made above, so be sure to read through all of it. Really!

Suppose you purchase several boxes of paperclips at the beginning of the period to use in your business. At the end of the period, it is likely that not many will be left. The ones that are missing have been used up in running the business, and if you know the cost of the missing boxes then you know the precise amount to record as supplies expense.

An insurance policy has a fixed term, so we can again measure exactly how many months of coverage have lapsed and determine the exact amount to record as insurance expense. The same is thing can be done with our prepaid rent.

After debiting the Supplies Expense account and crediting Supplies, the balance remaining in the Supplies account will be equal to the cost of the supplies that are still on hand. Likewise, after the adjusting entries are made, the balances in Prepaid Insurance and Prepaid Rent will be equal to the cost of the unexpired insurance coverage and the cost of the remaining time left in the rental agreement. This is all in keeping with the Cost Principle, which requires us to carry our assets on the balance sheet at their costs.

Let’s now consider a long-term asset and think about the way it differs from supplies, insurance and rent. After 500,000 miles, the delivery truck is, unlike supplies, still all there (though you may have trouble getting it out of the driveway and down the street). Also, unlike insurance and rent, we have no contract that tells us exactly how many more months are left before the truck breaks down for good and has to be scrapped. That means we have no way of determining exactly how much the truck has depreciated, since we cannot measure exactly how much benefit is left and how much benefit has been lost.

To make matters even worse, the Cost Principle requires us to carry the truck at original cost, so if the truck is still “all there,” we can’t credit the Truck account when we debit the expense account. How can we ever reduce the account balance in order to record expense without violating the Cost Principle? It is questions exactly like these that provide us with such great job security in accounting, and with such high rates of pay! ☺

F. As we explained above, the form of the entry to record depreciation expense differs from the adjusting entries we made for supplies, insurance and rent expense. Since the *Cost Principle* (remember the cost principle?) requires that assets be carried at original historical cost, *the long-term asset account cannot be directly credited* when the expense account is debited. Instead, a ***contra-asset account*** called ***Accumulated Depreciation*** is credited. The entry to record *depreciation expense,* then, is made as follows:

	Debit	Credit
Depreciation Expense	***$X***	
Accumulated Depreciation		***$X***

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1. The *Accumulated Depreciation* contra-account "attaches to" the long-term asset account. In effect, we have two accounts now for one asset. The asset account balance is always equal to the original cost of the asset, and the reductions in the asset that occur as it is depreciated are recorded in the separate Accumulated Depreciation account.

2. When it is time to prepare the balance sheet both accounts are listed together, and the credit balance in Accumulated Depreciation is subtracted from the asset account's debit balance. The resulting amount is called the asset's ***book value*** (also called its *carrying value*). This is because it is the amount at which the asset is "carried" in the company's "books." It is this value that is reported for the asset on the balance sheet:

Asset	*$ X*		
Minus: Accumulated Depreciation	*(X)*	=	*$ Book Value*

3. So there now. We have managed to (1) preserve the original cost of the asset in the asset account (in keeping with the Cost Principle), while still (2) recording depreciation expense and reducing the asset's reported value on the balance sheet (in keeping with the rules of accrual basis accounting). We're brilliant, aren't we?

G. Before we leave our discussion about depreciation expense, we should note that not all long-term assets depreciate. Land, for example, can lose its value because of hazardous waste spills or volcanic eruptions, but land does not suffer from "wear and tear." Therefore, the Land account is never depreciated.

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IV. Adjustments to Recognize Deferred Revenue Items

A. Deferred revenue items are recorded in the ***Unearned Revenue*** account. This is the first time that we have encountered this account, so we will need to explain a few things about it before we can talk about adjusting this account balance.

1. *Unearned Revenues* represent prepayments received from customers for services to be rendered in the future. That is, a customer pays *in advance* of actually receiving the service, before he or she is legally obligated to pay.

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2. Since the payment that is received from the customer has not yet been earned, it cannot be recorded as revenue. Until the work for the customer is done, the payment represents an obligation the company has to the customer. This is because the payment would have to be refunded if the customer changes his or her mind and cancels the order before the work is done. Therefore, the company *defers* (postpones) the recording of revenue until the work is done, and records a *liability* instead.

3. The liability account that is used in these cases is called *Unearned Revenue*, so when the customer's payment is received the company records a debit to Cash and then credits the ***Unearned Revenue*** account:

	Debit	Credit
Cash	**$X**	
Unearned Revenue		**$X**

4. Once the company does the work and earns the revenue, the customer can no longer demand a refund. The *Unearned Revenue* account can then be reduced and revenue can be recorded:

	Debit	Credit
Unearned Revenue	**$X**	
Revenue		**$X**

B. The unearned revenue is earned as the work is done, but entries will not be made minute by minute to record the revenue . Therefore, at the end of the accounting period, it will be necessary to examine any unfinished customer orders and determine the amount of the customer's prepayment that has been earned to date. We can then make an adjusting entry to record that portion of the customer's prepayment as revenue.

1. If one-half of the work has been done for the customer, then one-half of the unearned revenue has been earned. If one-fourth of the work has been done, then one-fourth of the revenue can be recorded, and so on.

2. *The form of the adjusting entry for deferred revenue items is always the same*. The liability account is debited (decreased) and a revenue account is increased (credited):

	Debit	Credit
Unearned Revenue	**$X**	
Revenue		**$X**

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V. Adjustments for Accrued Revenue and Expense Items.

A. In the case of ***accrued expenses***, cash has not yet been paid because payment is not due, but the expense has been incurred and the company is obligated to pay. Therefore, it is necessary to increase an expense account and then record the liability for future payment.

> ***Video Lectures***
> *The video below pertains to making adjusting entries for accrued expense and revenue items. After you read through the sections below, click here to play or to download the video:*
>
> *Adjusting Entries, Part 2:* ***http://youtu.be/-XhzRKZRIGQ***

1. Examples of expenses that *accrue* include the wages of employees, utilities, and interest on bank loans.

2. *The form of the adjusting entry for accrued expense items is always the same.* One of the expense accounts is debited (increased) and a liability account is credited (increased):

	Debit	Credit
? Expense	***$X***	
? Payable		***$X***

3. Note: *Accounts Payable is not used in the adjusting entries!* That account is reserved for trade creditors, the businesses from which the company buys its supplies and equipment. The liability accounts that are used in the adjusting entries for accrued expenses will be accounts such as *Wages Payable*, *Utilities Payable*, or *Interest Payable*.

   Our general ledger will contain several different liability accounts in addition to Accounts Payable and Notes Payable. These liability accounts will be ones that are used in recording adjusting entries for accrued expenses.

4. *Caution!* If adjustments for accrued expenses were made in the previous period, the bookkeeper must remember that a liability (the "payable" portion of the adjusting entry) is now in the accounts. This means that when the actual payment is made, only a portion of the total payment can be recorded as expense. The remainder is a pay-down of that liability balance. The entry to record the future payment will be:

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? Expense	***$X***	
? Payable	***$X***	
Cash		***$X***

B. In the case of ***accrued revenue items***, cash has not yet been received from a customer because payment is not due, but the revenue has been earned and the customer is obligated to pay. Therefore, it is necessary to increase a revenue account and increase Accounts Receivable.

1. Examples of accrued revenues include revenue earned from work performed but not yet billed because the job has not been completed, or interest revenue earned on loans made by the business that has not yet been collected.

2. *The form of the adjusting entry for accrued revenue items is always the same*. A revenue account is credited (increased) and an asset account (a receivable) is debited (increased). In the case of work done for a customer but not yet billed, the adjusting entry would be:

Accounts Receivable	***$X***	
Service Revenue		***$X***

Accounts Receivable is reserved for balances owed to the company by its customers for services provided. When an adjustment is made for non-service revenues, it is not appropriate to use *Accounts Receivable* in the entry. To record accrued interest on a loan, the adjusting entry would be:

Interest Receivable	***$X***	
Interest Revenue		***$X***

3. If adjustments for accrued expenses were made in the previous period, the bookkeeper must remember that a receivable was recorded that must be reduced when payment is received. This means that only a portion of the total payment is revenue to recognize in the current period. The entry will be:

Cash	***$X***	
? Receivable		***$X***
? Revenue		***$X***

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Another Example… To clarify these types of adjusting entries for accrued expenses and accrued revenues, a supplemental exercise, Sally Sam's Custard Shop, is attached. A set of solutions is provided for this practice exercise. Click here to jump to this supplement.

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VI. The Adjusted Trial Balance and the Accounting Cycle

A. Once the adjusting entries have been journalized and posted to the general ledger accounts, it will be necessary to prepare another trial balance in order to check for errors that may have been made in the adjustment process. This trial balance is called the ***adjusted trial balance***. The financial statements will be prepared using the figures from the adjusted trial balance.

B. The steps of the accounting cycle (the series of steps the accountant completes in accounting for the business during the accounting period) covered to date may be summarized as follows:

1. Journalize transactions from source documents as they occur.

2. At the end of the accounting period, post debit and credit entries from the general journal to the general ledger accounts.

3. Total account balances and prepare a trial balance.

4. Journalize and post adjusting entries, recalculate the account balances, then prepare an *adjusted trial balance*.

5. Prepare financial statements.

6. Journalize and post the closing entries (explained in detail in Module 4).

VI. GAAP and Relevant Accounting Principles

A. **Generally Accepted Accounting Principles** are based upon a set of fundamental accounting *principles*, *assumptions*, and *concepts* that

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anyone completing a basic course in accounting should know about. The principles that are relevant to this module are:

1. ***Accounting Period Concept***
   For reporting purposes an organization's overall life must be divided up into *accounting periods* (months, years, etc.). When the accounting period is one year long, a *calendar year* might used (January 1 to December 31), but often a *fiscal year* is used instead (a one-year period beginning some time other than January 1 and ending 12 months later).

   The revenues earned during the accounting period and the expenses incurred during the period must be measured and reported on that period's income statement.

2. ***Going Concern Principle*** (or "continuity assumption")
   Unless there is evidence to the contrary, it is assumed that the business is a "going concern," able to meet its obligations and continue in business indefinitely. This allows us to apportion expenses (depreciation of long-lived buildings, for example) over many future accounting periods without having to worry about the length of the life of the business.

3. ***Revenue Recognition Principle***
   Revenue is generally recognized (recorded) when the earnings process is "complete." This when services have been rendered (the work has been completed or partially completed) or when goods are sold and delivered to the customer (that is, at the "point of sale"). It does not matter whether payment has been received or not.

4. ***Matching Principle***
   Business expenses should be recognized (recorded) in the same period in which they were incurred. This way they will be "matched" against the revenues they helped to produce. In other words, the revenues earned in a period and the expenses incurred in that period will be matched and reported together on the period's income statement. This guarantees that the reported income or loss is an accurate measurement of the business' profitability or lack thereof.

B. ***Why is Accrual Basis Accounting Required?***

1. The answer to this question illustrates the importance of accounting theory and its underlying principles in the business world. ***Accrual basis accounting*** is an accounting method in

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which revenues are recorded when goods are sold or when services are rendered, and expenses are recorded when they have been incurred. This is in accordance with the revenue recognition and matching principles, and these principles are a part of GAAP.

2. ***Cash basis accounting*** is an accounting method in which revenues are only recognized when cash is collected and expenses are only recognized when paid. This is a violation of the revenue recognition and matching principles, and it creates distortions on the period's income statement. This happens because expenses and revenues become *mismatched*.

Here's what we mean…

Suppose a student decides to make a little extra money by typing other students' term papers. The student goes through the following steps in starting up and conducting this money-making operation:

1. *In November, the student purchases a word processor for $500, and various supplies for $100.*
2. *In December, she types up the term papers for her customers, using up all the supplies. She bills her customers for $500, but does not collect any of the money in December.*
3. *In January, she collects the $500 from her customers, and she then sells the word processor for $500 and closes her business.*

In order to understand the differences between cash basis and accrual basis, let's prepare income statements for each of the three months that the student was in business (the accounting period will be one month in length).

Cash Basis
Under cash basis accounting, any deposit of cash is considered to be revenue and any payment of cash is considered to be expense. Therefore, $600 of "expenses" would be recorded in the month of November (when the word processor and the supplies are purchased). No revenue or expense would be recorded in December since no cash was received or spent. In December, $1,000 of cash was received from customers and from the sale of the word processor, so $1,000 of "revenue" would be recorded. The income statements for each of the three months would look like so:

	November	December	January	Total
Revenues	$ 0	$ 0	$1,000	$1,000
Expenses	(600)	0	0	(600)
Net Income (Loss)	$(600)	0	$1,000	$ 400

Accrual Basis
Under accrual basis accounting, revenue is recorded when services are performed, whether cash has been received or not. Expenses are recorded when they have been incurred, whether cash has been paid or not. Therefore, the $600 paid in the month of November for the word processor and the supplies is not an expense since no expense was incurred. Instead, the transaction represented a purchase of assets. However, $100 of expense was incurred in December, when the supplies were

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used up. Likewise, $500 of revenue was earned in December, when the papers were typed for the customers. No revenue or expense would be recorded in January, since no revenue was earned and no expense was incurred. Accounts receivable were collected, and an asset was sold for its original cost (this means that there is no depreciation expense to record since the asset did not depreciate). Accrual-based income statements for month would appear as follows:

	November	December	January	Total
Revenues	$ 0	$ 500	$ 0	$ 500
Expenses	0	(100)	0	(100)
Net Income (Loss)	$ 0	$ 400	$ 0	$ 400

Note that in both cases, $400 of net income is recorded during the life of the business. However, the cash basis income statements indicate that a large loss was incurred in November, and that nothing was earned in December. We know that there was actually no loss in November, since the assets had not been used yet and could probably be sold for the amount that was paid for them. The revenues and expenses were actually all earned and incurred in December, when the work was done and the supplies were used. The accrual basis statement reports this, but the cash basis statement does not. In January, nothing happened in terms of revenues and expenses, since no work was done and no expenses were incurred. The cash basis statement indicates that everything happened in January. That is the month, according to cash basis, when all the profits were made.

The reason we are not allowed to use cash basis is because of these kinds of distortions. It is true that the business did earn $400 over all three months, as both statements report, but the cash basis statements mismatch the revenues and expenses, reporting them in different months instead of matching them to the month in which they both occurred. As a result, the reported monthly income and loss amounts are distorted and are quite incorrect.

3. Since cash basis accounting violates the revenue recognition and matching principles, it is **not** acceptable under GAAP. As you can see, the basic principles that form GAAP guide and shape the specific rules that determine what is acceptable practice and what is not. Without them, accounting would be full of conflicting procedures and practices, and the information reported in the financial statements would be very unreliable.

VII. ***Vertical analysis*** of the information on the statements is another technique used by investors and creditors to evaluate the company's profitability and liquidity. It is named as it is because the analyst works *up and down* the statements (i.e., *vertically*), stating each reported figure as a percentage of some common base.

1. On the income statement, the base that is used is the total revenue figure. This is illustrated in the table below.

2. The analyst looks for relationships that reveal the causes of any improvement or deterioration in the company's profitability and liquidity position.

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3. From the vertical analysis presented in the table below it is clear that Wages Expense has consumed a much larger percentage of Revenues in 20X2 than it did in 20X1. The small improvement in Utilities Expense and Supplies Expense was not enough to prevent net income from falling drastically. In 20X2 the company's profit was only 13 cents from every dollar of revenue that was earned, down from 24 cents in 20X1.

4. Why did these things happen? Again, the analysis only tells us that they did. We will need to talk to company representatives, read press releases, talk to other analysts and industry insiders, and conduct a wealth of additional research in order to fully understand what is causing these trends (and whether the company is a good investment or a good candidate for a loan).

Vertical Analysis of XYZ Corporation Consolidated Statements of Income for the Years Ended December 31, 20X1 and 20X2				
	20X2		20X1	
Services Revenue	$120,000	100%	$100,000	100%
Wages Expense	(80,000)	75%	(50,000)	50%
Utilities Expense	(10,000)	8%	(10,000)	10%
Telephone Expense	(10,000)	8%	(8,000)	8%
Office Supplies Expense	(4,000)	3%	(8,000)	8%
Net Income	16,000	13%	24,000	24%

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-END-

(see following pages for supplements)

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Supplemental Exercise I
Accounting for Deferred Expenses and Revenues

Part I. Record the following for Mel's Merry Manor Motel. Mel adjusts his accounts only at the end of the year (December 31). The solution is given below.

1. a. On January 1, 20X1 purchased $5,000 of office supplies from Thompson's Supplies, Equipment, Insurance, Equipment Maintenance and Janitorial Services Company to use at the front desk. There was no balance in the office supplies account until this transaction occurred, and no other purchases of office supplies occurred in 20X1.
   b. On December 31, 20X1 took an inventory of the supplies, determining that $1,000 of the supplies were still on hand. Adjusted the account balance.
   c. On January 2, 20X2 purchased an additional $3,500 of office supplies to use at the front desk.
   d. On December 31, 20X2 took an inventory of the supplies, determining that $500 of the supplies were still on hand. Adjusted the account balance.
2. a. On January 1, 20X1 purchased equipment from Thompson's for $6,000. It was estimated that the equipment would be used for 3 years, at which time it would be disposed of for no value.
   b. On December 31, 20X1 made an adjusting entry to recognize depreciation expense.
   c. On December 31, 20X2 made an adjusting entry to recognize depreciation expense.
   d. On December 31, 20X3 made an adjusting entry to recognize depreciation expense and recorded the disposal of the equipment, which had been given away.
3. a. On November 1, 20X1 purchased more equipment from Thompson's for $3,000. It was estimated that the equipment would be used for 10 years, at which time it would be disposed of for no value.
   b. On December 31, 20X1 made an adjusting entry to recognize depreciation expense.
   c. On December 31, 20X2 made an adjusting entry to recognize depreciation expense.
4. a. On October 1 paid Thompson's $200 for equipment maintenance services (debit Prepaid Maintenance Services) over the four-month period beginning October 1 and ending January 31, 20X2.
   b. On December 31, 20X1, adjusted the Prepaid Maintenance account balance to recognize the expense incurred.
   c. On January 31, 20X2, adjusted the Prepaid Maintenance account balance to recognize the expense incurred.
5. a. On August 1, 20X1 purchased a 2-year insurance policy from Thompson's for $4,800.

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b. On December 31, 20X1, adjusted the Prepaid Insurance account balance to recognize the expense incurred.
c. On December 31, 20X2, adjusted the Prepaid Insurance account.
d. On December 31, 20X3, adjusted the Prepaid Insurance account.

6. a. On November 1 paid Thompson's $600 for janitorial services to be provided over the 3-month period November 1 through January 31, 20X2. (Debit "Prepaid Janitorial Cost").
b. On December 31, 20X1, adjusted the Prepaid Janitorial Cost account balance to recognize the expense incurred.
c. On January 31, 20X2, adjusted the Prepaid Janitorial Cost account balance to recognize the expense incurred.

Part II. Record the transactions in numbers 4, 5 and 6 above as they would appear on Thompson's books. Thompson's adjusts its accounts only at year-end (December 31).

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Supplemental Exercise II
Accounting for Accrued Expenses and Revenues

Part I. Record each of the following for Sally Sam's Custard Shoppe. Sally makes adjusting entries only at the end of the year. The solution is given below.

1. a. On November 1, 20X1 Sally agreed to rent store space from Washington Mall at $500 per month, the rent payable at the end of each 6-month period that the space is occupied. Sally immediately moved into the location and began operations.
   b. On December 31 made an adjusting entry to record rent expense.
   c. On April 30 paid the rent due to Washington Mall.
2. a. Received and paid the November electric bill on December 5 for November's utilities, $150. Electricity service is provided by Washington Mall which operates its own generating system and sells power to mall businesses.
   b. The December utility bill will not be received until January, but on December 31 Sally estimated it would be equal to November's bill.
   c. On January 6 received and paid the December utility bill of $155.
3. a. On November 15 entered into an agreement with Washington Mall in which the mall will provide janitorial services to the Custard Shop at a cost of $200 per month, payable on the 15th day of each month.
   b. On December 15 paid $200 to Washington Mall for the janitorial services provided (debit "Maintenance Expense").
   c. On December 31 made an adjusting entry to record accrued maintenance
   d. On January 15, 20X2 paid $200 to Washington Mall for the janitorial services provided.
4. a. Washington Mall maintains a staff of experienced sales people whom the mall businesses may employ. The earnings are collected by Washington Mall and credited to the mall's Staffing Revenue account. On December 13 hired a Washington Mall staff person to serve custard who will start work on Monday, December 16. This person will earn $100 per week (Monday through Friday), payable bi-weekly (every other Friday) for the previous two weeks' work.
   b. On Friday, December 27, paid Washington Mall the person's two-week salary (debit Wages Expense).
   c. On December 31 made an adjusting entry to record accrued wages.
   d. On Friday, January 10, 20X2 paid Washington Mall the worker's two-week salary.
5. a. On December 1 agreed to share in a promotional campaign run by Washington Mall. Advertisements will be run on the Mall outdoor electronic billboard during December and January in which the custard shop will be featured along with other mall businesses. The cost will be divided among the businesses affected, and each will pay its share at the end of January.
   b. As of December 31, 20X1 several ads had run. The Custard Shop's share as of that time amounted to $300.

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c. On January 31, 20X2, paid the Custard Shop's $500 share of the total advertising cost to Washington Mall.

6. a. On November 1 entered into an agreement with *The Ledger Standard*, the Washington Mall's local area sales newspaper, in which the *Standard* agrees to print 30 Custard Shop advertisements at reduced rates ($20 per ad) when there happens to be unsold space in the paper. Payment is due after all the ads have appeared.
   b. As of December 31, 20 ads had been printed in the paper.
   c. On January 29 paid Washington Mall $600 since all the ads had run.

Part II. Record the transactions and adjustments above as they would appear on the books of the Washington Mall. Washington Mall adjusts its books only at year-end (December 31).

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Solution to Mel's Merry Manor
Deferred Expenses and Revenues

Part I.

	Account	Debit	Credit
1. a.	Supplies	5,000	
	Cash		5,000
b.	Supplies Expense	4,000	
	Supplies		4,000
c.	Supplies	3,500	
	Cash		3,500
d.	Supplies Expense	4,000	
	Supplies		4,000
2. a.	Equipment	6,000	
	Cash		6,000
b.	Depreciation Expense	2,000	
	Accumulated Depreciation		2,000
c.	Depreciation Expense	2,000	
	Accumulated Depreciation		2,000
d.	Depreciation Expense	2,000	
	Accumulated Depreciation		2,000
	Accumulated Depreciation	6,000	
	Equipment		6,000
3. a.	Equipment	3,000	
	Cash		3,000
b.	Depreciation Expense	50	
	Accumulated Depreciation		50
c.	Depreciation Expense	300	
	Accumulated Depreciation		300
4. a.	Prepaid Maintenance	200	
	Cash		200
b.	Maintenance Expense	150	
	Prepaid Maintenance		150
c.	Maintenance Expense	50	
	Prepaid Maintenance		50
5. a.	Prepaid Insurance	4,800	
	Cash		4,800
b.	Insurance Expense	1,000	
	Prepaid Insurance		1,000
c.	Insurance Expense	2,400	
	Prepaid Insurance		2,400
d.	Insurance Expense	1,400	
	Prepaid Insurance		1,400

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6. a.	Prepaid Jan. Services	600	
	Cash		600
b.	Janitorial Expense	400	
	Prepaid Jan. Services		400
c.	Janitorial Expense	200	
	Prepaid Jan. Services		200
Part II.			
4. a.	Cash	200	
	Unearned Revenue		200
b.	Unearned Revenue	150	
	Maintenance Revenue		150
c.	Unearned Revenue	50	
	Maintenance Revenue		50
5. a.	Cash	4,800	
	Unearned Revenue		4,800
b.	Unearned Revenue	1,000	
	Insurance Revenue		1,000
c.	Unearned Revenue	2,400	
	Insurance Revenue		2,400
d.	Unearned Revenue	1,400	
	Insurance Revenue		1,400
6. a.	Cash	600	
	Unearned Jan. Revenue		600
b.	Unearned Jan. Revenue	400	
	Janitorial Revenue		400
c.	Unearned Jan. Revenue	200	
	Janitorial Revenue		200

Solution to Sally Sam's Custard Shoppe Accrued Expenses and Revenues

Part I.

1. a.	No Entry		
b.	Rent Expense	1,000	
	Rent Payable		1,000
c.	Rent Expense	2,000	
	Rent Payable	1,000	
	Cash		3,000

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2. a.	Utilities Expense	150	
	Cash		150
b.	Utilities Expense	150	
	Utilities Payable		150
c.	Utilities Payable	150	
	Utilities Expense	5	
	Cash		155
3. a.	No entry.		
b.	Maintenance Expense	200	
	Cash		200
c.	Maintenance Expense	100	
	Maintenance Payable		100
d.	Maintenance Expense	100	
	Maintenance Payable	100	
	Cash		200
4. a.	No entry.		
b.	Wages Expense	200	
	Cash		200
c.	Wages Expense	40	
	Wages Payable		40
d.	Wages Expense	160	
	Wages Payable	40	
	Cash		200
5. a.	No entry.		
b.	Advertising Expense	300	
	Advertising Payable		300
c.	Advertising Expense	200	
	Advertising Payable	300	
	Cash		500
6. a.	No entry.		
b.	Advertising Expense	400	
	Advertising Payable		400
c.	Advertising Expense	200	
	Advertising Payable	400	
	Cash		600

Part II.

1. a.	No Entry		
b.	Rent Receivable	1,000	
	Rent Revenue		1,000
c.	Cash	3,000	
	Rent Receivable		1,000
	Rent Revenue		2,000

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2. a.	Cash	150	
	Utilities Revenue		150
b.	Utilities Receivable	150	
	Utilities Revenue		150
c.	Cash	155	
	Utilities Receivable		150
	Utilities Revenue		5
3. a.	No entry.		
b.	Cash	200	
	Maintenance Revenues		200
c.	Maintenance Receivable	100	
	Maintenance Revenues		100
d.	Cash	200	
	Maintenance Receivable		100
	Maintenance Revenues		100
4. a.	No entry.		
b.	Cash	200	
	Staffing Revenue		200
c.	Staffing Receivable	40	
	Staffing Revenue		40
d.	Cash	200	
	Staffing Receivable		40
	Staffing Revenue		160
5. a.	No entry.		
b.	Advertising Receivable	300	
	Advertising Revenue		300
c.	Cash	500	
	Advertising Revenue		200
	Advertising Receivable		300
6. a.	No entry.		
b.	Advertising Receivable	400	
	Advertising Revenue		400
c.	Cash	600	
	Advertising Revenue		200
	Advertising Receivable		400

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