

Adjustments and the Worksheet

WILLAMETTE VALLEY

VINEYARDS

www.willamettevalleyvineyards.com

The Willamette Valley is the heart of Oregon's agriculture country. The valley is one of Oregon's major wine-growing regions and boasts over 200 wineries that produce a variety of vintages. *Willamette Valley Vineyards* is regarded as one of Oregon's top wineries. Started in 1983 with a small 50-acre vineyard, the company has carefully nurtured its growth, producing top-quality wines that have been served at the White House and consistently earn high marks from *Wine Spectator* and *Wine Enthusiast*. In any given year, Willamette incurs expenses like wages and advertising as well as the expenses associated with harvesting its grapes. When it sells its wine, the



company records the revenue on the sale. The company must make sure that the expenses associated with the making of the wine are recorded in the same year as the sale of the wine so that the company has an accurate annual view of how the business is doing.

The importance of matching these revenues and expenses within the same year was hammered home in 2006 by the Alcohol and Tobacco Tax Trade Board. Willamette pays alcohol excise taxes based on product sales to both the Oregon Liquor Control Commission and to the U.S. Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau. An audit by the Alcohol and Tobacco Tax Trade Board uncovered some reporting issues and though Willamette Valley disputed the findings, it eventually acknowledged that an expense of \$80,000 claimed should have been recognized as a liability across three years rather than recognizing it all in one year. The company had to restate its financial statements for three previous years to reflect the correct excise tax for each of those periods and to record the estimated interest and penalties with respect to the related estimated excise tax liability.

thinking critically

Careful recordkeeping is critical to all businesses, large and small. Why does matching these revenues and expenses within the same year matter so much?

LEARNING OBJECTIVES

- 5-1.** Complete a trial balance on a worksheet.
- 5-2.** Prepare adjustments for unrecorded business transactions.
- 5-3.** Complete the worksheet.
- 5-4.** Prepare an income statement, statement of owner's equity, and balance sheet from the completed worksheet.
- 5-5.** Journalize and post the adjusting entries.
- 5-6.** Define the accounting terms new to this chapter.

NEW TERMS

account form balance sheet	depreciation
adjusting entries	prepaid expenses
adjustments	report form balance sheet
book value	salvage value
contra account	straight-line depreciation
contra asset account	worksheet

Section 1

SECTION OBJECTIVES

>> 5-1. Complete a trial balance on a worksheet.

WHY IT'S IMPORTANT

Time and effort can be saved when the trial balance is prepared directly on the worksheet. Amounts can be easily transferred to other sections of the worksheet.

>> 5-2. Prepare adjustments for unrecorded business transactions.

WHY IT'S IMPORTANT

Not all business transactions occur between separate business entities. Some financial events occur within a business and need to be recorded.

TERMS TO LEARN

adjusting entries
adjustments
book value
contra account
contra asset account
depreciation
prepaid expenses
salvage value
straight-line depreciation
worksheet

The Worksheet

Financial statements are completed as soon as possible in order to be useful. One way to speed the preparation of financial statements is to use a worksheet. A **worksheet** is a form used to gather all data needed at the end of an accounting period to prepare the financial statements. Preparation of the worksheet is the fourth step in the accounting cycle.

Figure 5.1 shows a common type of worksheet. The heading shows the company name, report title, and period covered. In addition to the Account Name column, this worksheet contains five sections: Trial Balance, Adjustments, Adjusted Trial Balance, Income Statement, and Balance Sheet. Each section includes a Debit column and a Credit column. The worksheet has 10 columns in which to enter dollar amounts.

>> 5-1. OBJECTIVE

Complete a trial balance on a worksheet.

recall

Trial Balance

If total debits do not equal total credits, there is an error in the financial records. The error must be found and corrected.

The Trial Balance Section

Refer to Figure 5.2 as you read about how to prepare the Trial Balance section of the worksheet.

1. Enter the general ledger account names.
2. Transfer the general ledger account balances to the Debit and Credit columns of the Trial Balance section.
3. Total the Debit and Credit columns to prove that the trial balance is in balance.
4. Place a double rule under each Trial Balance column to show that the work in that column is complete.

FIGURE 5.1

Ten-Column Worksheet

Wells' Consulting Services					
Worksheet					
Month Ended December 31, 2016					
ACCOUNT NAME	TRIAL BALANCE		ADJUSTMENTS		
	DEBIT	CREDIT	DEBIT	CREDIT	
1					
2					
3					
4					
5					

FIGURE 5.2 A Partial Worksheet

Wells' Consulting Services										
Worksheet										
Month Ended December 31, 2016										
	ACCOUNT NAME	TRIAL BALANCE				ADJUSTMENTS				
		DEBIT		CREDIT		DEBIT		CREDIT		
1	Cash	111	350	00						
2	Accounts Receivable	5	000	00						
3	Supplies	1	500	00			(a)	500	00	
4	Prepaid Rent	8	000	00			(b)	400	00	
5	Equipment	11	000	00						
6	Accumulated Depreciation—Equipment						(c)	183	00	
7	Accounts Payable				3	500	00			
8	Carolyn Wells, Capital				100	000	00			
9	Carolyn Wells, Drawing	5	000	00						
10	Fees Income				47	000	00			
11	Salaries Expense	8	000	00						
12	Utilities Expense	6	500	00						
13	Supplies Expense						(a)	500	00	
14	Rent Expense						(b)	400	00	
15	Depreciation Expense—Equipment						(c)	183	00	
16	Totals	150	500	00	150	500	00	4	683	00
17										
18										
19										

Notice that the trial balance has four new accounts: *Accumulated Depreciation—Equipment*, *Supplies Expense*, *Rent Expense*, and *Depreciation Expense—Equipment*. These accounts have zero balances now, but they will be needed later as the worksheet is completed.

The Adjustments Section

Usually, account balances change because of transactions with other businesses or individuals. For Wells' Consulting Services, the account changes recorded in Chapter 4 were caused by transactions with the firm's suppliers, customers, the landlord, and employees. It is easy to recognize, journalize, and post these transactions as they occur.

Some changes are not caused by transactions with other businesses or individuals. They arise from the internal operations of the firm during the accounting period. Journal entries made to update accounts for previously unrecorded items are called **adjustments** or **adjusting entries**. These changes are first entered on the worksheet at the end of each accounting period. The worksheet provides a convenient form for gathering the information and determining the effects of the changes. Let's look at the adjustments made by Wells' Consulting Services on December 31, 2016.

>> 5-2. OBJECTIVE

Prepare adjustments for unrecorded business transactions.

	ADJUSTED TRIAL BALANCE		INCOME STATEMENT		BALANCE SHEET	
	DEBIT	CREDIT	DEBIT	CREDIT	DEBIT	CREDIT
1						
2						
3						
4						
5						

recall

Trial Balance

On the trial balance, accounts are listed in this order: assets, liabilities, owner's equity, revenue, and expenses.

ADJUSTING FOR SUPPLIES USED

On November 28, 2016, Wells' Consulting Services purchased \$1,500 of supplies. On December 31, the trial balance shows a \$1,500 balance in the *Supplies* account. This amount is too high because some of the supplies were used during December.

An adjustment must be made for the supplies used. Otherwise, the asset account, *Supplies*, is overstated because fewer supplies are actually on hand. The expense account, *Supplies Expense*, is understated. The cost of the supplies used represents an operating expense that has not been recorded.

On December 31, Carlos Valdez counted the supplies. Remaining supplies totaled \$1,000. This meant that supplies amounting to \$500 were used during December ($\$1,500 - \$1,000 = \$500$). At the end of December, an adjustment must be made to reflect the supplies used. The adjustment reduces the *Supplies* account to \$1,000, the amount of supplies remaining. It increases the *Supplies Expense* account by \$500 for the amount of supplies used. Notice that the adjustment for supplies is based on actual usage.

Refer to Figure 5.2 on page 125 to review the adjustment on the worksheet: a debit of \$500 to *Supplies Expense* and a credit of \$500 to *Supplies*. Both the debit and credit are labeled (a) to identify the two parts of the adjustment.

Supplies is a type of prepaid expense. **Prepaid expenses** are items that are acquired and paid for in advance of their use. Other common prepaid expenses are prepaid rent, prepaid insurance, and prepaid advertising. When cash is paid for these items, amounts are debited to *Prepaid Rent*, *Prepaid Insurance*, and *Prepaid Advertising*; all are asset accounts. As prepaid expenses are used, an adjustment is made to reduce the asset accounts and to increase the related expense accounts.

ADJUSTMENT

Record the adjustment for supplies.

ABOUT ACCOUNTING

Accounting Software

The use of accounting software eliminates the need to prepare a worksheet. However, adjusting entries must always be made to properly reflect account balances at the end of a reporting period.

ANALYSIS		▼
The expense account, <i>Supplies Expense</i> , is increased by \$500. The asset account, <i>Supplies</i> , is decreased by \$500.		▼
DEBIT-CREDIT RULES		▼
DEBIT	Increases to expense accounts are recorded as debits. Debit <i>Supplies Expense</i> for \$500.	▼
CREDIT	Decreases to asset accounts are recorded as credits. Credit <i>Supplies</i> for \$500.	▼
T-ACCOUNT PRESENTATION		▼
Supplies Expense		Supplies
+ 500	-	+ 500

Let's review the effect of the adjustment on the asset account, *Supplies*. Recall that the *Supplies* account already had a balance of \$1,500. If no adjustment is made, the balance would remain at \$1,500, even though only \$1,000 of supplies are left.

Supplies			
		+	-
Bal.		1,500	
Bal.		1,000	
	Adj.		500

ADJUSTING FOR EXPIRED RENT

On November 30, 2016, Wells' Consulting Services paid \$8,000 rent for December and January. The right to occupy facilities for the specified period is an asset. The \$8,000 was debited to **Prepaid Rent**, an asset account. On December 31, 2016, the **Prepaid Rent** balance is \$8,000. This is too high because one month of rent has been used. The expired rent is \$4,000 ($\$8,000 \div 2$ months). At the end of December, an adjustment is made to reflect the expired rent.

ADJUSTMENT

Record the adjustment for expired rent.

ANALYSIS													
The expense account, Rent Expense , is increased by \$4,000. The asset account, Prepaid Rent , is decreased by \$4,000.													
DEBIT-CREDIT RULES													
DEBIT	Increases to expense accounts are recorded as debits. Debit Rent Expense for \$4,000.												
CREDIT	Decreases to asset accounts are recorded as credits. Credit Prepaid Rent for \$4,000.												
T-ACCOUNT PRESENTATION													
<table border="1"> <thead> <tr> <th colspan="2">Rent Expense</th> </tr> <tr> <th>+</th> <th>-</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">4,000</td> <td></td> </tr> </tbody> </table>	Rent Expense		+	-	4,000		<table border="1"> <thead> <tr> <th colspan="2">Prepaid Rent</th> </tr> <tr> <th>+</th> <th>-</th> </tr> </thead> <tbody> <tr> <td></td> <td style="text-align: center;">4,000</td> </tr> </tbody> </table>	Prepaid Rent		+	-		4,000
Rent Expense													
+	-												
4,000													
Prepaid Rent													
+	-												
	4,000												

Let's review the effect of the adjustment on the asset account, **Prepaid Rent**. The beginning balance of \$8,000 represents prepaid rent for the months of December and January. By December 31, the prepaid rent for the month of December is "used up." The adjustment reducing **Prepaid Rent** recognizes the expense of occupying the facilities in December. The \$4,000 ending balance represents prepaid rent for the month of January.

Prepaid Rent			
		+	-
Bal.		8,000	
Bal.		4,000	
	Adj.		4,000

important!

Prepaid Expense

Prepaid rent is recorded as an asset at the time it is paid. As time elapses, the asset is used up. An adjustment is made to reduce the asset and to recognize rent expense.

Refer again to Figure 5.2 to review the adjustment on the worksheet: a debit of \$4,000 to *Rent Expense* and a credit of \$4,000 to *Prepaid Rent*. Both parts of the adjustment are labeled (b).

ADJUSTING FOR DEPRECIATION

There is one more adjustment to make at the end of December. It involves the equipment purchased in November. The cost of long-term assets such as equipment is not recorded as an expense when purchased. Instead, the cost is recorded as an asset and spread over the time the assets are used for the business. **Depreciation** is the process of allocating the cost of long-term assets over their expected useful lives. There are many ways to calculate depreciation. Wells' Consulting Services uses the **straight-line depreciation** method. This method results in an equal amount of depreciation being charged to each accounting period during the asset's useful life. The formula for straight-line depreciation is

$$\text{Depreciation} = \frac{\text{Cost} - \text{Salvage value}}{\text{Estimated useful life}}$$

Salvage value is an estimate of the amount that may be received by selling or disposing of an asset at the end of its useful life.

Wells' Consulting Services purchased \$11,000 worth of equipment. The equipment has an estimated useful life of five years and no salvage value. The depreciation for December, the first month of operations, is \$183 (rounded).

$$\frac{\$11,000 - \$0}{60 \text{ months}} = \$183 \text{ (rounded)}$$

1. Convert the asset's useful life from years to months: 5 years \times 12 months = 60 months.
2. Divide the total depreciation to be taken by the total number of months:
\$11,000 \div 60 = \$183 (rounded).
3. Record depreciation expense of \$183 each month for the next 60 months.

Conoco Inc. depreciates property such as refinery equipment, pipelines, and deepwater drill ships on a straight-line basis over the estimated life of each asset, ranging from 15 to 25 years.

important!

Contra Accounts

The normal balance for a contra account is the opposite of the related account.

Accumulated Depreciation

is a contra asset account.

The normal balance of an asset account is a *debit*. The normal balance of a contra asset account is a *credit*.

As the cost of the equipment is gradually transferred to expense, its recorded value as an asset must be reduced. This procedure cannot be carried out by directly decreasing the balance in the asset account. Generally accepted accounting principles require that the original cost of a long-term asset continue to appear in the asset account until the firm has used up or disposed of the asset.

The adjustment for depreciation is recorded in a contra account entitled **Accumulated Depreciation—Equipment**. A **contra account** has a normal balance that is opposite that of a related account. For example, the **Equipment** account is an asset and has a normal debit balance. **Accumulated Depreciation—Equipment** is a **contra asset account** with a normal credit balance, which is opposite the normal balance of an asset account. The adjustment to reflect depreciation for December is a \$183 debit to **Depreciation Expense—Equipment** and a \$183 credit to **Accumulated Depreciation—Equipment**.

The **Accumulated Depreciation—Equipment** account is a record of all depreciation taken on the equipment. The financial records show the original cost of the equipment (**Equipment**,

\$11,000) and all depreciation taken (*Accumulated Depreciation—Equipment*, \$183). The difference between the two accounts is called book value. **Book value** is that portion of an asset's original cost that has not yet been depreciated. Three amounts are reported on the financial statements for equipment:

Equipment	\$11,000
Less accumulated depreciation	<u>—183</u>
Equipment at book value	\$10,817

ADJUSTMENT

Record the adjustment for depreciation.

ANALYSIS

The expense account, *Depreciation Expense—Equipment*, is increased by \$183. The contra asset account, *Accumulated Depreciation—Equipment*, is increased by \$183.

DEBIT-CREDIT RULES

DEBIT Increases to expense accounts are recorded as debits. Debit *Depreciation Expense—Equipment* for \$183.

CREDIT Increases to contra asset accounts are recorded as credits. Credit *Accumulated Depreciation—Equipment* for \$183.

T-ACCOUNT PRESENTATION

Depreciation Expense—Equipment		Accumulated Depreciation—Equipment	
+	—	—	+
183			183

Refer to Figure 5.2 on page 125 to review the depreciation adjustment on the worksheet. The two parts of the adjustment are labeled (c).

If Wells' Consulting Services had other kinds of long-term tangible assets, an adjustment for depreciation would be made for each one. Long-term tangible assets include land, buildings, equipment, trucks, automobiles, furniture, and fixtures. Depreciation is calculated on all long-term tangible assets except land. Land is not depreciated.

Notice that each adjustment involved a balance sheet account (an asset or a contra asset) and an income statement account (an expense). When all adjustments have been entered, total and rule the Adjustments columns. Be sure that the totals of the Debit and Credit columns are equal. If they are not, locate and correct the error or errors before continuing. Figure 5.2 shows the completed Adjustments section.

Section 1 Self Review

QUESTIONS

1. Why is the worksheet prepared?
2. Why are prepaid expenses adjusted at the end of an accounting period?
3. What are adjustments?

EXERCISES

4. A firm paid \$2,400 for supplies during the accounting period. At the end of the accounting period, the firm had \$500 of supplies on hand. What adjustment is entered on the worksheet?
 - a. **Supplies Expense** is debited for \$1,900 and **Supplies** is credited for \$1,900.
 - b. **Supplies** is debited for \$500 and **Supplies Expense** is credited for \$500.
 - c. **Supplies Expense** is debited for \$500 and **Supplies** is credited for \$500.
 - d. **Supplies** is debited for \$1,900 and **Supplies Expense** is credited for \$1,900.
5. On January 1, a firm paid \$24,000 for six months' rent, January through June. What is the adjustment for rent expense at the end of January?
 - a. **Rent Expense** is debited for \$24,000 and **Prepaid Rent** is credited for \$24,000.
 - b. **Rent Expense** is debited for \$4,000 and **Prepaid Rent** is credited for \$4,000.
 - c. **Prepaid Rent** is debited for \$4,000 and **Rent Expense** is credited for \$4,000.
 - d. No adjustment is made until the end of June.

ANALYSIS

6. Three years ago, KB Delivery bought a delivery truck for \$90,000. The truck has no salvage value and a five-year useful life. What is the book value of the truck at the end of three years?

(Answers to Section 1 Self Review are on page 153.)

Section 2

SECTION OBJECTIVES

- >> 5-3. Complete the worksheet.
WHY IT'S IMPORTANT
 The worksheet summarizes both internal and external financial events of a period.
- >> 5-4. Prepare an income statement, statement of owner's equity, and balance sheet from the completed worksheet.
WHY IT'S IMPORTANT
 Using a worksheet saves time in preparing the financial statements.
- >> 5-5. Journalize and post the adjusting entries.
WHY IT'S IMPORTANT
 Adjusting entries update the financial records of the business.

TERMS TO LEARN

account form balance sheet
report form balance sheet

Financial Statements

The worksheet is used to prepare the financial statements. Preparing financial statements is the fifth step in the accounting cycle.

The Adjusted Trial Balance Section

The next task is to prepare the Adjusted Trial Balance section.

1. Combine the figures from the Trial Balance section and the Adjustments section of the worksheet. Record the computed results in the Adjusted Trial Balance columns.
2. Total the Debit and Credit columns in the Adjusted Trial Balance section. Confirm that debits equal credits.

Figure 5.3 on pages 132–133 shows the completed Adjusted Trial Balance section of the worksheet. The accounts that do not have adjustments are simply extended from the Trial Balance section to the Adjusted Trial Balance section. For example, the *Cash* account balance of \$111,350 is recorded in the Debit column of the Adjusted Trial Balance section without change.

The balances of accounts that are affected by adjustments are recomputed. Look at the *Supplies* account. It has a \$1,500 debit balance in the Trial Balance section and shows a \$500 credit in the Adjustments section. The new balance is \$1,000 (\$1,500 – \$500). It is recorded in the Debit column of the Adjusted Trial Balance section.

Use the following guidelines to compute the amounts for the Adjusted Trial Balance section.

- If the account has a debit balance in the Trial Balance section and a debit entry in the Adjustments section, add the two amounts.

>> **5-3. OBJECTIVE**
Complete the worksheet.

If the Trial Balance section has a:	AND if the entry in the Adjustments section is a:	Then:
Debit balance	Debit	Add the amounts.
Debit balance	Credit	Subtract the credit amount.
Credit balance	Credit	Add the amounts.
Credit balance	Debit	Subtract the debit amount.

FIGURE 5.3 A Partial Worksheet

Wells' Consulting Services									
Worksheet									
Month Ended December 31, 2016									
	ACCOUNT NAME	TRIAL BALANCE				ADJUSTMENTS			
		DEBIT		CREDIT		DEBIT		CREDIT	
1	Cash	111	350	00					
2	Accounts Receivable	5	000	00					
3	Supplies	1	500	00			(a)	5	000
4	Prepaid Rent	8	000	00			(b)	4	000
5	Equipment	11	000	00					
6	Accumulated Depreciation—Equipment						(c)	1	83
7	Accounts Payable				3	500	00		
8	Carolyn Wells, Capital				100	000	00		
9	Carolyn Wells, Drawing	5	000	00					
10	Fees Income				47	000	00		
11	Salaries Expense	8	000	00					
12	Utilities Expense	6	500	00					
13	Supplies Expense						(a)	5	000
14	Rent Expense						(b)	4	000
15	Depreciation Expense—Equipment						(c)	1	83
16	Totals	150	500	00	150	500	00	4	683
17	Net Income								

- If the account has a debit balance in the Trial Balance section and a credit entry in the Adjustments section, subtract the credit amount.
- If the account has a credit balance in the Trial Balance section and a credit entry in the Adjustments section, add the two amounts.
- If the account has a credit balance in the Trial Balance section and a debit entry in the Adjustments section, subtract the debit amount.

Prepaid Rent has a Trial Balance debit of \$8,000 and an Adjustments credit of \$4,000. Enter \$4,000 (\$8,000 – \$4,000) in the Adjusted Trial Balance Debit column.

Four accounts that started with zero balances in the Trial Balance section are affected by adjustments. They are **Accumulated Depreciation—Equipment**, **Supplies Expense**, **Rent Expense**, and **Depreciation Expense—Equipment**. The figures in the Adjustments section are simply extended to the Adjusted Trial Balance section. For example, **Accumulated Depreciation—Equipment** has a zero balance in the Trial Balance section and a \$183 credit in the Adjustments section. Extend the \$183 to the Adjusted Trial Balance Credit column.

Once all account balances are recorded in the Adjusted Trial Balance section, total and rule the Debit and Credit columns. Be sure that total debits equal total credits. If they are not equal, find and correct the error or errors.

The Income Statement and Balance Sheet Sections

The Income Statement and Balance Sheet sections of the worksheet are used to separate the amounts needed for the balance sheet and the income statement. For example, to prepare an income statement, all revenue and expense account balances must be in one place.

Starting at the top of the Adjusted Trial Balance section, examine each general ledger account. For accounts that appear on the balance sheet, enter the amount in the appropriate column of the Balance Sheet section. For accounts that appear on the income statement, enter the amount in the appropriate column of the Income Statement section. Take care to enter debit amounts in the Debit column and credit amounts in the Credit column.

ADJUSTED TRIAL BALANCE				INCOME STATEMENT				BALANCE SHEET			
DEBIT		CREDIT		DEBIT		CREDIT		DEBIT		CREDIT	
111	350	00									1
	500	00									2
	100	00									3
	400	00									4
	1100	00									5
											6
			183								7
			350								8
			100								9
	500	00									10
			470								11
	800	00									12
	650	00									13
	500	00									14
	400	00									15
	183	00									16
	150683	00	150683								17

PREPARING THE BALANCE SHEET SECTION

Refer to Figure 5.4 on pages 134–135 as you learn how to complete the worksheet. Asset, liability, and owner’s equity accounts appear on the balance sheet. The first five accounts that appear on the worksheet are assets. Extend the asset accounts to the Debit column of the Balance Sheet section. The next account, *Accumulated Depreciation—Equipment*, is a contra asset account. Extend it to the Credit column of the Balance Sheet section. Extend *Accounts Payable* and *Carolyn Wells, Capital* to the Credit column of the Balance Sheet section. Extend *Carolyn Wells, Drawing* to the Debit column of the Balance Sheet section.

PREPARING THE INCOME STATEMENT SECTION

Revenue and expense accounts appear on the income statement. Extend the *Fees Income* account to the Credit column of the Income Statement section. The last five accounts on the worksheet are expense accounts. Extend these accounts to the Debit column of the Income Statement section.

After all account balances are transferred from the Adjusted Trial Balance section of the worksheet to the financial statement sections, total the Debit and Credit columns in the Income Statement section. For Wells’ Consulting Services, the debits (expenses) total \$13,333 and the credits (revenue) total \$47,000.

Next, total the columns in the Balance Sheet section. For Wells’ Consulting Services, the debits (assets and drawing account) total \$137,350 and the credits (contra asset, liabilities, and owner’s equity) total \$103,683.

Return to the Income Statement section. The totals of these columns are used to determine the net income or net loss. Subtract the smaller column total from the larger one. Enter the difference on the line below the smaller total. In the Account Name column, enter “Net Income” or “Net Loss.”

In this case, the total of the Credit column, \$47,000, exceeds the total of the Debit column, \$13,333. The Credit column total represents revenue. The Debit column total represents expenses. The difference between the two amounts is a net income of \$33,667. Enter \$33,667 in the Debit column of the Income Statement section.

recall

Locating Errors

If total debits do not equal total credits, find the difference between total debits and total credits. If the difference is divisible by 9, there could be a transposition error. If the difference is divisible by 2, an amount could be entered in the wrong (Debit or Credit) column.

FIGURE 5.4 A Completed Worksheet

Wells' Consulting Services									
Worksheet									
Month Ended December 31, 2016									
	ACCOUNT NAME	TRIAL BALANCE				ADJUSTMENTS			
		DEBIT		CREDIT		DEBIT		CREDIT	
1	Cash	111	350	00					
2	Accounts Receivable	5	000	00					
3	Supplies	1	500	00			(a)	5	000
4	Prepaid Rent	8	000	00			(b)	4	000
5	Equipment	11	000	00					
6	Accumulated Depreciation—Equipment						(c)	1	830
7	Accounts Payable				3	500	00		
8	Carolyn Wells, Capital				100	000	00		
9	Carolyn Wells, Drawing	5	000	00					
10	Fees Income				47	000	00		
11	Salaries Expense	8	000	00					
12	Utilities Expense	6	500	00					
13	Supplies Expense						(a)	5	000
14	Rent Expense						(b)	4	000
15	Depreciation Expense—Equipment						(c)	1	830
16	Totals	150	500	00	150	500	00	4	683
17	Net Income								
18									

important!

Net Income

The difference between the Debit and Credit columns of the Income Statement section represents net income. The difference between the Debit and Credit columns of the Balance Sheet section should equal the net income amount.

Net income causes a net increase in owner's equity. As a check on accuracy, the amount in the Balance Sheet Debit column is subtracted from the amount in the Credit column and compared to net income. In the Balance Sheet section, subtract the smaller column total from the larger one. The difference should equal the net income or net loss computed in the Income Statement section. Enter the difference on the line below the smaller total. For Wells' Consulting Services, enter \$33,667 in the Credit column of the Balance Sheet section.

Total the Income Statement and Balance Sheet columns. Make sure that total debits equal total credits for each section.

Wells' Consulting Services had a net income. If it had a loss, the loss would be entered in the Credit column of the Income Statement section and the Debit column of the Balance Sheet section. "Net Loss" would be entered in the Account Name column on the worksheet.

Preparing Financial Statements

When the worksheet is complete, the next step is to prepare the financial statements, starting with the income statement. Preparation of the financial statements is the fifth step in the accounting cycle.

>> 5-4. OBJECTIVE

Prepare an income statement, statement of owner's equity, and balance sheet from the completed worksheet.

PREPARING THE INCOME STATEMENT

Use the Income Statement section of the worksheet to prepare the income statement. Figure 5.5 on page 136 shows the income statement for Wells' Consulting Services. Compare it to the worksheet in Figure 5.4.

If the firm had incurred a net loss, the final amount on the income statement would be labeled "Net Loss for the Month."

ADJUSTED TRIAL BALANCE				INCOME STATEMENT				BALANCE SHEET						
DEBIT		CREDIT		DEBIT		CREDIT		DEBIT		CREDIT				
111	350	00						111	350	00		1		
	500	00							500	00		2		
	100	00							100	00		3		
	400	00							400	00		4		
	110	00							110	00		5		
			183								183	6		
			350								350	7		
			100								100	8		
	500	00							500	00		9		
			47			47						10		
	800	00		800	00							11		
	650	00		650	00							12		
	500	00		500	00							13		
	400	00		400	00							14		
	183	00		183	00							15		
150	683	00	150	1333	00	47	00	137	350	00	103	683	00	16
				33	667	00					33	667	00	17
				47	00	00	47	137	350	00	137	350	00	18

PREPARING THE STATEMENT OF OWNER'S EQUITY

The statement of owner's equity reports the changes that have occurred in the owner's financial interest during the reporting period. Use the data in the Balance Sheet section of the worksheet, as well as the net income or net loss figure, to prepare the statement of owner's equity.

- From the Balance Sheet section of the worksheet, use the amounts for owner's capital; owner's withdrawals, if any; and owner's investments, if any.
- From the Income Statement section of the worksheet, use the amount calculated for net income or net loss.

The statement of owner's equity is prepared before the balance sheet because the ending capital balance is needed to prepare the balance sheet. The statement of owner's equity reports the change in owner's capital during the period (\$28,667) as well as the ending capital (\$128,667). Figure 5.6 on page 136 shows the statement of owner's equity for Wells' Consulting Services.

PREPARING THE BALANCE SHEET

The accounts listed on the balance sheet are taken directly from the Balance Sheet section of the worksheet. Figure 5.7 on page 136 shows the balance sheet for Wells' Consulting Services.

Note that the equipment's book value is reported on the balance sheet (\$10,817). Do not confuse book value with market value. Book value is the portion of the original cost that has not been depreciated. *Market value* is what a willing buyer will pay a willing seller for the asset. Market value may be higher or lower than book value.

Notice that the amount for *Carolyn Wells, Capital*, \$128,667, comes from the statement of owner's equity.

The balance sheet in Figure 5.7 is prepared using the report form. The **report form balance sheet** lists the asset accounts first, followed by liabilities and owner's equity. Chapters 2 and 3 illustrated the **account form balance sheet**, with assets on the left and liabilities

FIGURE 5.5

Income Statement

Wells' Consulting Services	
Income Statement	
Month Ended December 31, 2016	
<i>Revenue</i>	
<i>Fees Income</i>	47 0 0 0 00
<i>Expenses</i>	
<i>Salaries Expense</i>	8 0 0 0 00
<i>Utilities Expense</i>	6 5 0 0 00
<i>Supplies Expense</i>	5 0 0 0 00
<i>Rent Expense</i>	4 0 0 0 00
<i>Depreciation Expense—Equipment</i>	1 8 3 0 00
<i>Total Expenses</i>	13 3 3 3 00
<i>Net Income for the Month</i>	33 6 6 7 00

FIGURE 5.6

Statement of Owner's Equity

Wells' Consulting Services	
Statement of Owner's Equity	
Month Ended December 31, 2016	
<i>Carolyn Wells, Capital, December 1, 2016</i>	100 0 0 0 00
<i>Net Income for December</i>	33 6 6 7 00
<i>Less Withdrawals for December</i>	5 0 0 0 00
<i>Increase in Capital</i>	28 6 6 7 00
<i>Carolyn Wells, Capital, December 31, 2016</i>	128 6 6 7 00

FIGURE 5.7

Balance Sheet

Wells' Consulting Services	
Balance Sheet	
December 31, 2016	
<i>Assets</i>	
<i>Cash</i>	111 3 5 0 00
<i>Accounts Receivable</i>	5 0 0 0 00
<i>Supplies</i>	1 0 0 0 00
<i>Prepaid Rent</i>	4 0 0 0 00
<i>Equipment</i>	11 0 0 0 00
<i>Less Accumulated Depreciation</i>	1 8 3 0 00
<i>Total Assets</i>	132 1 6 7 00
<i>Liabilities and Owner's Equity</i>	
<i>Liabilities</i>	
<i>Accounts Payable</i>	3 5 0 0 00
<i>Owner's Equity</i>	
<i>Carolyn Wells, Capital</i>	128 6 6 7 00
<i>Total Liabilities and Owner's Equity</i>	132 1 6 7 00

FIGURE 5.8A Worksheet Summary

The worksheet is used to gather all the data needed at the end of an accounting period to prepare the financial statements. The worksheet heading contains the name of the company (*WHO*), the title of the statement being prepared (*WHAT*), and the period covered (*WHEN*). The worksheet contains 10 money columns that are arranged in five sections labeled Trial Balance, Adjustments, Adjusted Trial Balance, Income Statement, and Balance Sheet. Each section includes a Debit column and a Credit column.

The information reflected in the worksheet below is for Wells' Consulting Services for the period ending December 31, 2016. The illustrations that follow will highlight the preparation of each part of the worksheet.

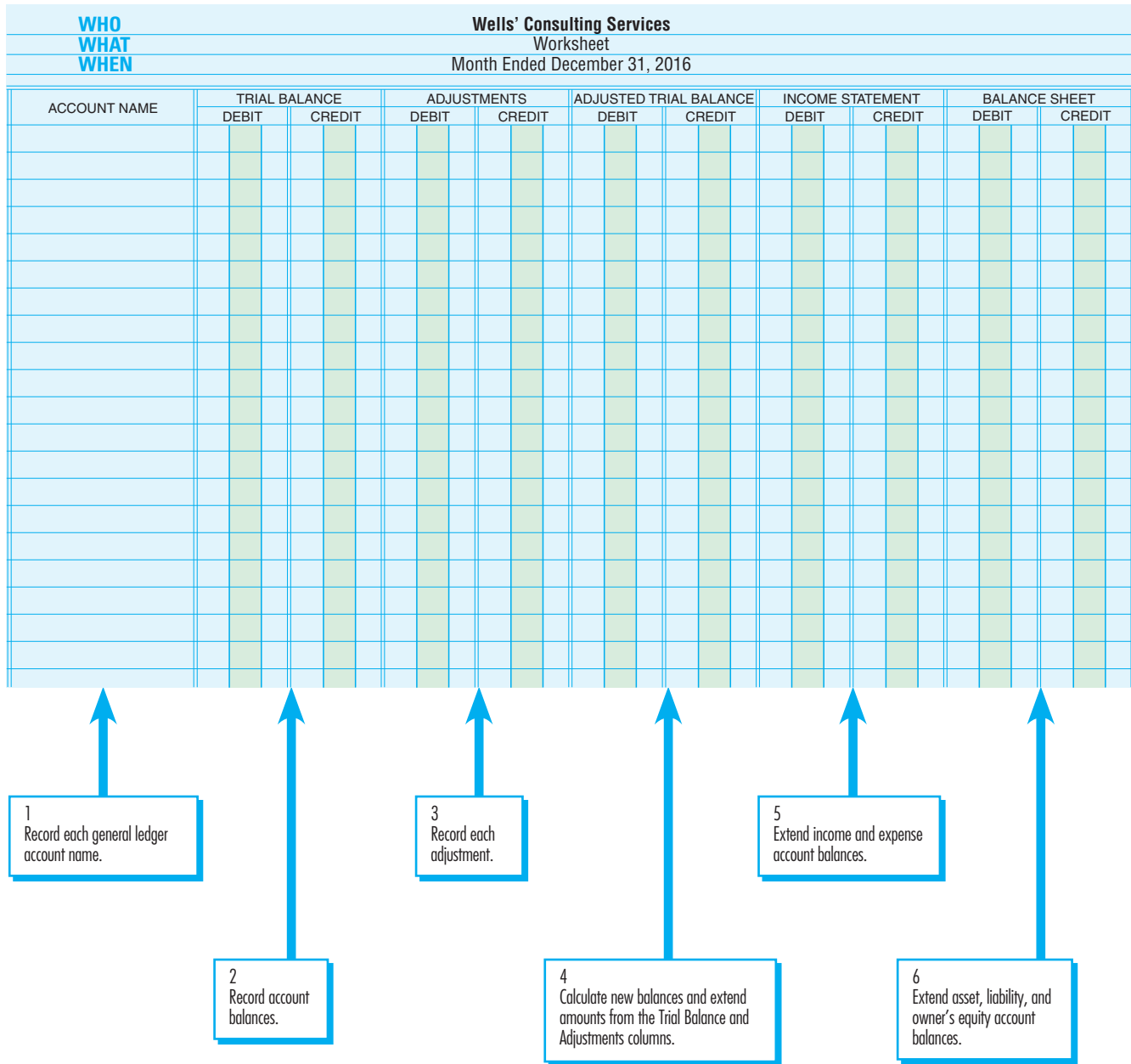


FIGURE 5.8B The Trial Balance Columns

The first step in preparing the worksheet for Wells' Consulting Services is to list the general ledger accounts and their balances in the Account Name and Trial Balance sections of the worksheet. The equality of total debits and credits is proved by totaling the Debit and Credit columns.

Wells' Consulting Services										
Worksheet										
Month Ended December 31, 2016										
ACCOUNT NAME	TRIAL BALANCE		ADJUSTMENTS		ADJUSTED TRIAL BALANCE		INCOME STATEMENT		BALANCE SHEET	
	DEBIT	CREDIT	DEBIT	CREDIT	DEBIT	CREDIT	DEBIT	CREDIT	DEBIT	CREDIT
Cash	111 350 00									
Accounts Receivable	5 000 00									
Supplies	1 500 00									
Prepaid Rent	8 000 00									
Equipment	11 000 00									
Accum. Depr.—Equipment										
Accounts Payable		3 500 00								
Carolyn Wells, Capital		100 000 00								
Carolyn Wells, Drawing	5 000 00									
Fees Income		47 000 00								
Salaries Expense	8 000 00									
Utilities Expense	650 00									
Supplies Expense										
Rent Expense										
Depr. Expense—Equipment										
Totals	150 500 00	150 500 00								

Draw a single rule to indicate the addition of the Debit and the Credit columns.

Draw a double rule under the totals of a set of Debit/Credit columns to indicate that no further amounts are to be added.

Trial Balance totals must be equal.

FIGURE 5.8C The Adjustments

The data in the general ledger accounts at the end of an accounting period does not present a complete picture of the firm's financial affairs even though transactions have been recorded accurately throughout the period. Certain financial changes have occurred with the business as a result of its operations that have not yet been entered in the accounting records. These changes must be recognized and recorded at the end of the accounting period. The Adjustments section of the worksheet is used to record these changes.

The Adjustments section of the worksheet for Wells' Consulting Services reflects three adjustments. Notice that the debit and credit parts of each adjustment are identified by a letter. After all adjustments are entered, the Debit and Credit columns of the Adjustments section are totaled to test that total debits equal total credits.

(a) 500 00

(b) 4 000 00

(c) 183 00

(a) 500 00

(b) 4 000 00

(c) 183 00

4 683 00 4 683 00

Draw a single rule to indicate that the columns are to be added.

Total debits must equal total credits.

Draw a double rule under the Debit/Credit column total.

FIGURE 5.8D The Adjusted Trial Balance

The third set of columns is the Adjusted Trial Balance. The balance for the accounts in this set of columns is obtained by combining the amounts in the Trial Balance columns with the amounts in the Adjustments columns. If no adjustment is made to an account, the amount in the Trial Balance column is extended to the appropriate column in the Adjusted Trial Balance section. If an adjustment is made to an account, the adjustment amount is added to or subtracted from the Trial Balance amount and the new total is extended to the appropriate column in the Adjusted Trial Balance section.

111 350 00	
5 000 00	
1 000 00	
4 000 00	
11 000 00	
	183 00
	3 500 00
	100 000 00
5 000 00	
	47 000 00
8 000 00	
650 00	
500 00	
4 000 00	
183 00	
<u>150 683 00</u>	<u>150 683 00</u>

Draw a single rule to indicate that the columns are to be added.

Total debits must equal total credits.

Draw a double rule under the Debit/Credit column totals.

FIGURE 5.8E The Financial Statement Columns

The accounts from the Adjusted Trial Balance columns are next extended to the columns of the statements on which the accounts will appear. The account balances for the asset, liability, and owner's capital accounts are extended to the Balance Sheet columns. The owner's drawing account balance is extended to the Balance Sheet Debit column and will be used when the formal statement of owner's equity is prepared. The balances of the revenue and expense accounts are extended to the Income Statement columns.

	111 350 00	
	5 000 00	
	1 000 00	
	4 000 00	
	11 000 00	
		183 00
		3 500 00
		100 000 00
		5 000 00
	47 000 00	
8 000 00		
650 00		
500 00		
4 000 00		
183 00		

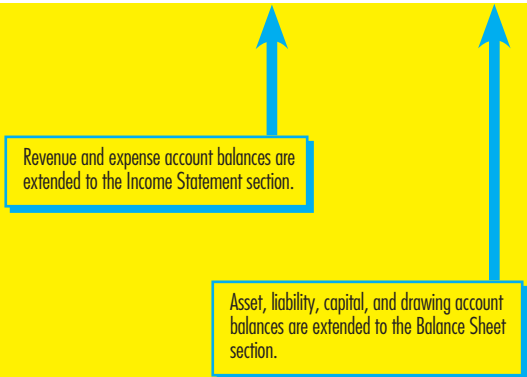



FIGURE 5.8F Determining Net Income or Net Loss

After all account balances have been transferred to the financial statement sections, the columns in the Income Statement and Balance Sheet sections are totaled. The difference between the larger and smaller column totals represents the net income or net loss for the period. In the case of Wells' Consulting Services, the difference of \$33,667.00 represents the net income for the period because the smaller column in the Income Statement section is the Debit column. This balance indicates that the firm had more revenue for the period than expenses. Notice that the smaller column in the Balance Sheet section of the worksheet is the Credit column. The net income is added to the smaller column total in the Balance Sheet section because the net income represents an increase of the owner's equity in the business.

After the net income or net loss is recorded on the worksheet, the Income Statement and Balance Sheet columns are totaled again. All pairs of columns should balance.

<u>13 333 00</u>	<u>47 000 00</u>	<u>137 350 00</u>	<u>103 683 00</u>
33 667 00			33 667 00
<u>47 000 00</u>	<u>47 000 00</u>	<u>137 350 00</u>	<u>137 350 00</u>

Net Income



The net income or net loss is the balancing amount for both the Income Statement and Balance Sheet columns. The income or loss will always be added to the smaller column total. If the smaller column is the Debit subtotal, a net income is reported for the period. If the smaller column is the Credit subtotal, a net loss is reported for the period.

FIGURE 5.8G Preparing the Financial Statements

The information needed to prepare the financial statements is obtained from the worksheet.

Wells' Consulting Services					
Income Statement					
Month Ended December 31, 2016					
<i>Revenue</i>					
Fees Income				47	000 00
<i>Expenses</i>					
Salaries Expense	8	000 00			
Utilities Expense		6 50 00			
Supplies Expense		5 00 00			
Rent Expense	4	000 00			
Depreciation Expense—Equipment		1 83 00			
Total Expenses				13	333 00
Net Income for the Month				33	667 00

When expenses for the period are less than revenue, a net income results. The net income is transferred to the statement of owner's equity.

Wells' Consulting Services					
Statement of Owner's Equity					
Month Ended December 31, 2016					
Carolyn Wells, Capital, December 1, 2016				100	000 00
Net Income for December	33	667 00			
Less Withdrawals for December		5 00 00			
Increase in Capital				28	667 00
Carolyn Wells, Capital, December 31, 2016				128	667 00

The withdrawals are subtracted from the net income for the period to determine the change in owner's equity.

Wells' Consulting Services					
Balance Sheet					
December 31, 2016					
<i>Assets</i>					
Cash				111	350 00
Accounts Receivable				5	000 00
Supplies				1	000 00
Prepaid Rent				4	000 00
Equipment	11	000 00			
Less Accumulated Depreciation		1 83 00		10	817 00
Total Assets				132	167 00
<i>Liabilities and Owner's Equity</i>					
<i>Liabilities</i>					
Accounts Payable				3	500 00
<i>Owner's Equity</i>					
Carolyn Wells, Capital				128	667 00
Total Liabilities and Owner's Equity				132	167 00

The ending capital balance is transferred from the statement of owner's equity to the balance sheet.

SUMMARY OF FINANCIAL STATEMENTS

THE INCOME STATEMENT

The income statement is prepared directly from the data in the Income Statement section of the worksheet. The heading of the income statement contains the name of the firm (WHO), the name of the statement (WHAT), and the period covered by the statement (WHEN). The revenue section of the statement is prepared first. The revenue account name is obtained from the Account Name column of the worksheet. The balance of the revenue account is obtained from the Credit column of the Income Statement section of the worksheet. The expenses section of the income statement is prepared next. The expense account titles are obtained from the Account Name column of the worksheet. The balance of each expense account is obtained from the Debit column of the Income Statement section of the worksheet.

Determining the net income or net loss for the period is the last step in preparing the income statement. If the firm has more revenue than expenses, a net income is reported for the period. If the firm has more expenses than revenue, a net loss is reported. The net income or net loss reported must agree with the amount calculated on the worksheet.

THE STATEMENT OF OWNER'S EQUITY

The statement of owner's equity is prepared from the data in the Balance Sheet section of the worksheet and the general ledger capital account. The statement of owner's equity is prepared before the balance sheet so that the amount of the ending capital balance is available for presentation on the balance sheet. The heading of the statement contains the name of the firm (WHO), the name of the statement (WHAT), and the date of the statement (WHEN).

The statement begins with the capital account balance at the beginning of the period. Next, the increase or decrease in the owner's capital account is determined. The increase or decrease is computed by adding the net income (or subtracting the net loss) for the period to any additional investments made by the owner during the period and subtracting withdrawals for the period. The increase or decrease is added to the beginning capital balance to obtain the ending capital balance.

THE BALANCE SHEET

The balance sheet is prepared from the data in the Balance Sheet section of the worksheet and the statement of owner's equity. The balance sheet reflects the assets, liabilities, and owner's equity of the firm on the balance sheet date. The heading of the statement contains the name of the firm (WHO), the name of the statement (WHAT), and the date of the statement (WHEN).

The assets section of the statement is prepared first. The asset account titles are obtained from the Account Name column of the worksheet. The balance of each asset account is obtained from the Debit column of the Balance Sheet section of the worksheet. The liability and owner's equity section is prepared next. The liability and owner's equity account titles are obtained from the Account Name column of the worksheet. The balance of each liability account is obtained from the Credit column of the Balance Sheet section of the worksheet. The ending balance for the owner's capital account is obtained from the statement of owner's equity. Total liabilities and owner's equity must equal total assets.

and owner's equity on the right. The report form is widely used because it provides more space for entering account names and its format is easier to prepare.

Some companies show long-term assets at a net amount. "Net" means that accumulated depreciation has been subtracted from the original cost. For example, The Boeing Company's consolidated statement of financial position as of December 31, 2011, states:

Property, plant, and equipment, net: \$9,313 million
The accumulated depreciation amount does not appear on the balance sheet.

Figure 5.8A through 5.8G on the preceding pages provides a step-by-step demonstration of how to complete the worksheet and financial statements for Wells' Consulting Services.

Journalizing and Posting Adjusting Entries

The worksheet is a tool. It is used to determine the effects of adjustments on account balances. It is also used to prepare the financial statements. However, the worksheet is not part of the permanent accounting record.

After the financial statements are prepared, the adjustments shown on the worksheet must become part of the permanent accounting record. Each adjustment is journalized and posted to the general ledger accounts. Journalizing and posting adjusting entries is the sixth step in the accounting cycle.

For Wells' Consulting Services, three adjustments are needed to provide a complete picture of the firm's operating results and its financial position. Adjustments are needed for supplies expense, rent expense, and depreciation expense.

Refer to Figure 5.4 on pages 134–135 for data needed to record the adjustments. Enter the words "Adjusting Entries" in the Description column of the general journal. Some accountants prefer to start a new page when they record the adjusting entries. Then journalize the adjustments in the order in which they appear on the worksheet.

After journalizing the adjusting entries, post them to the general ledger accounts. Figure 5.9 on page 138 shows how the adjusting entries for Wells' Consulting Services on December 31, 2016, were journalized and posted. Account numbers appear in the general journal Posting Reference column because all entries have been posted. In each general ledger account, the word "Adjusting" appears in the Description column.

Remember that the worksheet is not part of the accounting records. Adjustments that are on the worksheet must be recorded in the general journal and posted to the general ledger in order to become part of the permanent accounting records.

>> 5-5. OBJECTIVE

Journalize and post the adjusting entries.

FIGURE 5.9

Journalized and Posted
Adjusting Entries

GENERAL JOURNAL										PAGE	3	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT								
2016	Adjusting Entries											1
Dec. 31	Supplies Expense	517	5 0 0 00									2
	Supplies	121		5 0 0 00								3
												4
	31 Rent Expense	520	4 0 0 0 00									5
	Prepaid Rent	137		4 0 0 0 00								6
												7
	31 Depr. Expense—Equipment	523	1 8 3 00									8
	Accum. Depr.—Equipment	142		1 8 3 00								9
												10
ACCOUNT <u>Supplies</u>										ACCOUNT NO.	121	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Nov. 28		J1	1 5 0 0 00		1 5 0 0 00							
Dec. 31	Adjusting	J3		5 0 0 00	1 0 0 0 00							
ACCOUNT <u>Prepaid Rent</u>										ACCOUNT NO.	137	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Nov. 30		J2	8 0 0 0 00		8 0 0 0 00							
Dec. 31	Adjusting	J3		4 0 0 0 00	4 0 0 0 00							
ACCOUNT <u>Accumulated Depreciation—Equipment</u>										ACCOUNT NO.	142	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Dec. 31	Adjusting	J3		1 8 3 00		1 8 3 00						
ACCOUNT <u>Supplies Expense</u>										ACCOUNT NO.	517	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Dec. 31	Adjusting	J3	5 0 0 00		5 0 0 00							
ACCOUNT <u>Rent Expense</u>										ACCOUNT NO.	520	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Dec. 31	Adjusting	J3	4 0 0 0 00		4 0 0 0 00							
ACCOUNT <u>Depreciation Expense—Equipment</u>										ACCOUNT NO.	523	
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	BALANCE							
					DEBIT	CREDIT						
2016												
Dec. 31	Adjusting	J3	1 8 3 00		1 8 3 00							

MANAGERIAL IMPLICATIONS <<

WORKSHEETS

- The worksheet permits quick preparation of the financial statements. Quick preparation of financial statements allows management to obtain timely information.
- Timely information allows management to:
 - evaluate the results of operations,
 - evaluate the financial position of the business,
 - make decisions.
- The worksheet provides a convenient form for gathering information and determining the effects of internal changes, such as:
 - recording an expense for the use of a long-term asset like equipment,
 - recording the actual use of prepaid items.

- The more accounts that a firm has in its general ledger, the more useful the worksheet is in speeding the preparation of the financial statements.
- It is important to management that the appropriate adjustments are recorded in order to present a complete and accurate picture of the firm's financial affairs.

THINKING CRITICALLY

Why is it necessary to record an adjustment for depreciation?

Section 2 Self Review

QUESTIONS

1. What amounts appear on the statement of owner's equity?
2. What is the difference between a report form balance sheet and an account form balance sheet?
3. Why is it necessary to journalize and post adjusting entries even though the data are already recorded on the worksheet?

EXERCISES

4. On a worksheet, the adjusted balance of the *Supplies* account is extended to the:
 - a. Balance Sheet Credit column.
 - b. Income Statement Credit column.
 - c. Income Statement Debit column.
 - d. Balance Sheet Debit column.
5. *Accumulated Depreciation—Equipment* is a(n):
 - a. contra liability account.
 - b. liability account.

- c. contra asset account.
- d. asset account.

ANALYSIS

6. Exes Repair Shop purchased equipment for \$32,000. *Depreciation Expense* for the month is \$800. What is the balance of the *Equipment* account after posting the depreciation entry? Why?

(Answers to Section 2 Self Review are on page 153.)

5

Chapter

REVIEW

Chapter Summary

At the end of the operating period, adjustments for internal events are recorded to update the accounting records. In this chapter, you have learned how the accountant uses the worksheet and adjusting entries to accomplish this task.

Learning Objectives

5-1 Complete a trial balance on a worksheet.

A worksheet is normally used to save time in preparing the financial statements. Preparation of the worksheet is the fourth step in the accounting cycle. The trial balance is the first section of the worksheet to be prepared.

5-2 Prepare adjustments for unrecorded business transactions.

Some changes arise from the internal operations of the firm itself. Adjusting entries are made to record these changes. Any adjustments to account balances should be entered in the Adjustments section of the worksheet.

- Prepaid expenses are expense items that are acquired and paid for in advance of their use. At the time of their acquisition, these items represent assets and are recorded in asset accounts. As they are used, their cost is transferred to expense by means of adjusting entries at the end of each accounting period.

Examples of general ledger asset accounts and the related expense accounts follow:

<u>Asset Accounts</u>	<u>Expense Accounts</u>
Supplies	Supplies Expense
Prepaid Rent	Rent Expense
Prepaid Insurance	Insurance Expense

- Depreciation is the process of allocating the cost of a long-term tangible asset to operations over its expected useful life. Part of the asset's cost is charged off as an expense at the end of each accounting period during the asset's useful life. The straight-line method of depreciation is widely used. The formula for straight-line depreciation is:

$$\text{Depreciation} = \frac{\text{Cost} - \text{Salvage value}}{\text{Estimated useful life}}$$

5-3 Complete the worksheet.

An adjusted trial balance is prepared to prove the equality of the debits and credits after adjustments have been entered on the worksheet. Once the Debit and Credit columns have been totaled and ruled, the Income Statement and Balance Sheet columns of the worksheet are completed. The net income or net loss for the period is determined, and the worksheet is completed.

5-4 Prepare an income statement, statement of owner's equity, and balance sheet from the completed worksheet.

All figures needed to prepare the financial statements are properly reflected on the completed worksheet. The accounts are arranged in the order in which they must appear on the income statement and balance sheet. Preparation of the financial statements is the fifth step of the accounting cycle.

5-5 Journalize and post the adjusting entries.

After the financial statements have been prepared, the accountant must make permanent entries in the accounting records for the adjustments shown on the worksheet. The adjusting entries are then posted to the general ledger. Journalizing and posting the adjusting entries is the sixth step in the accounting cycle.

To summarize the steps of the accounting cycle discussed so far:

1. Analyze transactions.
2. Journalize transactions.
3. Post the journal entries.
4. Prepare a worksheet.
5. Prepare financial statements.
6. Record adjusting entries.

5-6 Define the accounting terms new to this chapter.

Glossary

Account form balance sheet (p. 135) A balance sheet that lists assets on the left and liabilities and owner's equity on the right (see Report form balance sheet)

Adjusting entries (p. 125) Journal entries made to update accounts for items that were not recorded during the accounting period

Adjustments (p. 125) See Adjusting entries

Book value (p. 129) That portion of an asset's original cost that has not yet been depreciated

Contra account (p. 128) An account with a normal balance that is opposite that of a related account

Contra asset account (p. 128) An asset account with a credit balance, which is contrary to the normal balance of an asset account

Depreciation (p. 128) Allocation of the cost of a long-term asset to operations during its expected useful life

Prepaid expenses (p. 126) Expense items acquired, recorded, and paid for in advance of their use

Report form balance sheet (p. 135) A balance sheet that lists the asset accounts first, followed by liabilities and owner's equity

Salvage value (p. 128) An estimate of the amount that could be received by selling or disposing of an asset at the end of its useful life

Straight-line depreciation (p. 128) Allocation of an asset's cost in equal amounts to each accounting period of the asset's useful life

Worksheet (p. 124) A form used to gather all data needed at the end of an accounting period to prepare financial statements

Comprehensive Self Review

1. Why are assets depreciated?
2. The *Supplies* account has a debit balance of \$8,000 in the Trial Balance column. The Credit column in the Adjustments section is \$2,400. What is the new balance? The new balance will be extended to which column of the worksheet?
3. Is the normal balance for *Accumulated Depreciation* a debit or credit balance?
4. Why is the net income for a period recorded in the Balance Sheet section of the worksheet as well as the Income Statement section?
5. The *Drawing* account is extended to which column of the worksheet?

(Answers to Comprehensive Self Review are on page 153.)

Discussion Questions

1. Why is it necessary to make an adjustment for supplies used?
2. What are prepaid expenses? Give four examples.
3. What adjustment would be recorded for expired insurance?
4. A firm purchases machinery, which has an estimated useful life of 10 years and no salvage value, for \$48,000 at the beginning of the accounting period. What is the adjusting entry for depreciation at the end of one month if the firm uses the straight-line method of depreciation?

5. What effect does each of the following items have on net income?
 - a. The owner withdrew cash from the business.
 - b. Credit customers paid \$1,000 on outstanding balances that were past due.
 - c. The business bought equipment on account that cost \$10,000.
 - d. The business journalized and posted an adjustment for depreciation of equipment.
6. What effect does each item in Question 5 have on owner's equity?
7. Why is it necessary to journalize and post adjusting entries?
8. What three amounts are reported on the balance sheet for a long-term asset such as equipment?
9. What is book value?
10. How does a contra asset account differ from a regular asset account?
11. Why is an accumulated depreciation account used in making the adjustment for depreciation?
12. Are the following assets depreciated? Why or why not?
 - a. Prepaid Insurance
 - b. Delivery Truck
 - c. Land
 - d. Manufacturing Equipment
 - e. Prepaid Rent
 - f. Furniture
 - g. Store Equipment
 - h. Prepaid Advertising
 - i. Computers
13. How does the straight-line method of depreciation work?
14. Give three examples of assets that are subject to depreciation.

APPLICATIONS

Exercises connect[®] | ACCOUNTING

Exercise 5.1 Objective 5-2

► Calculating adjustments.

Determine the necessary end-of-June adjustments for Brown Company.

1. On June 1, 2016, Brown Company, a new firm, paid \$7,000 rent in advance for a seven-month period. The \$7,000 was debited to the *Prepaid Rent* account.
2. On June 1, 2016, the firm bought supplies for \$7,950. The \$7,950 was debited to the *Supplies* account. An inventory of supplies at the end of June showed that items costing \$3,300 were on hand.
3. On June 1, 2016, the firm bought equipment costing \$64,800. The equipment has an expected useful life of 9 years and no salvage value. The firm will use the straight-line method of depreciation.

Exercise 5.2 Objective 5-2

► Calculating adjustments.

For each of the following situations, determine the necessary adjustments.

1. A firm purchased a three-year insurance policy for \$12,600 on July 1, 2016. The \$12,600 was debited to the *Prepaid Insurance* account. What adjustment should be made to record expired insurance on the firm's July 31, 2016, worksheet?

2. On December 1, 2016, a firm signed a contract with a local radio station for advertising that will extend over a two-year period. The firm paid \$32,400 in advance and debited the amount to *Prepaid Advertising*. What adjustment should be made to record expired advertising on the firm's December 31, 2016, worksheet?

Worksheet through Adjusted Trial Balance.

On January 31, 2016, the general ledger of Meeks Company showed the following account balances. Prepare the worksheet through the Adjusted Trial Balance section. Assume that every account has the normal debit or credit balance. The worksheet covers the month of January.

ACCOUNTS	
Cash	63,000
Accounts Receivable	22,500
Supplies	9,000
Prepaid Insurance	8,200
Equipment	91,500
Accum. Depr. — Equip.	0
Accounts Payable	16,700
Lorraine Meeks, Capital	81,950
Fees Income	117,000
Depreciation Exp. — Equip.	0
Insurance Expense	0
Rent Expense	10,600
Salaries Expense	10,850
Supplies Expense	0

Additional information:

- Supplies used during January totaled \$5,700.
- Expired insurance totaled \$2,050.
- Depreciation expense for the month was \$1,825.

Correcting net income.

Assume that a firm reports net income of \$90,000 prior to making adjusting entries for the following items: expired rent, \$7,000; depreciation expense, \$8,200; and supplies used, \$3,600.

Assume that the required adjusting entries have not been made. What effect do these errors have on the reported net income?

Journalizing and posting adjustments.

Zavier Company must make three adjusting entries on December 31, 2016.

- Supplies used, \$11,000; (supplies totaling \$18,000 were purchased on December 1, 2016, and debited to the *Supplies* account).
- Expired insurance, \$8,200; on December 1, 2016, the firm paid \$49,200 for six months' insurance coverage in advance and debited *Prepaid Insurance* for this amount.
- Depreciation expense for equipment, \$5,800.

Make the journal entries for these adjustments and post the entries to the general ledger accounts: Use page 3 of the general journal for the adjusting entries. Use the following accounts and numbers.

Supplies	121
Prepaid Insurance	131
Accum. Depr. — Equip.	142
Depreciation Exp. — Equip.	517
Insurance Expense	521
Supplies Expense	523

Exercise 5.3

Objectives 5-1, 5-2

Exercise 5.4

Objectives 5-2, 5-3

Exercise 5.5

Objective 5-5

PROBLEMS

Problem Set A



Problem 5.1A ▶ Completing the worksheet.

Objectives 5-1, 5-2, 5-3

The trial balance of Nixon Company as of January 31, 2016, after the company completed the first month of operations, is shown in the partial worksheet below.

INSTRUCTIONS

- Record the trial balance in the Trial Balance section of the worksheet.
- Complete the worksheet by making the following adjustments: supplies on hand at the end of the month, \$4,200; expired insurance, \$5,500; depreciation expense for the period, \$1,600.

Analyze: How does the insurance adjustment affect *Prepaid Insurance*?

Nixon Company									
Worksheet (Partial)									
Month Ended January 31, 2016									
	ACCOUNT NAME	TRIAL BALANCE				ADJUSTMENTS			
		DEBIT		CREDIT		DEBIT		CREDIT	
1	Cash	105	00	00	00				
2	Accounts Receivable	21	80	00	00				
3	Supplies	39	40	00	00				
4	Prepaid Insurance	66	00	00	00				
5	Equipment	109	00	00	00				
6	Accumulated Depreciation—Equipment								
7	Accounts Payable					25	80	00	00
8	Robert Nixon, Capital					253	00	00	00
9	Robert Nixon, Drawing	15	40	00	00				
10	Fees Income					114	20	00	00
11	Depreciation Expense—Equipment								
12	Insurance Expense								
13	Salaries Expense	32	20	00	00				
14	Supplies Expense								
15	Utilities Expense	4	20	00	00				
16	Totals	393	00	00	00	393	00	00	00

Problem 5.2A ▶ Reconstructing a partial worksheet.

Objectives 5-1, 5-2, 5-3

The adjusted trial balance of College Book Store as of November 30, 2016, after the firm's first month of operations, appears on the next page.

Appropriate adjustments have been made for the following items:

- Supplies used during the month, \$5,800.
- Expired rent for the month, \$7,000.
- Depreciation expense for the month, \$1,900.

INSTRUCTIONS

- Record the Adjusted Trial Balance in the Adjusted Trial Balance columns of the worksheet.
- Prepare the adjusting entries in the Adjustments columns.
- Complete the Trial Balance columns of the worksheet prior to making the adjusting entries.

Analyze: What was the balance of *Prepaid Rent* prior to the adjusting entry for expired rent?

College Book Store Adjusted Trial Balance November 30, 2016		
Account Name	Debit	Credit
Cash	\$ 46,150	
Accounts Receivable	7,624	
Supplies	9,200	
Prepaid Rent	42,000	
Equipment	55,000	
Accumulated Depreciation—Equipment		\$ 1,900
Accounts Payable		18,000
Randy Moss, Capital		83,674
Randy Moss, Drawing	8,000	
Fees Income		97,100
Depreciation Expense—Equipment	1,900	
Rent Expense	7,000	
Salaries Expense	17,000	
Supplies Expense	5,800	
Utilities Expense	1,000	
Totals	<u>\$200,674</u>	<u>\$200,674</u>

Preparing financial statements from the worksheet.

The completed worksheet for Vasquez Corporation as of December 31, 2016, after the company had completed the first month of operation, appears across the tops of pages 146–147.

INSTRUCTIONS

1. Prepare an income statement.
2. Prepare a statement of owner's equity. The owner made no additional investments during the month.
3. Prepare a balance sheet (use the report form).

Analyze: If the adjustment to *Prepaid Advertising* had been \$6,800 instead of \$3,400, what net income would have resulted?

Preparing a worksheet and financial statements, journalizing adjusting entries, and posting to ledger accounts.

Paula Judge owns Judge Creative Designs. The trial balance of the firm for January 31, 2016, the first month of operations, is shown on the bottom of page 146.

INSTRUCTIONS

1. Complete the worksheet for the month.
2. Prepare an income statement, statement of owner's equity, and balance sheet. No additional investments were made by the owner during the month.
3. Journalize and post the adjusting entries. Use 3 for the journal page number. Use the following account numbers: Supplies, 121; Prepaid Advertising, 130; Prepaid Rent, 131; Accumulated Depreciation—Equipment, 142; Supplies Expense, 517; Advertising Expense, 519; Rent Expense, 520; Depreciation Expense, 523.

End-of-the-month adjustments must account for the following items:

- a. Supplies were purchased on January 1, 2016; inventory of supplies on January 31, 2016, is \$1,600.
- b. The prepaid advertising contract was signed on January 1, 2016, and covers a four-month period.

◀ Problem 5.3A Objective 5-4

◀ Problem 5.4A Objectives 5-1, 5-2, 5-3, 5-4, 5-5



Sage 50
Complete Accounting

Vasquez Corporation
Worksheet
Month Ended December 31, 2016

	ACCOUNT NAME	TRIAL BALANCE		ADJUSTMENTS	
		DEBIT	CREDIT	DEBIT	CREDIT
1	Cash	78 2 0 0 00			
2	Accounts Receivable	13 0 0 0 00			
3	Supplies	12 1 0 0 00			(a) 7 0 0 0 00
4	Prepaid Advertising	20 4 0 0 00			(b) 3 4 0 0 00
5	Equipment	85 0 0 0 00			
6	Accumulated Depreciation—Equipment				(c) 1 7 0 0 00
7	Accounts Payable		13 0 0 0 00		
8	Rosa Vasquez, Capital		109 0 0 0 00		
9	Rosa Vasquez, Drawing	8 2 0 0 00			
10	Fees Income		115 5 0 0 00		
11	Advertising Expense			(b) 3 4 0 0 00	
12	Depreciation Expense—Equipment			(c) 1 7 0 0 00	
13	Salaries Expense	17 8 0 0 00			
14	Supplies Expense			(a) 7 0 0 0 00	
15	Utilities Expense	2 8 0 0 00			
16	Totals	237 5 0 0 00	237 5 0 0 00	12 1 0 0 00	12 1 0 0 00
17	Net Income				
18					
19					

c. Rent of \$2,100 expired during the month.

d. Depreciation is computed using the straight-line method. The equipment has an estimated useful life of 10 years with no salvage value.

Analyze: If the adjusting entries had not been made for the month, would net income be overstated or understated?

Judge Creative Designs
Worksheet (Partial)
Month Ended January 31, 2016

	ACCOUNT NAME	TRIAL BALANCE	
		DEBIT	CREDIT
1	Cash	36 5 0 0 00	
2	Accounts Receivable	13 6 0 0 00	
3	Supplies	9 7 5 0 00	
4	Prepaid Advertising	12 4 0 0 00	
5	Prepaid Rent	25 2 0 0 00	
6	Equipment	33 6 0 0 00	
7	Accumulated Depreciation—Equipment		
8	Accounts Payable		16 5 5 0 00
9	Paula Judge, Capital		61 0 0 0 00
10	Paula Judge, Drawing	8 0 0 0 00	
11	Fees Income		74 1 0 0 00
12	Advertising Expense		
13	Depreciation Expense—Equipment		
14	Rent Expense		
15	Salaries Expense	10 7 0 0 00	
16	Supplies Expense		
17	Utilities Expense	1 9 0 0 00	
18	Totals	151 6 5 0 00	151 6 5 0 00
19			

ADJUSTED TRIAL BALANCE				INCOME STATEMENT				BALANCE SHEET				
DEBIT		CREDIT		DEBIT		CREDIT		DEBIT		CREDIT		
78 2 0 0 00								78 2 0 0 00				1
13 0 0 0 00								13 0 0 0 00				2
5 1 0 0 00								5 1 0 0 00				3
17 0 0 0 00								17 0 0 0 00				4
85 0 0 0 00								85 0 0 0 00				5
		1 7 0 0 00								1 7 0 0 00		6
		13 0 0 0 00								13 0 0 0 00		7
		109 0 0 0 00								109 0 0 0 00		8
8 2 0 0 00								8 2 0 0 00				9
		115 5 0 0 00				115 5 0 0 00						10
3 4 0 0 00				3 4 0 0 00								11
1 7 0 0 00				1 7 0 0 00								12
17 8 0 0 00				17 8 0 0 00								13
7 0 0 0 00				7 0 0 0 00								14
2 8 0 0 00				2 8 0 0 00								15
239 2 0 0 00	239 2 0 0 00			32 7 0 0 00	115 5 0 0 00			206 5 0 0 00	123 7 0 0 00			16
				82 8 0 0 00					82 8 0 0 00			17
				115 5 0 0 00	115 5 0 0 00			206 5 0 0 00	206 5 0 0 00			18
												19

Problem Set B

Completing the worksheet.

The trial balance of Sanchez Company as of February 29, 2016, appears below.

◀ **Problem 5.1B**
Objectives 5-1, 5-2, 5-3

Sanchez Company					
Worksheet (Partial)					
Month Ended February 29, 2016					
	ACCOUNT NAME	TRIAL BALANCE		ADJUSTMENTS	
		DEBIT	CREDIT	DEBIT	CREDIT
1	Cash	73 0 0 0 00			
2	Accounts Receivable	6 4 0 0 00			
3	Supplies	4 2 0 0 00			
4	Prepaid Rent	24 0 0 0 00			
5	Equipment	46 0 0 0 00			
6	Accumulated Depreciation—Equipment				
7	Accounts Payable		12 0 0 0 00		
8	Maria Sanchez, Capital		98 5 0 0 00		
9	Maria Sanchez, Drawing	3 0 0 0 00			
10	Fees Income		54 0 0 0 00		
11	Depreciation Expense—Equipment				
12	Rent Expense				
13	Salaries Expense	6 3 0 0 00			
14	Supplies Expense				
15	Utilities Expense	1 6 0 0 00			
16	Totals	164 5 0 0 00	164 5 0 0 00		
17					

INSTRUCTIONS

1. Record the trial balance in the Trial Balance section of the worksheet.
2. Complete the worksheet by making the following adjustments: supplies on hand at the end of the month, \$2,200; expired rent, \$2,000; depreciation expense for the period, \$1,000.

Analyze: Why do you think the account *Accumulated Depreciation—Equipment* has a zero balance on the trial balance shown?

Problem 5.2B ► **Reconstructing a partial worksheet.**

Objectives 5-1, 5-2, 5-3

The adjusted trial balance of Lisa Morgan, Attorney-at-Law, as of November 30, 2016, after the company had completed the first month of operations, appears below.

Appropriate adjustments have been made for the following items:

- a. Supplies used during the month, \$14,400.
- b. Expired rent for the month, \$13,600.
- c. Depreciation expense for the month, \$2,200.

Lisa Morgan, Attorney-at-Law Adjusted Trial Balance Month Ended November 30, 2016		
Account Name	Debit	Credit
Cash	\$140,200	
Accounts Receivable	34,000	
Supplies	27,200	
Prepaid Rent	163,200	
Equipment	264,000	
Accumulated Depreciation—Equipment		\$ 2,200
Accounts Payable		68,000
Lisa Morgan, Capital		320,000
Lisa Morgan, Drawing	24,000	
Fees Income		342,800
Depreciation Expense—Equipment	2,200	
Rent Expense	13,600	
Salaries Expense	43,200	
Supplies Expense	14,400	
Utilities Expense	7,000	
Totals	<u>\$733,000</u>	<u>\$733,000</u>

INSTRUCTIONS

1. Record the adjusted trial balance in the Adjusted Trial Balance columns of the worksheet.
2. Prepare the adjusting entries in the Adjustments columns.
3. Complete the Trial Balance columns of the worksheet prior to making the adjusting entries.

Analyze: Which contra asset account is on the adjusted trial balance?

Problem 5.3B ► **Preparing financial statements from the worksheet.**

Objective 5-4

The completed worksheet for CJ's Accounting Services for the month ended December 31, 2016, appears on pages 150–151.

INSTRUCTIONS

1. Prepare an income statement.

- Prepare a statement of owner's equity. The owner made no additional investments during the month.
- Prepare a balance sheet.

Analyze: By what total amount did the value of assets reported on the balance sheet decrease due to the adjusting entries?

Preparing a worksheet and financial statements, journalizing adjusting entries, and posting to ledger accounts.

◀ **Problem 5.4B**
Objectives
5-1, 5-2, 5-3, 5-4, 5-5

Sam Nix owns Nix Estate Planning and Investments. The trial balance of the firm for June 30, 2016, the first month of operations, is shown below.

Nix Estate Planning and Investments										
Worksheet (Partial)										
Month Ended June 30, 2016										
	ACCOUNT NAME	TRIAL BALANCE				ADJUSTMENTS				
		DEBIT		CREDIT		DEBIT		CREDIT		
1	Cash	39	4	0	0	00				
2	Accounts Receivable	12	2	0	0	00				
3	Supplies	15	2	0	0	00				
4	Prepaid Advertising	28	8	0	0	00				
5	Prepaid Rent	72	0	0	0	00				
6	Equipment	96	0	0	0	00				
7	Accumulated Depreciation—Equipment									
8	Accounts Payable				21	6	0	0	00	
9	Sam Nix, Capital				120	2	0	0	00	
10	Sam Nix, Drawing	8	0	0	0	00				
11	Fees Income				147	6	0	0	00	
12	Advertising Expense									
13	Depreciation Expense—Equipment									
14	Rent Expense									
15	Salaries Expense	15	2	0	0	00				
16	Supplies Expense									
17	Utilities Expense	2	6	0	0	00				
18	Totals	289	4	0	0	00	289	4	0	00
19										

INSTRUCTIONS

- Complete the worksheet for the month.
- Prepare an income statement, statement of owner's equity, and balance sheet. No additional investments were made by the owner during the month.
- Journalize and post the adjusting entries. Use 3 for the journal page number. Use the account numbers provided in Problem 5.4A.

End-of-month adjustments must account for the following:

- The supplies were purchased on June 1, 2016; inventory of supplies on June 30, 2016, showed a value of \$6,000.
- The prepaid advertising contract was signed on June 1, 2016, and covers a four-month period.
- Rent of \$6,000 expired during the month.
- Depreciation is computed using the straight-line method. The equipment has an estimated useful life of five years with no salvage value.

Analyze: Why are the costs that reduce the value of equipment not directly posted to the asset account Equipment?

		CJ's Accounting Services														
		Worksheet														
		Month Ended December 31, 2016														
	ACCOUNT NAME	TRIAL BALANCE						ADJUSTMENTS								
		DEBIT			CREDIT			DEBIT			CREDIT					
1	Cash	16	9	5	0	00										
2	Accounts Receivable	2	2	0	0	00										
3	Supplies	1	5	0	0	00					(a)	6	0	0	00	
4	Prepaid Advertising	4	0	0	0	00					(b)	8	0	0	00	
5	Fixtures	18	0	0	0	00										
6	Accumulated Depreciation—Fixtures										(c)	3	0	0	00	
7	Accounts Payable						7	5	0	0	00					
8	Charlene Jordan, Capital						30	0	0	0	00					
9	Charlene Jordan, Drawing	3	0	0	0	00										
10	Fees Income						31	3	3	0	00					
11	Advertising Expense									(b)	8	0	0	00		
12	Depreciation Expense—Fixtures									(c)	3	0	0	00		
13	Rent Expense	3	5	0	0	00										
14	Salaries Expense	18	6	0	0	00										
15	Supplies Expense									(a)	6	0	0	00		
16	Utilities Expense	1	0	8	0	00										
17	Totals	68	8	3	0	00	68	8	3	0	00	1	7	0	0	00
18	Net Income															
19																
20																

Critical Thinking Problem 5.1

The Effect of Adjustments

Assume you are the accountant for Parkland Industries. James Parkland, the owner of the company, is in a hurry to receive the financial statements for the year ended December 31, 2016, and asks you how soon they will be ready. You tell him you have just completed the trial balance and are getting ready to prepare the adjusting entries. Mr. Parkland tells you not to waste time preparing adjusting entries but to complete the worksheet without them and prepare the financial statements based on the data in the trial balance. According to him, the adjusting entries will not make that much difference. The trial balance shows the following account balances:

Prepaid Rent	\$ 21,000
Supplies	9,000
Building	210,000
Accumulated Depreciation—Building	16,800

If the income statement were prepared using trial balance amounts, the net income would be \$82,750.

A review of the company's records reveals the following information:

1. Rent of \$21,000 was paid on July 1, 2016, for 12 months.
2. Purchases of supplies during the year totaled \$9,000. An inventory of supplies taken at year-end showed supplies on hand of \$1,750.
3. The building was purchased three years ago and has an estimated life of 25 years.
4. No adjustments have been made to any of the accounts during the year.

Write a memo to Mr. Parkland explaining the effect on the financial statements of omitting the adjustments. Indicate the change to net income that results from the adjusting entries.