Decision Maker Answer—p. 125

Analyst You are analyzing the financial condition of a fitness club to assess its ability to meet upcoming loan payments. You compute its current ratio as 1.2. You also find that a major portion of accounts receivable is due from one client who has not made any payments in the past 12 months. Removing this receivable from current assets lowers the current ratio to 0.7. What do you conclude?

Nestlé's current ratio averaged 1.0 for 2005–2008. The current ratio for each of these years suggests that the company' short-term obligations are just about covered by its short-term assets. If the ratio were *less* than 1.0, current liabilities would exceed current assets, and the company's ability to pay short-term obligations could be in doubt.

Demonstration Problem 1

The following information relates to Fanning's Electronics on December 31, 2011. The company, which uses the calendar year as its annual reporting period, initially records prepaid and unearned items in balance sheet accounts (assets and liabilities, respectively).

a. The company's weekly payroll is $8,750, paid each Friday for a five-day workweek. Assume December 31, 2011, falls on a Monday, but the employees will not be paid their wages until Friday, January 4, 2012.

b. Eighteen months earlier, on July 1, 2010, the company purchased equipment that cost $20,000. Its useful life is predicted to be five years, at which time the equipment is expected to be worthless (zero salvage value).

c. On October 1, 2011, the company agreed to work on a new housing development. The company is paid $120,000 on October 1 in advance of future installation of similar alarm systems in 24 new homes. That amount was credited to the Unearned Services Revenue account. Between October 1 and December 31, work on 20 homes was completed.

d. On September 1, 2011, the company purchased a 12-month insurance policy for $1,800. The transaction was recorded with an $1,800 debit to Prepaid Insurance.

e. On December 29, 2011, the company completed a $7,000 service that has not been billed and not recorded as of December 31, 2011.

Required

1. Prepare any necessary adjusting entries on December 31, 2011, in relation to transactions and events *a* through *e*.

2. Prepare T-accounts for the accounts affected by adjusting entries, and post the adjusting entries. Determine the adjusted balances for the Unearned Revenue and the Prepaid Insurance accounts.

3. Complete the following table and determine the amounts and effects of your adjusting entries on the year 2011 income statement and the December 31, 2011, balance sheet. Use up (down) arrows to indicate an increase (decrease) in the Effect columns.

Entry	Amount in the Entry	Effect on Net Income	Effect on Total Assets	Effect on Total Liabilities	Effect on Total Equity

Planning the Solution

- Analyze each situation to determine which accounts need to be updated with an adjustment.
- Calculate the amount of each adjustment and prepare the necessary journal entries.
- Show the amount of each adjustment in the designated accounts, determine the adjusted balance, and identify the balance sheet classification of the account.
- Determine each entry's effect on net income for the year and on total assets, total liabilities, and total equity at the end of the year.

Solution to Demonstration Problem 1

1. Adjusting journal entries.

(*a*) Dec. 31	Wages Expense	1,750	
	Wages Payable		1,750
	To accrue wages for the last day of the year ($8,750 × 1/5).		
(*b*) Dec. 31	Depreciation Expense—Equipment	4,000	
	Accumulated Depreciation—Equipment		4,000
	To record depreciation expense for the year ($20,000/5 years = $4,000 per year).		
(*c*) Dec. 31	Unearned Services Revenue	100,000	
	Services Revenue		100,000
	To recognize services revenue earned ($120,000 × 20/24).		
(*d*) Dec. 31	Insurance Expense	600	
	Prepaid Insurance		600
	To adjust for expired portion of insurance ($1,800 × 4/12).		
(*e*) Dec. 31	Accounts Receivable	7,000	
	Services Revenue		7,000
	To record services revenue earned.		

2. T-accounts for adjusting journal entries *a* through *e*.

Wages Expense

(*a*)	1,750		

Wages Payable

		(*a*)	1,750

Depreciation Expense—Equipment

(*b*)	4,000		

Accumulated Depreciation—Equipment

		(*b*)	4,000

Unearned Revenue

		Unadj. Bal.	120,000
(*c*)	100,000		
		Adj. Bal.	20,000

Services Revenue

		(*c*)	100,000
		(*e*)	7,000
		Adj. Bal.	107,000

Insurance Expense

(*d*)	600		

Prepaid Insurance

Unadj. Bal.	1,800		
		(*d*)	600
Adj. Bal.	1,200		

Accounts Receivable

(*e*)	7,000		

3. Financial statement effects of adjusting journal entries.

Entry	Amount in the Entry	Effect on Net Income	Effect on Total Assets	Effect on Total Liabilities	Effect on Total Equity
a	$ 1,750	$ 1,750 ↓	No effect	$ 1,750 ↑	$ 1,750 ↓
b	4,000	4,000 ↓	$4,000 ↓	No effect	4,000 ↓
c	100,000	100,000 ↑	No effect	$100,000 ↓	100,000 ↑
d	600	600 ↓	$ 600 ↓	No effect	600 ↓
e	7,000	7,000 ↑	$7,000 ↑	No effect	7,000 ↑