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Accounting

WARREN • REEVE • DUCHAC



Word cloud containing various accounting terms and numbers:

- Assets
- Equity
- Liabilities
- Success
- Activate Learning
- Notes Payable
- Expense
- IFRS
- 36 months
- 2.32
- 2.2%
- \$270,000
- 17.5%
- Cash
- FIFO
- Accounts Receivable
- Depreciation
- 97.3
- 7%
- Sales
- Business
- \$18,000
- 2.43
- 2.2%
- 7%

WARREN REEVE DUCHAC

ACCOUNTING

25e

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Accounting 25e

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This set is a merchandising business operated as a proprietorship. It includes business documents, and it can be solved manually or with the General Ledger software.

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This set includes payroll transactions for a merchandising business operated as a proprietorship. It includes business documents, and it can be solved manually or with the General Ledger software.

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Learning Objectives

After studying this chapter, you should be able to:

Example Exercises

- | | | |
|--------------|---|--------------------------------------|
| OBJ 1 | Describe the nature of a business and the role of accounting and ethics in business.
Nature of Business and Accounting
Types of Businesses
Role of Accounting in Business
Role of Ethics in Accounting and Business
Opportunities for Accountants | |
| OBJ 2 | Summarize the development of accounting principles and relate them to practice.
Generally Accepted Accounting Principles
Business Entity Concept
Cost Concept | EE 1-1 |
| OBJ 3 | State the accounting equation and define each element of the equation.
The Accounting Equation | EE 1-2 |
| OBJ 4 | Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.
Business Transactions and the Accounting Equation | EE 1-3 |
| OBJ 5 | Describe the financial statements of a proprietorship and explain how they interrelate.
Financial Statements
Income Statement
Statement of Owner's Equity
Balance Sheet
Statement of Cash Flows
Interrelationships Among Financial Statements | EE 1-4
EE 1-5
EE 1-6
EE 1-7 |
| OBJ 6 | Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.
Financial Analysis and Interpretation: Ratio of Liabilities to Owner's Equity | EE 1-8 |

At a Glance **1**

Page 22

- OBJ 1** Describe the nature of business and the role of accounting and ethics in business.

Nature of Business and Accounting

A **business**¹ is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells over \$10 billion of coffee and related products each year.

The objective of most businesses is to earn a **profit**. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. This text focuses on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Three types of businesses operating for profit include service, merchandising, and manufacturing businesses. Some examples of each type of business are given below.

Service businesses provide services rather than products to customers.

Delta Air Lines (transportation services)

The Walt Disney Company (entertainment services)

¹ A complete glossary of terms appears at the end of the text.

EXHIBIT 4

Accounting Career Paths and Salaries

Accounting Career Track	Description	Career Options	Annual Starting Salaries*	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	\$38,500	
		Payroll clerk	\$37,000	Certified Payroll Professional (CPP)
		General accountant	\$44,625	
		Budget analyst	\$47,250	
		Cost accountant	\$46,625	Certified Management Accountant (CMA)
		Internal auditor	\$51,875	Certified Internal Auditor (CIA)
		Information technology auditor	\$60,750	Certified Information Systems Auditor (CISA)
Public Accounting	Accountants employed individually or within a public accounting firm in tax or audit services.	Local firms	\$47,313	Certified Public Accountant (CPA)
		National firms	\$57,250	Certified Public Accountant (CPA)

Source: Robert Half 2012 U.S. Salary Guide (Finance and Accounting), Robert Half International, Inc. (<http://www.rhi.com/salaryguides>)
 *Mean salaries of a reported range. Private accounting salaries are reported for large companies. Salaries may vary by region.

starting salaries. Accountants who provide audit services, called auditors, verify the accuracy of financial records, accounts, and systems. As shown in Exhibit 4, several private accounting careers have certification options.

Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**. CPAs typically perform general accounting, audit, or tax services. As can be seen in Exhibit 4, CPAs have slightly better starting salaries than private accountants. Career statistics indicate, however, that these salary differences tend to disappear over time.

Because all functions within a business use accounting information, experience in private or public accounting provides a solid foundation for a career. Many positions in industry and in government agencies are held by individuals with accounting backgrounds.

OBJ 2 Summarize the development of accounting principles and relate them to practice.

Generally Accepted Accounting Principles

If a company's management could record and report financial data as it saw fit, comparisons among companies would be difficult, if not impossible. Thus, financial accountants follow **generally accepted accounting principles (GAAP)** in preparing reports. These reports allow investors and other users to compare one company to another.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles. The FASB publishes *Statements of Financial*

Note:
All business transactions can be stated in terms of changes in the elements of the accounting equation.

All business transactions can be stated in terms of changes in the elements of the accounting equation. How business transactions affect the accounting equation can be illustrated by using some typical transactions. As a basis for illustration, a business organized by Chris Clark is used.

Assume that on November 1, 2013, Chris Clark begins a business that will be known as **NetSolutions**. The first phase of Chris's business plan is to operate NetSolutions as a service business assisting individuals and small businesses in developing Web pages and installing computer software. Chris expects this initial phase of the business to last one to two years. During this period, Chris plans on gathering information on the software and hardware needs of customers. During the second phase of the business plan, Chris plans to expand NetSolutions into a personalized retailer of software and hardware for individuals and small businesses.

Each transaction during NetSolutions' first month of operations is described in the following paragraphs. The effect of each transaction on the accounting equation is then shown.

Transaction A *Nov. 1, 2013 Chris Clark deposited \$25,000 in a bank account in the name of NetSolutions.*

This transaction increases the asset cash (on the left side of the equation) by \$25,000. To balance the equation, the owner's equity (on the right side of the equation) increases by the same amount. The equity of the owner is identified using the owner's name and "Capital," such as "Chris Clark, Capital."

The effect of this transaction on NetSolutions' accounting equation is shown below.

$$\left. \begin{array}{l} \text{Assets} \\ \text{Cash} \\ \text{a. } 25,000 \end{array} \right\} = \left\{ \begin{array}{l} \text{Owner's Equity} \\ \text{Chris Clark, Capital} \\ 25,000 \end{array} \right.$$

Since Chris Clark is the sole owner, NetSolutions is a proprietorship. Also, the accounting equation shown above is only for the business, NetSolutions. Under the

Business
Connection

THE ACCOUNTING EQUATION

The accounting equation serves as the basic foundation for the accounting systems of all companies. From the smallest business, such as the local convenience store, to

the largest business, such as [Ford Motor Company](#), companies use the accounting equation. Some examples taken from recent financial reports of well-known companies are shown below.

Company	Assets*	=	Liabilities	+	Owner's Equity
The Coca-Cola Company	\$72,921	=	\$41,918	+	\$31,003
Dell, Inc.	\$38,599	=	\$30,833	+	\$7,766
eBay, Inc.	\$22,004	=	\$6,702	+	\$15,302
Google	\$57,851	=	\$11,610	+	\$46,241
McDonald's	\$31,975	=	\$17,341	+	\$14,634
Microsoft Corporation	\$86,113	=	\$39,938	+	\$46,175
Southwest Airlines Co.	\$15,463	=	\$9,226	+	\$6,237
Walmart	\$180,663	=	\$109,416	+	\$71,247

*Amounts are shown in millions of dollars.

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	Assets			=	Liabilities		+	Owner's Equity						
	Cash	+ Supp.	+ Land	=	Accounts Payable	+ Chris Clark, Capital		Chris Clark, Drawing	+ Fees Earned	- Wages Exp.	- Rent Exp.	- Supplies Exp.	- Utilities Exp.	- Misc. Exp.
a.	+25,000					+25,000								
b.	-20,000		+20,000											
Bal.	5,000		20,000			25,000								
c.		+1,350			+1,350									
Bal.	5,000	1,350	20,000		1,350	25,000								
d.	+7,500							+7,500						
Bal.	12,500	1,350	20,000		1,350	25,000		7,500						
e.	-3,650								-2,125	-800			-450	-275
Bal.	8,850	1,350	20,000		1,350	25,000		7,500	-2,125	-800			-450	-275
f.	-950				-950									
Bal.	7,900	1,350	20,000		400	25,000		7,500	-2,125	-800			-450	-275
g.		-800										-800		
Bal.	7,900	550	20,000		400	25,000		7,500	-2,125	-800		-800	-450	-275
h.	-2,000							-2,000						
Bal.	5,900	550	20,000		400	25,000		-2,000	7,500	-2,125	-800	-800	-450	-275

The four types of transactions affecting owner's equity are illustrated in Exhibit 5.

EXHIBIT 5

Types of Transactions Affecting Owner's Equity



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Example Exercise 1-3 Transactions

OBJ 4

Salvo Delivery Service is owned and operated by Joel Salvo. The following selected transactions were completed by Salvo Delivery Service during February:

1. Received cash from owner as additional investment, \$35,000.
2. Paid creditors on account, \$1,800.
3. Billed customers for delivery services on account, \$11,250.
4. Received cash from customers on account, \$6,740.
5. Paid cash to owner for personal use, \$1,000.

Indicate the effect of each transaction on the accounting equation elements (Assets, Liabilities, Owner's Equity, Drawing, Revenue, and Expense). Also indicate the specific item within the accounting equation element that is affected. To illustrate, the answer to (1) is shown below.

(1) Asset (Cash) increases by \$35,000; Owner's Equity (Joel Salvo, Capital) increases by \$35,000.

Follow My Example 1-3

- (2) Asset (Cash) decreases by \$1,800; Liability (Accounts Payable) decreases by \$1,800.
- (3) Asset (Accounts Receivable) increases by \$11,250; Revenue (Delivery Service Fees) increases by \$11,250.
- (4) Asset (Cash) increases by \$6,740; Asset (Accounts Receivable) decreases by \$6,740.
- (5) Asset (Cash) decreases by \$1,000; Drawing (Joel Salvo, Drawing) increases by \$1,000.

Practice Exercises: **PE 1-3A, PE 1-3B**



Bank loan officers use a business's financial statements in deciding whether to grant a loan to the business. Once the loan is granted, the borrower may be required to maintain a certain level of assets in excess of liabilities. The business's financial statements are used to monitor this level.

as of November 30, 2013, is taken from the statement of owner's equity. The form of balance sheet shown in Exhibit 6 is called the **account form**. This is because it resembles the basic format of the accounting equation, with assets on the left side and the liabilities and owner's equity sections on the right side.³

The assets section of the balance sheet presents assets in the order that they will be converted into cash or used in operations. Cash is presented first, followed by receivables, supplies, prepaid insurance, and other assets. The assets of a more permanent nature are shown next, such as land, buildings, and equipment.

In the liabilities section of the balance sheet in Exhibit 6, accounts payable is the only liability. When there are two or more liabilities, each should be listed and the total amount of liabilities presented as follows:

Liabilities		
Accounts payable	\$12,900	
Wages payable	<u>2,570</u>	
Total liabilities		\$15,470

Example Exercise 1-6 Balance Sheet

Obj 5

Using the following data for Chickadee Travel Service as well as the statement of owner's equity shown in Example Exercise 1-5, prepare a balance sheet as of April 30, 2014.

Accounts payable	\$12,200
Accounts receivable	31,350
Cash	53,050
Land	80,000
Supplies	3,350

Follow My Example 1-6

Chickadee Travel Service Balance Sheet April 30, 2014

Assets		Liabilities	
Cash.....	\$ 53,050	Accounts payable.....	\$ 12,200
Accounts receivable	31,350		
Supplies	3,350	Owner's Equity	
Land.....	<u>80,000</u>	Adam Cellini, capital	<u>155,550</u>
Total assets.....	<u>\$167,750</u>	Total liabilities and owner's equity	<u>\$167,750</u>

Practice Exercises: PE 1-6A, PE 1-6B

Statement of Cash Flows

The statement of cash flows consists of the following three sections, as shown in Exhibit 6:

1. operating activities
2. investing activities
3. financing activities

Each of these sections is briefly described below.

Cash Flows from Operating Activities This section reports a summary of cash receipts and cash payments from operations. The net cash flow from operating activities normally differs from the amount of net income for the period. In Exhibit 6, NetSolutions

³ An alternative form of balance sheet, called the *report form*, is illustrated in Chapter 6. It presents the liabilities and owner's equity sections below the assets section.

equity is 1.18 in the recent year and 1.15 in the prior year. Since McDonald's ratio of liabilities to stockholders' equity increased slightly, its creditors are slightly more at risk at the end of the recent year. Also, McDonald's creditors are more at risk than are Google's creditors. The creditors of both companies are, however, well protected against the risk of nonpayment.

Example Exercise 1-8 Ratio of Liabilities to Owner's Equity

OBJ
6

The following data were taken from Hawthorne Company's balance sheet:

	Dec. 31, 2014	Dec. 31, 2013
Total liabilities	\$120,000	\$105,000
Total owner's equity	80,000	75,000

- Compute the ratio of liabilities to owner's equity.
- Has the creditors' risk increased or decreased from December 31, 2013, to December 31, 2014?

Follow My Example 1-8

a.	Dec. 31, 2014	Dec. 31, 2013
Total liabilities	\$120,000	\$105,000
Total owner's equity	80,000	75,000
Ratio of liabilities to owner's equity	1.50	1.40
	(\$120,000/\$80,000)	(\$105,000/\$75,000)

- Increased

Practice Exercises: PE 1-8A, PE 1-8B

At a Glance 1

OBJ
1

Describe the nature of a business and the role of accounting and ethics in business.

Key Points A business provides goods or services (outputs) to customers with the objective of earning a profit. Three types of businesses include service, merchandising, and manufacturing businesses.

Accounting is an information system that provides reports to users about the economic activities and condition of a business.

Ethics are moral principles that guide the conduct of individuals. Good ethical conduct depends on individual character and firm culture.

Accountants are engaged in private accounting or public accounting.

Learning Outcomes

- Distinguish among service, merchandising, and manufacturing businesses.
- Describe the role of accounting in business, and explain why accounting is called the "language of business."
- Define ethics, and list two factors affecting ethical conduct.
- Differentiate between private and public accounting.

Example
Exercises

Practice
Exercises

2.

Assets				=	Liabilities +		Owner's Equity									
Cash	Accts. Rec.	Supp.	Land	Accts Pay.	Cecil Jameson, Capital	Cecil Jameson, Drawing	Fees Earned	Paralegal Exp.	Rent Exp.	Wages Exp.	Utilities Exp.	Answering Service Exp.	Supp. Exp.	Misc. Exp.		
Bal. 1,000	3,200	850	10,000	1,530	13,520											
a. +3,928							3,928									
Bal. 4,928	3,200	850	10,000	1,530	13,520		3,928									
b. -1,055				-1,055												
Bal. 3,873	3,200	850	10,000	475	13,520		3,928									
c. +3,700					+3,700											
Bal. 7,573	3,200	850	10,000	475	17,220		3,928									
d. -1,200									-1,200							
Bal. 6,373	3,200	850	10,000	475	17,220		3,928		-1,200							
e. +2,025							+2,025									
Bal. 6,373	5,225	850	10,000	475	17,220		5,953		-1,200							
f. +245		+245		+245												
Bal. 6,373	5,225	1,095	10,000	720	17,220		5,953		-1,200							
g. +3,000	-3,000															
Bal. 9,373	2,225	1,095	10,000	720	17,220		5,953		-1,200							
h. +1,635				+1,635				-1,635								
Bal. 9,373	2,225	1,095	10,000	2,355	17,220		5,953	-1,635	-1,200							
i. -1,500										-850	-325	-250		-75		
Bal. 7,873	2,225	1,095	10,000	2,355	17,220		5,953	-1,635	-1,200	-850	-325	-250		-75		
j. -115		-115											-115			
Bal. 7,873	2,225	980	10,000	2,355	17,220		5,953	-1,635	-1,200	-850	-325	-250	-115	-75		
k. -1,000						-1,000										
Bal. 6,873	2,225	980	10,000	2,355	17,220	-1,000	5,953	-1,635	-1,200	-850	-325	-250	-115	-75		

3.

Cecil Jameson, Attorney-at-Law Income Statement For the Month Ended July 31, 2013	
Fees earned.....	\$5,953
Expenses:	
Paralegal expense.....	\$1,635
Rent expense.....	1,200
Wages expense.....	850
Utilities expense.....	325
Answering service expense.....	250
Supplies expense.....	115
Miscellaneous expense.....	75
Total expenses.....	<u>4,450</u>
Net income.....	<u>\$1,503</u>

Cecil Jameson, Attorney-at-Law Statement of Owner's Equity For the Month Ended July 31, 2013	
Cecil Jameson, capital, July 1, 2013.....	\$13,520
Additional investment by owner.....	3,700
Net income for the month.....	<u>1,503</u>
	\$5,203
Less withdrawals.....	<u>1,000</u>
Increase in owner's equity.....	<u>4,203</u>
Cecil Jameson, capital, July 31, 2013.....	<u>\$17,723</u>

(Continued)

Example Exercises

EE 1-5 p. 16

PE 1-5B Statement of owner's equity**OBJ. 5**

Using the income statement for Sentinel Travel Service shown in Practice Exercise 1-4B, prepare a statement of owner's equity for the current year ended August 31, 2014. Barb Schroeder, the owner, invested an additional \$36,000 in the business during the year and withdrew cash of \$18,000 for personal use. Barb Schroeder, capital as of September 1, 2013, was \$380,000.

EE 1-6 p. 18

PE 1-6A Balance sheet**OBJ. 5**

Using the following data for Sunset Travel Service as well as the statement of owner's equity shown in Practice Exercise 1-5A, prepare a balance sheet as of April 30, 2014.

Accounts payable	\$ 61,000
Accounts receivable	124,000
Cash	274,000
Land	450,000
Supplies	13,000

EE 1-6 p. 18

PE 1-6B Balance sheet**OBJ. 5**

Using the following data for Sentinel Travel Service as well as the statement of owner's equity shown in Practice Exercise 1-5B, prepare a balance sheet as of August 31, 2014.

Accounts payable	\$ 44,600
Accounts receivable	75,500
Cash	45,400
Land	310,000
Supplies	4,700

EE 1-7 p. 19

PE 1-7A Statement of cash flows**OBJ. 5**

A summary of cash flows for Sunset Travel Service for the year ended April 30, 2014, is shown below.

Cash receipts:	
Cash received from customers	\$1,500,000
Cash received from additional investment of owner	75,000
Cash payments:	
Cash paid for operating expenses	1,215,000
Cash paid for land	240,000
Cash paid to owner for personal use	66,000

The cash balance as of May 1, 2013, was \$220,000.

Prepare a statement of cash flows for Sunset Travel Service for the year ended April 30, 2014.

EE 1-7 p. 19

PE 1-7B Statement of cash flows**OBJ. 5**

A summary of cash flows for Sentinel Travel Service for the year ended August 31, 2014, is shown below.

Cash receipts:	
Cash received from customers	\$734,000
Cash received from additional investment of owner	36,000
Cash payments:	
Cash paid for operating expenses	745,600
Cash paid for land	50,000
Cash paid to owner for personal use	18,000

The cash balance as of September 1, 2013, was \$89,000.

EX 1-12 Transactions**OBJ. 4**

The following selected transactions were completed by Reuben's Delivery Service during October:

1. Received cash from owner as additional investment, \$20,000.
2. Purchased supplies for cash, \$900.
3. Paid rent for October, \$3,000.
4. Paid advertising expense, \$2,500.
5. Received cash for providing delivery services, \$23,100.
6. Billed customers for delivery services on account, \$41,750.
7. Paid creditors on account, \$4,500.
8. Received cash from customers on account, \$36,200.
9. Determined that the cost of supplies on hand was \$175 and \$725 of supplies had been used during the month.
10. Paid cash to owner for personal use, \$1,000.

Indicate the effect of each transaction on the accounting equation by listing the numbers identifying the transactions, (1) through (10), in a column, and inserting at the right of each number the appropriate letter from the following list:

- a. Increase in an asset, decrease in another asset.
- b. Increase in an asset, increase in a liability.
- c. Increase in an asset, increase in owner's equity.
- d. Decrease in an asset, decrease in a liability.
- e. Decrease in an asset, decrease in owner's equity.

✓ d. \$7,200

EX 1-13 Nature of transactions**OBJ. 4**


Angela Howard operates her own catering service. Summary financial data for July are presented in equation form as follows. Each line designated by a number indicates the effect of a transaction on the equation. Each increase and decrease in owner's equity, except transaction (5), affects net income.

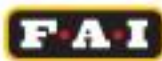
	Assets			=	Liabilities +		Owner's Equity		
	Cash	+ Supplies	+ Land	=	Accounts Payable	+ Angela Howard, Capital	- Angela Howard, Drawing	+ Fees Earned	- Expenses
Bal.	30,000	2,000	80,000	=	12,000	100,000			
1.	+33,000							+33,000	
2.	-20,000		+20,000						
3.	-24,000								-24,000
4.		+1,000			+1,000				
5.	-3,000						-3,000		
6.	-6,000				-6,000				
7.		-1,800							-1,800
Bal.	<u>10,000</u>	<u>1,200</u>	<u>100,000</u>	=	<u>7,000</u>	<u>100,000</u>	<u>-3,000</u>	<u>33,000</u>	<u>-25,800</u>

- a. Describe each transaction.
- b. What is the amount of the net decrease in cash during the month?
- c. What is the amount of the net increase in owner's equity during the month?
- d. What is the amount of the net income for the month?
- e. How much of the net income for the month was retained in the business?

EX 1-14 Net income and owner's withdrawals**OBJ. 5**

The income statement of a proprietorship for the month of February indicates a net income of \$17,500. During the same period, the owner withdrew \$25,500 in cash from the business for personal use.

 Would it be correct to say that the business incurred a net loss of \$8,000 during the month? Discuss.

**EX 1-26 Ratio of liabilities to stockholders' equity****OBJ. 6**

The Home Depot, Inc., is the world's largest home improvement retailer and one of the largest retailers in the United States based on net sales volume. The Home Depot operates over 2,200 Home Depot® stores that sell a wide assortment of building materials and home improvement and lawn and garden products.

The Home Depot recently reported the following balance sheet data (in millions):

	Year 2	Year 1
Total assets	\$40,125	\$40,877
Total stockholders' equity	18,889	19,393

- Determine the total liabilities at the end of Years 2 and 1.
- Determine the ratio of liabilities to stockholders' equity for Year 2 and Year 1. Round to two decimal places.
- What conclusions regarding the margin of protection to the creditors can you draw from (b)?

**EX 1-27 Ratio of liabilities to stockholders' equity****OBJ. 6**

Lowe's Companies Inc., a major competitor of The Home Depot in the home improvement business, operates over 1,700 stores. Lowe's recently reported the following balance sheet data (in millions):

	Year 2	Year 1
Total assets	\$33,699	\$33,005
Total liabilities	15,587	13,936

- Determine the total stockholders' equity as of at the end of Years 2 and 1.
- Determine the ratio of liabilities to stockholders' equity for Year 2 and Year 1. Round to two decimal places.
- What conclusions regarding the risk to the creditors can you draw from (b)?
- Using the balance sheet data for The Home Depot in Exercise 1-26, how does the ratio of liabilities to stockholders' equity of Lowe's compare to that of The Home Depot?

Problems Series A

✓ Cash bal. at end of June: \$29,250

PR 1-1A Transactions**OBJ. 4**

On June 1 of the current year, Bret Eisen established a business to manage rental property. He completed the following transactions during June:

- Opened a business bank account with a deposit of \$30,000 from personal funds.
- Purchased office supplies on account, \$1,200.
- Received cash from fees earned for managing rental property, \$7,200.
- Paid rent on office and equipment for the month, \$3,000.
- Paid creditors on account, \$750.
- Billed customers for fees earned for managing rental property, \$5,000.
- Paid automobile expenses (including rental charges) for month, \$600, and miscellaneous expenses, \$300.
- Paid office salaries, \$1,800.
- Determined that the cost of supplies on hand was \$700; therefore, the cost of supplies used was \$500.
- Withdrew cash for personal use, \$1,500.

Instructions

- Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

Wolverine Realty
Statement of Cash Flows
For the Month Ended April 30, 2014

Cash flows from operating activities:		
Cash received from customers.....	\$ (k)	
Deduct cash payments for expenses and payments to creditors.....	<u>(387,500)</u>	
Net cash flows from operating activities.....		\$ (l)
Cash flows from investing activities:		
Cash payments for acquisition of land		(m)
Cash flows from financing activities:		
Cash received as owner's investment	\$ (n)	
Deduct cash withdrawal by owner.....	<u>(o)</u>	
Net cash flows from financing activities.....		(p)
Net increase (decrease) in cash and April 30, 2014, cash balance		<u>\$ (q)</u>

Instructions

By analyzing the interrelationships among the four financial statements, determine the proper amounts for (a) through (q).

Problems Series B

✓ Cash bal. at end of March: \$48,650

PR 1-1B Transactions

OBJ. 4

Amy Austin established an insurance agency on March 1 of the current year and completed the following transactions during March:

- a. Opened a business bank account with a deposit of \$50,000 from personal funds.
- b. Purchased supplies on account, \$4,000.
- c. Paid creditors on account, \$2,300.
- d. Received cash from fees earned on insurance commissions, \$13,800.
- e. Paid rent on office and equipment for the month, \$5,000.
- f. Paid automobile expenses for month, \$1,150, and miscellaneous expenses, \$300.
- g. Paid office salaries, \$2,500.
- h. Determined that the cost of supplies on hand was \$2,700; therefore, the cost of supplies used was \$1,300.
- i. Billed insurance companies for sales commissions earned, \$12,500.
- j. Withdrew cash for personal use, \$3,900.

Instructions

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

Assets	=	Liabilities	+	Owner's Equity														
Accounts Cash + Receivable + Supplies	=	Accounts Payable	+	Amy Austin, Capital	-	Amy Austin, Drawing	+	Fees Earned	-	Rent Expense	-	Salaries Expense	-	Supplies Expense	-	Auto Expense	-	Misc. Expense

2. Briefly explain why the owner's investment and revenues increased owner's equity, while withdrawals and expenses decreased owner's equity.
3. Determine the net income for March.
4. How much did March's transactions increase or decrease Amy Austin's capital?

Continuing Problem

✓ 2. Net income:
\$1,340



Peyton Smith enjoys listening to all types of music and owns countless CDs. Over the years, Peyton has gained a local reputation for knowledge of music from classical to rap and the ability to put together sets of recordings that appeal to all ages.

During the last several months, Peyton served as a guest disc jockey on a local radio station. In addition, Peyton has entertained at several friends' parties as the host deejay.

On June 1, 2014, Peyton established a proprietorship known as PS Music. Using an extensive collection of music MP3 files, Peyton will serve as a disc jockey on a fee basis for weddings, college parties, and other events. During June, Peyton entered into the following transactions:

- June 1. Deposited \$4,000 in a checking account in the name of PS Music.
2. Received \$3,500 from a local radio station for serving as the guest disc jockey for June.
 2. Agreed to share office space with a local real estate agency, Pinnacle Realty. PS Music will pay one-fourth of the rent. In addition, PS Music agreed to pay a portion of the salary of the receptionist and to pay one-fourth of the utilities. Paid \$800 for the rent of the office.
 4. Purchased supplies from City Office Supply Co. for \$350. Agreed to pay \$100 within 10 days and the remainder by July 5, 2014.
 6. Paid \$500 to a local radio station to advertise the services of PS Music twice daily for two weeks.
 8. Paid \$675 to a local electronics store for renting digital recording equipment.
 12. Paid \$350 (music expense) to Cool Music for the use of its current music demos to make various music sets.
 13. Paid City Office Supply Co. \$100 on account.
 16. Received \$300 from a dentist for providing two music sets for the dentist to play for her patients.
 22. Served as disc jockey for a wedding party. The father of the bride agreed to pay \$1,000 in July.
 25. Received \$500 for serving as the disc jockey for a cancer charity ball hosted by the local hospital.
 29. Paid \$240 (music expense) to Galaxy Music for the use of its library of music demos.
 30. Received \$900 for serving as PS disc jockey for a local club's monthly dance.
 30. Paid Pinnacle Realty \$400 for PS Music's share of the receptionist's salary for June.
 30. Paid Pinnacle Realty \$300 for PS Music's share of the utilities for June.
 30. Determined that the cost of supplies on hand is \$170. Therefore, the cost of supplies used during the month was \$180.
 30. Paid for miscellaneous expenses, \$415.
 30. Paid \$1,000 royalties (music expense) to National Music Clearing for use of various artists' music during the month.
 30. Withdrew \$500 of cash from PS Music for personal use.

Instructions

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

Assets	=	Liabilities +				Owner's Equity							
Accts.		Accounts	Peyton	Peyton		Office	Equipment		Advertising	Wages	Utilities	Supplies	Misc.
Cash + Rec. + Supplies		Payable	+ Capital	- Drawing	+ Earned	- Exp.	- Exp.	- Exp.	- Exp.	- Exp.	- Exp.	- Exp.	- Exp.

2. Prepare an income statement for PS Music for the month ended June 30, 2014.
3. Prepare a statement of owner's equity for PS Music for the month ended June 30, 2014.
4. Prepare a balance sheet for PS Music as of June 30, 2014.

In an actual accounting system, a more formal account form replaces the T account. Later in this chapter, a four-column account is illustrated. The T account, however, is a simple way to illustrate the effects of transactions on accounts and financial statements. For this reason, T accounts are often used in business to explain transactions.

Each of the columns in Exhibit 1 can be converted into an account form in a similar manner as was done for the Cash column of Exhibit 1. However, as mentioned earlier, recording increases and decreases in accounts must follow certain rules. These rules are discussed after the chart of accounts is described.

Chart of Accounts

A group of accounts for a business entity is called a **ledger**. A list of the accounts in the ledger is called a **chart of accounts**. The accounts are normally listed in the order in which they appear in the financial statements. The balance sheet accounts are listed first, in the order of assets, liabilities, and owner's equity. The income statement accounts are then listed in the order of revenues and expenses.

Assets are resources owned by the business entity. These resources can be physical items, such as cash and supplies, or intangibles that have value. Examples of intangible assets include patent rights, copyrights, and trademarks. Assets also include accounts receivable, prepaid expenses (such as insurance), buildings, equipment, and land.

Liabilities are debts owed to outsiders (creditors). Liabilities are often identified on the balance sheet by titles that include *payable*. Examples of liabilities include accounts payable, notes payable, and wages payable. Cash received before services are delivered creates a liability to perform the services. These future service commitments are called *unearned revenues*. Examples of unearned revenues include magazine subscriptions received by a publisher and tuition received at the beginning of a term by a college.

Owner's equity is the owner's right to the assets of the business after all liabilities have been paid. For a proprietorship, the owner's equity is represented by the balance of the owner's **capital account**. A **drawing** account represents the amount of withdrawals made by the owner.

Revenues are increases in owner's equity as a result of selling services or products to customers. Examples of revenues include fees earned, fares earned, commissions revenue, and rent revenue.

Business



Connection

THE HIJACKING RECEIVABLE

A company's chart of accounts should reflect the basic nature of its operations. Occasionally, however, transactions take place that give rise to unusual accounts. The following is a story of one such account.

Before strict airport security was implemented across the United States, several airlines experienced hijacking incidents. One such incident occurred when a **Southern Airways** jet en route from Memphis to Miami was hijacked during a stopover in Birmingham, Alabama. The three hijackers boarded the plane in Birmingham armed with handguns and hand grenades. At gunpoint, the hijackers took the plane, the plane's crew, and the passengers to nine American cities, Toronto, and eventually to Havana, Cuba.

During the long flight, the hijackers demanded a ransom of \$10 million. Southern Airways, however, was only able to come up with \$2 million. Eventually, the pilot

talked the hijackers into settling for the \$2 million when the plane landed in Chattanooga for refueling.

Upon landing in Havana, the Cuban authorities arrested the hijackers and, after a brief delay, sent the plane, passengers, and crew back to the United States. The hijackers and \$2 million stayed in Cuba.

How did Southern Airways account for and report the hijacking payment in its subsequent financial statements? As you might have analyzed, the initial entry credited Cash for \$2 million. The debit was to an account entitled "Hijacking Payment." This account was reported as a type of receivable under "other assets" on Southern Airways' balance sheet. The company maintained that it would be able to collect the cash from the Cuban government and that, therefore, a receivable existed. In fact, Southern Airways was later repaid \$2 million by the Cuban government, which was, at that time, attempting to improve relations with the United States.



A journal can be thought of as being similar to an individual's diary of significant day-to-day life events.

The transaction is recorded in the journal using the following steps:

- Step 1. The date of the transaction is entered in the Date column.
- Step 2. The title of the account to be debited is recorded in the left-hand margin under the Description column, and the amount to be debited is entered in the Debit column.
- Step 3. The title of the account to be credited is listed below and to the right of the debited account title, and the amount to be credited is entered in the Credit column.
- Step 4. A brief description may be entered below the credited account.
- Step 5. The Post. Ref. (Posting Reference) column is left blank when the journal entry is initially recorded. This column is used later in this chapter when the journal entry amounts are transferred to the accounts in the ledger.

The process of recording a transaction in the journal is called **journalizing**. The entry in the journal is called a **journal entry**.

The following is a useful method for analyzing and journalizing transactions:

1. Carefully read the description of the transaction to determine whether an asset, a liability, an owner's equity, a revenue, an expense, or a drawing account is affected.
2. For each account affected by the transaction, determine whether the account increases or decreases.
3. Determine whether each increase or decrease should be recorded as a debit or a credit, following the rules of debit and credit shown in Exhibit 3.
4. Record the transaction using a journal entry.

The following table summarizes terminology that is often used in describing a transaction along with the related accounts that would be debited and credited.

Common transaction terminology	Journal Entry Account	
	Debit	Credit
Received cash for services provided	Cash	Fees Earned
Services provided on account	Accounts Receivable	Fees Earned
Received cash on account	Cash	Accounts Receivable
Purchased on account	Asset account	Accounts Payable
Paid on account	Accounts Payable	Cash
Paid cash	Asset or expense account	Cash
Owner investments	Cash and/or other assets	(Owner's name), Capital
Owner withdrawals	(Owner's name), Drawing	Cash

The remaining transactions of NetSolutions for November are analyzed and journalized next.

Transaction B Nov. 5 NetSolutions paid \$20,000 for the purchase of land as a future building site.

Analysis

This transaction increases one asset account and decreases another. It is recorded in the journal as a \$20,000 increase (debit) to Land and a \$20,000 decrease (credit) to Cash.

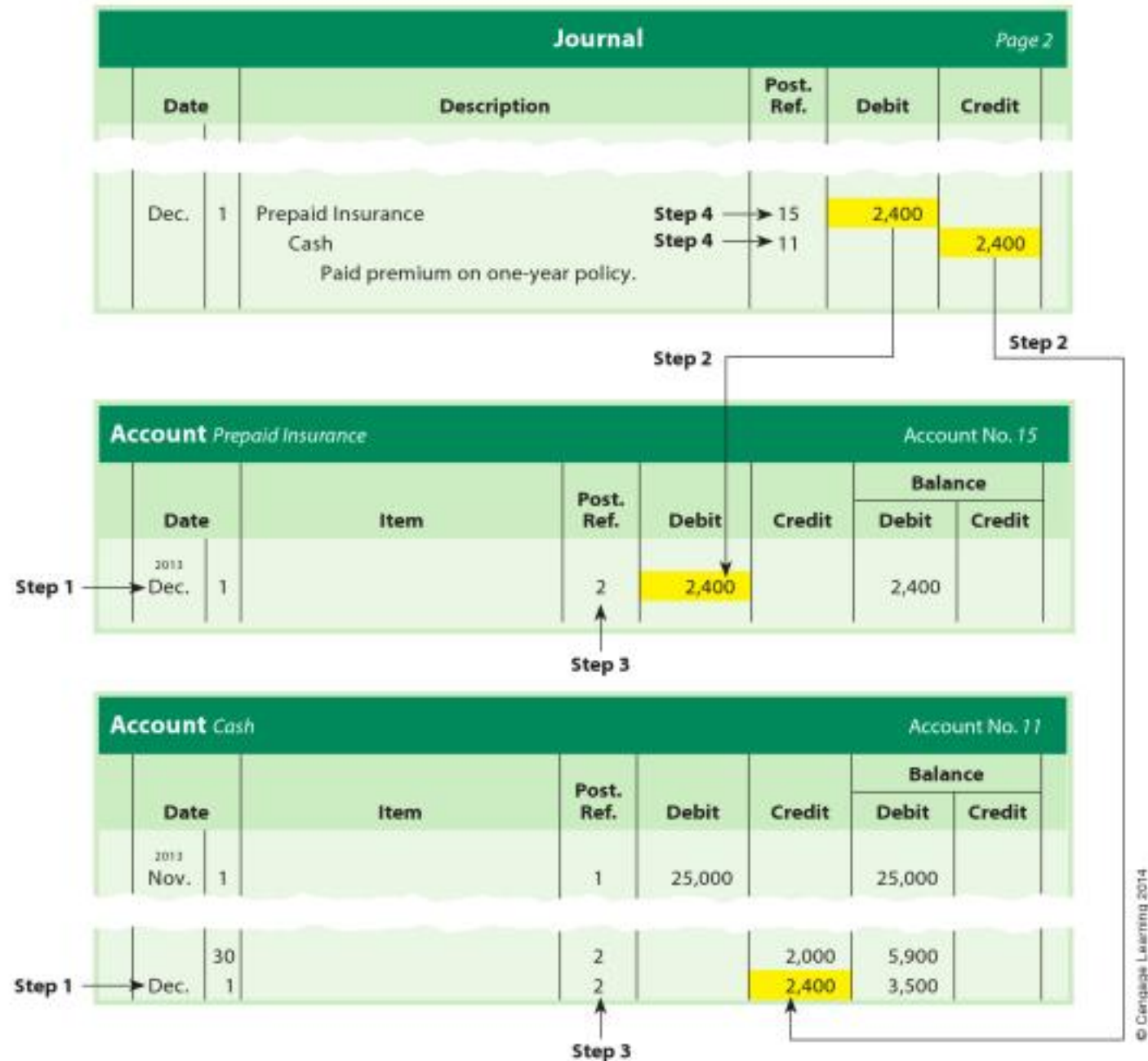
Journal Entry

	Nov.	5	Land				
			Cash		20,000		
			Purchased land for building site.			20,000	

Accounting Equation Impact

Assets		=	Liabilities		+	Owner's Equity	
Land							
Nov. 5	20,000						
Cash							
						Nov. 5	20,000

The posting of the preceding December 1 transaction is shown in Exhibit 4. Notice that the T account form is not used in Exhibit 4. In practice, the T account is usually replaced with a standard account form similar to that shown in Exhibit 4.

EXHIBIT 4**Diagram of the Recording and Posting of a Debit and a Credit**

The debits and credits for each journal entry are posted to the accounts in the order in which they occur in the journal. To illustrate, the debit portion of the December 1 journal entry is posted to the prepaid account in Exhibit 4 using the following four steps:

- Step 1. The date (Dec. 1) of the journal entry is entered in the Date column of Prepaid Insurance.
- Step 2. The amount (2,400) is entered into the Debit column of Prepaid Insurance.
- Step 3. The journal page number (2) is entered in the Posting Reference (Post. Ref.) column of Prepaid Insurance.
- Step 4. The account number (15) is entered in the Posting Reference (Post. Ref.) column in the journal.

As shown in Exhibit 4, the credit portion of the December 1 journal entry is posted to the cash account in a similar manner.

The remaining December transactions for NetSolutions are analyzed and journalized in the following paragraphs. These transactions are posted to the ledger in Exhibit 5 on pages 69–70. To simplify, some of the December transactions are stated

Transaction *Dec. 20 NetSolutions paid \$900 to Executive Supply Co. on the \$1,800 debt owed from the December 4 transaction.*

Analysis

This is similar to the transaction of December 11. This transaction is recorded as a \$900 decrease (debit) to Accounts Payable and a \$900 decrease (credit) to Cash.

Journal Entry

		20	Accounts Payable		21	900			
			Cash		11		900		
			Paid creditors on account.						

Accounting Equation Impact

Assets	=	Liabilities	+	Owner's Equity
Cash		Accounts Payable		
11		21		
Dec. 20 900		Dec. 20 900		

Transaction *Dec. 21 NetSolutions received \$650 from customers in payment of their accounts.*

Analysis

When customers pay amounts owed for services they have previously received, one asset increases and another asset decreases. This transaction is recorded as a \$650 increase (debit) to Cash and a \$650 decrease (credit) to Accounts Receivable.

Journal Entry

		21	Cash		11	650			
			Accounts Receivable		12		650		
			Received cash from customers on account.						

Accounting Equation Impact

Assets	=	Liabilities	+	Owner's Equity
Cash				
11				
Dec. 21 650				
Accounts Receivable				
12				
Dec. 21 650				

Transaction *Dec. 23 NetSolutions paid \$1,450 for supplies.*

Accounting Equation Impact

One asset account (Supplies) increases, and another asset account (Cash) decreases. This transaction is recorded as a \$1,450 increase (debit) to Supplies and a \$1,450 decrease (credit) to Cash.

Journal Entry

		23	Supplies		14	1,450			
			Cash		11		1,450		
			Purchased supplies.						

Assets	=	Liabilities	+	Owner's Equity
Cash				
11				
Dec. 23 1,450				
Supplies				
14				
Dec. 23 1,450				

Transaction *Dec. 27 NetSolutions paid the receptionist and the part-time assistant \$1,200 for two weeks' wages.*

Analysis

This transaction is similar to the transaction of December 13. This transaction is recorded as a \$1,200 increase (debit) to Wages Expense and a \$1,200 decrease (credit) to Cash.

EXHIBIT 5**Cash Receipts Journal for a Merchandising Business (concluded)**

Account Fees Earned					Account No. 41	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 18		1		7,500		7,500
Dec. 16		3		3,100		10,600
16		3		1,750		12,350
31		4		2,870		15,220
31		4		1,120		16,340

Account Utilities Expense					Account No. 54	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	450			450
Dec. 31		3	310			760
31		4	225			985

Account Wages Expense					Account No. 57	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	2,125			2,125
Dec. 13		3	950			3,075
27		3	1,200			4,275

Account Supplies Expense					Account No. 55	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	800			800

Account Rent Expense					Account No. 52	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	800			800
Dec. 1		2	800			1,600

Account Miscellaneous Expense					Account No. 59	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	275			275
Dec. 6		2	180			455

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OBJ 4 Prepare an unadjusted trial balance and explain how it can be used to discover errors.

Trial Balance

Errors may occur in posting debits and credits from the journal to the ledger. One way to detect such errors is by preparing a **trial balance**. Double-entry accounting requires that debits must always equal credits. The trial balance verifies this equality. The steps in preparing a trial balance are as follows:

- Step 1. List the name of the company, the title of the trial balance, and the date the trial balance is prepared.
- Step 2. List the accounts from the ledger, and enter their debit or credit balance in the Debit or Credit column of the trial balance.
- Step 3. Total the Debit and Credit columns of the trial balance.
- Step 4. Verify that the total of the Debit column equals the total of the Credit column.

The trial balance for NetSolutions as of December 31, 2013, is shown in Exhibit 6. The account balances in Exhibit 6 are taken from the ledger shown in Exhibit 5. Before a trial balance is prepared, each account balance in the ledger must be determined. When the standard account form is used as in Exhibit 5, the balance of each account appears in the balance column on the same line as the last posting to the account.

The trial balance shown in Exhibit 6 is titled an **unadjusted trial balance**. This is to distinguish it from other trial balances that will be prepared in later chapters.

NetSolutions Unadjusted Trial Balance December 31, 2013		
	Debit Balances	Credit Balances
Cash	2,065	
Accounts Receivable	2,220	
Supplies	2,000	
Prepaid Insurance	2,400	
Land	20,000	
Office Equipment	1,800	
Accounts Payable		900
Unearned Rent		360
Chris Clark, Capital		25,000
Chris Clark, Drawing	4,000	
Fees Earned		16,340
Wages Expense	4,275	
Rent Expense	1,600	
Utilities Expense	985	
Supplies Expense	800	
Miscellaneous Expense	455	
	42,600	42,600

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These other trial balances include an adjusted trial balance and a post-closing trial balance.³

Errors Affecting the Trial Balance

If the trial balance totals are not equal, an error has occurred. In this case, the error must be found and corrected. A method useful in discovering errors is as follows:

1. If the difference between the Debit and Credit column totals is 10, 100, or 1,000, an error in addition may have occurred. In this case, re-add the trial balance column totals. If the error still exists, recompute the account balances.
2. If the difference between the Debit and Credit column totals can be evenly divisible by 2, the error may be due to the entering of a debit balance as a credit balance, or vice versa. In this case, review the trial balance for account balances of one-half the difference that may have been entered in the wrong column. For example, if the Debit column total is \$20,640 and the Credit column total is \$20,236, the difference of \$404 ($\$20,640 - \$20,236$) may be due to a credit account balance of \$202 that was entered as a debit account balance.
3. If the difference between the Debit and Credit column totals is evenly divisible by 9, trace the account balances back to the ledger to see if an account balance was incorrectly copied from the ledger. Two common types of copying errors are transpositions and slides. A **transposition** occurs when the order of the digits is copied incorrectly, such as writing \$542 as \$452 or \$524. In a **slide**, the entire number is copied incorrectly one or more spaces to the right or the left, such as writing \$542.00 as \$54.20 or \$5,420.00. In both cases, the resulting error will be evenly divisible by 9.
4. If the difference between the Debit and Credit column totals is not evenly divisible by 2 or 9, review the ledger to see if an account balance in the amount of the error has been omitted from the trial balance. If the error is not discovered, review the journal postings to see if a posting of a debit or credit may have been omitted.

³ The adjusted trial balance will be discussed in Chapter 3 and the post-closing trial balance in Chapter 4.

5. If an error is not discovered by the preceding steps, the accounting process must be retraced, beginning with the last journal entry.

The trial balance does not provide complete proof of the accuracy of the ledger. It indicates only that the debits and the credits are equal. This proof is of value, however, because errors often affect the equality of debits and credits.

Example Exercise 2-6 Trial Balance Errors

OBJ
4

For each of the following errors, considered individually, indicate whether the error would cause the trial balance totals to be unequal. If the error would cause the trial balance totals to be unequal, indicate whether the debit or credit total is higher and by how much.

- Payment of a cash withdrawal of \$5,600 was journalized and posted as a debit of \$6,500 to Salary Expense and a credit of \$6,500 to Cash.
- A fee of \$2,850 earned from a client was debited to Accounts Receivable for \$2,580 and credited to Fees Earned for \$2,850.
- A payment of \$3,500 to a creditor was posted as a debit of \$3,500 to Accounts Payable and a debit of \$3,500 to Cash.

Follow My Example 2-6

- The totals are equal since both the debit and credit entries were journalized and posted for \$6,500.
- The totals are unequal. The credit total is higher by \$270 (\$2,850 – \$2,580).
- The totals are unequal. The debit total is higher by \$7,000 (\$3,500 + \$3,500).

Practice Exercises: PE 2-6A, PE 2-6B

Errors Not Affecting the Trial Balance

An error may occur that does not cause the trial balance totals to be unequal. Such an error may be discovered when preparing the trial balance or may be indicated by an unusual account balance. For example, a credit balance in the supplies account indicates an error has occurred. This is because a business cannot have “negative” supplies. When such errors are discovered, they should be corrected. If the error has already been journalized and posted to the ledger, a **correcting journal entry** is normally prepared.

To illustrate, assume that on May 5 a \$12,500 purchase of office equipment on account was incorrectly journalized and posted as a debit to Supplies and a credit to Accounts Payable for \$12,500. This posting of the incorrect entry is shown in the following T accounts:

Incorrect:

Supplies	Accounts Payable
12,500	12,500

Before making a correcting journal entry, it is best to determine the debit(s) and credit(s) that should have been recorded. These are shown in the following T accounts:

Correct:

Office Equipment	Accounts Payable
12,500	12,500

Comparing the two sets of T accounts shows that the incorrect debit to Supplies may be corrected by debiting Office Equipment for \$12,500 and crediting Supplies for \$12,500. The following correcting entry is then journalized and posted:

Entry to Correct Error:

May	31	Office Equipment	18	12,500	
		Supplies	14		12,500
		To correct erroneous debit to Supplies on May 5. See invoice from Bell Office Equipment Co.			

Example Exercise 2-7 Correcting Entries

OBJ
4

The following errors took place in journalizing and posting transactions:

- A withdrawal of \$6,000 by Cheri Ramey, owner of the business, was recorded as a debit to Office Salaries Expense and a credit to Cash.
- Utilities Expense of \$4,500 paid for the current month was recorded as a debit to Miscellaneous Expense and a credit to Accounts Payable.

Journalize the entries to correct the errors. Omit explanations.

Follow My Example 2-7

a.	Cheri Ramey, Drawing.....	6,000	
	Office Salaries Expense.....		6,000
b.	Accounts Payable.....	4,500	
	Miscellaneous Expense.....		4,500
	Utilities Expense.....	4,500	
	Cash.....		4,500

Note: The first entry in (b) reverses the incorrect entry, and the second entry records the correct entry. These two entries could also be combined into one entry; however, preparing two entries will make it easier for someone later to understand what had happened and why the entries were necessary.

Practice Exercises: PE 2-7A, PE 2-7B

Financial Analysis and Interpretation: Horizontal Analysis

FAI

OBJ
5

Describe and illustrate the use of horizontal analysis in evaluating a company's performance and financial condition.

A single item in a financial statement, such as net income, is often useful in interpreting the financial performance of a company. However, a comparison with prior periods often makes the financial information even more useful. For example, comparing net income of the current period with the net income of the prior period will indicate whether the company's operating performance has improved.

In **horizontal analysis**, the amount of each item on a current financial statement is compared with the same item on an earlier statement. The increase or decrease in the *amount* of the item is computed together with the *percent* of increase or decrease. When two statements are being compared, the earlier statement is used as the base for computing the amount and the percent of change.

To illustrate, the horizontal analysis of two income statements for J. Holmes, Attorney-at-Law, is shown on the following page.

J. Holmes, Attorney-at-Law
Income Statements
For the Years Ended December 31

	2014	2013	Increase (Decrease)	
			Amount	Percent
Fees earned	\$187,500	\$150,000	\$37,500	25.0%*
Operating expenses:				
Wages expense	\$ 60,000	\$ 45,000	\$15,000	33.3
Rent expense	15,000	12,000	3,000	25.0
Utilities expense	12,500	9,000	3,500	38.9
Supplies expense	2,700	3,000	(300)	(10.0)
Miscellaneous expense	2,300	1,800	500	27.8
Total operating expenses	\$ 92,500	\$ 70,800	\$21,700	30.6
Net income	\$ 95,000	\$ 79,200	\$15,800	19.9

*\$37,500 ÷ \$150,000

The horizontal analysis for J. Holmes, Attorney-at-Law, indicates both favorable and unfavorable trends. The increase in fees earned is a favorable trend, as is the decrease in supplies expense. Unfavorable trends include the increase in wages expense, utilities expense, and miscellaneous expense. These expenses increased the same as or faster than the increase in revenues, with total operating expenses increasing by 30.6%. Overall, net income increased by \$15,800, or 19.9%, a favorable trend.

The significance of the various increases and decreases in the revenue and expense items should be investigated to see if operations could be further improved. For example, the increase in utilities expense of 38.9% was the result of renting additional office space for use by a part-time law student in performing paralegal services. This explains the increase in rent expense of 25.0% and the increase in wages expense of 33.3%. The increase in revenues of 25.0% reflects the fees generated by the new paralegal.

The preceding example illustrates how horizontal analysis can be useful in interpreting and analyzing the income statement. Horizontal analyses can also be performed for the balance sheet, the statement of owner's equity, and the statement of cash flows.

To illustrate, horizontal analysis for two recent years of **Apple Inc.**'s statements of cash flows (in millions) is shown below.

Apple Inc.
Statements of Cash Flows
For the Years Ended

	Year 2	Year 1	Increase (Decrease)	
			Amount	Percent
Cash flows from operating activities	\$37,529	\$ 18,595	\$18,934	101.8%
Cash flows used for investing activities	(40,419)	(13,854)	(26,565)	(197.7)
Cash flows from financing activities	1,444	1,257	187	14.9
Net increase (decrease) in cash	\$ (1,446)	\$ 5,998	\$(7,444)	(124.1)
Beginning of the year balance of cash	11,261	5,263	5,998	114.0
End of the year balance of cash	\$ 9,815	\$ 11,261	\$(1,446)	(10.2)

The horizontal analysis of cash flows for Apple Inc. indicates an increase in cash flows from operating activities of 101.8%, which is a favorable trend. At the same time, Apple increased the cash used in its investing activities by 197.7% and increased the cash it received from financing activities by 14.9%. Overall, Apple had a 124.1% decrease in cash for the year, which decreased the end-of-the-year cash balance by 10.2%. In contrast, in the prior year Apple decreased its ending cash balance, which is the beginning cash balance of the current year, by 114.0%.

OBJ
5

Describe and illustrate the use of horizontal analysis in evaluating a company's performance and financial condition.

Key Points In horizontal analysis, the amount of each item on a current financial statement is compared with the same item on an earlier statement. The increase or decrease in the *amount* of the item is computed, together with the *percent* of increase or decrease. When two statements are being compared, the earlier statement is used as the base for computing the amount and the percent of change.

Learning Outcomes

- Describe horizontal analysis.
- Prepare a horizontal analysis report of a financial statement.

*Example
Exercises*

EE2-8

*Practice
Exercises*

PE2-8A, 2-8B

Key Terms

account (52)
account receivable (65)
assets (54)
balance of the account (53)
capital account (54)
chart of accounts (54)
correcting journal entry (72)
credit (53)
debit (53)
double-entry accounting system (55)

drawing (54)
expenses (55)
horizontal analysis (73)
journal (57)
journal entry (58)
journalizing (58)
ledger (54)
liabilities (54)
normal balance of an account (56)
owner's equity (54)

posting (61)
revenues (54)
rules of debit and credit (55)
slide (71)
T account (52)
transposition (71)
trial balance (70)
unadjusted trial balance (70)
unearned revenue (63)

Illustrative Problem

J. F. Outz, M.D., has been practicing as a cardiologist for three years. During April 2013, Outz completed the following transactions in her practice of cardiology:

- Apr.
1. Paid office rent for April, \$800.
 3. Purchased equipment on account, \$2,100.
 5. Received cash on account from patients, \$3,150.
 8. Purchased X-ray film and other supplies on account, \$245.
 9. One of the items of equipment purchased on April 3 was defective. It was returned with the permission of the supplier, who agreed to reduce the account for the amount charged for the item, \$325.
 12. Paid cash to creditors on account, \$1,250.

- Apr. 17. Paid cash for renewal of a six-month property insurance policy, \$370.
20. Discovered that the balances of the cash account and the accounts payable account as of April 1 were overstated by \$200. A payment of that amount to a creditor in March had not been recorded. Journalize the \$200 payment as of April 20.
24. Paid cash for laboratory analysis, \$545.
27. Paid cash from business bank account for personal and family expenses, \$1,250.
30. Recorded the cash received in payment of services (on a cash basis) to patients during April, \$1,720.
30. Paid salaries of receptionist and nurses, \$1,725.
30. Paid various utility expenses, \$360.
30. Recorded fees charged to patients on account for services performed in April, \$5,145.
30. Paid miscellaneous expenses, \$132.

Outz's account titles, numbers, and balances as of April 1 (all normal balances) are listed as follows: Cash, 11, \$4,123; Accounts Receivable, 12, \$6,725; Supplies, 13, \$290; Prepaid Insurance, 14, \$465; Equipment, 18, \$19,745; Accounts Payable, 22, \$765; J. F. Outz, Capital, 31, \$30,583; J. F. Outz, Drawing, 32, \$0; Professional Fees, 41, \$0; Salary Expense, 51, \$0; Rent Expense, 53, \$0; Laboratory Expense, 55, \$0; Utilities Expense, 56, \$0; Miscellaneous Expense, 59, \$0.

Instructions

1. Open a ledger of standard four-column accounts for Dr. Outz as of April 1. Enter the balances in the appropriate balance columns and place a check mark (✓) in the Posting Reference column. (*Hint:* Verify the equality of the debit and credit balances in the ledger before proceeding with the next instruction.)
2. Journalize each transaction in a two-column journal.
3. Post the journal to the ledger, extending the month-end balances to the appropriate balance columns after each posting.
4. Prepare an unadjusted trial balance as of April 30.

Solution 1., 2., and 3.

Journal					Page 27
Date	Description	Post. Ref.	Debit	Credit	
2013					
Apr. 1	Rent Expense	53	800		
	Cash	11		800	
	Paid office rent for April.				
3	Equipment	18	2,100		
	Accounts Payable	22		2,100	
	Purchased equipment on account.				
5	Cash	11	3,150		
	Accounts Receivable	12		3,150	
	Received cash on account.				
8	Supplies	13	245		
	Accounts Payable	22		245	
	Purchased supplies.				
9	Accounts Payable	22	325		
	Equipment	18		325	
	Returned defective equipment.				
12	Accounts Payable	22	1,250		
	Cash	11		1,250	
	Paid creditors on account.				
17	Prepaid Insurance	14	370		
	Cash	11		370	
	Renewed six-month property policy.				
20	Accounts Payable	22	200		
	Cash	11		200	
	Recorded March payment to creditor.				

Journal					Page 28
Date	Description	Post. Ref.	Debit	Credit	
2013					
Apr. 24	Laboratory Expense	55	545		
	Cash	11		545	
	Paid for laboratory analysis.				
27	J. F. Outz, Drawing	32	1,250		
	Cash	11		1,250	
	J. F. Outz withdrew cash for personal use.				
30	Cash	11	1,720		
	Professional Fees	41		1,720	
	Received fees from patients.				
30	Salary Expense	51	1,725		
	Cash	11		1,725	
	Paid salaries.				
30	Utilities Expense	56	360		
	Cash	11		360	
	Paid utilities.				
30	Accounts Receivable	12	5,145		
	Professional Fees	41		5,145	
	Recorded fees earned on account.				
30	Miscellaneous Expense	59	132		
	Cash	11		132	
	Paid expenses.				

Account Cash					Account No. 11	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Apr. 1	Balance	✓			4,123	
1		27		800	3,323	
5		27	3,150		6,473	
12		27		1,250	5,223	
17		27		370	4,853	
20		27		200	4,653	
24		28		545	4,108	
27		28		1,250	2,858	
30		28	1,720		4,578	
30		28		1,725	2,853	
30		28		360	2,493	
30		28		132	2,361	

Account Accounts Receivable					Account No. 12	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Apr. 1	Balance	✓			6,725	
5		27		3,150	3,575	
30		28	5,145		8,720	

Account Supplies					Account No. 13	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Apr. 1	Balance	✓			290	
8		27	245		535	

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Account <i>Prepaid Insurance</i>					Account No. 14	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 1	Balance	✓			465	
17		27	370		835	

Account <i>Equipment</i>					Account No. 18	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 1	Balance	✓			19,745	
3		27	2,100		21,845	
9		27		325	21,520	

Account <i>Accounts Payable</i>					Account No. 22	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 1	Balance	✓				765
3		27		2,100		2,865
8		27		245		3,110
9		27	325			2,785
12		27	1,250			1,535
20		27	200			1,335

Account <i>J. F. Outz, Capital</i>					Account No. 31	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 1	Balance	✓				30,583

Account <i>J. F. Outz, Drawing</i>					Account No. 32	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 27		28	1,250		1,250	

Account <i>Professional Fees</i>					Account No. 41	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 30		28		1,720		1,720
30		28		5,145		6,865

Account <i>Salary Expense</i>					Account No. 51	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 30		28	1,725		1,725	

Account <i>Rent Expense</i>					Account No. 53	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 1		27	800		800	

Account <i>Laboratory Expense</i>					Account No. 55	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 24		28	545		545	

Account <i>Utilities Expense</i>					Account No. 56	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 30		28	360		360	

Account <i>Miscellaneous Expense</i>					Account No. 59	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013 Apr. 30		28	132		132	

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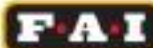
4.

J. F. Outz, M.D. Unadjusted Trial Balance April 30, 2013		
	Debit Balances	Credit Balances
Cash	2,361	
Accounts Receivable.....	8,720	
Supplies	535	
Prepaid Insurance	835	
Equipment.....	21,520	
Accounts Payable		1,335
J. F. Outz, Capital		30,583
J. F. Outz, Drawing.....	1,250	
Professional Fees.....		6,865
Salary Expense.....	1,725	
Rent Expense	800	
Laboratory Expense	545	
Utilities Expense	360	
Miscellaneous Expense	132	
	<u>38,783</u>	<u>38,783</u>

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Discussion Questions

- What is the difference between an account and a ledger?
- Do the terms *debit* and *credit* signify increase or decrease or can they signify either? Explain.
- McIntyre Company adheres to a policy of depositing all cash receipts in a bank account and making all payments by check. The cash account as of December 31 has a credit balance of \$1,850, and there is no undeposited cash on hand. (a) Assuming no errors occurred during journalizing or posting, what caused this unusual balance? (b) Is the \$1,850 credit balance in the cash account an asset, a liability, owner's equity, a revenue, or an expense?
- eCatalog Services Company performed services in October for a specific customer, for a fee of \$7,890. Payment was received the following November. (a) Was the revenue earned in October or November? (b) What accounts should be debited and credited in (1) October and (2) November?
- If the two totals of a trial balance are equal, does it mean that there are no errors in the accounting records? Explain.
- Assume that a trial balance is prepared with an account balance of \$8,900 listed as \$9,800 and an account balance of \$1,000 listed as \$100. Identify the transposition and the slide.
- Assume that when a purchase of supplies of \$2,650 for cash was recorded, both the debit and the credit were journalized and posted as \$2,560. (a) Would this error cause the trial balance to be out of balance? (b) Would the trial balance be out of balance if the \$2,650 entry had been journalized correctly but the credit to Cash had been posted as \$2,560?
- Assume that Muscular Consulting erroneously recorded the payment of \$7,500 of owner withdrawals as a debit to Salary Expense. (a) How would this error affect the equality of the trial balance? (b) How would this error affect the income statement, statement of owner's equity, and balance sheet?
- Assume that Sunshine Realty Co. borrowed \$300,000 from Columbia First Bank and Trust. In recording the transaction, Sunshine erroneously recorded the receipt as a debit to Cash, \$300,000, and a credit to Fees Earned, \$300,000. (a) How would this error affect the equality of the trial balance? (b) How would this error affect the income statement, statement of owner's equity, and balance sheet?
- Checking accounts are one of the most common forms of deposits for banks. Assume that Surety Storage has a checking account at Ada Savings Bank. What type of account (asset, liability, owner's equity, revenue, expense, drawing) does the account balance of \$11,375 represent from the viewpoint of (a) Surety Storage and (b) Ada Savings Bank?



Fuller Company
Income Statements
For Years Ended December 31

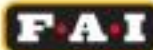
	2014	2013
Fees earned	\$680,000	\$850,000
Operating expenses	541,875	637,500
Net income	<u>\$138,125</u>	<u>\$212,500</u>

Prepare a horizontal analysis of Fuller Company's income statements.

EE 2-8 p. 75

PE 2-8B Horizontal analysis

OBJ. 5



Two income statements for Paragon Company are shown below.

Paragon Company
Income Statements
For Years Ended December 31

	2014	2013
Fees earned	\$1,416,000	\$1,200,000
Operating expenses	1,044,000	900,000
Net income	<u>\$ 372,000</u>	<u>\$ 300,000</u>

Prepare a horizontal analysis of Paragon Company's income statements.

Exercises

**EX 2-1 Chart of accounts**

OBJ. 1

The following accounts appeared in recent financial statements of [Continental Airlines](#):

Accounts Payable	Flight Equipment
Air Traffic Liability	Landing Fees (Expense)
Aircraft Fuel Expense	Passenger Revenue
Cargo and Mail Revenue	Purchase Deposits for Flight Equipment
Commissions (Expense)	Spare Parts and Supplies

Identify each account as either a balance sheet account or an income statement account. For each balance sheet account, identify it as an asset, a liability, or owner's equity. For each income statement account, identify it as a revenue or an expense.

EX 2-2 Chart of accounts

OBJ. 1

Innerscape Interiors is owned and operated by Gina Kissel, an interior decorator. In the ledger of Innerscape Interiors, the first digit of the account number indicates its major account classification (1—assets, 2—liabilities, 3—owner's equity, 4—revenues, 5—expenses). The second digit of the account number indicates the specific account within each of the preceding major account classifications.

Match each account number with its most likely account in the list below. The account numbers are 11, 12, 13, 21, 31, 32, 41, 51, 52, and 53.

Accounts Payable	Gina Kissel, Drawing
Accounts Receivable	Land
Cash	Miscellaneous Expense
Fees Earned	Supplies Expense
Gina Kissel, Capital	Wages Expense

EX 2-3 Chart of accounts

OBJ. 1

LeadCo School is a newly organized business that teaches people how to inspire and influence others. The list of accounts to be opened in the general ledger is as follows:

Accounts Payable	Miscellaneous Expense
Accounts Receivable	Prepaid Insurance
Cash	Rent Expense
Equipment	Supplies
Fees Earned	Supplies Expense
Ivy Bishop, Capital	Unearned Rent
Ivy Bishop, Drawing	Wages Expense

List the accounts in the order in which they should appear in the ledger of LeadCo School and assign account numbers. Each account number is to have two digits: the first digit is to indicate the major classification (1 for assets, etc.), and the second digit is to identify the specific account within each major classification (11 for Cash, etc.).

EX 2-4 Rules of debit and credit**OBJ. 1, 2**

The following table summarizes the rules of debit and credit. For each of the items (a) through (l), indicate whether the proper answer is a debit or a credit.

	Increase	Decrease	Normal Balance
Balance sheet accounts:			
Asset	(a)	(b)	Debit
Liability	(c)	Debit	(d)
Owner's equity:			
Capital	Credit	(e)	(f)
Drawing	(g)	(h)	(i)
Income statement accounts:			
Revenue	(j)	(k)	Credit
Expense	(l)	Credit	Debit

EX 2-5 Normal entries for accounts**OBJ. 2**

During the month, Gates Labs Co. has a substantial number of transactions affecting each of the following accounts. State for each account whether it is likely to have (a) debit entries only, (b) credit entries only, or (c) both debit and credit entries.

- | | |
|------------------------|----------------------------|
| 1. Accounts Payable | 5. Insurance Expense |
| 2. Accounts Receivable | 6. Steve Campbell, Drawing |
| 3. Cash | 7. Utilities Expense |
| 4. Fees Earned | |

EX 2-6 Normal balances of accounts**OBJ. 1, 2**

Identify each of the following accounts of Kaiser Services Co. as asset, liability, owner's equity, revenue, or expense, and state in each case whether the normal balance is a debit or a credit.

- | | |
|-----------------------------|---------------------|
| a. Accounts Payable | f. Fees Earned |
| b. Accounts Receivable | g. Office Equipment |
| c. Amanda Whitmore, Capital | h. Rent Expense |
| d. Amanda Whitmore, Drawing | i. Supplies |
| e. Cash | j. Wages Expense |

EX 2-7 Transactions**OBJ. 2**

Value Consulting Co. has the following accounts in its ledger: Cash; Accounts Receivable; Supplies; Office Equipment; Accounts Payable; Dennis Isberg, Capital; Dennis Isberg, Drawing; Fees Earned; Rent Expense; Advertising Expense; Utilities Expense; Miscellaneous Expense.

Journalize the following selected transactions for July 2014 in a two-column journal. Journal entry explanations may be omitted.

- July
1. Paid rent for the month, \$3,200.
 3. Paid advertising expense, \$750.
 5. Paid cash for supplies, \$1,300.
 6. Purchased office equipment on account, \$12,500.
 10. Received cash from customers on account, \$11,400.
 15. Paid creditor on account, \$1,175.
 27. Paid cash for repairs to office equipment, \$600.
 30. Paid telephone bill for the month, \$180.
 31. Fees earned and billed to customers for the month, \$33,760.
 31. Paid electricity bill for the month, \$1,300.
 31. Withdrew cash for personal use, \$4,000.

EX 2-8 Journalizing and posting**OBJ. 2, 3**

On May 22, 2014, Hillcrest Co. purchased \$6,180 of supplies on account. In Hillcrest Co.'s chart of accounts, the supplies account is No. 15, and the accounts payable account is No. 21.

- a. Journalize the May 22, 2014, transaction on page 19 of Hillcrest Co.'s two-column journal. Include an explanation of the entry.
- b. Prepare a four-column account for Supplies. Enter a debit balance of \$1,500 as of May 1, 2014. Place a check mark (✓) in the Posting Reference column.
- c. Prepare a four-column account for Accounts Payable. Enter a credit balance of \$16,750 as of May 1, 2014. Place a check mark (✓) in the Posting Reference column.
- d. Post the May 22, 2014, transaction to the accounts.
- e. Do the rules of debit and credit apply to all companies?

SPREADSHEET**EX 2-9 Transactions and T accounts****OBJ. 2, 3**

The following selected transactions were completed during January of the current year:

1. Billed customers for fees earned, \$48,600.
 2. Purchased supplies on account, \$1,975.
 3. Received cash from customers on account, \$31,400.
 4. Paid creditors on account, \$1,350.
- a. Journalize the above transactions in a two-column journal, using the appropriate number to identify the transactions. Journal entry explanations may be omitted.
 - b. Post the entries prepared in (a) to the following T accounts: Cash, Supplies, Accounts Receivable, Accounts Payable, Fees Earned. To the left of each amount posted in the accounts, place the appropriate number to identify the transactions.
 - c. Assume that the unadjusted trial balance on January 31 shows a credit balance for Accounts Receivable. Does this credit balance mean an error has occurred?

EX 2-10 Cash account balance**OBJ. 1, 2, 3**

During the month, Warwick Co. received \$515,000 in cash and paid out \$375,000 in cash.

- a. Do the data indicate that Warwick Co. had net income of \$140,000 during the month? Explain.
- b. If the balance of the cash account is \$200,000 at the end of the month, what was the cash balance at the beginning of the month?

EX 2-11 Account balances**OBJ. 1, 2, 3**

✓ c. \$107,340

- a. During March, \$276,500 was paid to creditors on account, and purchases on account were \$261,000. Assuming the March 31 balance of Accounts Payable was \$76,000, determine the account balance on March 1.
- b. On July 1, the accounts receivable account balance was \$49,000. During July, \$525,000 was collected from customers on account. Assuming the July 31 balance was \$61,500, determine the fees billed to customers on account during July.

- c. On September 1, the cash account balance was \$28,440. During September, cash receipts totaled \$112,100 and the September 30 balance was \$33,200. Determine the cash payments made during September.

EX 2-12 Capital account balance**OBJ. 1, 2**

As of January 1, Terrace Waters, Capital, had a credit balance of \$314,000. During the year, withdrawals totaled \$10,000, and the business incurred a net loss of \$320,000.

- Compute the balance of Terrace Waters, Capital, as of the end of the year.
- Assuming that there have been no recording errors, will the balance sheet prepared at December 31 balance? Explain.

EX 2-13 Identifying transactions**OBJ. 1, 2**

Grand Canyon Tours Co. is a travel agency. The nine transactions recorded by Grand Canyon Tours during April 2014, its first month of operations, are indicated in the following T accounts:

Cash		Equipment		Luis Chavez, Drawing	
(1) 75,000	(2) 4,000	(3) 25,000		(9) 5,000	
(7) 11,000	(3) 3,000				
	(4) 2,700				
	(6) 9,000				
	(9) 5,000				
Accounts Receivable		Accounts Payable		Service Revenue	
(5) 19,500	(7) 11,000	(6) 9,000	(3) 22,000		(5) 19,500
Supplies		Luis Chavez, Capital		Operating Expenses	
(2) 4,000	(8) 2,000		(1) 75,000	(4) 2,700	
				(8) 2,000	

Indicate for each debit and each credit: (a) whether an asset, liability, owner's equity, drawing, revenue, or expense account was affected and (b) whether the account was increased (+) or decreased (-). Present your answers in the following form, with transaction (1) given as an example:

Transaction	Account Debited		Account Credited	
	Type	Effect	Type	Effect
(1)	asset	+	owner's equity	+

EX 2-14 Journal entries**OBJ. 1, 2**

Based upon the T accounts in Exercise 2-13, prepare the nine journal entries from which the postings were made. Journal entry explanations may be omitted.

EX 2-15 Trial balance**OBJ. 4**

Based upon the data presented in Exercise 2-13, (a) prepare an unadjusted trial balance, listing the accounts in their proper order. (b) Based upon the unadjusted trial balance, determine the net income or net loss.

EX 2-16 Trial balance**OBJ. 4**

The accounts in the ledger of Leaf Co. as of December 31, 2014, are listed in alphabetical order as follows. All accounts have normal balances. The balance of the cash account has been intentionally omitted.

✓ Total of Debit
column: \$107,500

SPREADSHEET

✓ Total of Credit
column: \$675,000

Accounts Payable	\$ 23,500	Notes Payable	\$ 50,000
Accounts Receivable	38,100	Prepaid Insurance	6,400
Cash	?	Rent Expense	36,000
Dan Leafdale, Capital	50,000	Supplies	3,200
Dan Leafdale, Drawing	16,000	Supplies Expense	9,000
Fees Earned	538,000	Unearned Rent	13,500
Insurance Expense	6,000	Utilities Expense	18,000
Land	40,000	Wages Expense	476,800
Miscellaneous Expense	12,000		

Prepare an unadjusted trial balance, listing the accounts in their normal order and inserting the missing figure for cash.

EX 2-17 Effect of errors on trial balance **OBJ. 4**

Indicate which of the following errors, each considered individually, would cause the trial balance totals to be unequal:

- A fee of \$21,000 earned and due from a client was not debited to Accounts Receivable or credited to a revenue account, because the cash had not been received.
- A receipt of \$11,300 from an account receivable was journalized and posted as a debit of \$11,300 to Cash and a credit of \$11,300 to Fees Earned.
- A payment of \$4,950 to a creditor was posted as a debit of \$4,950 to Accounts Payable and a debit of \$4,950 to Cash.
- A payment of \$5,000 for equipment purchased was posted as a debit of \$500 to Equipment and a credit of \$500 to Cash.
- Payment of a cash withdrawal of \$19,000 was journalized and posted as a debit of \$1,900 to Salary Expense and a credit of \$19,000 to Cash.

Indicate which of the preceding errors would require a correcting entry.

✓ Total of Credit column: \$525,000

EX 2-18 Errors in trial balance **OBJ. 4**

The following preliminary unadjusted trial balance of Ranger Co., a sports ticket agency, does not balance:

Ranger Co.		
Unadjusted Trial Balance		
August 31, 2014		
	Debit	Credit
	Balances	Balances
Cash	77,600	
Accounts Receivable	37,750	
Prepaid Insurance		12,000
Equipment	19,000	
Accounts Payable		29,100
Unearned Rent		10,800
Carmen Meeks, Capital	110,000	
Carmen Meeks, Drawing	13,000	
Service Revenue		385,000
Wages Expense		213,000
Advertising Expense	16,350	
Miscellaneous Expense		18,400
	<u>273,700</u>	<u>668,300</u>

When the ledger and other records are reviewed, you discover the following: (1) the debits and credits in the cash account total \$77,600 and \$62,100, respectively; (2) a billing of \$9,000 to a customer on account was not posted to the accounts receivable account; (3) a payment of \$4,500 made to a creditor on account was not posted to the accounts payable account; (4) the balance of the unearned rent account is \$5,400; (5) the correct balance of the equipment account is \$190,000; and (6) each account has a normal balance.

Prepare a corrected unadjusted trial balance.

Instructions

- Record the above transactions directly in the following T accounts, without journalizing: Cash; Accounts Receivable; Supplies; Prepaid Insurance; Automobiles; Equipment; Notes Payable; Accounts Payable; Lynn Cantwell, Capital; Professional Fees; Rent Expense; Salary Expense; Blueprint Expense; Automobile Expense; Miscellaneous Expense. To the left of the amount entered in the accounts, place the appropriate letter to identify the transaction.
- Determine account balances of the T accounts. Accounts containing a single entry only (such as Prepaid Insurance) do not need a balance.
- Prepare an unadjusted trial balance for Lynn Cantwell, Architect, as of July 31, 2014.
- Determine the net income or net loss for July.

✓ 4. c. \$7,875

SPREADSHEET

GENERAL LEDGER

PR 2-2A Journal entries and trial balance

OBJ. 1, 2, 3, 4

On January 1, 2014, Alicia Masingale established Leopard Realty, which completed the following transactions during the month:

- Alicia Masingale transferred cash from a personal bank account to an account to be used for the business, \$23,500.
- Paid rent on office and equipment for the month, \$4,000.
- Purchased supplies on account, \$1,800.
- Paid creditor on account, \$675.
- Earned sales commissions, receiving cash, \$16,750.
- Paid automobile expenses (including rental charge) for month, \$1,000, and miscellaneous expenses, \$800.
- Paid office salaries, \$2,150.
- Determined that the cost of supplies used was \$925.
- Withdrew cash for personal use, \$1,600.

Instructions

- Journalize entries for transactions (a) through (i), using the following account titles: Cash; Supplies; Accounts Payable; Alicia Masingale, Capital; Alicia Masingale, Drawing; Sales Commissions; Rent Expense; Office Salaries Expense; Automobile Expense; Supplies Expense; Miscellaneous Expense. Explanations may be omitted.
- Prepare T accounts, using the account titles in (1). Post the journal entries to these accounts, placing the appropriate letter to the left of each amount to identify the transactions. Determine the account balances, after all posting is complete. Accounts containing only a single entry do not need a balance.
- Prepare an unadjusted trial balance as of January 31, 2014.
- Determine the following:
 - Amount of total revenue recorded in the ledger.
 - Amount of total expenses recorded in the ledger.
 - Amount of net income for January.
- Determine the increase or decrease in owner's equity for January.

PR 2-3A Journal entries and trial balance

OBJ. 1, 2, 3, 4

On June 1, 2014, Ellie Hopkins established an interior decorating business, First-Class Designs. During the month, Ellie completed the following transactions related to the business:

- June
- Ellie transferred cash from a personal bank account to an account to be used for the business, \$21,500.
 - Paid rent for period of June 1 to end of month, \$4,200.
 - Purchased office equipment on account, \$8,500.
 - Purchased a used truck for \$28,000, paying \$3,000 cash and giving a note payable for the remainder.
 - Purchased supplies for cash, \$1,800.
 - Received cash for job completed, \$9,000.

✓ 3. Total of Credit column: \$74,375

SPREADSHEET

GENERAL LEDGER

- June 15. Paid annual premiums on property and casualty insurance, \$2,700.
- 23. Recorded jobs completed on account and sent invoices to customers, \$13,650.
- 24. Received an invoice for truck expenses, to be paid in July, \$975.

Enter the following transactions on Page 2 of the two-column journal.

- 29. Paid utilities expense, \$2,480.
- 29. Paid miscellaneous expenses, \$750.
- 30. Received cash from customers on account, \$7,800.
- 30. Paid wages of employees, \$5,100.
- 30. Paid creditor a portion of the amount owed for equipment purchased on June 6, \$4,250.
- 30. Withdrew cash for personal use, \$3,000.

Instructions

1. Journalize each transaction in a two-column journal beginning on Page 1, referring to the following chart of accounts in selecting the accounts to be debited and credited. (Do not insert the account numbers in the journal at this time.) Explanations may be omitted.

11 Cash	31 Ellie Hopkins, Capital
12 Accounts Receivable	32 Ellie Hopkins, Drawing
13 Supplies	41 Fees Earned
14 Prepaid Insurance	51 Wages Expense
16 Equipment	53 Rent Expense
18 Truck	54 Utilities Expense
21 Notes Payable	55 Truck Expense
22 Accounts Payable	59 Miscellaneous Expense

2. Post the journal to a ledger of four-column accounts, inserting appropriate posting references as each item is posted. Extend the balances to the appropriate balance columns after each transaction is posted.
3. Prepare an unadjusted trial balance for First-Class Designs as of June 30, 2014.
4. Determine the excess of revenues over expenses for June.
5. Can you think of any reason why the amount determined in (4) might not be the net income for June?

PR 2-4A Journal entries and trial balance

OBJ. 1, 2, 3, 4

Elite Realty acts as an agent in buying, selling, renting, and managing real estate. The unadjusted trial balance on March 31, 2014, is shown below.

✓ 4. Total of Debit column: \$532,525

GENERAL LEDGER

	Debit Balances	Credit Balances
11 Cash	26,300	
12 Accounts Receivable	61,500	
13 Prepaid Insurance	3,000	
14 Office Supplies	1,800	
16 Land	—	
21 Accounts Payable		14,000
22 Unearned Rent		—
23 Notes Payable		—
31 Lester Wagner, Capital		46,000
32 Lester Wagner, Drawing	2,000	
41 Fees Earned		240,000
51 Salary and Commission Expense	148,200	
52 Rent Expense	30,000	
53 Advertising Expense	17,800	
54 Automobile Expense	5,500	
59 Miscellaneous Expense	3,900	
	300,000	300,000

The following business transactions were completed by Elite Realty during April 2014:

- Apr. 1. Paid rent on office for month, \$6,500.
 2. Purchased office supplies on account, \$2,300.
 5. Paid insurance premiums, \$6,000.
 10. Received cash from clients on account, \$52,300.
 15. Purchased land for a future building site for \$200,000, paying \$30,000 in cash and giving a note payable for the remainder.
 17. Paid creditors on account, \$6,450.
 20. Returned a portion of the office supplies purchased on April 2, receiving full credit for their cost, \$325.
 23. Paid advertising expense, \$4,300.

Enter the following transactions on Page 19 of the two-column journal.

27. Discovered an error in computing a commission; received cash from the salesperson for the overpayment, \$2,500.
 28. Paid automobile expense (including rental charges for an automobile), \$1,500.
 29. Paid miscellaneous expenses, \$1,400.
 30. Recorded revenue earned and billed to clients during the month, \$57,000.
 30. Paid salaries and commissions for the month, \$11,900.
 30. Withdrew cash for personal use, \$4,000.
 30. Rented land purchased on April 15 to local merchants association for use as a parking lot in May and June, during a street rebuilding program; received advance payment of \$10,000.

Instructions

- Record the April 1, 2014, balance of each account in the appropriate balance column of a four-column account, write *Balance* in the item section, and place a check mark (✓) in the Posting Reference column.
- Journalize the transactions for April in a two-column journal beginning on Page 18. Journal entry explanations may be omitted.
- Post to the ledger, extending the account balance to the appropriate balance column after each posting.
- Prepare an unadjusted trial balance of the ledger as of April 30, 2014.
- Assume that the April 30 transaction for salaries and commissions should have been \$19,100. (a) Why did the unadjusted trial balance in (4) balance? (b) Journalize the correcting entry. (c) Is this error a transposition or slide?

PR 2-5A Corrected trial balance

OBJ. 4

The Colby Group has the following unadjusted trial balance as of August 31, 2014.


The Colby Group Unadjusted Trial Balance August 31, 2014		
	Debit Balances	Credit Balances
Cash	17,300	
Accounts Receivable.....	37,000	
Supplies	7,400	
Prepaid Insurance	1,900	
Equipment.....	196,000	
Notes Payable.....		97,600
Accounts Payable		26,000
Terry Colby, Capital.....		129,150
Terry Colby, Drawing	56,000	
Fees Earned.....		454,450
Wages Expense	270,000	
Rent Expense	51,800	
Advertising Expense.....	25,200	
Miscellaneous Expense	5,100	
	667,700	707,200

✓ 1. Total of Debit column: \$725,000

The debit and credit totals are not equal as a result of the following errors:

- The cash entered on the trial balance was understated by \$6,000.
- A cash receipt of \$5,600 was posted as a debit to Cash of \$6,500.
- A debit of \$11,000 to Accounts Receivable was not posted.
- A return of \$150 of defective supplies was erroneously posted as a \$1,500 credit to Supplies.
- An insurance policy acquired at a cost of \$1,200 was posted as a credit to Prepaid Insurance.
- The balance of Notes Payable was understated by \$20,000.
- A credit of \$4,800 in Accounts Payable was overlooked when determining the balance of the account.
- A debit of \$7,000 for a withdrawal by the owner was posted as a credit to Terry Colby, Capital.
- The balance of \$58,100 in Rent Expense was entered as \$51,800 in the trial balance.
- Gas, Electricity, and Water Expense, with a balance of \$24,150, was omitted from the trial balance.

Instructions

- Prepare a corrected unadjusted trial balance as of August 31, 2014.
-  Does the fact that the unadjusted trial balance in (1) is balanced mean that there are no errors in the accounts? Explain.

Problems Series B

✓ 3. Total of Debit column: \$69,550

PR 2-1B Entries into T accounts and trial balance

OBJ. 1, 2, 3, 4

Ken Jones, an architect, opened an office on April 1, 2014. During the month, he completed the following transactions connected with his professional practice:

- Transferred cash from a personal bank account to an account to be used for the business, \$18,000.
- Purchased used automobile for \$19,500, paying \$2,500 cash and giving a note payable for the remainder.
- Paid April rent for office and workroom, \$3,150.
- Paid cash for supplies, \$1,450.
- Purchased office and computer equipment on account, \$6,500.
- Paid cash for annual insurance policies on automobile and equipment, \$2,400.
- Received cash from a client for plans delivered, \$12,000.
- Paid cash to creditors on account, \$1,800.
- Paid cash for miscellaneous expenses, \$375.
- Received invoice for blueprint service, due in May, \$2,500.
- Recorded fee earned on plans delivered, payment to be received in May, \$15,650.
- Paid salary of assistant, \$2,800.
- Paid cash for miscellaneous expenses, \$200.
- Paid installment due on note payable, \$300.
- Paid gas, oil, and repairs on automobile for April, \$550.

Instructions

- Record the above transactions directly in the following T accounts, without journalizing: Cash; Accounts Receivable; Supplies; Prepaid Insurance; Automobiles; Equipment; Notes Payable; Accounts Payable; Ken Jones, Capital; Professional Fees; Rent Expense; Salary Expense; Blueprint Expense; Automobile Expense; Miscellaneous Expense. To the left of each amount entered in the accounts, place the appropriate letter to identify the transaction.
- Determine account balances of the T accounts. Accounts containing a single entry only (such as Prepaid Insurance) do not need a balance.

3. Prepare an unadjusted trial balance for Ken Jones, Architect, as of April 30, 2014.
4. Determine the net income or net loss for April.

✓ 4. c. \$4,550

SPREADSHEET

GENERAL LEDGER

PR 2-2B Journal entries and trial balance

OBJ. 1, 2, 3, 4

On August 1, 2014, Rafael Masey established Planet Realty, which completed the following transactions during the month:

- a. Rafael Masey transferred cash from a personal bank account to an account to be used for the business, \$17,500.
- b. Purchased supplies on account, \$2,300.
- c. Earned sales commissions, receiving cash, \$13,300.
- d. Paid rent on office and equipment for the month, \$3,000.
- e. Paid creditor on account, \$1,150.
- f. Withdrew cash for personal use, \$1,800.
- g. Paid automobile expenses (including rental charge) for month, \$1,500, and miscellaneous expenses, \$400.
- h. Paid office salaries, \$2,800.
- i. Determined that the cost of supplies used was \$1,050.

Instructions

1. Journalize entries for transactions (a) through (i), using the following account titles: Cash; Supplies; Accounts Payable; Rafael Masey, Capital; Rafael Masey, Drawing; Sales Commissions; Rent Expense; Office Salaries Expense; Automobile Expense; Supplies Expense; Miscellaneous Expense. Journal entry explanations may be omitted.
2. Prepare T accounts, using the account titles in (1). Post the journal entries to these accounts, placing the appropriate letter to the left of each amount to identify the transactions. Determine the account balances, after all posting is complete. Accounts containing only a single entry do not need a balance.
3. Prepare an unadjusted trial balance as of August 31, 2014.
4. Determine the following:
 - a. Amount of total revenue recorded in the ledger.
 - b. Amount of total expenses recorded in the ledger.
 - c. Amount of net income for August.
5. Determine the increase or decrease in owner's equity for August.

PR 2-3B Journal entries and trial balance

OBJ. 1, 2, 3, 4

On October 1, 2014, Jay Pryor established an interior decorating business, Pioneer Designs. During the month, Jay completed the following transactions related to the business:

- Oct. 1. Jay transferred cash from a personal bank account to an account to be used for the business, \$18,000.
4. Paid rent for period of October 4 to end of month, \$3,000.
 10. Purchased a used truck for \$23,750, paying \$3,750 cash and giving a note payable for the remainder.
 13. Purchased equipment on account, \$10,500.
 14. Purchased supplies for cash, \$2,100.
 15. Paid annual premiums on property and casualty insurance, \$3,600.
 15. Received cash for job completed, \$8,950.

Enter the following transactions on Page 2 of the two-column journal.

21. Paid creditor a portion of the amount owed for equipment purchased on October 13, \$2,000.
24. Recorded jobs completed on account and sent invoices to customers, \$14,150.
26. Received an invoice for truck expenses, to be paid in November, \$700.
27. Paid utilities expense, \$2,240.

✓ 3. Total of Credit column: \$70,300


SPREADSHEET

GENERAL LEDGER

The debit and credit totals are not equal as a result of the following errors:

- a. The cash entered on the trial balance was overstated by \$8,000.
- b. A cash receipt of \$4,100 was posted as a debit to Cash of \$1,400.
- c. A debit of \$12,350 to Accounts Receivable was not posted.
- d. A return of \$235 of defective supplies was erroneously posted as a \$325 credit to Supplies.
- e. An insurance policy acquired at a cost of \$3,000 was posted as a credit to Prepaid Insurance.
- f. The balance of Notes Payable was overstated by \$21,000.
- g. A credit of \$3,450 in Accounts Payable was overlooked when the balance of the account was determined.
- h. A debit of \$6,000 for a withdrawal by the owner was posted as a debit to Thad Engelberg, Capital.
- i. The balance of \$28,350 in Advertising Expense was entered as \$23,850 in the trial balance.
- j. Miscellaneous Expense, with a balance of \$4,600, was omitted from the trial balance.

Instructions

1. Prepare a corrected unadjusted trial balance as of January 31, 2014.
2.  Does the fact that the unadjusted trial balance in (1) is balanced mean that there are no errors in the accounts? Explain.

Continuing Problem



✓ 4. Total of Debit column: \$40,750

GENERAL LEDGER

The transactions completed by PS Music during June 2014 were described at the end of Chapter 1. The following transactions were completed during July, the second month of the business's operations:

- July
1. Peyton Smith made an additional investment in PS Music by depositing \$5,000 in PS Music's checking account.
 1. Instead of continuing to share office space with a local real estate agency, Peyton decided to rent office space near a local music store. Paid rent for July, \$1,750.
 1. Paid a premium of \$2,700 for a comprehensive insurance policy covering liability, theft, and fire. The policy covers a one-year period.
 2. Received \$1,000 on account.
 3. On behalf of PS Music, Peyton signed a contract with a local radio station, KXMD, to provide guest spots for the next three months. The contract requires PS Music to provide a guest disc jockey for 80 hours per month for a monthly fee of \$3,600. Any additional hours beyond 80 will be billed to KXMD at \$40 per hour. In accordance with the contract, Peyton received \$7,200 from KXMD as an advance payment for the first two months.
 3. Paid \$250 on account.
 4. Paid an attorney \$900 for reviewing the July 3 contract with KXMD. (Record as Miscellaneous Expense.)
 5. Purchased office equipment on account from Office Mart, \$7,500.
 8. Paid for a newspaper advertisement, \$200.
 11. Received \$1,000 for serving as a disc jockey for a party.
 13. Paid \$700 to a local audio electronics store for rental of digital recording equipment.
 14. Paid wages of \$1,200 to receptionist and part-time assistant.

Enter the following transactions on Page 2 of the two-column journal.

- July 16. Received \$2,000 for serving as a disc jockey for a wedding reception.
18. Purchased supplies on account, \$850.
21. Paid \$620 to Upload Music for use of its current music demos in making various music sets.
22. Paid \$800 to a local radio station to advertise the services of PS Music twice daily for the remainder of July.
23. Served as disc jockey for a party for \$2,500. Received \$750, with the remainder due August 4, 2014.
27. Paid electric bill, \$915.
28. Paid wages of \$1,200 to receptionist and part-time assistant.
29. Paid miscellaneous expenses, \$540.
30. Served as a disc jockey for a charity ball for \$1,500. Received \$500, with the remainder due on August 9, 2014.
31. Received \$3,000 for serving as a disc jockey for a party.
31. Paid \$1,400 royalties (music expense) to National Music Clearing for use of various artists' music during July.
31. Withdrew \$1,250 cash from PS Music for personal use.

PS Music's chart of accounts and the balance of accounts as of July 1, 2014 (all normal balances), are as follows:

11 Cash	\$3,920	41 Fees Earned	\$6,200
12 Accounts Receivable	1,000	50 Wages Expense	400
14 Supplies	170	51 Office Rent Expense	800
15 Prepaid Insurance	—	52 Equipment Rent Expense	675
17 Office Equipment	—	53 Utilities Expense	300
21 Accounts Payable	250	54 Music Expense	1,590
23 Unearned Revenue	—	55 Advertising Expense	500
31 Peyton Smith, Capital	4,000	56 Supplies Expense	180
32 Peyton Smith, Drawing	500	59 Miscellaneous Expense	415

Instructions


1. Enter the July 1, 2014, account balances in the appropriate balance column of a four-column account. Write *Balance* in the Item column, and place a check mark (✓) in the Posting Reference column. (*Hint:* Verify the equality of the debit and credit balances in the ledger before proceeding with the next instruction.)
2. Analyze and journalize each transaction in a two-column journal beginning on Page 1, omitting journal entry explanations.
3. Post the journal to the ledger, extending the account balance to the appropriate balance column after each posting.
4. Prepare an unadjusted trial balance as of July 31, 2014.

Cases & Projects



CP 2-1 Ethics and professional conduct in business

At the end of the current month, Gil Frank prepared a trial balance for College App Services. The credit side of the trial balance exceeds the debit side by a significant amount. Gil has decided to add the difference to the balance of the miscellaneous expense account in order to complete the preparation of the current month's financial statements by a 5 o'clock deadline. Gil will look for the difference next week when he has more time.

 Discuss whether Gil is behaving in a professional manner.

CP 2-2 Account for revenue

Bozeman College requires students to pay tuition each term before classes begin. Students who have not paid their tuition are not allowed to enroll or to attend classes.

What journal entry do you think Bozeman College would use to record the receipt of the students' tuition payments? Describe the nature of each account in the entry.

CP 2-3 Record transactions

The following discussion took place between Tony Cork, the office manager of Hallmark Data Company, and a new accountant, Cassie Miles.

Cassie: I've been thinking about our method of recording entries. It seems that it's inefficient.

Tony: In what way?

Cassie: Well—correct me if I'm wrong—it seems like we have unnecessary steps in the process. We could easily develop a trial balance by posting our transactions directly into the ledger and bypassing the journal altogether. In this way, we could combine the recording and posting process into one step and save ourselves a lot of time. What do you think?

Tony: We need to have a talk.

 What should Tony say to Cassie?

CP 2-4 Debits and credits**Group Project**

The following excerpt is from a conversation between Kate Purvis, the president and chief operating officer of Light House Company, and her neighbor, Dot Evers.

Dot: Kate, I'm taking a course in night school, "Intro to Accounting." I was wondering—could you answer a couple of questions for me?


Kate: Well, I will if I can.

Dot: Okay, our instructor says that it's critical we understand the basic concepts of accounting, or we'll never get beyond the first test. My problem is with those rules of debit and credit . . . you know, assets increase with debits, decrease with credits, etc.

Kate: Yes, pretty basic stuff. You just have to memorize the rules. It shouldn't be too difficult.

Dot: Sure, I can memorize the rules, but my problem is I want to be sure I understand the basic concepts behind the rules. For example, why can't assets be increased with credits and decreased with debits like revenue? As long as everyone did it that way, why not? It would seem easier if we had the same rules for all increases and decreases in accounts. Also, why is the left side of an account called the debit side? Why couldn't it be called something simple . . . like the "LE" for Left Entry? The right side could be called just "RE" for Right Entry. Finally, why are there just two sides to an entry? Why can't there be three or four sides to an entry?

In a group of four or five, select one person to play the role of Kate and one person to play the role of Dot.

-  After listening to the conversation between Kate and Dot, help Kate answer Dot's questions.
- What information (other than just debit and credit journal entries) could the accounting system gather that might be useful to Kate in managing Light House Company?


CP 2-5 Transactions and income statement

Cory Neece is planning to manage and operate Eagle Caddy Service at Canyon Lake Golf and Country Club during June through August 2014. Cory will rent a small maintenance building from the country club for \$500 per month and will offer caddy services, including cart rentals, to golfers. Cory has had no formal training in record keeping.

Cory keeps notes of all receipts and expenses in a shoe box. An examination of Cory's shoe box records for June revealed the following:

- June
1. Transferred \$2,000 from personal bank account to be used to operate the caddy service.
 1. Paid rent expense to Canyon Lake Golf and Country Club, \$500.
 2. Paid for golf supplies (practice balls, etc.), \$750.
 3. Arranged for the rental of 40 regular (pulling) golf carts and 20 gasoline-driven carts for \$3,000 per month. Paid \$600 in advance, with the remaining \$2,400 due June 20.
 7. Purchased supplies, including gasoline, for the golf carts on account, \$1,000. Canyon Lake Golf and Country Club has agreed to allow Cory to store the gasoline in one of its fuel tanks at no cost.
 15. Received cash for services from June 1–15, \$5,400.
 17. Paid cash to creditors on account, \$1,000.
 20. Paid remaining rental on golf carts, \$2,400.
 22. Purchased supplies, including gasoline, on account, \$850.
 25. Accepted IOUs from customers on account, \$1,800.
 28. Paid miscellaneous expenses, \$395.
 30. Received cash for services from June 16–30, \$4,200.
 30. Paid telephone and electricity (utilities) expenses, \$340.
 30. Paid wages of part-time employees, \$850.
 30. Received cash in payment of IOUs on account, \$1,500.
 30. Determined the amount of supplies on hand at the end of June, \$675.

Cory has asked you several questions concerning his financial affairs to date, and he has asked you to assist with his record keeping and reporting of financial data.

- a. To assist Cory with his record keeping, prepare a chart of accounts that would be appropriate for Eagle Caddy Service.
- b. Prepare an income statement for June in order to help Cory assess the profitability of Eagle Caddy Service. For this purpose, the use of T accounts may be helpful in analyzing the effects of each June transaction.
- c. Based on Cory's records of receipts and payments, compute the amount of cash on hand on June 30. For this purpose, a T account for cash may be useful.
- d.  A count of the cash on hand on June 30 totaled \$6,175. Briefly discuss the possible causes of the difference between the amount of cash computed in (c) and the actual amount of cash on hand.

Internet Project

CP 2-6 Opportunities for accountants

The increasing complexity of the current business and regulatory environment has created an increased demand for accountants who can analyze business transactions and interpret their effects on the financial statements. In addition, a basic ability to analyze the effects of transactions is necessary to be successful in all fields of business as well as in other disciplines, such as law. To better understand the importance of accounting in today's environment, search the Internet or your local newspaper for job opportunities. One possible Internet site is <http://www.careerbuilder.com>. Then do one of the following:

1. Print a listing of one or two ads for accounting jobs. Alternatively, bring to class one or two newspaper ads for accounting jobs.
2. Print a listing of one or two ads for nonaccounting jobs for which some knowledge of accounting is preferred or necessary. Alternatively, bring to class one or two newspaper ads for such jobs.

The Adjusting Process

At the end of the accounting period, many of the account balances in the ledger are reported in the financial statements without change. For example, the balances of the cash and land accounts are normally the amounts reported on the balance sheet.

Some accounts, however, require updating for the following reasons:¹

1. Some expenses are not recorded daily. For example, the daily use of supplies would require many entries with small amounts. Also, the amount of supplies on hand on a day-to-day basis is normally not needed.
2. Some revenues and expenses are incurred as time passes rather than as separate transactions. For example, rent received in advance (unearned rent) expires and becomes revenue with the passage of time. Likewise, prepaid insurance expires and becomes an expense with the passage of time.
3. Some revenues and expenses may be unrecorded. For example, a company may have provided services to customers that it has not billed or recorded at the end of the accounting period. Likewise, a company may not pay its employees until the next accounting period even though the employees have earned their wages in the current period.

The analysis and updating of accounts at the end of the period before the financial statements are prepared is called the **adjusting process**. The journal entries that bring the accounts up to date at the end of the accounting period are called **adjusting entries**. All adjusting entries affect at least one income statement account and one balance sheet account. Thus, an adjusting entry will *always* involve a revenue or an expense account *and* an asset or a liability account.

Example Exercise 3-1 Accounts Requiring Adjustment



Indicate with a *Yes* or *No* whether or not each of the following accounts normally requires an adjusting entry.

- | | | |
|-----------------|------------------|------------------------|
| a. Cash | c. Wages Expense | e. Accounts Receivable |
| b. Prepaid Rent | d. Land | f. Unearned Rent |

Follow My Example 3-1

- | | | |
|--------|--------|--------|
| a. No | c. Yes | e. Yes |
| b. Yes | d. No | f. Yes |

Practice Exercises: **PE 3-1A, PE 3-1B**

Types of Accounts Requiring Adjustment

Four basic types of accounts require adjusting entries as shown below.

- | | |
|----------------------|---------------------|
| 1. Prepaid expenses | 3. Accrued revenues |
| 2. Unearned revenues | 4. Accrued expenses |

Prepaid expenses are the advance payment of *future* expenses and are recorded as assets when cash is paid. Prepaid expenses become expenses over time or during normal operations. To illustrate, the following transaction of **NetSolutions** from Chapter 2 is used.

Dec. 1 NetSolutions paid \$2,400 as a premium on a one-year insurance policy.

On December 1, the cash payment of \$2,400 was recorded as a debit to Prepaid Insurance and credit to Cash for \$2,400. At the end of December, only \$200 (\$2,400 divided

¹ Under the cash basis of accounting, accounts do not require adjusting. This is because transactions are recorded only when cash is received or paid. Thus, the matching concept is not used under the cash basis.

by 12 months) of the insurance premium is expired and has become an expense. The remaining \$2,200 of prepaid insurance will become an expense in future months. Thus, the \$200 is insurance expense of December and should be recorded with an adjusting entry.

Other examples of prepaid expenses include supplies, prepaid advertising, and prepaid interest.

Exhibit 1 summarizes the nature of prepaid expenses.

EXHIBIT 1		Prepaid Expenses																																
Transaction	<i>Cash is paid in advance for an expense.</i>																																	
Analysis	Advance payments of future expenses are recorded as assets when the cash is paid. The transaction is recorded as a debit to a prepaid expense account and a credit to the cash account.																																	
Journal Entry	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;"></td> <td style="width: 30%; text-align: center;">Prepaid Expense</td> <td style="width: 10%;"></td> <td style="width: 10%; text-align: center;">XXX</td> <td style="width: 10%;"></td> </tr> <tr> <td></td> <td style="text-align: center;">Cash</td> <td></td> <td></td> <td style="text-align: center;">XXX</td> </tr> <tr> <td></td> <td colspan="4" style="text-align: center;">Paid an expense in advance.</td> </tr> </table>				Prepaid Expense		XXX			Cash			XXX		Paid an expense in advance.																			
	Prepaid Expense		XXX																															
	Cash			XXX																														
	Paid an expense in advance.																																	
Accounting Equation Impact	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%;"></td> <td style="width: 25%; text-align: center;">Assets</td> <td style="width: 5%; text-align: center;">=</td> <td style="width: 25%; text-align: center;">Liabilities</td> <td style="width: 5%; text-align: center;">+</td> <td style="width: 20%; text-align: center;">Owner's Equity</td> </tr> <tr> <td></td> <td style="text-align: center; background-color: #fff9c4;">Cash</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td style="text-align: center; border: 1px solid black;">XXX</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td style="text-align: center; background-color: #fff9c4;">Prepaid Expense</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td style="text-align: center; border: 1px solid black;">XXX</td> <td></td> <td></td> <td></td> <td></td> </tr> </table>					Assets	=	Liabilities	+	Owner's Equity		Cash						XXX						Prepaid Expense						XXX				
	Assets	=	Liabilities	+	Owner's Equity																													
	Cash																																	
	XXX																																	
	Prepaid Expense																																	
	XXX																																	
Adjustment	<i>An end-of-period adjustment is needed to update the prepaid expense account.</i>																																	
Analysis	The prepaid expense account is decreased (credited) for the amount of the prepaid expense that has expired or has been used, and the related expense account is increased (debited).																																	
Adjusting Journal Entry	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%;"></td> <td style="width: 30%; text-align: center;">Expense</td> <td style="width: 10%;"></td> <td style="width: 10%; text-align: center;">XXX</td> <td style="width: 10%;"></td> </tr> <tr> <td></td> <td style="text-align: center;">Prepaid Expense</td> <td></td> <td></td> <td style="text-align: center;">XXX</td> </tr> <tr> <td></td> <td colspan="4" style="text-align: center;">Adjustment for prepaid expense.</td> </tr> </table>				Expense		XXX			Prepaid Expense			XXX		Adjustment for prepaid expense.																			
	Expense		XXX																															
	Prepaid Expense			XXX																														
	Adjustment for prepaid expense.																																	
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	Assets	=	Liabilities	+	Owner's Equity (Expense)																													
	Prepaid Expense				Expense																													
	XXX				XXX																													

Unearned revenues are the advance receipt of *future* revenues and are recorded as liabilities when cash is received. Unearned revenues become earned revenues over time or during normal operations. To illustrate, the following December 1 transaction of NetSolutions is used.

Dec. 1 NetSolutions received \$360 from a local retailer to rent land for three months.

On December 1, the cash receipt of \$360 was recorded as a debit to Cash and a credit to Unearned Rent for \$360. At the end of December, \$120 (\$360 divided by 3 months) of the unearned rent has been earned. The remaining \$240 will become rent revenue in future months. Thus, the \$120 is rent revenue of December and should be recorded with an adjusting entry.

Other examples of unearned revenues include tuition received in advance by a school, an annual retainer fee received by an attorney, premiums received in advance by an insurance company, and magazine subscriptions received in advance by a publisher.

Exhibit 2 summarizes the nature of unearned revenues.

EXHIBIT 2 Unearned Revenues

Cash is received for an unearned revenue.

Advance receipts for future services to be provided are recorded as liabilities when the cash is received. The transaction is recorded as a debit to the cash account and a credit to the unearned revenue account.

		Cash		XXX		
		Unearned Revenue			XXX	
		Received cash for unearned revenue.				

Assets		=	Liabilities		+	Owner's Equity	
Cash			Unearned Revenue				
XXX				XXX			

Transaction

Analysis

Journal Entry

Accounting Equation Impact

An end-of-period adjustment is needed to update the unearned revenue account.

The unearned revenue account is decreased (debited) for the amount of the revenue that has been earned, and the related revenue account is increased (credited).

		Unearned Revenue		XXX		
		Revenue			XXX	
		Adjustment for unearned revenue.				

Assets		=	Liabilities		+	Owner's Equity (Revenue)	
			Unearned Revenue			Revenue	
			XXX				XXX

Adjustment

Analysis

Adjusting Journal Entry

Accounting Equation Impact

Accrued revenues are unrecorded revenues that have been earned and for which cash has yet to be received. Fees for services that an attorney or a doctor has provided but not yet billed are accrued revenues. To illustrate, the following example involving NetSolutions and one of its customers is used.

Dec. 15 NetSolutions signed an agreement with Dankner Co. under which NetSolutions will bill Dankner Co. on the fifteenth of each month for services rendered at the rate of \$20 per hour.

From December 16–31, NetSolutions provided 25 hours of service to Dankner Co. Although the revenue of \$500 (25 hours × \$20) has been earned, it will not be billed until January 15. Likewise, cash of \$500 will not be received until Dankner pays its bill. Thus, the \$500 of accrued revenue and the \$500 of fees earned should be recorded with an adjusting entry on December 31.

Other examples of accrued revenues include accrued interest on notes receivable and accrued rent on property rented to others.

Exhibit 3 summarizes the nature of accrued revenues.

EXHIBIT 3		Accrued Revenues													
Transaction	<i>Revenue has been earned but has not been recorded.</i>														
Analysis	Revenues have been earned, but the revenue has not been recorded nor has cash been received. No journal entry has been recorded even though revenues have been earned.														
Journal Entry	No entry has been recorded.														
Accounting Equation Impact	Assets	=	Liabilities + Owner's Equity												
	No impact, since the revenue has not been recorded.														
Adjustment	<i>An end-of-period adjustment is needed to recognize accrued revenue.</i>														
Analysis	An asset account is increased (debited) for the amount of the revenue that has been earned, and the related revenue account is increased (credited). The type of receivable account that is debited depends upon the type of revenue. For example, Accounts Receivable would be debited for fees earned. Interest Receivable would be debited for interest earned.														
Adjusting Journal Entry	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%;"></td> <td style="width: 25%; text-align: center;">Asset (Receivable)</td> <td style="width: 25%;"></td> <td style="width: 25%; text-align: center;">XXX</td> </tr> <tr> <td></td> <td style="text-align: center;">Revenue</td> <td></td> <td style="text-align: center;">XXX</td> </tr> <tr> <td></td> <td colspan="3" style="text-align: center;">Adjustment for accrued revenue.</td> </tr> </table>				Asset (Receivable)		XXX		Revenue		XXX		Adjustment for accrued revenue.		
	Asset (Receivable)		XXX												
	Revenue		XXX												
	Adjustment for accrued revenue.														
Accounting Equation Impact	Assets	=	Liabilities + Owner's Equity (Revenue)												
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; text-align: center;">Receivable</td> <td style="width: 50%;"></td> </tr> <tr> <td style="text-align: center;">XXX</td> <td></td> </tr> </table>	Receivable		XXX		=	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;"></td> <td style="width: 50%; text-align: center;">Revenue</td> </tr> <tr> <td></td> <td style="text-align: center;">XXX</td> </tr> </table>		Revenue		XXX				
Receivable															
XXX															
	Revenue														
	XXX														

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Accrued expenses are unrecorded expenses that have been incurred and for which cash has yet to be paid. Wages owed to employees at the end of a period but not yet paid are an accrued expense. To illustrate, the following example involving NetSolutions and its employees is used.

Dec. 31 NetSolutions owes its employees wages of \$250 for Monday and Tuesday, December 30 and 31.

NetSolutions paid wages of \$950 on December 13 and \$1,200 on December 27, 2013. These payments covered the biweekly pay periods that ended on those days. As of December 31, 2013, NetSolutions owes its employees wages of \$250 for Monday and Tuesday, December 30 and 31. The wages of \$250 will be paid on January 10, 2014; however, they are an expense of December. Thus, \$250 of accrued wages should be recorded with an adjusting entry on December 31.

Other examples of accrued expenses include accrued interest on notes payable and accrued taxes.

Exhibit 4 summarizes the nature of accrued expenses.

EXHIBIT 4 Accrued Expenses

An expense has been incurred but has not been recorded.

An expense has been incurred, but the expense has not been recorded nor has cash been paid. No journal entry has been recorded even though an expense has been incurred.

			No entry has been recorded.				
--	--	--	-----------------------------	--	--	--	--

Assets = Liabilities + Owner's Equity

No impact, since the expense has not been recorded.

Transaction

Analysis

Journal Entry

Accounting Equation Impact

An end-of-period adjustment is needed to recognize the accrued expense.

An expense account is increased (debited) for the amount of the expense that has been incurred, and the related liability account is increased (credited). The liability account that is credited depends upon the type of expense. For example, Wages Payable would be credited for wages expense. Interest Payable would be credited for interest expense.

		Expense			XXX		
		Liability (Payable)				XXX	
		Adjustment for accrued expense.					

Assets = Liabilities + Owner's Equity (Expense)

		Payable		Expense	
		XXX		XXX	

Adjustment

Analysis

Adjusting Journal Entry

Accounting Equation Impact

As illustrated in Exhibit 4, accrued revenues are earned revenues that are unrecorded. The cash receipts for accrued revenues are normally received in the next accounting period. Accrued expenses are expenses that have been incurred, but are unrecorded. The cash payments for accrued expenses are normally paid in the next accounting period.

Prepaid expenses and unearned revenues are sometimes referred to as *deferrals*. This is because the recording of the related expense or revenue is deferred to a future period. Accrued revenues and accrued expenses are sometimes referred to as *accruals*. This is because the related revenue or expense should be recorded or accrued in the current period.

Example Exercise 3-2 Type of AdjustmentOBJ
1

Classify the following items as (1) prepaid expense, (2) unearned revenue, (3) accrued expense, or (4) accrued revenue.

- | | |
|---------------------------------|--------------------------------------|
| a. Wages owed but not yet paid. | c. Fees received but not yet earned. |
| b. Supplies on hand. | d. Fees earned but not yet received. |

Follow My Example 3-2

- | | |
|--------------------|---------------------|
| a. Accrued expense | c. Unearned revenue |
| b. Prepaid expense | d. Accrued revenue |

Practice Exercises: PE 3-2A, PE 3-2B

by a total of \$1,440 (\$1,240 + \$200), and net income will be overstated by \$1,440. On the balance sheet, Supplies and Prepaid Insurance will be overstated by a total of \$1,440. Since net income increases owner's equity, Chris Clark, Capital will also be overstated by \$1,440 on the balance sheet. The effects of omitting these adjusting entries on the income statement and balance sheet are as follows:

	Amount of Misstatement
Income Statement	
Revenues correctly stated	\$ XXX
Expenses understated by	(1,440)
Net income overstated by	<u>\$1,440</u>
Balance Sheet	
Assets overstated by	<u>\$1,440</u>
Liabilities correctly stated	\$ XXX
Owner's equity overstated by	<u>1,440</u>
Total liabilities and owner's equity overstated by	<u>\$1,440</u>

Arrow (1) indicates the effect of the understated expenses on assets. Arrow (2) indicates the effect of the overstated net income on owner's equity.

Payments for prepaid expenses are sometimes made at the beginning of the period in which they will be *entirely used or consumed*. To illustrate, the following December 1 transaction of NetSolutions is used.

Dec. 1 NetSolutions paid rent of \$800 for the month.

On December 1, the rent payment of \$800 represents Prepaid Rent. However, the Prepaid Rent expires daily, and at the end of December there will be no asset left. In such cases, the payment of \$800 is recorded as Rent Expense rather than as Prepaid Rent. In this way, no adjusting entry is needed at the end of the period.²

Example Exercise 3-3 Adjustment for Prepaid Expense



The prepaid insurance account had a beginning balance of \$6,400 and was debited for \$3,600 of premiums paid during the year. Journalize the adjusting entry required at the end of the year, assuming the amount of unexpired insurance related to future periods is \$3,250.

Follow My Example 3-3

Insurance Expense	6,750	
Prepaid Insurance		6,750
Insurance expired (\$6,400 + \$3,600 – \$3,250).		

Practice Exercises: PE 3-3A, PE 3-3B

Integrity, Objectivity, and Ethics in Business



FREE ISSUE

Office supplies are often available to employees on a "free issue" basis. This means that employees do not have to "sign" for the release of office supplies but merely obtain the necessary supplies from a local storage area as needed. Just

because supplies are easily available, however, doesn't mean they can be taken for personal use. There are many instances where employees have been terminated for taking supplies home for personal use.

² An alternative treatment of recording the cost of supplies, rent, and other prepayments of expenses is discussed in an appendix that can be downloaded from the book's companion Web site (www.cengagebrain.com).

Unearned Revenues

The December 31 unadjusted trial balance of NetSolutions indicates a balance in the unearned rent account of \$360. This balance represents the receipt of three months' rent on December 1 for December, January, and February. At the end of December, one month's rent has been earned. Thus, the unearned rent account is decreased (debited) by \$120, and the rent revenue account is increased (credited) by \$120. The \$120 represents the rental revenue for one month (\$360/3). The adjusting journal entry and T accounts are shown below.

	31	Unearned Rent Rent Revenue Rent earned (\$360/3 months).	23	120	
			42		120

Assets	=	Liabilities	+	Owner's Equity (Revenue)
		Unearned Rent	23	Rent Revenue
		Dec. 31	120	Dec. 31
		Bal.	360	120
		Adj. Bal.	240	

Adjusting Journal Entry

Accounting Equation Impact

After the adjusting entry is recorded and posted, the unearned rent account has a credit balance of \$240. This balance is a liability that will become revenue in a future period. Rent Revenue has a balance of \$120, which is revenue of the current period.³

If the preceding adjustment of unearned rent and rent revenue is not recorded, the financial statements prepared on December 31 will be misstated. On the income statement, Rent Revenue and the net income will be understated by \$120. On the balance sheet, Unearned Rent will be overstated by \$120, and Chris Clark, Capital will be understated by \$120. The effects of omitting this adjusting entry are shown below.



Best Buy sells extended warranty contracts with terms between 12 and 36 months. The receipts from sales of these contracts are reported as unearned revenue on Best Buy's balance sheet. Revenue is recorded as the contracts expire.

	Amount of Misstatement
Income Statement	
Revenues understated by	\$ (120)
Expenses correctly stated	XXX
Net income understated by	\$ (120)
Balance Sheet	
Assets correctly stated	\$ XXX
Liabilities overstated by	\$ 120
Owner's equity understated by	(120)
Total liabilities and owner's equity correctly stated	\$ XXX

Example Exercise 3-4 Adjustment for Unearned Revenue

OBJ 2

The balance in the unearned fees account, before adjustment at the end of the year, is \$44,900. Journalize the adjusting entry required if the amount of unearned fees at the end of the year is \$22,300.

Follow My Example 3-4

Unearned Fees.....		22,600
Fees Earned.....		22,600
Fees earned (\$44,900 - \$22,300).		

Practice Exercises: PE 3-4A, PE 3-4B

³ An alternative treatment of recording revenues received in advance of their being earned is discussed in an appendix that can be downloaded from the book's companion Web site (www.cengagebrain.com).



RadioShack Corporation is engaged in consumer electronics retailing. RadioShack accrues revenue for finance charges and late payment charges related to its credit operations.

Accrued Revenues

During an accounting period, some revenues are recorded only when cash is received. Thus, at the end of an accounting period, there may be revenue that has been earned *but has not been recorded*. In such cases, the revenue is recorded by increasing (debiting) an asset account and increasing (crediting) a revenue account.

To illustrate, assume that NetSolutions signed an agreement with Dankner Co. on December 15. The agreement provides that NetSolutions will answer computer questions and render assistance to Dankner Co.'s employees. The services will be billed to Dankner Co. on the fifteenth of each month at a rate of \$20 per hour. As of December 31, NetSolutions had provided 25 hours of assistance to Dankner Co. The revenue of \$500 (25 hours × \$20) will be billed on January 15. However, NetSolutions earned the revenue in December.

The claim against the customer for payment of the \$500 is an account receivable (*an asset*). Thus, the accounts receivable account is increased (debited) by \$500, and the fees earned account is increased (credited) by \$500. The adjusting journal entry and T accounts are shown below.

Adjusting Journal Entry		Accounting Equation Impact				
31	Accounts Receivable	12		500		
	Fees Earned	41			500	
	Accrued fees (25 hrs. × \$20).					
		Assets	=	Liabilities	+	
		Accounts Receivable			Owner's Equity (Revenue)	
		12			Fees Earned	
					41	
	Bal.	2,220			Bal.	16,340
	Dec. 31	500			Dec. 31	500
	Adj. Bal.	2,750			Adj. Bal.	16,840

If the adjustment for the accrued revenue (\$500) is not recorded, Fees Earned and the net income will be understated by \$500 on the income statement. On the balance sheet, Accounts Receivable and Chris Clark, Capital will be understated by \$500. The effects of omitting this adjusting entry are shown below.

	Amount of Misstatement
Income Statement	
Revenues understated by	\$ (500)
Expenses correctly stated	XXX
Net income understated by	<u>\$ (500)</u>
Balance Sheet	
Assets understated by	<u>\$ (500)</u>
Liabilities correctly stated	\$ XXX
Owner's equity understated by	<u>(500)</u>
Total liabilities and owner's equity understated by	<u>\$ (500)</u>

Example Exercise 3-5 Adjustment for Accrued Revenues

OBJ 2

At the end of the current year, \$13,680 of fees have been earned but have not been billed to clients. Journalize the adjusting entry to record the accrued fees.

Follow My Example 3-5

Accounts Receivable	13,680	
Fees Earned		13,680
Accrued fees.		

Practice Exercises: PE 3-5A, PE 3-5B

Accrued Expenses

Some types of services used in earning revenues are paid for *after* the service has been performed. For example, wages expense is used hour by hour, but is paid only daily, weekly, biweekly, or monthly. At the end of the accounting period, the amount of such *accrued* but unpaid items is an expense and a liability.

For example, if the last day of the employees' pay period is not the last day of the accounting period, an accrued expense (wages expense) and the related liability (wages payable) must be recorded by an adjusting entry. This adjusting entry is necessary so that expenses are properly matched to the period in which they were incurred in earning revenue.

To illustrate, NetSolutions pays its employees biweekly. During December, NetSolutions paid wages of \$950 on December 13 and \$1,200 on December 27. These payments covered pay periods ending on those days as shown in Exhibit 7.

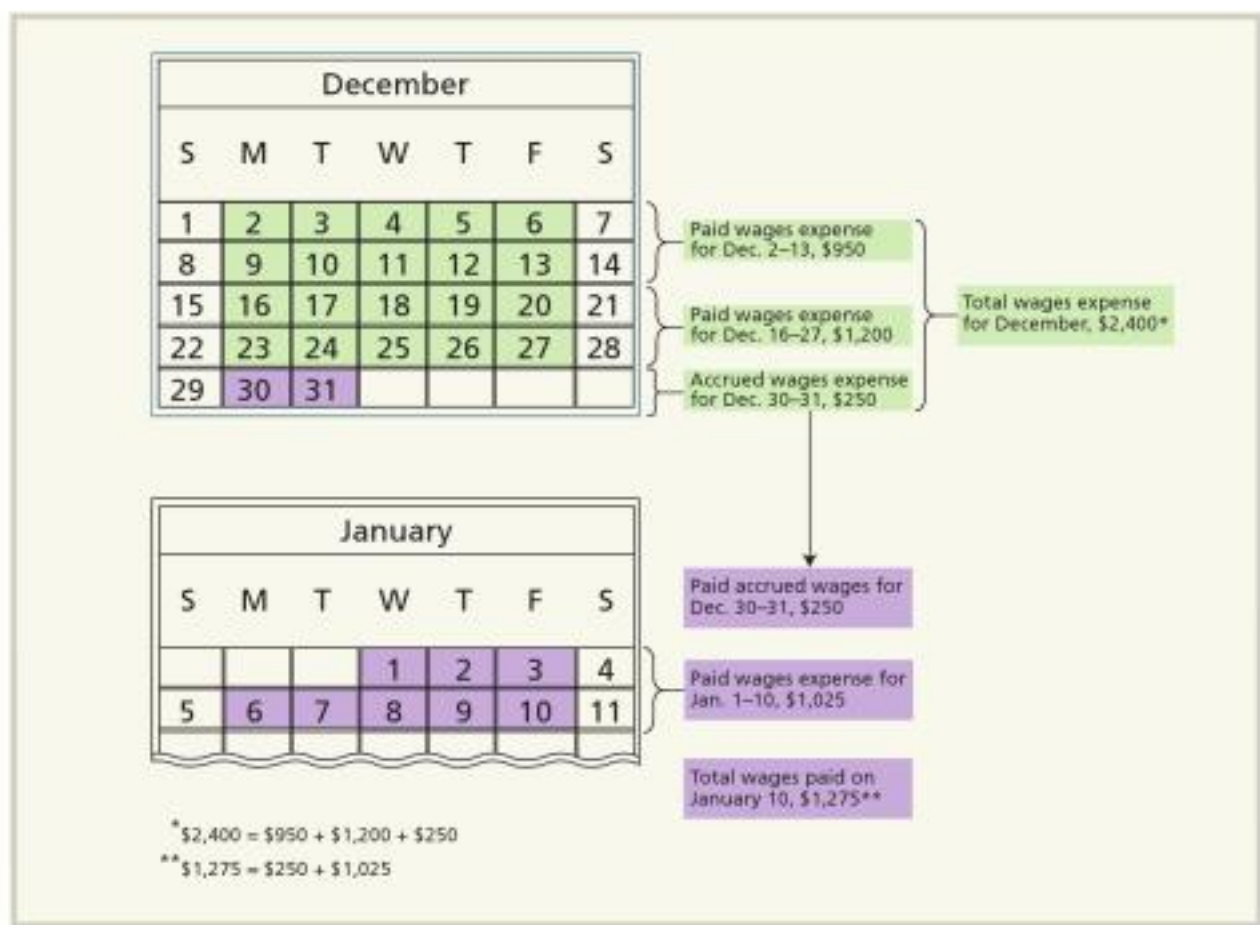


EXHIBIT 7
Accrued Wages

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As of December 31, NetSolutions owes \$250 of wages to employees for Monday and Tuesday, December 30 and 31. Thus, the wages expense account is increased (debited) by \$250 and the wages payable account is increased (credited) by \$250. The adjusting journal entry and T accounts are shown below.

	31	Wages Expense Wages Payable Accrued wages.	51 22	250	250
--	----	--	----------	-----	-----

Assets	=	Liabilities	+	Owner's Equity (Expense)
		Wages Payable	22	Wages Expense
		Dec. 31	250	Bal. 4,275
			←	Dec. 31 250
				Adj. Bal. 4,525

Adjusting Journal Entry

Accounting Equation Impact



Callaway Golf Company, a manufacturer of such innovative golf clubs as the "RAZR Hawk" driver, reports accrued warranty expense on its balance sheet.

After the adjusting entry is recorded and posted, the debit balance of the wages expense account is \$4,525. This balance of \$4,525 is the wages expense for two months, November and December. The credit balance of \$250 in Wages Payable is the liability for wages owed on December 31.

As shown in Exhibit 7, NetSolutions paid wages of \$1,275 on January 10. This payment includes the \$250 of accrued wages recorded on December 31. Thus, on January 10, the wages payable account is decreased (debited) by \$250. Also, the wages expense account is increased (debited) by \$1,025 (\$1,275 - \$250), which is the wages expense for January 1-10. Finally, the cash account is decreased (credited) by \$1,275. The journal entry for the payment of wages on January 10 is shown below.⁴

Jan.	10	Wages Expense	51	1,025	
		Wages Payable	22	250	
		Cash	11		1,275

If the adjustment for wages (\$250) is not recorded, Wages Expense will be understated by \$250, and the net income will be overstated by \$250 on the income statement. On the balance sheet, Wages Payable will be understated by \$250, and Chris Clark, Capital will be overstated by \$250. The effects of omitting this adjusting entry are shown as follows:

	Amount of Misstatement
Income Statement	
Revenues correctly stated	\$ XXX
Expenses understated by	(250)
Net income overstated by	<u>\$ 250</u>
Balance Sheet	
Assets correctly stated	<u>\$ XXX</u>
Liabilities understated by	\$ (250)
Owner's equity overstated by	250
Total liabilities and owner's equity correctly stated	<u>\$ XXX</u>

Example Exercise 3-6 Adjustment for Accrued Expense

OBJ 2

Sanregret Realty Co. pays weekly salaries of \$12,500 on Friday for a five-day week ending on that day. Journalize the necessary adjusting entry at the end of the accounting period, assuming that the period ends on Thursday.

Follow My Example 3-6

Salaries Expense	10,000	
Salaries Payable		10,000
Accrued salaries [(\$12,500/5 days) × 4 days].		

Practice Exercises: PE 3-6A, PE 3-6B

⁴ To simplify the subsequent recording of the following period's transactions, some accountants use what is known as reversing entries for certain types of adjustments. Reversing entries are discussed and illustrated in Appendix B at the end of the textbook.

	Amount of Misstatement
Income Statement	
Revenues correctly stated	\$ XX
Expenses understated by	(50)
Net income overstated by	\$ 50
Balance Sheet	
Assets overstated by	\$ 50
Liabilities correctly stated	\$ XX
Owner's equity overstated by	50
Total liabilities and owner's equity overstated by	\$ 50

Example Exercise 3-7 Adjustment for Depreciation

OBJ
2

The estimated amount of depreciation on equipment for the current year is \$4,250. Journalize the adjusting entry to record the depreciation.

Follow My Example 3-7

Depreciation Expense	4,250	
Accumulated Depreciation—Equipment		4,250
Depreciation on equipment.		

Practice Exercises: PE 3-7A, PE 3-7B

Summary of Adjustment Process

OBJ
3

Summarize the adjustment process.

A summary of the basic types of adjusting entries is shown in Exhibit 8 on page 120. The adjusting entries for NetSolutions are shown in Exhibit 9 on page 121. The adjusting entries are dated as of the last day of the period. However, because collecting the adjustment data requires time, the entries are usually recorded at a later date. An explanation is normally included with each adjusting entry.

NetSolutions' adjusting entries are posted to the ledger shown in Exhibit 10 on pages 122–123. The adjustments are shown in color in Exhibit 10 to distinguish them from other transactions.

Example Exercise 3-8 Effect of Omitting Adjustments

OBJ
3

For the year ending December 31, 2014, Mann Medical Co. mistakenly omitted adjusting entries for (1) \$8,600 of unearned revenue that was earned, (2) earned revenue of \$12,500 that was not billed, and (3) accrued wages of \$2,900. Indicate the combined effect of the errors on (a) revenues, (b) expenses, and (c) net income for the year ended December 31, 2014.

Follow My Example 3-8

- Revenues were understated by \$21,100 (\$8,600 + \$12,500).
- Expenses were understated by \$2,900.
- Net income was understated by \$18,200 (\$8,600 + \$12,500 – \$2,900).

Practice Exercises: PE 3-8A, PE 3-8B

EXHIBIT 8 Summary of Adjustments

PREPAID EXPENSES							
Examples	Reason for Adjustment	Adjusting Entry		Examples from NetSolutions		Financial Statement Impact if Adjusting Entry Is Omitted	
Supplies, prepaid insurance	Prepaid expenses (assets) have been used or consumed in the business operations.	Expense Asset	Dr. Cr.	Supplies Expense Supplies Insurance Expense Prepaid Insurance	1,240 1,240 200 200	Income Statement: Revenues Expenses Net income Balance Sheet: Assets Liabilities Owner's equity (capital)	No effect Understated Overstated Overstated No effect Overstated
UNEARNED REVENUES							
Unearned rent, magazine subscriptions received in advance, fees received in advance of services	Cash received before the services have been provided is recorded as a liability. Some services have been provided to the customer before the end of the accounting period.	Liability Revenue	Dr. Cr.	Unearned Rent Rent Revenue	120 120	Income Statement: Revenues Expenses Net income Balance Sheet: Assets Liabilities Owner's equity (capital)	Understated No effect Understated No effect Overstated Understated
ACCRUED REVENUES							
Services performed but not billed, interest to be received	Services have been provided to the customer, but have not been billed or recorded. Interest has been earned, but has not been received or recorded.	Asset Revenue	Dr. Cr.	Accounts Receivable Fees Earned	500 500	Income Statement: Revenues Expenses Net income Balance Sheet: Assets Liabilities Owner's equity (capital)	Understated No effect Understated Understated No effect Understated
ACCRUED EXPENSES							
Wages or salaries incurred but not paid, interest incurred but not paid	Expenses have been incurred, but have not been paid or recorded.	Expense Liability	Dr. Cr.	Wages Expense Wages Payable	250 250	Income Statement: Revenues Expenses Net income Balance Sheet: Assets Liabilities Owner's equity (capital)	No effect Understated Overstated No effect Understated Overstated
DEPRECIATION							
Depreciation of equipment and buildings	Fixed assets depreciate as they are used or consumed in the business operations.	Expense Contra Asset	Dr. Cr.	Depreciation Expense Accum. Depreciation— Office Equipment	50 50	Income Statement: Revenues Expenses Net income Balance Sheet: Assets Liabilities Owner's equity (capital)	No effect Understated Overstated Overstated No effect Overstated

Journal					Page 5
Date	Description	Post. Ref.	Debit	Credit	
2013 Dec. 31	Adjusting Entries				
31	Supplies Expense	55	1,240		
	Supplies	14		1,240	
	Supplies used (\$2,000 – \$760).				
31	Insurance Expense	56	200		
	Prepaid Insurance	15		200	
	Insurance expired (\$2,400/12 months).				
31	Unearned Rent	23	120		
	Rent Revenue	42		120	
	Rent earned (\$360/3 months).				
31	Accounts Receivable	12	500		
	Fees Earned	41		500	
	Accrued fees (25 hrs. × \$20).				
31	Wages Expense	51	250		
	Wages Payable	22		250	
	Accrued wages.				
31	Depreciation Expense	53	50		
	Accum. Depreciation—Office Equipment	19		50	
	Depreciation on office equipment.				

EXHIBIT 9

Adjusting Entries—
NetSolutions

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An accountant may check whether all adjustments have been made by comparing current period adjustments with those of the prior period.

Business Connection

MICROSOFT CORPORATION

Microsoft Corporation develops, manufactures, licenses, and supports a wide range of computer software products, including Windows Vista, Windows 7, Windows XP, Word, Excel, and the Xbox® gaming system. When Microsoft sells its products, it incurs an obligation to support its software with technical support and periodic updates. As

a result, not all the revenue is earned on the date of sale; some of the revenue on the date of sale is unearned. The portion of revenue related to support services, such as updates and technical support, is earned as time passes and support is provided to customers. Thus, each year Microsoft makes adjusting entries transferring some of its unearned revenue to revenue. The following excerpts were taken from recent financial statements of Microsoft:

The percentage of revenue recorded as unearned . . . ranges from approximately 15% to 25% of the sales price for Windows XP Home, approximately 5% to 15% of the sales price for Windows XP Professional, . . .

Unearned Revenue:

	Recent Year	Prior Year
Unearned revenue (in millions)	\$14,830	\$14,284

During the next year, Microsoft expects to record over \$13,652 million of unearned revenue as revenue. At the

same time, Microsoft will record additional unearned revenue from current period sales.

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EXHIBIT 10 Ledger with Adjusting Entries—NetSolutions

Account <i>Cash</i>					Account No. 11	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 1		1	25,000		25,000	
5		1		20,000	5,000	
18		1	7,500		12,500	
30		1		3,650	8,850	
30		1		950	7,900	
30		2		2,000	5,900	
Dec. 1		2		2,400	3,500	
1		2		800	2,700	
1		2	360		3,060	
6		2		180	2,880	
11		2		400	2,480	
13		3		950	1,530	
16		3	3,100		4,630	
20		3		900	3,730	
21		3	650		4,380	
23		3		1,450	2,930	
27		3		1,200	1,730	
31		3		310	1,420	
31		4		225	1,195	
31		4	2,870		4,065	
31		4		2,000	2,065	

Account <i>Accounts Receivable</i>					Account No. 12	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 16		3	1,750		1,750	
21		3		650	1,100	
31		4	1,120		2,220	
31	Adjusting	5	500		2,720	

Account <i>Supplies</i>					Account No. 14	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 10		1	1,350		1,350	
30		1		800	550	
Dec. 23		3	1,450		2,000	
31	Adjusting	5		1,240	760	

Account <i>Prepaid Insurance</i>					Account No. 15	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 1		2	2,400		2,400	
31	Adjusting	5		200	2,200	

Account <i>Land</i>					Account No. 17	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 5		1	20,000		20,000	

Account <i>Office Equipment</i>					Account No. 18	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 4		2	1,800		1,800	

Account <i>Accum. Depr.—Office Equip.</i>					Account No. 19	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 1	Adjusting	5		50		50

Account <i>Accounts Payable</i>					Account No. 21	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 10		1		1,350		1,350
30		1	950			400
Dec. 4		2		1,800		2,200
11		2	400			1,800
20		3	900			900

Account <i>Wages Payable</i>					Account No. 22	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 31	Adjusting	5		250		250

Account <i>Unearned Rent</i>					Account No. 23	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 1		2		360		360
31	Adjusting	5	120			240

Account <i>Chris Clark, Capital</i>					Account No. 31	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 1		1		25,000		25,000

EXHIBIT 10**Ledger with Adjusting Entries—NetSolutions (Concluded)**

Account <i>Chris Clark, Drawing</i> Account No. 32						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		2	2,000		2,000		
Dec. 31		4	2,000		4,000		

Account <i>Fees Earned</i> Account No. 41						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 18		1		7,500		7,500	
Dec. 16		3		3,100		10,600	
16		3		1,750		12,350	
31		4		2,870		15,220	
31		4		1,120		16,340	
31	Adjusting	5		500		16,840	

Account <i>Rent Revenue</i> Account No. 42						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Dec. 31	Adjusting	5		120		120	

Account <i>Wages Expense</i> Account No. 51						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		1	2,125		2,125		
Dec. 13		3	950		3,075		
27		3	1,200		4,275		
31	Adjusting	5	250		4,525		

Account <i>Rent Expense</i> Account No. 52						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		1	800		800		
Dec. 1		2	800		1,600		

Account <i>Depreciation Expense</i> Account No. 53						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Dec. 31	Adjusting	5	50		50		

Account <i>Utilities Expense</i> Account No. 54						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		1	450		450		
Dec. 31		3	310		760		
31		4	225		985		

Account <i>Supplies Expense</i> Account No. 55						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		1	800		800		
Dec. 31	Adjusting	5	1,240		2,040		

Account <i>Insurance Expense</i> Account No. 56						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Dec. 31	Adjusting	5	200		200		

Account <i>Miscellaneous Expense</i> Account No. 59						Balance	
Date	Item	Post. Ref.	Debit	Credit	Debit	Credit	
2013							
Nov. 30		1	275		275		
Dec. 6		2	180		455		

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Adjusted Trial Balance

After the adjusting entries are posted, an **adjusted trial balance** is prepared. The adjusted trial balance verifies the equality of the total debit and credit balances before the financial statements are prepared. If the adjusted trial balance does not balance, an error has occurred. However, as discussed in Chapter 2, errors may occur even though the adjusted trial balance totals agree. For example, if an adjusting entry were omitted, the adjusted trial balance totals would still agree.



OBJ 4 Prepare an adjusted trial balance.

Although RealNetworks still reported a loss in Year 2, it has improved its control of expenses significantly from Year 1. However, the decrease in Revenues from \$562,264 to \$401,733 is a major concern. Apparently, RealNetworks reduced its expenses in response to its decreasing revenues.

Example Exercise 3-10 Vertical Analysis

OBJ
5

Two income statements for Fortson Company are shown below.

**Fortson Company
Income Statements
For the Years Ended December 31, 2014 and 2013**

	2014	2013
Fees earned	\$425,000	\$375,000
Operating expenses	263,500	210,000
Operating income	\$161,500	\$165,000

- a. Prepare a vertical analysis of Fortson Company's income statements.
- b. Does the vertical analysis indicate a favorable or an unfavorable trend?

Follow My Example 3-10

a. **Fortson Company
Income Statements
For the Years Ended December 31, 2014 and 2013**

	2014		2013	
	Amount	Percent	Amount	Percent
Fees earned	\$425,000	100%	\$375,000	100%
Operating expenses	263,500	62	210,000	56
Operating income	\$161,500	38%	\$165,000	44%

- b. An unfavorable trend of increasing operating expenses and decreasing operating income is indicated.

Practice Exercises: PE 3-10A, PE 3-10B

At a Glance 3

OBJ
1

Describe the nature of the adjusting process.

Key Points The accrual basis of accounting requires that revenues are reported in the period in which they are earned and expenses are matched with the revenues they generate. The updating of accounts at the end of the accounting period is called the adjusting process. Each adjusting entry affects an income statement and balance sheet account. The four types of accounts requiring adjusting entries are prepaid expenses, unearned revenues, accrued revenues, and accrued expenses.

Learning Outcomes

- Explain why accrual accounting requires adjusting entries.
- List accounts that do and do NOT require adjusting entries at the end of the accounting period.
- Give an example of a prepaid expense, unearned revenue, accrued revenue, and accrued expense.

Example Exercises

- EE3-1
- EE3-2

Practice Exercises

- PE3-1A, 3-1B
- PE3-2A, 3-2B

OBJ
2**Journalize entries for accounts requiring adjustment.**

Key Points At the end of the period, adjusting entries are needed for prepaid expenses, unearned revenues, accrued revenues, and accrued expenses. In addition, an adjusting entry is necessary to record depreciation on fixed assets.

Learning Outcomes

- Prepare an adjusting entry for a prepaid expense.
- Prepare an adjusting entry for an unearned revenue.
- Prepare an adjusting entry for an accrued revenue.
- Prepare an adjusting entry for an accrued expense.
- Prepare an adjusting entry for depreciation expense.

Example Exercises

EE3-3

EE3-4

EE3-5

EE3-6

EE3-7

Practice Exercises

PE3-3A, 3-3B

PE3-4A, 3-4B

PE3-5A, 3-5B

PE3-6A, 3-6B

PE3-7A, 3-7B

OBJ
3**Summarize the adjustment process.**

Key Points A summary of adjustments, including the type of adjustment, reason for the adjustment, the adjusting entry, and the effect of omitting an adjustment on the financial statements, is shown in Exhibit 8.

Learning Outcome

- Determine the effect on the income statement and balance sheet of omitting an adjusting entry for prepaid expense, unearned revenue, accrued revenue, accrued expense, and depreciation.

Example Exercises

EE3-8

Practice Exercises

PE3-8A, 3-8B

OBJ
4**Prepare an adjusted trial balance.**

Key Points After all the adjusting entries have been posted, the equality of the total debit balances and total credit balances is verified by an adjusted trial balance.

Learning Outcomes

- Prepare an adjusted trial balance.
- Determine the effect of errors on the equality of the adjusted trial balance.

Example Exercises

EE3-9

Practice Exercises

PE3-9A, 3-9B

OBJ
5**Describe and illustrate the use of vertical analysis in evaluating a company's performance and financial condition.**

Key Points Comparing each item on a financial statement with a total amount from the same statement is called vertical analysis. On the balance sheet, each asset is expressed as a percent of total assets, and each liability and owner's equity is expressed as a percent of total liabilities and owner's equity. On the income statement, each revenue and expense is expressed as a percent of total revenues or fees earned.

Learning Outcomes

- Describe vertical analysis.
- Prepare a vertical analysis report of a financial statement.

Example Exercises

EE3-10

Practice Exercises

PE3-10A, 3-10B

Key Terms

accounting period concept (104)	book value of the asset (or net book value) (118)	fixed assets (or plant assets) (117)
accrual basis of accounting (104)	cash basis of accounting (104)	matching concept (or matching principle) (104)
accrued expenses (108)	contra accounts (or contra asset accounts) (117)	prepaid expenses (105)
accrued revenues (107)	depreciate (117)	revenue recognition concept (104)
Accumulated Depreciation (117)	depreciation (117)	unearned revenues (106)
adjusted trial balance (123)	depreciation expense (117)	vertical analysis (124)
adjusting entries (105)		
adjusting process (105)		

Illustrative Problem

Three years ago, T. Roderick organized Harbor Realty. At July 31, 2014, the end of the current year, the unadjusted trial balance of Harbor Realty appears as shown below.

Harbor Realty Unadjusted Trial Balance July 31, 2014		
	Debit Balances	Credit Balances
Cash	3,425	
Accounts Receivable	7,000	
Supplies	1,270	
Prepaid Insurance	620	
Office Equipment	51,650	
Accumulated Depreciation—Office Equipment		9,700
Accounts Payable		925
Wages Payable		0
Unearned Fees		1,250
T. Roderick, Capital		29,000
T. Roderick, Drawing	5,200	
Fees Earned		59,125
Wages Expense	22,415	
Depreciation Expense	0	
Rent Expense	4,200	
Utilities Expense	2,715	
Supplies Expense	0	
Insurance Expense	0	
Miscellaneous Expense	1,505	
	<u>100,000</u>	<u>100,000</u>

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The data needed to determine year-end adjustments are as follows:

- Supplies on hand at July 31, 2014, \$380.
- Insurance premiums expired during the year, \$315.
- Depreciation of equipment during the year, \$4,950.
- Wages accrued but not paid at July 31, 2014, \$440.
- Accrued fees earned but not recorded at July 31, 2014, \$1,000.
- Unearned fees on July 31, 2014, \$750.

Instructions

- Prepare the necessary adjusting journal entries. Include journal entry explanations.
- Determine the balance of the accounts affected by the adjusting entries, and prepare an adjusted trial balance.

Solution

1.

Journal					
Date		Description	Post. Ref.	Debit	Credit
2014 July	31	Supplies Expense Supplies Supplies used (\$1,270 – \$380).		890	890
	31	Insurance Expense Prepaid Insurance Insurance expired.		315	315
	31	Depreciation Expense Accumulated Depreciation—Office Equipment Depreciation expense.		4,950	4,950
	31	Wages Expense Wages Payable Accrued wages.		440	440
	31	Accounts Receivable Fees Earned Accrued fees.		1,000	1,000
	31	Unearned Fees Fees Earned Fees earned (\$1,250 – \$750).		500	500

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Solution (concluded)

2.

Harbor Realty Adjusted Trial Balance July 31, 2014		
	Debit Balances	Credit Balances
Cash	3,425	
Accounts Receivable	8,000	
Supplies	380	
Prepaid Insurance	305	
Office Equipment	51,650	
Accumulated Depreciation—Office Equipment		14,650
Accounts Payable		925
Wages Payable		440
Unearned Fees		750
T. Roderick, Capital		29,000
T. Roderick, Drawing	5,200	
Fees Earned		60,625
Wages Expense	22,855	
Depreciation Expense	4,950	
Rent Expense	4,200	
Utilities Expense	2,715	
Supplies Expense	890	
Insurance Expense	315	
Miscellaneous Expense	1,505	
	<u>106,390</u>	<u>106,390</u>

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Discussion Questions

- How are revenues and expenses reported on the income statement under (a) the cash basis of accounting and (b) the accrual basis of accounting?
- Is the matching concept related to (a) the cash basis of accounting or (b) the accrual basis of accounting?
- Why are adjusting entries needed at the end of an accounting period?
- What is the difference between *adjusting entries* and *correcting entries*?
- Identify the four different categories of adjusting entries frequently required at the end of an accounting period.
- If the effect of the debit portion of an adjusting entry is to increase the balance of an asset account, which of the following statements describes the effect of the credit portion of the entry?
 - Increases the balance of a revenue account.
 - Increases the balance of an expense account.
 - Increases the balance of a liability account.
- If the effect of the credit portion of an adjusting entry is to increase the balance of a liability account, which of the following statements describes the effect of the debit portion of the entry?
 - Increases the balance of a revenue account.
 - Increases the balance of an expense account.
 - Increases the balance of an asset account.
- Does every adjusting entry have an effect on determining the amount of net income for a period? Explain.
- On November 1 of the current year, a business paid the November rent on the building that it occupies. (a) Do the rights acquired at November 1 represent an asset or an expense? (b) What is the justification for debiting Rent Expense at the time of payment?
- (a) Explain the purpose of the two accounts: Depreciation Expense and Accumulated Depreciation. (b) What is the normal balance of each account? (c) Is it customary for the balances of the two accounts to be equal in amount? (d) In what financial statements, if any, will each account appear?

Example
Exercises

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**PE 3-10A Vertical analysis**

OBJ. 5

Two income statements for Hemlock Company are shown below.

Hemlock Company Income Statements For Years Ended December 31		
	2014	2013
Fees earned	\$725,000	\$615,000
Operating expenses	<u>435,000</u>	<u>356,700</u>
Operating income	<u>\$290,000</u>	<u>\$258,300</u>

- Prepare a vertical analysis of Hemlock Company's income statements.
- Does the vertical analysis indicate a favorable or an unfavorable trend?

EE 3-10 p. 126

**PE 3-10B Vertical analysis**

OBJ. 5

Two income statements for Cornea Company are shown below.

Cornea Company Income Statements For Years Ended December 31		
	2014	2013
Fees earned	\$1,640,000	\$1,300,000
Operating expenses	<u>869,200</u>	<u>715,000</u>
Operating income	<u>\$ 770,800</u>	<u>\$ 585,000</u>

- Prepare a vertical analysis of Cornea Company's income statements.
- Does the vertical analysis indicate a favorable or an unfavorable trend?

Exercises

EX 3-1 Classifying types of adjustments

OBJ. 1

Classify the following items as (a) prepaid expense, (b) unearned revenue, (c) accrued revenue, or (d) accrued expense.

- A three-year premium paid on a fire insurance policy.
- Fees earned but not yet received.
- Fees received but not yet earned.
- Salary owed but not yet paid.
- Subscriptions received in advance by a magazine publisher.
- Supplies on hand.
- Taxes owed but payable in the following period.
- Utilities owed but not yet paid.

EX 3-2 Classifying adjusting entries

OBJ. 1

The following accounts were taken from the unadjusted trial balance of Orion Co., a congressional lobbying firm. Indicate whether or not each account would normally require an adjusting entry. If the account normally requires an adjusting entry, use the following notation to indicate the type of adjustment:

- AE—Accrued Expense
- AR—Accrued Revenue
- PE—Prepaid Expense
- UR—Unearned Revenue

(Continued)

To illustrate, the answer for the first account is shown below.

Account	Answer
Accounts Receivable	Normally requires adjustment (AR).
Cash	
Interest Expense	
Interest Receivable	
Johann Atkins, Capital	
Land	
Office Equipment	
Prepaid Rent	
Supplies	
Unearned Fees	
Wages Expense	

EX 3-3 Adjusting entry for supplies **OBJ. 2**

The balance in the supplies account, before adjustment at the end of the year, is \$2,389. Journalize the adjusting entry required if the amount of supplies on hand at the end of the year is \$830.

EX 3-4 Determining supplies purchased **OBJ. 2**

The supplies and supplies expense accounts at December 31, after adjusting entries have been posted at the end of the first year of operations, are shown in the following T accounts:

Supplies		Supplies Expense	
Bal.	1,560	Bal.	4,250

Determine the amount of supplies purchased during the year.

EX 3-5 Effect of omitting adjusting entry **OBJ. 2, 3**

At March 31, the end of the first month of operations, the usual adjusting entry transferring prepaid insurance expired to an expense account is omitted. Which items will be incorrectly stated, because of the error, on (a) the income statement for March and (b) the balance sheet as of March 31? Also indicate whether the items in error will be overstated or understated.

EX 3-6 Adjusting entries for prepaid insurance **OBJ. 2**

The balance in the prepaid insurance account, before adjustment at the end of the year, is \$21,700. Journalize the adjusting entry required under each of the following *alternatives* for determining the amount of the adjustment: (a) the amount of insurance expired during the year is \$16,450; (b) the amount of unexpired insurance applicable to future periods is \$5,250.

EX 3-7 Adjusting entries for prepaid insurance **OBJ. 2**

The prepaid insurance account had a balance of \$12,000 at the beginning of the year. The account was debited for \$18,000 for premiums on policies purchased during the year. Journalize the adjusting entry required at the end of the year for each of the following situations: (a) the amount of unexpired insurance applicable to future periods is \$13,600; (b) the amount of insurance expired during the year is \$16,400.

EX 3-8 Adjusting entries for unearned fees **OBJ. 2**

The balance in the unearned fees account, before adjustment at the end of the year, is \$37,500. Journalize the adjusting entry required if the amount of unearned fees at the end of the year is \$12,300.

EX 3-9 Effect of omitting adjusting entry **OBJ. 2, 3**

At the end of July, the first month of the business year, the usual adjusting entry transferring rent earned to a revenue account from the unearned rent account was omitted. Indicate which items will be incorrectly stated, because of the error, on (a) the income statement for July and (b) the balance sheet as of July 31. Also indicate whether the items in error will be overstated or understated.

EX 3-10 Adjusting entry for accrued fees**OBJ. 2**

At the end of the current year, \$8,450 of fees have been earned but have not been billed to clients.

- Journalize the adjusting entry to record the accrued fees.
- If the cash basis rather than the accrual basis had been used, would an adjusting entry have been necessary? Explain.

EX 3-11 Adjusting entries for unearned and accrued fees**OBJ. 2**

The balance in the unearned fees account, before adjustment at the end of the year, is \$112,000. Of these fees, \$71,600 have been earned. In addition, \$47,400 of fees have been earned but have not been billed. Journalize the adjusting entries (a) to adjust the unearned fees account and (b) to record the accrued fees.

EX 3-12 Effect of omitting adjusting entry**OBJ. 2, 3**

The adjusting entry for accrued fees was omitted at October 31, the end of the current year. Indicate which items will be in error, because of the omission, on (a) the income statement for the current year and (b) the balance sheet as of October 31. Also indicate whether the items in error will be overstated or understated.

EX 3-13 Adjusting entries for accrued salaries**OBJ. 2**

✓ a. Amount of entry:
\$7,050

Ocular Realty Co. pays weekly salaries of \$11,750 on Friday for a five-day workweek ending on that day. Journalize the necessary adjusting entry at the end of the accounting period, assuming that the period ends (a) on Wednesday and (b) on Thursday.

EX 3-14 Determining wages paid**OBJ. 2**

The wages payable and wages expense accounts at May 31, after adjusting entries have been posted at the end of the first month of operations, are shown in the following T accounts:

Wages Payable		Wages Expense	
Bal.	7,175	Bal.	73,250

Determine the amount of wages paid during the month.

EX 3-15 Effect of omitting adjusting entry**OBJ. 2, 3**

Accrued salaries owed to employees for October 30 and 31 are not considered in preparing the financial statements for the year ended October 31. Indicate which items will be erroneously stated, because of the error, on (a) the income statement for the year and (b) the balance sheet as of October 31. Also indicate whether the items in error will be overstated or understated.

EX 3-16 Effect of omitting adjusting entry**OBJ. 2, 3**

Assume that the error in Exercise 3-15 was not corrected and that the accrued salaries were included in the first salary payment in November. Indicate which items will be erroneously stated, because of failure to correct the initial error, on (a) the income statement for the month of November and (b) the balance sheet as of November 30.

EX 3-17 Adjusting entries for prepaid and accrued taxes**OBJ. 2**

✓ b. \$71,400

Diamond Services was organized on April 1 of the current year. On April 2, Diamond Services prepaid \$28,800 to the city for taxes (license fees) for the *next* 12 months and debited the prepaid taxes account. Diamond Services is also required to pay in January an annual tax (on property) for the *previous* calendar year. The estimated amount of the property tax for the current year (April 1 to December 31) is \$49,800.

- Journalize the two adjusting entries required to bring the accounts affected by the two taxes up to date as of December 31, the end of the current year.
- What is the amount of tax expense for the current year?

EX 3-18 Adjustment for depreciation**OBJ. 2**

The estimated amount of depreciation on equipment for the current year is \$6,760. Journalize the adjusting entry to record the depreciation.

EX 3-19 Determining fixed asset's book value **OBJ. 2**

The balance in the equipment account is \$1,375,000, and the balance in the accumulated depreciation—equipment account is \$725,000.

- a. What is the book value of the equipment?
- b. Does the balance in the accumulated depreciation account mean that the equipment's loss of value is \$725,000? Explain.



EX 3-20 Book value of fixed assets **OBJ. 2**

In a recent balance sheet, **Microsoft Corporation** reported *Property, Plant, and Equipment* of \$16,259 million and *Accumulated Depreciation* of \$8,629 million.

- a. What was the book value of the fixed assets?
- b. Would the book value of Microsoft Corporation's fixed assets normally approximate their fair market values?



EX 3-21 Effects of errors on financial statements **OBJ. 2, 3**

For a recent period, the balance sheet for **Costco Wholesale Corporation** reported accrued expenses of \$1,893 million. For the same period, Costco reported income before income taxes of \$2,054 million. Assume that the adjusting entry for \$1,893 million of accrued expenses was not recorded at the end of the current period. What would have been the income (loss) before income taxes?



EX 3-22 Effects of errors on financial statements **OBJ. 2, 3**

For a recent year, the balance sheet for **The Campbell Soup Company** includes accrued expenses of \$560 million. The income before taxes for The Campbell Soup Company for the year was \$1,242 million.

- a. Assume the adjusting entry for \$560 million of accrued expenses was not recorded at the end of the year. By how much would income before taxes have been misstated?
- b. What is the percentage of the misstatement in (a) to the reported income of \$1,242 million? Round to one decimal place.

✓ 1. a. Revenue understated, \$23,250

EX 3-23 Effects of errors on financial statements **OBJ. 2, 3**

The accountant for Astaire Medical Co., a medical services consulting firm, mistakenly omitted adjusting entries for (a) unearned revenue earned during the year (\$23,250) and (b) accrued wages (\$4,000). Indicate the effect of each error, considered individually, on the income statement for the current year ended August 31. Also indicate the effect of each error on the August 31 balance sheet. Set up a table similar to the following, and record your answers by inserting the dollar amount in the appropriate spaces. Insert a zero if the error does not affect the item.

	Error (a)		Error (b)	
	Over-stated	Under-stated	Over-stated	Under-stated
1. Revenue for the year would be	\$ ____	\$ ____	\$ ____	\$ ____
2. Expenses for the year would be	\$ ____	\$ ____	\$ ____	\$ ____
3. Net income for the year would be	\$ ____	\$ ____	\$ ____	\$ ____
4. Assets at August 31 would be	\$ ____	\$ ____	\$ ____	\$ ____
5. Liabilities at August 31 would be	\$ ____	\$ ____	\$ ____	\$ ____
6. Owner's equity at August 31 would be	\$ ____	\$ ____	\$ ____	\$ ____

EX 3-24 Effects of errors on financial statements **OBJ. 2, 3**

If the net income for the current year had been \$113,650 in Exercise 3-23, what would have been the correct net income if the proper adjusting entries had been made?

EX 3-25 Adjusting entries for depreciation; effect of error **OBJ. 2, 3**

On December 31, a business estimates depreciation on equipment used during the first year of operations to be \$13,900.

- a. Journalize the adjusting entry required as of December 31.
- b. If the adjusting entry in (a) were omitted, which items would be erroneously stated on (1) the income statement for the year and (2) the balance sheet as of December 31?

EX 3-26 Adjusting entries from trial balances**OBJ. 4**

The unadjusted and adjusted trial balances for Editorial Services Co. on March 31, 2014, are shown below.

	Unadjusted		Adjusted	
	Debit Balances	Credit Balances	Debit Balances	Credit Balances
Cash	8		8	
Accounts Receivable.....	19		22	
Supplies	6		5	
Prepaid Insurance	10		4	
Land	13		13	
Equipment.....	20		20	
Accumulated Depreciation—Equipment.....		4		6
Accounts Payable		13		13
Wages Payable		0		1
Valerie Nolan, Capital.....		46		46
Valerie Nolan, Drawing	4		4	
Fees Earned.....		37		40
Wages Expense	12		13	
Rent Expense	4		4	
Insurance Expense	0		6	
Utilities Expense	2		2	
Depreciation Expense	0		2	
Supplies Expense.....	0		1	
Miscellaneous Expense	2		2	
	<u>100</u>	<u>100</u>	<u>106</u>	<u>106</u>

Journalize the five entries that adjusted the accounts at March 31, 2014. None of the accounts were affected by more than one adjusting entry.

EX 3-27 Adjusting entries from trial balances**OBJ. 4**

The accountant for Eva's Laundry prepared the following unadjusted and adjusted trial balances. Assume that all balances in the unadjusted trial balance and the amounts of the adjustments are correct. Identify the errors in the accountant's adjusting entries, assuming that none of the accounts were affected by more than one adjusting entry.

	Unadjusted		Adjusted	
	Debit Balances	Credit Balances	Debit Balances	Credit Balances
Cash	7,500		7,500	
Accounts Receivable.....	18,250		23,250	
Laundry Supplies.....	3,750		6,750	
Prepaid Insurance*	5,200		1,600	
Laundry Equipment	190,000		177,000	
Accumulated Depreciation—Laundry Equipment.....		48,000		48,000
Accounts Payable		9,600		9,600
Wages Payable				1,000
Eva Bruns, Capital		110,300		110,300
Eva Bruns, Drawing	28,775		28,775	
Laundry Revenue.....		182,100		182,100
Wages Expense	49,200		49,200	
Rent Expense	25,575		25,575	
Utilities Expense	18,500		18,500	
Depreciation Expense			13,000	
Laundry Supplies Expense			3,000	
Insurance Expense			600	
Miscellaneous Expense	3,250		3,250	
	<u>350,000</u>	<u>350,000</u>	<u>358,000</u>	<u>351,000</u>

* \$3,600 of insurance expired during the year.

✓ Corrected trial balance totals, \$369,000

For preparing the adjusting entries, the following data were assembled:

- Fees earned but unbilled on June 30 were \$12,700.
- Supplies on hand on June 30 were \$4,175.
- Depreciation of equipment was estimated to be \$7,400 for the year.
- The balance in unearned fees represented the June 1 receipt in advance for services to be provided. Only \$14,200 of the services was provided between June 1 and June 30.
- Unpaid wages accrued on June 30 were \$1,100.

Instructions

- Journalize the adjusting entries necessary on June 30, 2014.
- Determine the revenues, expenses, and net income of Electro Service & Repairs before the adjusting entries.
- Determine the revenues, expense, and net income of Electro Service & Repairs after the adjusting entries.
- Determine the effect of the adjusting entries on Amy Wolf, Capital.

PR 3-4A Adjusting entries

OBJ. 2, 3, 4

Good Note Company specializes in the repair of music equipment and is owned and operated by Robin Stahl. On November 30, 2014, the end of the current year, the accountant for Good Note Company prepared the following trial balances:

Good Note Company
Trial Balances
November 30, 2014

	Unadjusted		Adjusted	
	Debit Balances	Credit Balances	Debit Balances	Credit Balances
Cash	38,250		38,250	
Accounts Receivable	89,500		89,500	
Supplies	11,250		2,400	
Prepaid Insurance	14,250		3,850	
Equipment	290,450		290,450	
Accumulated Depreciation—Equipment		94,500		106,100
Automobiles	129,500		129,500	
Accumulated Depreciation—Automobiles		54,750		62,050
Accounts Payable		24,930		26,130
Salaries Payable		—		8,100
Unearned Service Fees		18,000		9,000
Robin Stahl, Capital		324,020		324,020
Robin Stahl, Drawing	75,000		75,000	
Service Fees Earned		733,800		742,800
Salary Expense	516,900		525,000	
Rent Expense	54,000		54,000	
Supplies Expense	—		8,850	
Depreciation Expense—Equipment	—		11,600	
Depreciation Expense—Automobiles	—		7,300	
Utilities Expense	12,900		14,100	
Taxes Expense	8,175		8,175	
Insurance Expense	—		10,400	
Miscellaneous Expense	9,825		9,825	
	<u>1,250,000</u>	<u>1,250,000</u>	<u>1,278,200</u>	<u>1,278,200</u>

Instructions

Journalize the seven entries that adjusted the accounts at November 30. None of the accounts were affected by more than one adjusting entry.

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✓ 2. Total of Debit column: \$780,500

SPREADSHEET

GENERAL LEDGER

PR 3-5A Adjusting entries and adjusted trial balances

OBJ. 2, 3, 4

Dickens Company is a small editorial services company owned and operated by Monica Baker. On October 31, 2014, the end of the current year, Dickens Company's accounting clerk prepared the unadjusted trial balance shown below.

	Debit Balances	Credit Balances
Cash	7,500	
Accounts Receivable.....	38,400	
Prepaid Insurance	7,200	
Supplies	1,980	
Land	112,500	
Building	150,250	
Accumulated Depreciation—Building.....		87,550
Equipment.....	135,300	
Accumulated Depreciation—Equipment		97,950
Accounts Payable		12,150
Unearned Rent.....		6,750
Monica Baker, Capital.....		221,000
Monica Baker, Drawing	15,000	
Fees Earned.....		324,600
Salaries and Wages Expense.....	193,370	
Utilities Expense	42,375	
Advertising Expense.....	22,800	
Repairs Expense.....	17,250	
Miscellaneous Expense	6,075	
	<u>750,000</u>	<u>750,000</u>

The data needed to determine year-end adjustments are as follows:

- Unexpired insurance at October 31, \$5,400.
- Supplies on hand at October 31, \$375.
- Depreciation of building for the year, \$6,000.
- Depreciation of equipment for the year, \$3,000.
- Rent unearned at October 31, \$1,350.
- Accrued salaries and wages at October 31, \$2,900.
- Fees earned but unbilled on October 31, \$18,600.

Instructions

- Journalize the adjusting entries using the following additional accounts: Salaries and Wages Payable; Rent Revenue; Insurance Expense; Depreciation Expense—Building; Depreciation Expense—Equipment; and Supplies Expense.
- Determine the balances of the accounts affected by the adjusting entries, and prepare an adjusted trial balance.

PR 3-6A Adjusting entries and errors

OBJ. 2, 3

At the end of April, the first month of operations, the following selected data were taken from the financial statements of Shelby Crawford, an attorney:

Net income for April	\$120,000
Total assets at April 30	750,000
Total liabilities at April 30	300,000
Total owner's equity at April 30	450,000

In preparing the financial statements, adjustments for the following data were overlooked:

- Supplies used during April, \$2,750.
- Unbilled fees earned at April 30, \$23,700.
- Depreciation of equipment for April, \$1,800.
- Accrued wages at April 30, \$1,400.

(Continued)

✓ 2. Corrected net income: \$137,750

SPREADSHEET

Instructions

1. Journalize the entries to record the omitted adjustments.
2. Determine the correct amount of net income for April and the total assets, liabilities, and owner's equity at April 30. In addition to indicating the corrected amounts, indicate the effect of each omitted adjustment by setting up and completing a columnar table similar to the following. Adjustment (a) is presented as an example.

	Net Income	Total Assets	=	Total Liabilities	+	Total Owner's Equity
Reported amounts	\$120,000	\$750,000		\$300,000		\$450,000
Corrections:						
Adjustment (a)	-2,750	-2,750		0		-2,750
Adjustment (b)	_____	_____		_____		_____
Adjustment (c)	_____	_____		_____		_____
Adjustment (d)	_____	_____		_____		_____
Corrected amounts	_____	_____		_____		_____

Problems Series B

SPREADSHEET

PR 3-1B Adjusting entries**OBJ. 2**

On May 31, 2014, the following data were accumulated to assist the accountant in preparing the adjusting entries for Oceanside Realty:

- a. Fees accrued but unbilled at May 31 are \$19,750.
- b. The supplies account balance on May 31 is \$12,300. The supplies on hand at May 31 are \$4,150.
- c. Wages accrued but not paid at May 31 are \$2,700.
- d. The unearned rent account balance at May 31 is \$9,000, representing the receipt of an advance payment on May 1 of three months' rent from tenants.
- e. Depreciation of office equipment is \$3,200.

Instructions

1. Journalize the adjusting entries required at May 31, 2014.
2. Briefly explain the difference between adjusting entries and entries that would be made to correct errors.

PR 3-2B Adjusting entries**OBJ. 2, 3**

Selected account balances before adjustment for Intuit Realty at November 30, 2014, the end of the current year, are shown below.

	Debits	Credits
Accounts Receivable	\$ 75,000	
Equipment	250,000	
Accumulated Depreciation—Equipment		\$ 12,000
Prepaid Rent	12,000	
Supplies	3,170	
Wages Payable		—
Unearned Fees		10,000
Fees Earned		400,000
Wages Expense	140,000	
Rent Expense	—	
Depreciation Expense	—	
Supplies Expense	—	

Data needed for year-end adjustments are as follows:

- a. Supplies on hand at November 30, \$550.
- b. Depreciation of equipment during year, \$1,675.

- c. Rent expired during year, \$8,500.
- d. Wages accrued but not paid at November 30, \$2,000.
- e. Unearned fees at November 30, \$4,000.
- f. Unbilled fees at November 30, \$5,380.

Instructions

1. Journalize the six adjusting entries required at November 30, based on the data presented.
2. What would be the effect on the income statement if adjustments (b) and (e) were omitted at the end of the year?
3. What would be the effect on the balance sheet if adjustments (b) and (e) were omitted at the end of the year?
4. What would be the effect on the "Net increase or decrease in cash" on the statement of cash flows if adjustments (b) and (e) were omitted at the end of the year?

PR 3-3B Adjusting entries**OBJ. 2**

Crazy Mountain Outfitters Co., an outfitter store for fishing treks, prepared the following unadjusted trial balance at the end of its first year of operations:

Crazy Mountain Outfitters Co.
Unadjusted Trial Balance
April 30, 2014

	Debit Balances	Credit Balances
Cash	11,400	
Accounts Receivable.....	72,600	
Supplies	7,200	
Equipment.....	112,000	
Accounts Payable		12,200
Unearned Fees		19,200
Diana Keck, Capital.....		137,800
Diana Keck, Drawing.....	10,000	
Fees Earned.....		305,800
Wages Expense	157,800	
Rent Expense	55,000	
Utilities Expense	42,000	
Miscellaneous Expense	7,000	
	<u>475,000</u>	<u>475,000</u>

For preparing the adjusting entries, the following data were assembled:

- a. Supplies on hand on April 30 were \$1,380.
- b. Fees earned but unbilled on April 30 were \$3,900.
- c. Depreciation of equipment was estimated to be \$3,000 for the year.
- d. Unpaid wages accrued on April 30 were \$2,475.
- e. The balance in unearned fees represented the April 1 receipt in advance for services to be provided. Only \$14,140 of the services was provided between April 1 and April 30.

Instructions

1. Journalize the adjusting entries necessary on April 30, 2014.
2. Determine the revenues, expenses, and net income of Crazy Mountain Outfitters Co. before the adjusting entries.
3. Determine the revenues, expense, and net income of Crazy Mountain Outfitters Co. after the adjusting entries.
4. Determine the effect of the adjusting entries on Diana Keck, Capital.

PR 3-4B Adjusting entries**OBJ. 2, 3, 4**

The Signage Company specializes in the maintenance and repair of signs, such as billboards. On March 31, 2014, the accountant for The Signage Company prepared the following trial balances:

(Continued)

GENERAL LEDGER

GENERAL LEDGER

The Signage Company
Trial Balances
March 31, 2014

	Unadjusted		Adjusted	
	Debit Balances	Credit Balances	Debit Balances	Credit Balances
Cash	4,750		4,750	
Accounts Receivable.....	17,400		17,400	
Supplies	6,200		2,175	
Prepaid Insurance	9,000		1,150	
Land	100,000		100,000	
Buildings	170,000		170,000	
Accumulated Depreciation—Buildings.....		51,500		61,000
Trucks	75,000		75,000	
Accumulated Depreciation—Trucks.....		12,000		17,000
Accounts Payable		6,920		8,750
Salaries Payable		—		1,400
Unearned Service Fees.....		10,500		3,850
Al Bosch, Capital		256,400		256,400
Al Bosch, Drawing	7,500		7,500	
Service Fees Earned		162,680		169,330
Salary Expense	80,000		81,400	
Depreciation Expense—Trucks	—		5,000	
Rent Expense	11,900		11,900	
Supplies Expense.....	—		4,025	
Utilities Expense	6,200		8,030	
Depreciation Expense—Buildings	—		9,500	
Taxes Expense	2,900		2,900	
Insurance Expense	—		7,850	
Miscellaneous Expense	9,150		9,150	
	<u>500,000</u>	<u>500,000</u>	<u>517,730</u>	<u>517,730</u>

Instructions

Journalize the seven entries that adjusted the accounts at March 31. None of the accounts were affected by more than one adjusting entry.

✓ 2. Total of Debit column: \$420,300

SPREADSHEET

GENERAL LEDGER

PR 3-5B Adjusting entries and adjusted trial balances

OBJ. 2, 3, 4


Reece Financial Services Co., which specializes in appliance repair services, is owned and operated by Joni Reece. Reece Financial Services Co.'s accounting clerk prepared the unadjusted trial balance at July 31, 2014, shown below.

Reece Financial Services Co.
Unadjusted Trial Balance
July 31, 2014

	Debit Balances	Credit Balances
Cash	10,200	
Accounts Receivable.....	34,750	
Prepaid Insurance	6,000	
Supplies	1,725	
Land	50,000	
Building	155,750	
Accumulated Depreciation—Building.....		62,850
Equipment.....	45,000	
Accumulated Depreciation—Equipment		17,650
Accounts Payable		3,750
Unearned Rent		3,600
Joni Reece, Capital		153,550
Joni Reece, Drawing	8,000	
Fees Earned.....		158,600
Salaries and Wages Expense.....	56,850	
Utilities Expense	14,100	
Advertising Expense	7,500	
Repairs Expense.....	6,100	
Miscellaneous Expense	4,025	
	<u>400,000</u>	<u>400,000</u>

After receiving the rejection notice, Daryl instructed his accountant to prepare the financial statements on an accrual basis. These statements included \$65,000 in accounts receivable and \$25,000 in accounts payable. Daryl then instructed his accountant to record an additional \$30,000 of accounts receivable for commissions on property for which a contract had been signed on December 28, 2013. The title to the property is to transfer on January 5, 2014, when an attorney formally records the transfer of the property to the buyer.

Daryl then applied for a \$375,000 loan from Free Spirit Bank, using the revised financial statements. On this application, Daryl indicated that he had not previously been rejected for credit.

 Discuss the ethical and professional conduct of Daryl Kirby in applying for the loan from Free Spirit Bank.



CP 3-2 Accrued expense

On December 30, 2014, you buy a Ford 350F truck. It comes with a three-year, 48,000-mile warranty. On February 3, 2015, you return the truck to the dealership for some basic repairs covered under the warranty. The cost of the repairs to the dealership is \$1,650. Assume that based upon past history, [Ford Motor Company](#) can reasonably estimate the cost of repairs for each model year for its Ford 350F. In what year, 2014 or 2015, should Ford recognize the cost of the warranty repairs as an expense?



CP 3-3 Accrued revenue

The following is an excerpt from a conversation between Sonia Lopez and Pete Lemke just before they boarded a flight to Paris on [Delta Air Lines](#). They are going to Paris to attend their company's annual sales conference.

Sonia: Pete, aren't you taking an introductory accounting course at college?

Pete: Yes, I decided it's about time I learned something about accounting. You know, our annual bonuses are based on the sales figures that come from the accounting department.

Sonia: I guess I never really thought about it.

Pete: You should think about it! Last year, I placed a \$5,000,000 order on December 30. But when I got my bonus, the \$5,000,000 sale wasn't included. They said it hadn't been shipped until January 9, so it would have to count in next year's bonus.

Sonia: A real bummer!


Pete: Right! I was counting on that bonus including the \$5,000,000 sale.

Sonia: Did you complain?

Pete: Yes, but it didn't do any good. Julie, the head accountant, said something about matching revenues and expenses. Also, something about not recording revenues until the sale is final. I figure I'd take the accounting course and find out whether she's just messing with me.

Sonia: I never really thought about it. When do you think Delta Air Lines will record its revenues from this flight?

Pete: Hmm ... I guess it could record the revenue when it sells the ticket ... or ... when the boarding passes are scanned at the door ... or ... when we get off the plane ... or when our company pays for the tickets ... or ... I don't know. I'll ask my accounting instructor.

 Discuss when Delta Air Lines should recognize the revenue from ticket sales to properly match revenues and expenses.

CP 3-4 Adjustments and financial statements

Several years ago, your brother opened Magna Appliance Repairs. He made a small initial investment and added money from his personal bank account as needed. He withdrew money for living expenses at irregular intervals. As the business grew, he hired an assistant. He is now considering adding more employees, purchasing additional service trucks, and purchasing the building he now rents. To secure funds for the expansion, your

(Continued)

brother submitted a loan application to the bank and included the most recent financial statements (shown below) prepared from accounts maintained by a part-time bookkeeper.

Magna Appliance Repairs		
Income Statement		
For the Year Ended October 31, 2014		
Service revenue		\$675,000
Less: Rent paid	\$187,200	
Wages paid	148,500	
Supplies paid	42,000	
Utilities paid	39,000	
Insurance paid	21,600	
Miscellaneous payments	54,600	492,900
Net income		\$ 182,100
Magna Appliance Repairs		
Balance Sheet		
October 31, 2014		
Assets		
Cash		\$ 95,400
Amounts due from customers		112,500
Truck		332,100
Total assets		\$540,000
Equities		
Owner's capital		\$540,000

After reviewing the financial statements, the loan officer at the bank asked your brother if he used the accrual basis of accounting for revenues and expenses. Your brother responded that he did and that is why he included an account for "Amounts Due from Customers." The loan officer then asked whether or not the accounts were adjusted prior to the preparation of the statements. Your brother answered that they had not been adjusted.

- a. Why do you think the loan officer suspected that the accounts had not been adjusted prior to the preparation of the statements?
- b. Indicate possible accounts that might need to be adjusted before an accurate set of financial statements could be prepared.



CP 3-5 Codes of ethics

Obtain a copy of your college or university's student code of conduct. In groups of three or four, answer the following questions:

1. Compare this code of conduct with the accountant's Codes of Professional Conduct, which is linked to the text Web site at www.cengagebrain.com.
2. One of your classmates asks you for permission to copy your homework, which your instructor will be collecting and grading for part of your overall term grade. Although your instructor has not stated whether one student may or may not copy another student's homework, is it ethical for you to allow your classmate to copy your homework? Is it ethical for your classmate to copy your homework?



Completing the Accounting Cycle

Electronic Arts Inc.

Most of us have had to file a personal tax return. At the beginning of the year, you estimate your upcoming income and decide whether you need to increase your payroll tax withholdings or perhaps pay estimated taxes. During the year, you earn income and enter into tax-related transactions, such as making charitable contributions. At the end of the year, your employer sends you a tax withholding information (W-2) form, and you collect the tax records needed for completing your yearly tax forms. As the next year begins, you start the cycle all over again.

Businesses also go through a cycle of activities. For example, **Electronic Arts Inc.**, the world's largest developer and marketer of electronic game software, begins its cycle by developing new or revised game titles, such as Madden NFL Football®, Need for Speed®, The Sims®, and The Lord of the Rings®. These games are marketed and sold throughout the year. During the year, operating transactions of the business are

recorded. For Electronic Arts, such transactions include the salaries of game developers, advertising expenditures, costs for producing and packaging games, and game revenues. At the end of the year, financial statements are prepared that summarize the operating activities for the year. Electronic Arts publishes these statements on its Web site at <http://investor.ea.com>. Finally, before the start of the next year, the accounts are readied for recording the operations of the next year.

In Chapter 1, the initial cycle for NetSolutions began with Chris Clark's investment in the business on November 1, 2013. The cycle continued with recording NetSolutions' transactions for November and

December, as we discussed and illustrated in Chapters 1 and 2. In Chapter 3, the cycle continued when the adjusting entries for the two months ending December 31, 2013, were recorded. In this chapter, the cycle is completed for NetSolutions by preparing financial statements and getting the accounts ready for recording transactions of the next period.



Learning Objectives

After studying this chapter, you should be able to:

Example Exercises

- | | | |
|--------------|---|------------------|
| OBJ 1 | Describe the flow of accounting information from the unadjusted trial balance into the adjusted trial balance and financial statements.
Flow of Accounting Information | EE 4-1 |
| OBJ 2 | Prepare financial statements from adjusted account balances.
Financial Statements
Income Statement
Statement of Owner's Equity
Balance Sheet | EE 4-2
EE 4-3 |
| OBJ 3 | Prepare closing entries.
Closing Entries
Journalizing and Posting Closing Entries
Post-Closing Trial Balance | EE 4-4 |
| OBJ 4 | Describe the accounting cycle.
Accounting Cycle | EE 4-5 |
| OBJ 5 | Illustrate the accounting cycle for one period.
Illustration of the Accounting Cycle | |
| OBJ 6 | Explain what is meant by the fiscal year and the natural business year.
Fiscal Year | |
| OBJ 7 | Describe and illustrate the use of working capital and the current ratio in evaluating a company's financial condition.
Financial Analysis and Interpretation: Working Capital and Current Ratio | EE 4-6 |

At a Glance **4** Page 176D

OBJ 1 Describe the flow of accounting information from the unadjusted trial balance into the adjusted trial balance and financial statements.



Many companies use Microsoft's Excel® software to prepare end-of-period spreadsheets.

Flow of Accounting Information

The process of adjusting the accounts and preparing financial statements is one of the most important in accounting. Using the **NetSolutions** illustration from Chapters 1–3 and an end-of-period spreadsheet, the flow of accounting data in adjusting accounts and preparing financial statements are summarized in Exhibit 1.

The end-of-period spreadsheet in Exhibit 1 begins with the unadjusted trial balance. The unadjusted trial balance verifies that the total of the debit balances equals the total of the credit balances. If the trial balance totals are unequal, an error has occurred. Any errors must be found and corrected before the end-of-period process can continue.

The adjustments for NetSolutions from Chapter 3 are shown in the Adjustments columns of the spreadsheet. Cross-referencing (by letters) the debit and credit of each adjustment is useful in reviewing the effect of the adjustments on the unadjusted account balances. The adjustments are normally entered in the order in which the data are assembled. If the titles of the accounts to be adjusted do not appear in the unadjusted trial balance, the accounts are inserted in their proper order in the Account Title column. The total of the Adjustments columns verifies that the total debits equal the total credits for the adjusting entries. The total of the Debit column must equal the total of the Credit column.

The adjustments in the spreadsheet are added to or subtracted from the amounts in the Unadjusted Trial Balance columns to arrive at the amounts inserted in the Adjusted Trial Balance columns. In this way, the Adjusted Trial Balance columns of the spreadsheet illustrate the effect of the adjusting entries on the unadjusted accounts. The totals of the Adjusted Trial Balance columns verify that the totals of the debit and credit balances are equal after adjustment.

EXHIBIT 1
End-of-Period
Spreadsheet and
Flow of Accounting
Data, NetSolutions

NetSolutions Balance Sheet December 31, 2013	
Assets	Liabilities
Current assets:	Current liabilities:
Cash \$ 2,065	Accounts payable..... \$900
Accounts receivable 2,720	Wages payable 250
Supplies 760	Unearned rent..... 240
Prepaid insurance 2,200	Total liabilities.....
Total current assets \$ 7,745	
Property, plant, and equipment:	Owner's Equity
Land \$20,000	Chris Clark, capital
Office equipment \$1,800	Total liabilities and
Less accum. depreciation..... 50	owner's equity
Total property, plant, and equipment	21,750
Total assets	<u>\$29,495</u>
	<u>28,105</u>

NetSolutions Statement of Owner's Equity For the Two Months Ended December 31, 2013	
Chris Clark, capital, November 1, 2013.....	\$ 0
Investment on November 1, 2013	\$25,000
Net income for November and December	7,105
	<u>\$32,105</u>
Less withdrawals	4,000
Increase in owner's equity	28,105
Chris Clark, capital, December 31, 2013.....	<u>\$28,105</u>

NetSolutions Income Statement For the Two Months Ended December 31, 2013	
Fees earned.....	\$16,840
Rent revenue	120
Total revenues	\$16,960
Expenses:	
Wages expense	\$ 4,525
Supplies expense	2,040
Rent expense	1,600
Utilities expense	985
Insurance expense	200
Depreciation expense	50
Miscellaneous expense	455
Total expenses.....	9,855
Net income	<u>\$ 7,105</u>

Account Title	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
8 Cash	2,065				2,065	
9 Accounts Receivable	2,220		(d) 500		2,720	
10 Supplies	2,000		(a) 1,240		760	
11 Prepaid Insurance	2,400		(b) 200		2,200	
12 Land	20,000				20,000	
13 Office Equipment	1,800		(f) 1,800			1,800
14 Accumulated Depreciation		50				50
15 Accounts Payable		900				900
16 Wages Payable			(e) 250			250
17 Unearned Rent		360	(c) 120			240
18 Chris Clark, Capital		25,000				25,000
19 Chris Clark, Drawing	4,000			4,000		
20 Fees Earned		16,340	(d) 500		16,840	
21 Rent Revenue			(c) 120			120
22 Wages Expense	4,275		(e) 250		4,525	
23 Supplies Expense	800		(a) 1,240		2,040	
24 Rent Expense	1,600			1,600		
25 Utilities Expense	985			985		
26 Insurance Expense			(b) 200			200
27 Depreciation Expense			(f) 50			50
28 Miscellaneous Expense	455			455		
	<u>42,600</u>	<u>42,600</u>	<u>2,360</u>	<u>2,360</u>	<u>43,400</u>	<u>43,400</u>



Integrity, Objectivity, and Ethics in Business

CEO'S HEALTH?

How much and what information to disclose in financial statements and to investors presents a common ethical dilemma for managers and accountants. For example, Steve Jobs, co-founder and CEO of Apple Inc., had been diagnosed and treated for pancreatic cancer. Apple Inc. had insisted that the status of Steve Jobs's health was a "private" matter and did not have to be disclosed to investors. Apple maintained this position even though

Jobs was a driving force behind Apple's innovation and financial success.

However, in response to increasing investor concerns and speculation, Jobs released a letter on January 5, 2009 to investors on his health. The letter indicated that his recent weight loss was due to a hormone imbalance and not due to the recurrence of cancer. On October 5, 2011, Steve Jobs died at the age of 56.

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Statement of Owner's Equity

The first item presented on the statement of owner's equity is the balance of the owner's capital account at the beginning of the period. The amount listed as owner's capital in the spreadsheet, however, is not always the account balance at the beginning of the period. The owner may have invested additional assets in the business during the period. For the beginning balance and any additional investments, it is necessary to refer to the owner's capital account in the ledger. These amounts, along with the net income (or net loss) and the drawing account balance, are used to determine the ending owner's capital account balance.

The basic form of the statement of owner's equity is shown in Exhibit 2. For NetSolutions, the amount of drawings by the owner was less than the net income. If the owner's withdrawals had exceeded the net income, the difference between the two items would then be deducted from the beginning capital account balance. Other factors, such as additional investments or a net loss, also require some change in the form, as shown below.

Allan Johnson, capital, January 1, 2013		\$39,000
Add: Investment during year	\$ 6,000	
Less: Net loss for year	(5,600)	
Withdrawals	(9,500)	
Decrease in owner's equity		(9,100)
Allan Johnson, capital, December 31, 2013		<u>\$29,900</u>

Example Exercise 4-2 Statement of Owner's Equity

OBJ
2

Zack Gaddis owns and operates Gaddis Employment Services. On January 1, 2013, Zack Gaddis, Capital had a balance of \$186,000. During the year, Zack invested an additional \$40,000 and withdrew \$25,000. For the year ended December 31, 2013, Gaddis Employment Services reported a net income of \$18,750. Prepare a statement of owner's equity for the year ended December 31, 2013.

Follow My Example 4-2

Gaddis Employment Services Statement of Owner's Equity For the Year Ended December 31, 2013

Zack Gaddis, capital, January 1, 2013		\$186,000
Add: Investment during 2013	\$40,000	
Net income	18,750	
	\$58,750	
Less: Withdrawals	25,000	
Increase in owner's equity		33,750
Zack Gaddis, capital, December 1, 2013		<u>\$219,750</u>

Practice Exercises: PE 4-2A, PE 4-2B

Balance Sheet

The balance sheet is prepared directly from the Adjusted Trial Balance columns of the Exhibit 1 spreadsheet, beginning with Cash of \$2,065. The asset and liability amounts are taken from the spreadsheet. The owner's equity amount, however, is taken from the statement of owner's equity, as illustrated in Exhibit 2.

The balance sheet in Exhibit 2 shows subsections for assets and liabilities. Such a balance sheet is a *classified balance sheet*. These subsections are described next.

Assets Assets are commonly divided into two sections on the balance sheet: (1) current assets and (2) property, plant, and equipment.

Current Assets Cash and other assets that are expected to be converted to cash or sold or used up usually within one year or less, through the normal operations of the business, are called **current assets**. In addition to cash, the current assets may include notes receivable, accounts receivable, supplies, and other prepaid expenses.

Notes receivable are amounts that customers owe. They are written promises to pay the amount of the note and interest. Accounts receivable are also amounts customers owe, but they are less formal than notes. Accounts receivable normally result from providing services or selling merchandise on account. Notes receivable and accounts receivable are current assets because they are usually converted to cash within one year or less.

Property, Plant, and Equipment The property, plant, and equipment section may also be described as **fixed assets** or **plant assets**. These assets include equipment, machinery, buildings, and land. With the exception of land, as discussed in Chapter 3, fixed assets depreciate over a period of time. The original cost, accumulated depreciation, and book value of each major type of fixed asset are normally reported on the balance sheet or in the notes to the financial statements.

Liabilities Liabilities are the amounts the business owes to creditors. Liabilities are commonly divided into two sections on the balance sheet: (1) current liabilities and (2) long-term liabilities.

Current Liabilities Liabilities that will be due within a short time (usually one year or less) and that are to be paid out of current assets are called **current liabilities**. The most common liabilities in this group are notes payable and accounts payable. Other current liabilities may include Wages Payable, Interest Payable, Taxes Payable, and Unearned Fees.

Long-Term Liabilities Liabilities that will not be due for a long time (usually more than one year) are called **long-term liabilities**. If NetSolutions had long-term liabilities, they would be reported below the current liabilities. As long-term liabilities come due and are to be paid within one year, they are reported as current liabilities. If they are to be renewed rather than paid, they would continue to be reported as long term. When an asset is pledged as security for a liability, the obligation may be called a *mortgage note payable* or a *mortgage payable*.

Owner's Equity The owner's right to the assets of the business is presented on the balance sheet below the liabilities section. The owner's equity is added to the total liabilities, and this total must be equal to the total assets.

Note:

Two common classes of assets are current assets and property, plant, and equipment.

Note:

Two common classes of liabilities are current liabilities and long-term liabilities.

Example Exercise 4-3 Classified Balance Sheet

OBJ
2

The following accounts appear in an adjusted trial balance of Hindsight Consulting. Indicate whether each account would be reported in the (a) current asset; (b) property, plant, and equipment; (c) current liability; (d) long-term liability; or (e) owner's equity section of the December 31, 2013, balance sheet of Hindsight Consulting.

- | | |
|---------------------------------------|---------------------------------------|
| 1. Jason Corbin, Capital | 5. Cash |
| 2. Notes Receivable (due in 6 months) | 6. Unearned Rent (3 months) |
| 3. Notes Payable (due in 2018) | 7. Accumulated Depreciation—Equipment |
| 4. Land | 8. Accounts Payable |

(Continued)

Follow My Example 4-3

- | | |
|-----------------------------------|-----------------------------------|
| 1. Owner's equity | 5. Current asset |
| 2. Current asset | 6. Current liability |
| 3. Long-term liability | 7. Property, plant, and equipment |
| 4. Property, plant, and equipment | 8. Current liability |

Practice Exercises: PE 4-3A, PE 4-3B

IFRS

International Connection

INTERNATIONAL DIFFERENCES

Financial statements prepared under accounting practices in other countries often differ from those prepared under generally accepted accounting principles in the United States. This is to be expected, since cultures and market structures differ from country to country.

To illustrate, **BMW Group** prepares its financial statements under International Financial Reporting Standards as adopted by the European Union. In doing so, BMW's balance sheet reports fixed assets first, followed by current assets. It also reports owner's equity before the liabilities. In contrast, balance sheets prepared under U.S. accounting principles

report current assets followed by fixed assets and current liabilities followed by long-term liabilities and owner's equity. The U.S. form of balance sheet is organized to emphasize creditor interpretation and analysis. For example, current assets and current liabilities are presented first to facilitate their interpretation and analysis by creditors. Likewise, to emphasize their importance, liabilities are reported before owner's equity.*

Regardless of these differences, the basic principles underlying the accounting equation and the double-entry accounting system are the same in Germany and the United States. Even though differences in recording and reporting exist, the accounting equation holds true: The total assets still equal the total liabilities and owner's equity.

*Examples of U.S. and IFRS financial statement reporting differences are further discussed and illustrated in Appendix D.

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OBJ
3

Prepare closing entries.

Closing Entries

As discussed in Chapter 3, the adjusting entries are recorded in the journal at the end of the accounting period. For NetSolutions, the adjusting entries are shown in Exhibit 9 of Chapter 3.

After the adjusting entries are posted to NetSolutions' ledger, shown in Exhibit 6 (on pages 160–161), the ledger agrees with the data reported on the financial statements.

The balances of the accounts reported on the balance sheet are carried forward from year to year. Because they are relatively permanent, these accounts are called **permanent accounts** or **real accounts**. For example, Cash, Accounts Receivable, Equipment, Accumulated Depreciation, Accounts Payable, and Owner's Capital are permanent accounts.

The balances of the accounts reported on the income statement are not carried forward from year to year. Also, the balance of the owner's drawing account, which is reported on the statement of owner's equity, is not carried forward. Because these accounts report amounts for only one period, they are called **temporary accounts** or **nominal accounts**. Temporary accounts are not carried forward because they relate only to one period. For example, the Fees Earned of \$16,840 and Wages Expense of \$4,525 for NetSolutions shown in Exhibit 2 are for the two months ending December 31, 2013, and should not be carried forward to 2014.

At the beginning of the next period, temporary accounts should have zero balances. To achieve this, temporary account balances are transferred to permanent accounts at the end of the accounting period. The entries that transfer these balances are called **closing entries**. The transfer process is called the **closing process** and is sometimes referred to as **closing the books**.

The closing process involves the following four steps:

1. Revenue account balances are transferred to an account called Income Summary.
2. Expense account balances are transferred to an account called Income Summary.

Note:
Closing entries transfer the balances of temporary accounts to the owner's capital account.

3. The balance of Income Summary (net income or net loss) is transferred to the owner's capital account.
4. The balance of the owner's drawing account is transferred to the owner's capital account.

Exhibit 3 diagrams the closing process.



EXHIBIT 3

The Closing Process

Income Summary is a temporary account that is only used during the closing process. At the beginning of the closing process, Income Summary has no balance. During the closing process, Income Summary will be debited and credited for various amounts. At the end of the closing process, Income Summary will again have no balance. Because Income Summary has the effect of clearing the revenue and expense accounts of their balances, it is sometimes called a **clearing account**. Other titles used for this account include Revenue and Expense Summary, Profit and Loss Summary, and Income and Expense Summary.

The four closing entries required in the closing process are as follows:

1. Debit each revenue account for its balance and credit Income Summary for the total revenue.
2. Credit each expense account for its balance and debit Income Summary for the total expenses.
3. Debit Income Summary for its balance and credit the owner's capital account.
4. Debit the owner's capital account for the balance of the drawing account and credit the drawing account.

In the case of a net loss, Income Summary will have a debit balance after the first two closing entries. In this case, credit Income Summary for the amount of its balance and debit the owner's capital account for the amount of the net loss.

Closing entries are recorded in the journal and are dated as of the last day of the accounting period. In the journal, closing entries are recorded immediately following the adjusting entries. The caption, *Closing Entries*, is often inserted above the closing entries to separate them from the adjusting entries.

It is possible to close the temporary revenue and expense accounts without using a clearing account such as Income Summary. In this case, the balances of the revenue and expense accounts are closed directly to the owner's capital account.

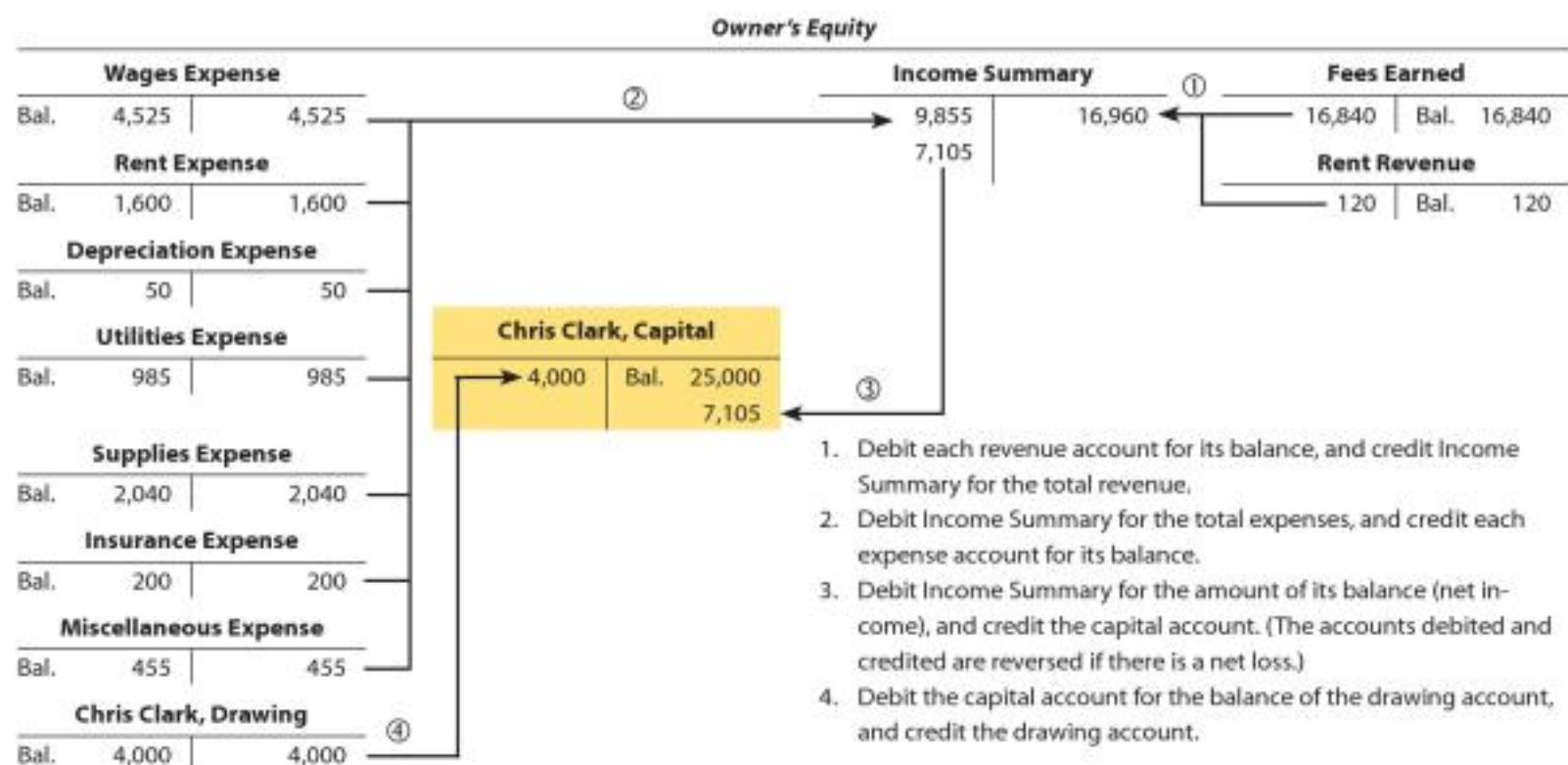
Note:

The income summary account does not appear on the financial statements.

Journalizing and Posting Closing Entries

A flowchart of the four closing entries for NetSolutions is shown in Exhibit 4. The balances in the accounts are those shown in the Adjusted Trial Balance columns of the end-of-period spreadsheet shown in Exhibit 1.

EXHIBIT 4 Flowchart of Closing Entries for NetSolutions



The closing entries for NetSolutions are shown in Exhibit 5. The account titles and balances for these entries may be obtained from the end-of-period spreadsheet, the adjusted trial balance, the income statement, the statement of owner's equity, or the ledger.

EXHIBIT 5

Closing Entries, NetSolutions

Journal					
					Page 6
Date		Description	Post. Ref.	Debit	Credit
2013		Closing Entries			
Dec.	31	Fees Earned	41	16,840	
		Rent Revenue	42	120	
		Income Summary	33		16,960
	31	Income Summary	33	9,855	
		Wages Expense	51		4,525
		Rent Expense	52		1,600
		Depreciation Expense	53		50
		Utilities Expense	54		985
		Supplies Expense	55		2,040
		Insurance Expense	56		200
		Miscellaneous Expense	59		455
	31	Income Summary	33	7,105	
		Chris Clark, Capital	31		7,105
	31	Chris Clark, Capital	31	4,000	
		Chris Clark, Drawing	32		4,000

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EXHIBIT 6

Ledger, NetSolutions (concluded)

Account <i>Chris Clark, Drawing</i>					Account No. 32	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		2	2,000		2,000	
Dec. 31		4	2,000		4,000	
31	Closing	6		4,000	—	—

Account <i>Income Summary</i>					Account No. 33	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 31	Closing	6		16,960	16,960	
31	Closing	6	9,855			7,105
31	Closing	6	7,105		—	—

Account <i>Fees Earned</i>					Account No. 41	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 18		1		7,500		7,500
Dec. 16		3		3,100		10,600
16		3		1,750		12,350
31		4		2,870		15,220
31		4		1,120		16,340
31	Adjusting	5		500		16,840
31	Closing	6	16,840		—	—

Account <i>Rent Revenue</i>					Account No. 42	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 31	Adjusting	5		120		120
31	Closing	6	120		—	—

Account <i>Wages Expense</i>					Account No. 51	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	2,125		2,125	
Dec. 13		3	950		3,075	
27		3	1,200		4,275	
31	Adjusting	5	250		4,525	
31	Closing	6		4,525	—	—

Account <i>Rent Expense</i>					Account No. 52	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	800		800	
Dec. 1		2	800		1,600	
31	Closing	6		1,600	—	—

Account <i>Depreciation Expense</i>					Account No. 53	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 31	Adjusting	5	50		50	
31	Closing	6		50	—	—

Account <i>Utilities Expense</i>					Account No. 54	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	450		450	
Dec. 31		3	310		760	
31		4	225		985	
31	Closing	6		985	—	—

Account <i>Supplies Expense</i>					Account No. 55	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	800		800	
Dec. 31	Adjusting	5	1,240		2,040	
31	Closing	6		2,040	—	—

Account <i>Insurance Expense</i>					Account No. 56	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Dec. 31	Adjusting	5	200		200	
31	Closing	6		200	—	—

Account <i>Miscellaneous Expense</i>					Account No. 59	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2013						
Nov. 30		1	275		275	
Dec. 6		2	180		455	
31	Closing	6		455	—	—

EXHIBIT 7**Post-Closing Trial Balance, NetSolutions**

NetSolutions Post-Closing Trial Balance December 31, 2013		
	Debit Balances	Credit Balances
Cash	2,065	
Accounts Receivable	2,720	
Supplies	760	
Prepaid Insurance	2,200	
Land	20,000	
Office Equipment	1,800	
Accumulated Depreciation		50
Accounts Payable		900
Wages Payable		250
Unearned Rent		240
Chris Clark, Capital		28,105
	<u>29,545</u>	<u>29,545</u>

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Describe the accounting cycle.

Accounting Cycle

The accounting process that begins with analyzing and journalizing transactions and ends with the post-closing trial balance is called the **accounting cycle**. The steps in the accounting cycle are as follows:

1. Transactions are analyzed and recorded in the journal.
2. Transactions are posted to the ledger.
3. An unadjusted trial balance is prepared.
4. Adjustment data are assembled and analyzed.
5. An optional end-of-period spreadsheet is prepared.
6. Adjusting entries are journalized and posted to the ledger.
7. An adjusted trial balance is prepared.
8. Financial statements are prepared.
9. Closing entries are journalized and posted to the ledger.
10. A post-closing trial balance is prepared.²

Example Exercise 4-5 Accounting Cycle

OBJ
4

From the following list of steps in the accounting cycle, identify what two steps are missing.

- a. Transactions are analyzed and recorded in the journal.
- b. Transactions are posted to the ledger.
- c. Adjustment data are assembled and analyzed.
- d. An optional end-of-period spreadsheet is prepared.
- e. Adjusting entries are journalized and posted to the ledger.
- f. Financial statements are prepared.
- g. Closing entries are journalized and posted to the ledger.
- h. A post-closing trial balance is prepared.

Follow My Example 4-5

The following two steps are missing: (1) the preparation of an unadjusted trial balance and (2) the preparation of the adjusted trial balance. The unadjusted trial balance should be prepared after step (b). The adjusted trial balance should be prepared after step (e).

Practice Exercises: PE 4-5A, PE 4-5B

² Some accountants include the journalizing and posting of “reversing entries” as the last step in the accounting cycle. Because reversing entries are not required, they are described and illustrated in Appendix B at the end of the book.

Exhibit 8 illustrates the accounting cycle in graphic form. It also illustrates how the accounting cycle begins with the source documents for a transaction and flows through the accounting system and into the financial statements.

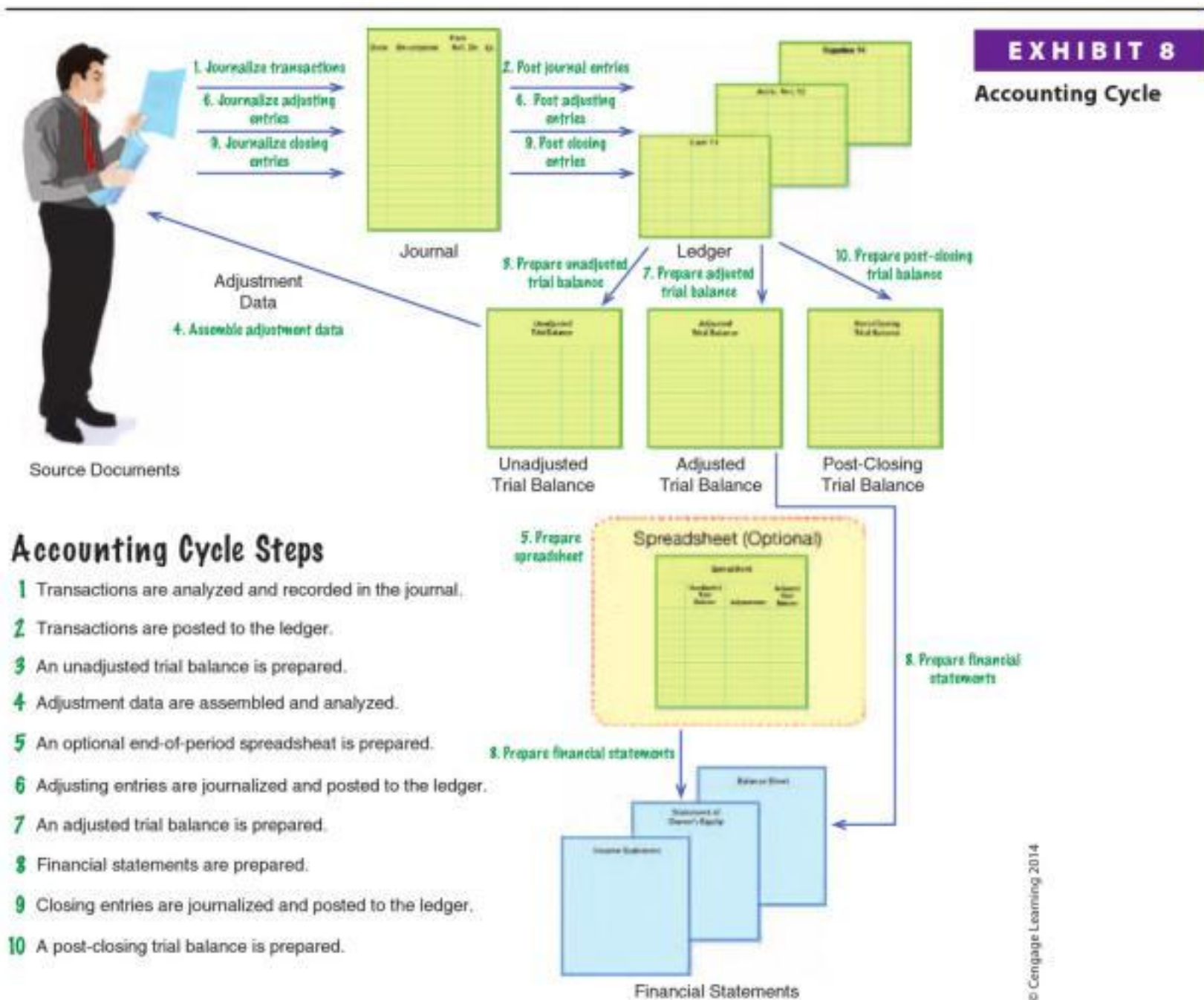


Illustration of the Accounting Cycle

In this section, the complete accounting cycle for one period is illustrated. Assume that for several years Kelly Pitney has operated a part-time consulting business from her home. As of April 1, 2014, Kelly decided to move to rented quarters and to operate the business on a full-time basis. The business will be known as Kelly Consulting. During April, Kelly Consulting entered into the following transactions:

- Apr. 1. The following assets were received from Kelly Pitney: cash, \$13,100; accounts receivable, \$3,000; supplies, \$1,400; and office equipment, \$12,500. There were no liabilities received.
1. Paid three months' rent on a lease rental contract, \$4,800.
 2. Paid the premiums on property and casualty insurance policies, \$1,800.
 4. Received cash from clients as an advance payment for services to be provided and recorded it as unearned fees, \$5,000.

OBJ 5 Illustrate the accounting cycle for one period.

- Apr. 5. Purchased additional office equipment on account from Office Station Co., \$2,000.
 6. Received cash from clients on account, \$1,800.
 10. Paid cash for a newspaper advertisement, \$120.
 12. Paid Office Station Co. for part of the debt incurred on April 5, \$1,200.
 12. Recorded services provided on account for the period April 1–12, \$4,200.
 14. Paid part-time receptionist for two weeks' salary, \$750.
 17. Recorded cash from cash clients for fees earned during the period April 1–16, \$6,250.
 18. Paid cash for supplies, \$800.
 20. Recorded services provided on account for the period April 13–20, \$2,100.
 24. Recorded cash from cash clients for fees earned for the period April 17–24, \$3,850.
 26. Received cash from clients on account, \$5,600.
 27. Paid part-time receptionist for two weeks' salary, \$750.
 29. Paid telephone bill for April, \$130.
 30. Paid electricity bill for April, \$200.
 30. Recorded cash from cash clients for fees earned for the period April 25–30, \$3,050.
 30. Recorded services provided on account for the remainder of April, \$1,500.
 30. Kelly withdrew \$6,000 for personal use.

Step 1. Analyzing and Recording Transactions in the Journal

The first step in the accounting cycle is to analyze and record transactions in the journal using the double-entry accounting system. As illustrated in Chapter 2, transactions are analyzed and journalized using the following steps:

1. Carefully read the description of the transaction to determine whether an asset, liability, owner's equity, revenue, expense, or drawing account is affected.
2. For each account affected by the transaction, determine whether the account increases or decreases.
3. Determine whether each increase or decrease should be recorded as a debit or a credit, following the rules of debit and credit shown in Exhibit 3 of Chapter 2.
4. Record the transaction using a journal entry.

The company's chart of accounts is useful in determining which accounts are affected by the transaction. The chart of accounts for Kelly Consulting is as follows:

11 Cash	31 Kelly Pitney, Capital
12 Accounts Receivable	32 Kelly Pitney, Drawing
14 Supplies	33 Income Summary
15 Prepaid Rent	41 Fees Earned
16 Prepaid Insurance	51 Salary Expense
18 Office Equipment	52 Rent Expense
19 Accumulated Depreciation	53 Supplies Expense
21 Accounts Payable	54 Depreciation Expense
22 Salaries Payable	55 Insurance Expense
23 Unearned Fees	59 Miscellaneous Expense

After analyzing each of Kelly Consulting's transactions for April, the journal entries are recorded as shown in Exhibit 9.

Step 2. Posting Transactions to the Ledger

Periodically, the transactions recorded in the journal are posted to the accounts in the ledger. The debits and credits for each journal entry are posted to the accounts in the order in which they occur in the journal. As illustrated in Chapters 2 and 3, journal entries are posted to the accounts using the following four steps:

1. The date is entered in the Date column of the account.
2. The amount is entered into the Debit or Credit column of the account.
3. The journal page number is entered in the Posting Reference column.
4. The account number is entered in the Posting Reference (Post. Ref.) column in the journal.

Journal					Page 1
Date	Description	Post. Ref.	Debit	Credit	
2014 Apr. 1	Cash	11	13,100		
	Accounts Receivable	12	3,000		
	Supplies	14	1,400		
	Office Equipment	18	12,500		
	Kelly Pitney, Capital	31		30,000	
1	Prepaid Rent	15	4,800		
	Cash	11		4,800	
2	Prepaid Insurance	16	1,800		
	Cash	11		1,800	
4	Cash	11	5,000		
	Unearned Fees	23		5,000	
5	Office Equipment	18	2,000		
	Accounts Payable	21		2,000	
6	Cash	11	1,800		
	Accounts Receivable	12		1,800	
10	Miscellaneous Expense	59	120		
	Cash	11		120	
12	Accounts Payable	21	1,200		
	Cash	11		1,200	
12	Accounts Receivable	12	4,200		
	Fees Earned	41		4,200	
14	Salary Expense	51	750		
	Cash	11		750	

Journal					Page 2
Date	Description	Post. Ref.	Debit	Credit	
2014 Apr. 17	Cash	11	6,250		
	Fees Earned	41		6,250	
18	Supplies	14	800		
	Cash	11		800	
20	Accounts Receivable	12	2,100		
	Fees Earned	41		2,100	
24	Cash	11	3,850		
	Fees Earned	41		3,850	
26	Cash	11	5,600		
	Accounts Receivable	12		5,600	
27	Salary Expense	51	750		
	Cash	11		750	
29	Miscellaneous Expense	59	130		
	Cash	11		130	

EXHIBIT 9**Journal Entries
for April, Kelly
Consulting**

(Continued)

EXHIBIT 12**Adjusting Entries,
Kelly Consulting**

Journal					
					Page 3
	Date	Description	Post. Ref.	Debit	Credit
		Adjusting Entries			
2014	Apr. 30	Insurance Expense	55	300	
		Prepaid Insurance	16		300
		Expired insurance.			
	30	Supplies Expense	53	850	
		Supplies	14		850
		Supplies used (\$2,200 – \$1,350).			
	30	Depreciation Expense	54	330	
		Accumulated Depreciation	19		330
		Depreciation of office equipment.			
	30	Salary Expense	51	120	
		Salaries Payable	22		120
		Accrued salary.			
	30	Rent Expense	52	1,600	
		Prepaid Rent	15		1,600
		Rent expired during April.			
	30	Unearned Fees	23	2,500	
		Fees Earned	41		2,500
		Fees earned (\$5,000 – \$2,500).			

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Each of the adjusting entries shown in Exhibit 12 is posted to Kelly Consulting's ledger shown in Exhibit 17 on pages 172–173. The adjusting entries are identified in the ledger as “Adjusting.”

Step 7. Preparing an Adjusted Trial Balance

After the adjustments have been journalized and posted, an adjusted trial balance is prepared to verify the equality of the total of the debit and credit balances. This is the last step before preparing the financial statements. If the adjusted trial balance does not balance, an error has occurred and must be found and corrected. The adjusted trial balance for Kelly Consulting as of April 30, 2014, is shown in Exhibit 13.

Step 8. Preparing the Financial Statements

The most important outcome of the accounting cycle is the financial statements. The income statement is prepared first, followed by the statement of owner's equity and then the balance sheet. The statements can be prepared directly from the adjusted trial balance, the end-of-period spreadsheet, or the ledger. The net income or net loss shown on the income statement is reported on the statement of owner's equity along with any additional investments by the owner and any withdrawals. The ending owner's capital is reported on the balance sheet and is added with total liabilities to equal total assets.

The financial statements for Kelly Consulting are shown in Exhibit 14. Kelly Consulting earned net income of \$18,300 for April. As of April 30, 2014, Kelly Consulting has total assets of \$45,720, total liabilities of \$3,420, and total owner's equity of \$42,300.

Kelly Consulting
Adjusted Trial Balance
April 30, 2014

	Debit Balances	Credit Balances
Cash	22,100	
Accounts Receivable	3,400	
Supplies	1,350	
Prepaid Rent	3,200	
Prepaid Insurance	1,500	
Office Equipment	14,500	
Accumulated Depreciation		330
Accounts Payable		800
Salaries Payable		120
Unearned Fees		2,500
Kelly Pitney, Capital		30,000
Kelly Pitney, Drawing	6,000	
Fees Earned		23,450
Salary Expense	1,620	
Rent Expense	1,600	
Supplies Expense	850	
Depreciation Expense	330	
Insurance Expense	300	
Miscellaneous Expense	450	
	<u>57,200</u>	<u>57,200</u>

EXHIBIT 13

**Adjusted Trial
Balance, Kelly
Consulting**

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Kelly Consulting
Income Statement
For the Month Ended April 30, 2014

Fees earned		\$23,450
Expenses:		
Salary expense	\$1,620	
Rent expense	1,600	
Supplies expense	850	
Depreciation expense	330	
Insurance expense	300	
Miscellaneous expense	450	
Total expenses		<u>5,150</u>
Net income		<u>\$18,300</u>

EXHIBIT 14

**Financial
Statements,
Kelly Consulting**

Kelly Consulting
Statement of Owner's Equity
For the Month Ended April 30, 2014

Kelly Pitney, capital, April 1, 2014		\$ 0
Investment during the month	\$30,000	
Net income for the month	<u>18,300</u>	
	\$48,300	
Less withdrawals	<u>6,000</u>	
Increase in owner's equity		<u>42,300</u>
Kelly Pitney, capital, April 30, 2014		<u>\$42,300</u>

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(Continued)

EXHIBIT 14**Financial Statements, Kelly Consulting (concluded)**

Kelly Consulting			
Balance Sheet			
April 30, 2014			
Assets		Liabilities	
Current assets:		Current liabilities:	
Cash.....	\$22,100	Accounts payable.....	\$ 800
Accounts receivable	3,400	Salaries payable	120
Supplies	1,350	Unearned fees.....	<u>2,500</u>
Prepaid rent.....	3,200	Total liabilities.....	\$ 3,420
Prepaid insurance	<u>1,500</u>		
Total current assets	\$31,550		
Property, plant, and equipment:		Owner's Equity	
Office equipment.....	\$14,500	Kelly Pitney, capital	<u>42,300</u>
Less accumulated depreciation	<u>330</u>	Total liabilities and	
Total property, plant,		owner's equity	<u>\$45,720</u>
and equipment	<u>14,170</u>		
Total assets.....	<u>\$45,720</u>		

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Step 9. Journalizing and Posting Closing Entries

As described earlier in this chapter, four closing entries are required at the end of an accounting period. These four closing entries are as follows:

1. Debit each revenue account for its balance and credit Income Summary for the total revenue.
2. Credit each expense account for its balance and debit Income Summary for the total expenses.
3. Debit Income Summary for its balance and credit the owner's capital account.
4. Debit the owner's capital account for the balance of the drawing account and credit the drawing account.

The four closing entries for Kelly Consulting are shown in Exhibit 15. The closing entries are posted to Kelly Consulting's ledger as shown in Exhibit 17 (pages 172–173). After the closing entries are posted, Kelly Consulting's ledger has the following characteristics:

1. The balance of Kelly Pitney, Capital of \$42,300 agrees with the amount reported on the statement of owner's equity and the balance sheet.
2. The revenue, expense, and drawing accounts will have zero balances.

The closing entries are normally identified in the ledger as "Closing." In addition, a line is often inserted in both balance columns after a closing entry is posted. This separates next period's revenue, expense, and withdrawal transactions from those of the current period.

Step 10. Preparing a Post-Closing Trial Balance

A post-closing trial balance is prepared after the closing entries have been posted. The purpose of the post-closing trial balance is to verify that the ledger is in balance at the beginning of the next period. The accounts and amounts in the post-closing trial balance should agree exactly with the accounts and amounts listed on the balance sheet at the end of the period.

Journal					Page 4
Date	Description	Post. Ref.	Debit	Credit	
Closing Entries					
2014 Apr. 30	Fees Earned	41	23,450		
	Income Summary	33		23,450	
30	Income Summary	33	5,150		
	Salary Expense	51		1,620	
	Rent Expense	52		1,600	
	Supplies Expense	53		850	
	Depreciation Expense	54		330	
	Insurance Expense	55		300	
	Miscellaneous Expense	59		450	
30	Income Summary	33	18,300		
	Kelly Pitney, Capital	31		18,300	
30	Kelly Pitney, Capital	31	6,000		
	Kelly Pitney, Drawing	32		6,000	

EXHIBIT 15**Closing Entries,
Kelly Consulting**

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The post-closing trial balance for Kelly Consulting is shown in Exhibit 16. The balances shown in the post-closing trial balance are taken from the ending balances in the ledger shown in Exhibit 17. These balances agree with the amounts shown on Kelly Consulting's balance sheet in Exhibit 14.

Kelly Consulting Post-Closing Trial Balance April 30, 2014		
	Debit Balances	Credit Balances
Cash	22,100	
Accounts Receivable	3,400	
Supplies	1,350	
Prepaid Rent	3,200	
Prepaid Insurance	1,500	
Office Equipment	14,500	
Accumulated Depreciation		330
Accounts Payable		800
Salaries Payable		120
Unearned Fees		2,500
Kelly Pitney, Capital		42,300
	<u>46,050</u>	<u>46,050</u>

EXHIBIT 16**Post-Closing
Trial Balance, Kelly
Consulting**

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EXHIBIT 17

Ledger, Kelly Consulting

Ledger						
Account Cash				Account No. 11		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1	13,100		13,100	
1		1		4,800	8,300	
2		1		1,800	6,500	
4		1	5,000		11,500	
6		1	1,800		13,300	
10		1		120	13,180	
12		1		1,200	11,980	
14		1		750	11,230	
17		2	6,250		17,480	
18		2		800	16,680	
24		2	3,850		20,530	
26		2	5,600		26,130	
27		2		750	25,380	
29		2		130	25,250	
30		2		200	25,050	
30		2	3,050		28,100	
30		2		6,000	22,100	

Account Accounts Receivable				Account No. 12		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1	3,000		3,000	
6		1		1,800	1,200	
12		1	4,200		5,400	
20		2	2,100		7,500	
26		2		5,600	1,900	
30		2	1,500		3,400	

Account Supplies				Account No. 14		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1	1,400		1,400	
18		2	800		2,200	
30	Adjusting	3		850	1,350	

Account Prepaid Rent				Account No. 15		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1	4,800		4,800	
30	Adjusting	3		1,600	3,200	

Account Prepaid Insurance				Account No. 16		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 2		1	1,800		1,800	
30	Adjusting	3		300	1,500	

Account Office Equipment				Account No. 18		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1	12,500		12,500	
5		1	2,000		14,500	

Account Accumulated Depreciation				Account No. 19		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 30	Adjusting	3		330		330

Account Accounts Payable				Account No. 21		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 5		1		2,000		2,000
12		1	1,200			800

Account Salaries Payable				Account No. 22		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 30	Adjusting	3		120		120

Account Unearned Fees				Account No. 23		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 4		1		5,000		5,000
30	Adjusting	3	2,500			2,500

Account Kelly Pitney, Capital				Account No. 31		
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Apr. 1		1		30,000		30,000
30	Closing	4		18,300		48,300
30	Closing	4	6,000			42,300

A positive working capital implies that the business is able to pay its current liabilities and is solvent. Thus, an increase in working capital increases or improves a company's short-term solvency.

To illustrate, NetSolutions' working capital at the end of 2013 is \$6,355 as computed below. This amount of working capital implies that NetSolutions is able to pay its current liabilities.

$$\begin{aligned}\text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\ &= \$7,745 - \$1,390 \\ &= \$6,355\end{aligned}$$

The **current ratio** is another means of expressing the relationship between current assets and current liabilities. The current ratio is computed by dividing current assets by current liabilities, as shown below.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

To illustrate, the current ratio for NetSolutions at the end of 2013 is 5.6, computed as follows:

$$\begin{aligned}\text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ &= \frac{\$7,745}{\$1,390} \\ &= 5.6 \text{ (Rounded)}\end{aligned}$$

The current ratio is more useful than working capital in making comparisons across companies or with industry averages. To illustrate, the following data (in millions) were taken from recent financial statements of [Electronic Arts Inc.](#) and [Take-Two Interactive Software, Inc.](#)

	Electronic Arts		Take-Two	
	Year 2	Year 1	Year 2	Year 1
Current assets	\$3,032	\$2,585	\$566	\$427
Current liabilities	2,001	1,574	231	210
Working capital	\$1,031	\$1,011	\$335	\$217
Current ratio*	1.52	1.64	2.45	2.03
	(\$3,032 ÷ \$2,001)	(\$2,585 ÷ \$1,574)	(\$566 ÷ \$231)	(\$427 ÷ \$210)

*Rounded to two decimal places.

Electronic Arts is larger than Take-Two and has Year 2 working capital of \$1,031 as compared to Take-Two's Year 2 working capital of \$335. Such size differences make comparisons across companies difficult. In contrast, the current ratio allows comparability across companies.

To illustrate, Electronic Arts has over three times more working capital (\$1,031) than does Take-Two (\$335). However, by using the current ratio the changes in liquidity of both companies can be directly compared. Specifically, Electronic Arts' current ratio declined from 1.64 to 1.52, or 0.12. In contrast, Take-Two's current ratio increased by 0.42 from 2.03 to 2.45. Thus, while Electronic Arts' liquidity declined in Year 2, Take-Two's short-term liquidity improved.

Example Exercise 4-6 Working Capital and Current Ratio

OBJ
7

Current assets and current liabilities for Fortson Company are shown below.

	2014	2013
Current assets	\$310,500	\$262,500
Current liabilities	172,500	150,000

- Determine the working capital and current ratio for 2014 and 2013.
- Does the change in the current ratio from 2013 to 2014 indicate a favorable or an unfavorable trend?

(Continued)

Follow My Example 4-6

a.

	2014	2013
Current assets	\$310,500	\$262,500
Current liabilities	172,500	150,000
Working capital	<u>\$138,000</u>	<u>\$112,500</u>
Current ratio	1.80	1.75
	(\$310,500 ÷ \$172,500)	(\$262,500 ÷ \$150,000)

b. The change from 1.75 to 1.80 indicates a favorable trend.

Practice Exercises: PE 4-6A, PE 4-6B

APPENDIX 1

End-of-Period Spreadsheet (Work Sheet)

Accountants often use working papers for analyzing and summarizing data. Such working papers are not a formal part of the accounting records. This is in contrast to the chart of accounts, the journal, and the ledger, which are essential parts of an accounting system. Working papers are usually prepared by using a computer spreadsheet program such as Microsoft's Excel™.

The end-of-period spreadsheet shown in Exhibit 1 is a working paper used to summarize adjusting entries and their effects on the accounts. As illustrated in the chapter, the financial statements for NetSolutions can be prepared directly from the spreadsheet's Adjusted Trial Balance columns.

Some accountants prefer to expand the end-of-period spreadsheet shown in Exhibit 1 to include financial statement columns. Exhibits 18 through 22 illustrate the step-by-step process of how to prepare this expanded spreadsheet. As a basis for illustration, NetSolutions is used.

Step 1. Enter the Title

The spreadsheet is started by entering the following data:

1. Name of the business: *NetSolutions*
2. Type of working paper: *End-of-Period Spreadsheet*
3. The period of time: *For the Two Months Ended December 31, 2013*

Exhibit 18 shows the preceding data entered for NetSolutions.

See Exhibit 18

Step 2. Enter the Unadjusted Trial Balance

Enter the unadjusted trial balance on the spreadsheet. The spreadsheet in Exhibit 18 shows the unadjusted trial balance for NetSolutions at December 31, 2013.

Step 3. Enter the Adjustments

The adjustments for NetSolutions from Chapter 3 are entered in the Adjustments columns, as shown in Exhibit 19. Cross-referencing (by letters) the debit and credit of each adjustment is useful in reviewing the spreadsheet. It is also helpful for identifying the adjusting entries that need to be recorded in the journal. This cross-referencing process is sometimes referred to as *keying* the adjustments.

The adjustments are normally entered in the order in which the data are assembled. If the titles of the accounts to be adjusted do not appear in the unadjusted trial balance, the accounts are inserted in their proper order in the Account Title column.

The adjusting entries for NetSolutions that are entered in the Adjustments columns are as follows:

- (a) **Supplies.** The supplies account has a debit balance of \$2,000. The cost of the supplies on hand at the end of the period is \$760. The supplies expense for December is the difference between the two amounts, or \$1,240 ($\$2,000 - \760). The adjustment is entered as (1) \$1,240 in the Adjustments Debit column on the same line as Supplies Expense and (2) \$1,240 in the Adjustments Credit column on the same line as Supplies.
- (b) **Prepaid Insurance.** The prepaid insurance account has a debit balance of \$2,400. This balance represents the prepayment of insurance for 12 months beginning December 1. Thus, the insurance expense for December is \$200 ($\$2,400 \div 12$). The adjustment is entered as (1) \$200 in the Adjustments Debit column on the same line as Insurance Expense and (2) \$200 in the Adjustments Credit column on the same line as Prepaid Insurance.
- (c) **Unearned Rent.** The unearned rent account had a credit balance of \$360. This balance represents the receipt of three months' rent, beginning with December. Thus, the rent revenue for December is \$120 ($\$360 \div 3$). The adjustment is entered as (1) \$120 in the Adjustments Debit column on the same line as Unearned Rent and (2) \$120 in the Adjustments Credit column on the same line as Rent Revenue.
- (d) **Accrued Fees.** Fees accrued at the end of December but not recorded total \$500. This amount is an increase in an asset and an increase in revenue. The adjustment is entered as (1) \$500 in the Adjustments Debit column on the same line as Accounts Receivable and (2) \$500 in the Adjustments Credit column on the same line as Fees Earned.
- (e) **Wages.** Wages accrued but not paid at the end of December total \$250. This amount is an increase in expenses and an increase in liabilities. The adjustment is entered as (1) \$250 in the Adjustments Debit column on the same line as Wages Expense and (2) \$250 in the Adjustments Credit column on the same line as Wages Payable.
- (f) **Depreciation.** Depreciation of the office equipment is \$50 for December. The adjustment is entered as (1) \$50 in the Adjustments Debit column on the same line as Depreciation Expense and (2) \$50 in the Adjustments Credit column on the same line as Accumulated Depreciation.

Turn Exhibit 19

After the adjustments have been entered, the Adjustments columns are totaled to verify the equality of the debits and credits. The total of the Debit column must equal the total of the Credit column.

Step 4. Enter the Adjusted Trial Balance

The adjusted trial balance is entered by combining the adjustments with the unadjusted balances for each account. The adjusted amounts are then extended to the Adjusted Trial Balance columns, as shown in Exhibit 20.

To illustrate, the cash amount of \$2,065 is extended to the Adjusted Trial Balance Debit column since no adjustments affected Cash. Accounts Receivable has an initial balance of \$2,220 and a debit adjustment of \$500. Thus, \$2,720 ($\$2,220 + \500) is entered in the Adjusted Trial Balance Debit column for Accounts Receivable. The same process continues until all account balances are extended to the Adjusted Trial Balance columns.

After the accounts and adjustments have been extended, the Adjusted Trial Balance columns are totaled to verify the equality of debits and credits. The total of the Debit column must equal the total of the Credit column.

Turn Exhibit 20

Step 5. Extend the Accounts to the Income Statement and Balance Sheet Columns

The adjusted trial balance amounts are extended to the Income Statement and Balance Sheet columns. The amounts for revenues and expenses are extended to the Income Statement columns. The amounts for assets, liabilities, owner's capital, and drawing are extended to the Balance Sheet columns.³

Turn Exhibit 21

³The balances of the owner's capital and drawing accounts are extended to the Balance Sheet columns because the spreadsheet does not have separate Statement of Owner's Equity columns.

EXHIBIT 18 Spreadsheet (Work Sheet) with Unadjusted Trial Balance Entered

	A	B	C	D	E	F	G	H	I	J	K
1											
2											
3											
4											
5											
6											
7											
8											
9											
10											
11											
12											
13											
14											
15											
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21											
22											
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24											
25											
26											
27											
28											
29											
30											
31											
32											

The spreadsheet (work sheet) is used for summarizing the effects of adjusting entries. It also aids in preparing financial statements.

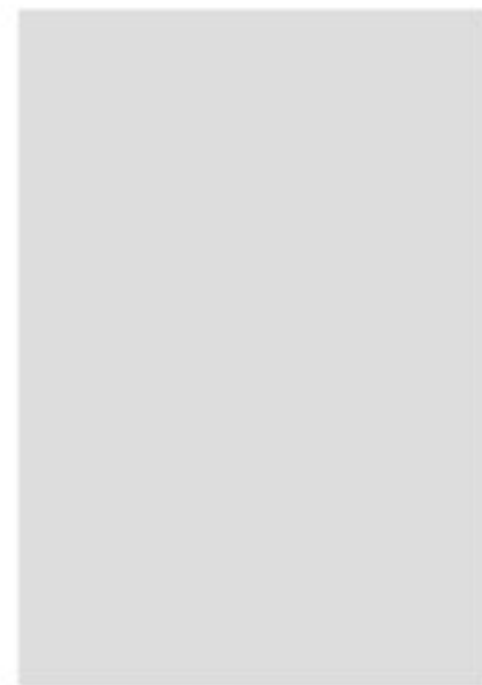
EXHIBIT 19**Spreadsheet (Work Sheet) with Unadjusted Trial Balance and Adjustments**

	(d)	500		
		(a)	1,240	
		(b)	200	
		(f)	50	
	(c)	120	(e)	250
		(d)	500	
		(c)	120	
	(e)	250		
	(a)	1,240		
	(b)	200		
	(f)	50		
		<u>2,360</u>	<u>2,360</u>	

The adjustments on the spreadsheet (work sheet) are used in preparing the adjusting journal entries.

EXHIBIT 22**Completed Spreadsheet (Work Sheet) with Net Income Shown**

Net income



<u>9,855</u>	<u>16,960</u>	<u>33,545</u>	<u>26,440</u>
<u>7,105</u>			<u>7,105</u>
<u>16,960</u>	<u>16,960</u>	<u>33,545</u>	<u>33,545</u>

The difference between the Income Statement column totals is the net income (or net loss) for the period. The difference between the Balance Sheet column totals is also the net income (or net loss) for the period.

The first account listed in the Adjusted Trial Balance columns is Cash with a debit balance of \$2,065. Cash is an asset, is listed on the balance sheet, and has a debit balance. Therefore, \$2,065 is extended to the Balance Sheet Debit column. The Fees Earned balance of \$16,840 is extended to the Income Statement Credit column. The same process continues until all account balances have been extended to the proper columns, as shown in Exhibit 21.

Turn Exhibit 21

Step 6. Total the Income Statement and Balance Sheet Columns, Compute the Net Income or Net Loss, and Complete the Spreadsheet

After the account balances are extended to the Income Statement and Balance Sheet columns, each of the columns is totaled. The difference between the two Income Statement column totals is the amount of the net income or the net loss for the period. This difference (net income or net loss) will also be the difference between the two Balance Sheet column totals.

If the Income Statement Credit column total (total revenue) is greater than the Income Statement Debit column total (total expenses), the difference is the net income. If the Income Statement Debit column total is greater than the Income Statement Credit column total, the difference is a net loss.

As shown in Exhibit 22, the total of the Income Statement Credit column is \$16,960, and the total of the Income Statement Debit column is \$9,855. Thus, the net income for NetSolutions is \$7,105 as shown below.

Turn Exhibit 22

Total of Income Statement Credit column (revenues)	\$16,960
Total of Income Statement Debit column (expenses)	9,855
Net income (excess of revenues over expenses)	<u>\$ 7,105</u>

The amount of the net income, \$7,105, is entered in the Income Statement Debit column and the Balance Sheet Credit column. *Net income* is also entered in the Account Title column. Entering the net income of \$7,105 in the Balance Sheet Credit column has the effect of transferring the net balance of the revenue and expense accounts to the owner's capital account.

If there was a net loss instead of net income, the amount of the net loss would be entered in the Income Statement Credit column and the Balance Sheet Debit column. *Net loss* would also be entered in the Account Title column.

After the net income or net loss is entered on the spreadsheet, the Income Statement and Balance Sheet columns are totaled. The totals of the two Income Statement columns must now be equal. The totals of the two Balance Sheet columns must also be equal.

Preparing the Financial Statements from the Spreadsheet

The spreadsheet can be used to prepare the income statement, the statement of owner's equity, and the balance sheet shown in Exhibit 2. The income statement is normally prepared directly from the spreadsheet. The expenses are listed in the income statement in Exhibit 2 in order of size, beginning with the larger items. Miscellaneous expense is the last item, regardless of its amount.

The first item normally presented on the statement of owner's equity is the balance of the owner's capital account at the beginning of the period. The amount listed as owner's capital in the spreadsheet, however, is not always the account balance at the beginning of the period. The owner may have invested additional assets in the business during the period. Thus, for the beginning balance and any additional investments, it is necessary to refer to the capital account in the ledger. These amounts, along with the net income (or net loss) and the drawing amount shown in the spreadsheet, are used to determine the ending capital account balance.

The balance sheet can be prepared directly from the spreadsheet columns except for the ending balance of owner's capital. The ending balance of owner's capital is taken from the statement of owner's equity.

When a spreadsheet is used, the adjusting and closing entries are normally not journalized or posted until after the spreadsheet and financial statements have been prepared. The data for the adjusting entries are taken from the Adjustments columns of the spreadsheet. The data for the first two closing entries are taken from the Income Statement columns of the spreadsheet. The amount for the third closing entry is the net income or net loss appearing at the bottom of the spreadsheet. The amount for the fourth closing entry is the drawing account balance that appears in the Balance Sheet Debit column of the spreadsheet.

At a Glance 4

OBJ
1

Describe the flow of accounting information from the unadjusted trial balance into the adjusted trial balance and financial statements.

Key Points Exhibit 1 illustrates the end-of-period process by which accounts are adjusted and how the adjusted accounts flow into the financial statements.

Learning Outcome

- Using an end-of-period spreadsheet, describe how the unadjusted trial balance accounts are affected by adjustments and how the adjusted trial balance accounts flow into the income statement and balance sheet.

*Example
Exercises*
EE4-1

*Practice
Exercises*
PE4-1A, 4-1B

OBJ
2

Prepare financial statements from adjusted account balances.

Key Points Using the end-of-period spreadsheet shown in Exhibit 1, the income statement and balance sheet for NetSolutions can be prepared. The statement of owner's equity is prepared by referring to transactions that have been posted to owner's capital accounts in the ledger. A classified balance sheet has sections for current assets; property, plant, and equipment; current liabilities; long-term liabilities; and owner's equity.

Learning Outcomes

- Describe how the net income or net loss from the period can be determined from an end-of-period spreadsheet.
- Prepare an income statement, a statement of owner's equity, and a balance sheet.
- Indicate how accounts would be reported on a classified balance sheet.

*Example
Exercises*
EE4-2
EE4-3

*Practice
Exercises*
PE4-2A, 4-2B
PE4-3A, 4-3B

OBJ
3**Prepare closing entries.**

Key Points Four entries are required in closing the temporary accounts. The first entry closes the revenue accounts to Income Summary. The second entry closes the expense accounts to Income Summary. The third entry closes the balance of Income Summary (net income or net loss) to the owner's capital account. The fourth entry closes the drawing account to the owner's capital account.

After the closing entries have been posted to the ledger, the balance in the capital account agrees with the amount reported on the statement of owner's equity and balance sheet. In addition, the revenue, expense, and drawing accounts will have zero balances.

Learning Outcomes	Example Exercises	Practice Exercises
• Prepare the closing entry for revenues.	EE4-4	PE4-4A, 4-4B
• Prepare the closing entry for expenses.	EE4-4	PE4-4A, 4-4B
• Prepare the closing entry for transferring the balance of Income Summary to the owner's capital account.	EE4-4	PE4-4A, 4-4B
• Prepare the closing entry for the owner's drawing account.	EE4-4	PE4-4A, 4-4B

OBJ
4**Describe the accounting cycle.**

Key Points The 10 basic steps of the accounting cycle are as follows:

1. Transactions are analyzed and recorded in the journal.
2. Transactions are posted to the ledger.
3. An unadjusted trial balance is prepared.
4. Adjustment data are assembled and analyzed.
5. An optional end-of-period spreadsheet is prepared.
6. Adjusting entries are journalized and posted to the ledger.
7. An adjusted trial balance is prepared.
8. Financial statements are prepared.
9. Closing entries are journalized and posted to the ledger.
10. A post-closing trial balance is prepared.

Learning Outcomes	Example Exercises	Practice Exercises
<ul style="list-style-type: none"> • List the 10 steps of the accounting cycle. • Determine whether any steps are out of order in a listing of accounting cycle steps. • Determine whether there are any missing steps in a listing of accounting cycle steps. 	EE4-5	PE4-5A, 4-5B

OBJ
5**Illustrate the accounting cycle for one period.**

Key Points The complete accounting cycle for Kelly Consulting for the month of April is described and illustrated on pages 163–173.

Learning Outcome	Example Exercises	Practice Exercises
• Complete the accounting cycle for a period from beginning to end.		

OBJ
6**Explain what is meant by the fiscal year and the natural business year.**

Key Points The annual accounting period adopted by a business is its fiscal year. A company's fiscal year that ends when business activities have reached the lowest point in its annual operating cycle is called the natural business year.

Learning Outcome

- Explain why companies use a fiscal year that is different from the calendar year.

Example
ExercisesPractice
ExercisesOBJ
7**Describe and illustrate the use of working capital and the current ratio in evaluating a company's financial condition.**

Key Points The ability to convert assets into cash is called liquidity, while the ability of a business to pay its debts is called solvency. Two financial measures for evaluating a business's short-term liquidity and solvency are working capital and the current ratio. Working capital is computed by subtracting current liabilities from current assets. An excess of current assets over current liabilities implies that the business is able to pay its current liabilities. The current ratio is computed by dividing current assets by current liabilities. The current ratio is more useful than working capital in making comparisons across companies or with industry averages.

Learning Outcomes

- Define liquidity and solvency.
- Compute working capital.
- Compute the current ratio.

Example
ExercisesPractice
Exercises

EE4-6

PE4-6A, 4-6B

EE4-6

PE4-6A, 4-6B

Key Terms

accounting cycle (162)
clearing account (157)
closing entries (156)
closing process (156)
closing the books (156)
current assets (155)
current liabilities (155)

current ratio (175)
fiscal year (173)
fixed (plant) assets (155)
Income Summary (157)
liquidity (174)
long-term liabilities (155)
natural business year (174)

notes receivable (155)
real (permanent) accounts (156)
solvency (174)
temporary (nominal) accounts (156)
working capital (174)

2.

Journal					Page
Date	Description	Post. Ref.	Debit	Credit	
2014 July	Closing Entries				
31	Fees Earned Income Summary		60,625	60,625	
31	Income Summary Wages Expense Depreciation Expense Rent Expense Utilities Expense Supplies Expense Insurance Expense Miscellaneous Expense		37,430	22,855 4,950 4,200 2,715 890 315 1,505	
31	Income Summary T. Roderick, Capital		23,195	23,195	
31	T. Roderick, Capital T. Roderick, Drawing		5,200	5,200	

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Discussion Questions

- Why do some accountants prepare an end-of-period spreadsheet?
- Describe the nature of the assets that compose the following sections of a balance sheet: (a) current assets, (b) property, plant, and equipment.
- What is the difference between a current liability and a long-term liability?
- What types of accounts are referred to as temporary accounts?
- Why are closing entries required at the end of an accounting period?
- What is the difference between adjusting entries and closing entries?
- What is the purpose of the post-closing trial balance?
- (a) What is the most important output of the accounting cycle? (b) Do all companies have an accounting cycle? Explain.
- What is the natural business year?
- The fiscal years for several well-known companies are as follows:

Company	Fiscal Year Ending
Sears	January 30
JCPenney	January 30
Target Corp.	January 30
Home Depot	January 31
Tiffany & Co.	January 31
Limited Brands, Inc.	January 31



What general characteristic shared by these companies explains why they do not have fiscal years ending December 31?

Practice Exercises

Example Exercises

EE 4-1 p. 152

PE 4-1A Flow of accounts into financial statements

OBJ. 1

The balances for the accounts listed below appear in the Adjusted Trial Balance columns of the end-of-period spreadsheet. Indicate whether each account would flow into the income statement, statement of owner's equity, or balance sheet.

- | | |
|-----------------------------------|---------------------|
| 1. Accounts Receivable | 5. Rent Revenue |
| 2. Depreciation Expense—Equipment | 6. Supplies Expense |
| 3. Gary Van Dyke, Capital | 7. Unearned Revenue |
| 4. Office Equipment | 8. Wages Payable |

EE 4-1 p. 152

PE 4-1B Flow of accounts into financial statements

OBJ. 1

The balances for the accounts listed below appear in the Adjusted Trial Balance columns of the end-of-period spreadsheet. Indicate whether each account would flow into the income statement, statement of owner's equity, or balance sheet.

- | | |
|--------------------------------------|------------------------|
| 1. Accumulated Depreciation—Building | 5. Prepaid Rent |
| 2. Cash | 6. Supplies |
| 3. Fees Earned | 7. Tina Greer, Drawing |
| 4. Insurance Expense | 8. Wages Expense |

EE 4-2 p. 154

PE 4-2A Statement of owner's equity

OBJ. 2

Francis Matthews owns and operates Daffodil Advertising Services. On January 1, 2013, Francis Matthews, Capital had a balance of \$475,000. During the year, Francis invested an additional \$50,000 and withdrew \$30,000. For the year ended December 31, 2013, Daffodil Advertising Services reported a net income of \$139,500. Prepare a statement of owner's equity for the year ended December 31, 2013.

EE 4-2 p. 154

PE 4-2B Statement of owner's equity

OBJ. 2

Blake Knudson owns and operates Grab Bag Delivery Services. On January 1, 2013, Blake Knudson, Capital had a balance of \$918,000. During the year, Blake made no additional investments and withdrew \$15,000. For the year ended December 31, 2013, Grab Bag Delivery Services reported a net loss of \$43,500. Prepare a statement of owner's equity for the year ended December 31, 2013.

EE 4-3 p. 155

PE 4-3A Classified balance sheet

OBJ. 2

The following accounts appear in an adjusted trial balance of Hampshire Consulting. Indicate whether each account would be reported in the (a) current asset; (b) property, plant, and equipment; (c) current liability; (d) long-term liability; or (e) owner's equity section of the December 31, 2013, balance sheet of Hampshire Consulting.

- | | |
|--------------------------------|--------------------------|
| 1. Building | 5. Salaries Payable |
| 2. Jessica Kountz, Capital | 6. Supplies |
| 3. Notes Payable (due in 2020) | 7. Taxes Payable |
| 4. Prepaid Rent | 8. Unearned Service Fees |

Example Exercises

EE 4-3 p. 155

PE 4-3B Classified balance sheet**OBJ. 2**

The following accounts appear in an adjusted trial balance of Kangaroo Consulting. Indicate whether each account would be reported in the (a) current asset; (b) property, plant, and equipment; (c) current liability; (d) long-term liability; or (e) owner's equity section of the December 31, 2013, balance sheet of Kangaroo Consulting.

- | | |
|--------------------------------------|-------------------------------|
| 1. Accounts Payable | 5. Lea Gabel, Capital |
| 2. Accounts Receivable | 6. Note Payable (due in 2021) |
| 3. Accumulated Depreciation—Building | 7. Supplies |
| 4. Cash | 8. Wages Payable |

EE 4-4 p. 159

PE 4-4A Closing entries**OBJ. 3**

After the accounts have been adjusted at August 31, the end of the fiscal year, the following balances were taken from the ledger of Marcy Delivery Services Co.:

Rita Sands, Capital	\$1,400,000
Rita Sands, Drawing	55,000
Fees Earned	880,000
Wages Expense	524,000
Rent Expense	80,000
Supplies Expense	16,000
Miscellaneous Expense	9,000

Journalize the four entries required to close the accounts.

EE 4-4 p. 159

PE 4-4B Closing entries**OBJ. 3**

After the accounts have been adjusted at April 30, the end of the fiscal year, the following balances were taken from the ledger of Nuclear Landscaping Co.:

Felix Godwin, Capital	\$643,600
Felix Godwin, Drawing	10,500
Fees Earned	356,500
Wages Expense	283,100
Rent Expense	56,000
Supplies Expense	11,500
Miscellaneous Expense	13,000

Journalize the four entries required to close the accounts.

EE 4-5 p. 162

PE 4-5A Accounting cycle**OBJ. 4**

From the following list of steps in the accounting cycle, identify what two steps are missing.

- Transactions are analyzed and recorded in the journal.
- An unadjusted trial balance is prepared.
- Adjustment data are assembled and analyzed.
- An optional end-of-period spreadsheet is prepared.
- Adjusting entries are journalized and posted to the ledger.
- An adjusted trial balance is prepared.
- Closing entries are journalized and posted to the ledger.
- A post-closing trial balance is prepared.

EE 4-5 p. 162

PE 4-5B Accounting cycle**OBJ. 4**

From the following list of steps in the accounting cycle, identify what two steps are missing.

- Transactions are analyzed and recorded in the journal.
- Transactions are posted to the ledger.

(Continued)

Example Exercises

- c. An unadjusted trial balance is prepared.
- d. An optional end-of-period spreadsheet is prepared.
- e. Adjusting entries are journalized and posted to the ledger.
- f. An adjusted trial balance is prepared.
- g. Financial statements are prepared.
- h. A post-closing trial balance is prepared.

EE 4-6 p. 175

**PE 4-6A Working capital and current ratio**

OBJ. 7

The following balance sheet data for Pecan Company are shown below.

	2014	2013
Current assets	\$1,467,000	\$1,269,000
Current liabilities	815,000	675,000

- a. Determine the working capital and current ratio for 2014 and 2013.
- b. Does the change in the current ratio from 2013 to 2014 indicate a favorable or an unfavorable trend?

EE 4-6 p. 175

**PE 4-6B Working capital and current ratio**

OBJ. 7

The following balance sheet data for Brimstone Company are shown below.

	2014	2013
Current assets	\$1,586,250	\$1,210,000
Current liabilities	705,000	550,000

- a. Determine the working capital and current ratio for 2014 and 2013.
- b. Does the change in the current ratio from 2013 to 2014 indicate a favorable or an unfavorable trend?

Exercises

EX 4-1 Flow of accounts into financial statements

OBJ. 1, 2

The balances for the accounts listed below appear in the Adjusted Trial Balance columns of the end-of-period spreadsheet. Indicate whether each account would flow into the income statement, statement of owner's equity, or balance sheet.

- | | |
|-------------------------|----------------------|
| 1. Accounts Payable | 6. Supplies |
| 2. Accounts Receivable | 7. Unearned Rent |
| 3. Cash | 8. Utilities Expense |
| 4. Chad Loomis, Drawing | 9. Wages Expense |
| 5. Fees Earned | 10. Wages Payable |

EX 4-2 Classifying accounts

OBJ. 1, 2

Balances for each of the following accounts appear in an adjusted trial balance. Identify each as (a) asset, (b) liability, (c) revenue, or (d) expense.

- | | |
|------------------------|----------------------|
| 1. Accounts Receivable | 7. Rent Revenue |
| 2. Equipment | 8. Salary Expense |
| 3. Fees Earned | 9. Salary Payable |
| 4. Insurance Expense | 10. Supplies |
| 5. Prepaid Advertising | 11. Supplies Expense |
| 6. Prepaid Rent | 12. Unearned Rent |

EX 4-3 Financial statements from the end-of-period spreadsheet**OBJ. 1, 2**

Holism Consulting is a consulting firm owned and operated by Scott Cutler. The end-of-period spreadsheet shown below was prepared for the year ended May 31, 2014.

	A	B	C	D	E	F	G
1	Holism Consulting						
2	End-of-Period Spreadsheet						
3	For the Year Ended May 31, 2014						
4		Unadjusted				Adjusted	
5		Trial Balance		Adjustments		Trial Balance	
6	Account Title	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
7							
8	Cash	38,000				38,000	
9	Accounts Receivable	90,000				90,000	
10	Supplies	9,600			(a) 6,000	3,600	
11	Office Equipment	74,000				74,000	
12	Accumulated Depreciation		10,000		(b) 4,800		14,800
13	Accounts Payable		24,400				24,400
14	Salaries Payable				(c) 1,500		1,500
15	Scott Cutler, Capital		90,400				90,400
16	Scott Cutler, Drawing	12,000				12,000	
17	Fees Earned		175,200				175,200
18	Salary Expense	69,000		(c) 1,500		70,500	
19	Supplies Expense			(a) 6,000		6,000	
20	Depreciation Expense			(b) 4,800		4,800	
21	Miscellaneous Expense	7,400				7,400	
22		300,000	300,000	12,300	12,300	306,300	306,300
23							

Based on the preceding spreadsheet, prepare an income statement, statement of owner's equity, and balance sheet for Holism Consulting.

EX 4-4 Financial statements from the end-of-period spreadsheet**OBJ. 1, 2**


Olympia Consulting is a consulting firm owned and operated by Raul Hann. The following end-of-period spreadsheet was prepared for the year ended April 30, 2014.

	A	B	C	D	E	F	G
1	Olympia Consulting						
2	End-of-Period Spreadsheet						
3	For the Year Ended April 30, 2014						
4		Unadjusted				Adjusted	
5		Trial Balance		Adjustments		Trial Balance	
6	Account Title	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
7							
8	Cash	27,500				27,500	
9	Accounts Receivable	53,500				53,500	
10	Supplies	3,000			(a) 1,800	1,200	
11	Office Equipment	30,500				30,500	
12	Accumulated Depreciation		4,500		(b) 750		5,250
13	Accounts Payable		3,300				3,300
14	Salaries Payable				(c) 450		450
15	Raul Hann, Capital		82,200				82,200
16	Raul Hann, Drawing	2,000				2,000	
17	Fees Earned		60,000				60,000
18	Salary Expense	32,000		(c) 450		32,450	
19	Supplies Expense			(a) 1,800		1,800	
20	Depreciation Expense			(b) 750		750	
21	Miscellaneous Expense	1,500				1,500	
22		150,000	150,000	3,000	3,000	151,200	151,200
23							

Based on the preceding spreadsheet, prepare an income statement, statement of owner's equity, and balance sheet for Olympia Consulting.

- a. Accounts Payable
- b. Accumulated Depreciation—Equipment
- c. Depreciation Expense—Equipment
- d. Equipment
- e. Ernie Hale, Capital
- f. Ernie Hale, Drawing
- g. Fees Earned
- h. Land
- i. Supplies
- j. Supplies Expense
- k. Wages Expense
- l. Wages Payable

EX 4-15 Closing entries **OBJ. 3**
 Prior to its closing, Income Summary had total debits of \$1,190,500 and total credits of \$1,476,300.

 Briefly explain the purpose served by the income summary account and the nature of the entries that resulted in the \$1,190,500 and the \$1,476,300.

EX 4-16 Closing entries with net income **OBJ. 3**
 After all revenue and expense accounts have been closed at the end of the fiscal year, Income Summary has a debit of \$490,750 and a credit of \$613,400. At the same date, Darcy Lewis, Capital has a credit balance of \$833,600, and Darcy Lewis, Drawing has a balance of \$55,000. (a) Journalize the entries required to complete the closing of the accounts. (b) Determine the amount of Darcy Lewis, Capital at the end of the period.

EX 4-17 Closing entries with net loss **OBJ. 3**
 Grande Services Co. offers its services to individuals desiring to improve their personal images. After the accounts have been adjusted at July 31, the end of the fiscal year, the following balances were taken from the ledger of Grande Services Co.

Gail Sabatini, Capital	\$842,500	Rent Expense	\$54,000
Gail Sabatini, Drawing	45,000	Supplies Expense	14,300
Fees Earned	337,900	Miscellaneous Expense	16,200
Wages Expense	277,500		

Journalize the four entries required to close the accounts.

EX 4-18 Identifying permanent accounts **OBJ. 3**
 Which of the following accounts will usually appear in the post-closing trial balance?

- a. Accounts Payable
- b. Accumulated Depreciation
- c. Casey Ryan, Capital
- d. Casey Ryan, Drawing
- e. Cash
- f. Depreciation Expense
- g. Fees Earned
- h. Office Equipment
- i. Salaries Expense
- j. Salaries Payable
- k. Supplies

EX 4-19 Post-closing trial balance **OBJ. 3**
 An accountant prepared the following post-closing trial balance:

Igloo Treasures Co. Post-Closing Trial Balance January 31, 2014		
	Debit Balances	Credit Balances
Cash	21,350	
Accounts Receivable	56,700	
Supplies		7,500
Equipment		74,450
Accumulated Depreciation—Equipment	12,400	
Accounts Payable	29,600	
Salaries Payable		3,200
Unearned Rent	11,000	
Nicole O'Brien, Capital	103,800	
	234,850	85,150

✓ Correct column totals, \$160,000

Prepare a corrected post-closing trial balance. Assume that all accounts have normal balances and that the amounts shown are correct.

EX 4-20 Steps in the accounting cycle**OBJ. 4**

Rearrange the following steps in the accounting cycle in proper sequence:

- Financial statements are prepared.
- An adjusted trial balance is prepared.
- Adjustment data are assembled and analyzed.
- Adjusting entries are journalized and posted to the ledger.
- Closing entries are journalized and posted to the ledger.
- An unadjusted trial balance is prepared.
- Transactions are posted to the ledger.
- Transactions are analyzed and recorded in the journal.
- An optional end-of-period spreadsheet (work sheet) is prepared.
- A post-closing trial balance is prepared.

EX 4-21 Working capital and current ratio**OBJ. 7**

The following data (in thousands) were taken from recent financial statements of [Under Armour, Inc.](#):

	December 31	
	Year 2	Year 1
Current assets	\$555,850	\$448,000
Current liabilities	149,147	120,162

- Compute the working capital and the current ratio as of December 31, Year 2 and Year 1. Round to two decimal places.
- What conclusions concerning the company's ability to meet its financial obligations can you draw from part (a)?

EX 4-22 Working capital and current ratio**OBJ. 7**

The following data (in thousands) were taken from recent financial statements of [Starbucks Corporation](#):

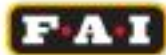
	Year 2	Year 1
	Current assets	\$2,756,400
Current liabilities	1,779,100	1,581,000

- Compute the working capital and the current ratio for Year 2 and Year 1. Round to two decimal places.
- What conclusions concerning the company's ability to meet its financial obligations can you draw from part (a)?

Appendix**EX 4-23 Completing an end-of-period spreadsheet (work sheet)**

List (a) through (j) in the order they would be performed in preparing and completing an end-of-period spreadsheet (work sheet).

- Add the Debit and Credit columns of the Unadjusted Trial Balance columns of the spreadsheet (work sheet) to verify that the totals are equal.
- Add the Debit and Credit columns of the Balance Sheet and Income Statement columns of the spreadsheet (work sheet) to verify that the totals are equal.

(Continued)

- c. Add or deduct adjusting entry data to trial balance amounts, and extend amounts to the Adjusted Trial Balance columns.
- d. Add the Debit and Credit columns of the Adjustments columns of the spreadsheet (work sheet) to verify that the totals are equal.
- e. Add the Debit and Credit columns of the Balance Sheet and Income Statement columns of the spreadsheet (work sheet) to determine the amount of net income or net loss for the period.
- f. Add the Debit and Credit columns of the Adjusted Trial Balance columns of the spreadsheet (work sheet) to verify that the totals are equal.
- g. Enter the adjusting entries into the spreadsheet (work sheet), based on the adjustment data.
- h. Enter the amount of net income or net loss for the period in the proper Income Statement column and Balance Sheet column.
- i. Enter the unadjusted account balances from the general ledger into the Unadjusted Trial Balance columns of the spreadsheet (work sheet).
- j. Extend the adjusted trial balance amounts to the Income Statement columns and the Balance Sheet columns.

Appendix

EX 4-24 Adjustment data on an end-of-period spreadsheet (work sheet)

Alert Security Services Co. offers security services to business clients. The trial balance for Alert Security Services Co. has been prepared on the end-of-period spreadsheet (work sheet) for the year ended October 31, 2014, shown below.

✓ Total debits of Adjustments column: \$31

SPREADSHEET

Account Title	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	12					
Accounts Receivable	90					
Supplies	8					
Prepaid Insurance	12					
Land	190					
Equipment	50					
Accum. Depr.—Equipment		4				
Accounts Payable		36				
Wages Payable		0				
Brenda Schultz, Capital		260				
Brenda Schultz, Drawing	8					
Fees Earned		200				
Wages Expense	110					
Rent Expense	12					
Insurance Expense	0					
Utilities Expense	6					
Supplies Expense	0					
Depreciation Expense	0					
Miscellaneous Expense	2					
	<u>500</u>	<u>500</u>				

The data for year-end adjustments are as follows:

- a. Fees earned, but not yet billed, \$13.
- b. Supplies on hand, \$4.
- c. Insurance premiums expired, \$10.

- d. Depreciation expense, \$3.
e. Wages accrued, but not paid, \$1.

Enter the adjustment data, and place the balances in the Adjusted Trial Balance columns.

Appendix

EX 4-25 Completing an end-of-period spreadsheet (work sheet)

Alert Security Services Co. offers security services to business clients. Complete the following end-of-period spreadsheet (work sheet) for Alert Security Services Co.

✓ Net income: \$65

SPREADSHEET

Account Title	Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	12					
Accounts Receivable	103					
Supplies	4					
Prepaid Insurance	2					
Land	190					
Equipment	50					
Accum. Depr.—Equipment		7				
Accounts Payable		36				
Wages Payable		1				
Brenda Schultz, Capital		260				
Brenda Schultz, Drawing	8					
Fees Earned		213				
Wages Expense	111					
Rent Expense	12					
Insurance Expense	10					
Utilities Expense	6					
Supplies Expense	4					
Depreciation Expense	3					
Miscellaneous Expense	2					
	<u>517</u>	<u>517</u>				
Net income (loss)						

Appendix

EX 4-26 Financial statements from an end-of-period spreadsheet (work sheet)

Based on the data in Exercise 4-25, prepare an income statement, statement of owner's equity, and balance sheet for Alert Security Services Co.

✓ Brenda Schultz,
capital, October 31,
2014: \$317

SPREADSHEET

Appendix

EX 4-27 Adjusting entries from an end-of-period spreadsheet (work sheet)

Based on the data in Exercise 4-24, prepare the adjusting entries for Alert Security Services Co.

Appendix

EX 4-28 Closing entries from an end-of-period spreadsheet (work sheet)

Based on the data in Exercise 4-25, prepare the closing entries for Alert Security Services Co.

Problems Series A

✓ 3. Total assets:
\$359,500

SPREADSHEET

GENERAL LEDGER

PR 4-1A Financial statements and closing entries

OBJ. 1, 2, 3

Watchdog Company maintains and repairs warning lights, such as those found on radio towers and lighthouses. Watchdog Company prepared the end-of-period spreadsheet shown below at July 31, 2014, the end of the current fiscal year:

	A	B	C	D	E	F	G
1				Watchdog Company			
2				End-of-Period Spreadsheet			
3				For the Year Ended July 31, 2014			
4		Unadjusted				Adjusted	
5		Trial Balance		Adjustments		Trial Balance	
6	Account Title	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
7							
8	Cash	10,800				10,800	
9	Accounts Receivable	38,900		(a) 4,400		43,300	
10	Prepaid Insurance	4,200			(b) 2,500	1,700	
11	Supplies	2,730			(c) 1,830	900	
12	Land	98,000				98,000	
13	Building	400,000				400,000	
14	Accum. Depr.—Building		205,300		(d) 1,600		206,900
15	Equipment	101,000				101,000	
16	Accum. Depr.—Equipment		85,100		(e) 4,200		89,300
17	Accounts Payable		15,700				15,700
18	Salaries & Wages Payable				(f) 1,800		1,800
19	Unearned Rent		2,100	(g) 1,000			1,100
20	Ted Hickman, Capital		203,100				203,100
21	Ted Hickman, Drawing	10,000				10,000	
22	Fees Earned		363,700		(a) 4,400		368,100
23	Rent Revenue				(g) 1,000		1,000
24	Salaries & Wages Expense	163,100		(f) 1,800		164,900	
25	Advertising Expense	21,700				21,700	
26	Utilities Expense	11,400				11,400	
27	Repairs Expense	8,850				8,850	
28	Depr. Exp.—Equipment			(e) 4,200		4,200	
29	Insurance Expense			(b) 2,500		2,500	
30	Supplies Expense			(c) 1,830		1,830	
31	Depr. Exp.—Building			(d) 1,600		1,600	
32	Misc. Expense	4,320				4,320	
33		875,000	875,000	17,330	17,330	887,000	887,000
34							

Instructions

1. Prepare an income statement for the year ended July 31.
2. Prepare a statement of owner's equity for the year ended July 31. No additional investments were made during the year.
3. Prepare a balance sheet as of July 31.
4. Based upon the end-of-period spreadsheet, journalize the closing entries.
5. Prepare a post-closing trial balance.

PR 4-2A Financial statements and closing entries

OBJ. 2, 3

Ironside Security Services is an investigative services firm that is owned and operated by Don Chadwell. On April 30, 2014, the end of the current fiscal year, the accountant for Ironside Security Services prepared an end-of-period spreadsheet, a part of which is shown on the next page.

✓ 1. Don Chadwell,
capital, April 30:
\$242,300

Instructions

1. For each account listed in the trial balance, enter the balance in the appropriate Balance column of a four-column account and place a check mark (✓) in the Posting Reference column.
2. (Optional.) Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet. Add the accounts listed in part (3) as needed.
3. Journalize and post the adjusting entries, inserting balances in the accounts affected. Record the adjusting entries on Page 26 of the journal. The following additional accounts from Lakota Freight Co.'s chart of accounts should be used: Wages Payable, 22; Supplies Expense, 52; Depreciation Expense—Equipment, 55; Depreciation Expense—Trucks, 56; Insurance Expense, 57.
4. Prepare an adjusted trial balance.
5. Prepare an income statement, a statement of owner's equity (no additional investments were made during the year), and a balance sheet.
6. Journalize and post the closing entries. Record the closing entries on Page 27 of the journal. (Income Summary is account #33 in the chart of accounts.) Indicate closed accounts by inserting a line in both Balance columns opposite the closing entry.
7. Prepare a post-closing trial balance.

✓ 8. Net income:
\$33,475

SPREADSHEET

PR 4-5A Complete accounting cycle**OBJ. 4, 5**

For the past several years, Steffy Lopez has operated a part-time consulting business from his home. As of July 1, 2014, Steffy decided to move to rented quarters and to operate the business, which was to be known as Diamond Consulting, on a full-time basis. Diamond Consulting entered into the following transactions during July:

- July 1. The following assets were received from Steffy Lopez: cash, \$13,500; accounts receivable, \$20,800; supplies, \$3,200; and office equipment, \$7,500. There were no liabilities received.
1. Paid two months' rent on a lease rental contract, \$4,800.
 2. Paid the premiums on property and casualty insurance policies, \$4,500.
 4. Received cash from clients as an advance payment for services to be provided and recorded it as unearned fees, \$5,500.
 5. Purchased additional office equipment on account from Office Station Co., \$6,500.
 6. Received cash from clients on account, \$15,300.
 10. Paid cash for a newspaper advertisement, \$400.
 12. Paid Office Station Co. for part of the debt incurred on July 5, \$5,200.
 12. Recorded services provided on account for the period July 1–12, \$13,300.
 14. Paid receptionist for two weeks' salary, \$1,750.

Record the following transactions on Page 2 of the journal.

17. Recorded cash from cash clients for fees earned during the period July 1–17, \$9,450.
18. Paid cash for supplies, \$600.
20. Recorded services provided on account for the period July 13–20, \$6,650.
24. Recorded cash from cash clients for fees earned for the period July 17–24, \$4,000.
26. Received cash from clients on account, \$12,000.
27. Paid receptionist for two weeks' salary, \$1,750.
29. Paid telephone bill for July, \$325.
31. Paid electricity bill for July, \$675.
31. Recorded cash from cash clients for fees earned for the period July 25–31, \$5,200.

(Continued)

- July 31. Recorded services provided on account for the remainder of July, \$3,000.
 31. Steffy withdrew \$12,500 for personal use.

Instructions

- Journalize each transaction in a two-column journal starting on Page 1, referring to the following chart of accounts in selecting the accounts to be debited and credited. (Do not insert the account numbers in the journal at this time.)

11 Cash	31 Steffy Lopez, Capital
12 Accounts Receivable	32 Steffy Lopez, Drawing
14 Supplies	41 Fees Earned
15 Prepaid Rent	51 Salary Expense
16 Prepaid Insurance	52 Rent Expense
18 Office Equipment	53 Supplies Expense
19 Accumulated Depreciation	54 Depreciation Expense
21 Accounts Payable	55 Insurance Expense
22 Salaries Payable	59 Miscellaneous Expense
23 Unearned Fees	
- Post the journal to a ledger of four-column accounts.
- Prepare an unadjusted trial balance.
- At the end of July, the following adjustment data were assembled. Analyze and use these data to complete parts (5) and (6).
 - Insurance expired during July is \$375.
 - Supplies on hand on July 31 are \$1,525.
 - Depreciation of office equipment for July is \$750.
 - Accrued receptionist salary on July 31 is \$175.
 - Rent expired during July is \$2,400.
 - Unearned fees on July 31 are \$2,750.
- (Optional.) Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet.
- Journalize and post the adjusting entries. Record the adjusting entries on Page 3 of the journal.
- Prepare an adjusted trial balance.
- Prepare an income statement, a statement of owner's equity, and a balance sheet.
- Prepare and post the closing entries. (Income Summary is account #33 in the chart of accounts.) Record the closing entries on Page 4 of the journal. Indicate closed accounts by inserting a line in both the Balance columns opposite the closing entry.
- Prepare a post-closing trial balance.

Problems Series B

✓ 3. Total assets:
\$342,425

SPREADSHEET

GENERAL LEDGER

PR 4-1B Financial statements and closing entries

OBJ. 1, 2, 3

Last Chance Company offers legal consulting advice to prison inmates. Last Chance Company prepared the end-of-period spreadsheet at the top of the following page at June 30, 2014, the end of the current fiscal year.

Instructions

- Prepare an income statement for the year ended June 30.
- Prepare a statement of owner's equity for the year ended June 30. No additional investments were made during the year.
- Prepare a balance sheet as of June 30.
- On the basis of the end-of-period spreadsheet, journalize the closing entries.
- Prepare a post-closing trial balance.

	A	B	C	D	E	F	G
1	Last Chance Company						
2	End-of-Period Spreadsheet						
3	For the Year Ended June 30, 2014						
4		Unadjusted				Adjusted	
5		Trial Balance		Adjustments		Trial Balance	
6	Account Title	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
7							
8	Cash	5,100				5,100	
9	Accounts Receivable	22,750		(a) 3,750		26,500	
10	Prepaid Insurance	3,600			(b) 1,300	2,300	
11	Supplies	2,025			(c) 1,500	525	
12	Land	80,000				80,000	
13	Building	340,000				340,000	
14	Accum. Depr.—Building		190,000		(d) 3,000		193,000
15	Equipment	140,000				140,000	
16	Accum. Depr.—Equipment		54,450		(e) 4,550		59,000
17	Accounts Payable		9,750			9,750	
18	Salaries & Wages Payable				(f) 1,900		1,900
19	Unearned Rent		4,500	(g) 3,000			1,500
20	Tami Garrigan, Capital		361,300				361,300
21	Tami Garrigan, Drawing	20,000				20,000	
22	Fees Earned		280,000		(a) 3,750		283,750
23	Rent Revenue				(g) 3,000		3,000
24	Salaries & Wages Expense	145,100		(f) 1,900		147,000	
25	Advertising Expense	86,800				86,800	
26	Utilities Expense	30,000				30,000	
27	Travel Expense	18,750				18,750	
28	Depr. Exp.—Equipment			(e) 4,550		4,550	
29	Depr. Exp.—Building			(d) 3,000		3,000	
30	Supplies Expense			(c) 1,500		1,500	
31	Insurance Expense			(b) 1,300		1,300	
32	Misc. Expense	5,875				5,875	
33		900,000	900,000	19,000	19,000	913,200	913,200
34							

PR 4-2B Financial statements and closing entries**OBJ. 2, 3**

✓ 1. Nicole Gorman,
capital, October 31:
\$313,000

The Gorman Group is a financial planning services firm owned and operated by Nicole Gorman. As of October 31, 2014, the end of the current fiscal year, the accountant for The Gorman Group prepared an end-of-period spreadsheet (work sheet), part of which is shown below.

	A	F	G
1	The Gorman Group		
2	End-of-Period Spreadsheet		
3	For the Year Ended October 31, 2014		
4		Adjusted	
5		Trial Balance	
6	Account Title	Dr.	Cr.
7			
8	Cash	11,000	
9	Accounts Receivable	28,150	
10	Supplies	6,350	
11	Prepaid Insurance	9,500	
12	Land	75,000	
13	Buildings	250,000	
14	Accumulated Depreciation—Buildings		117,200
15	Equipment	240,000	
16	Accumulated Depreciation—Equipment		151,700
17	Accounts Payable		33,300
18	Salaries Payable		3,300
19	Unearned Rent		1,500
20	Nicole Gorman, Capital		220,000
21	Nicole Gorman, Drawing	20,000	
22	Service Fees		468,000
23	Rent Revenue		5,000
24	Salaries Expense	291,000	
25	Depreciation Expense—Equipment	17,500	
26	Rent Expense	15,500	
27	Supplies Expense	9,000	
28	Utilities Expense	8,500	
29	Depreciation Expense—Buildings	6,600	
30	Repairs Expense	3,450	
31	Insurance Expense	3,000	
32	Miscellaneous Expense	5,450	
33		1,000,000	1,000,000

(Continued)

Instructions

1. Prepare an income statement, a statement of owner's equity (no additional investments were made during the year), and a balance sheet.
2. Journalize the entries that were required to close the accounts at October 31.
3. If the balance of Nicole Gorman, Capital had instead increased \$115,000 after the closing entries were posted, and the withdrawals remained the same, what would have been the amount of net income or net loss?

PR 4-3B T accounts, adjusting entries, financial statements, and closing entries; optional end-of-period spreadsheet (work sheet)

OBJ. 2, 3

✓ 5. Net income: \$27,350

GENERAL LEDGER

The unadjusted trial balance of La Mesa Laundry at August 31, 2014, the end of the current fiscal year, is shown below.

	Debit Balances	Credit Balances
Cash	3,800	
Laundry Supplies	9,000	
Prepaid Insurance	6,000	
Laundry Equipment	180,800	
Accumulated Depreciation		49,200
Accounts Payable		7,800
Bobbi Downey, Capital		95,000
Bobbi Downey, Drawing	2,400	
Laundry Revenue		248,000
Wages Expense	135,800	
Rent Expense	43,200	
Utilities Expense	16,000	
Miscellaneous Expense	3,000	
	400,000	400,000

The data needed to determine year-end adjustments are as follows:

- a. Wages accrued but not paid at August 31 are \$2,200.
- b. Depreciation of equipment during the year is \$8,150.
- c. Laundry supplies on hand at August 31 are \$2,000.
- d. Insurance premiums expired during the year are \$5,300.

Instructions

1. For each account listed in the unadjusted trial balance, enter the balance in a T account. Identify the balance as "Aug. 31 Bal." In addition, add T accounts for Wages Payable, Depreciation Expense, Laundry Supplies Expense, Insurance Expense, and Income Summary.
2. (Optional.) Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet. Add the accounts listed in part (1) as needed.
3. Journalize and post the adjusting entries. Identify the adjustments by "Adj." and the new balances as "Adj. Bal."
4. Prepare an adjusted trial balance.
5. Prepare an income statement, a statement of owner's equity (no additional investments were made during the year), and a balance sheet.
6. Journalize and post the closing entries. Identify the closing entries by "Clos."
7. Prepare a post-closing trial balance.

✓ 5. Net income:
\$46,150

SPREADSHEET

PR 4-4B Ledger accounts, adjusting entries, financial statements,
and closing entries; optional end-of-period spreadsheet (work sheet)

OBJ. 2, 3

The unadjusted trial balance of Recessive Interiors at January 31, 2014, the end of the current year, is shown below.

Recessive Interiors Unadjusted Trial Balance January 31, 2014		Debit Balances	Credit Balances
11	Cash	13,100	
13	Supplies	8,000	
14	Prepaid Insurance	7,500	
16	Equipment	113,000	
17	Accumulated Depreciation—Equipment		12,000
18	Trucks	90,000	
19	Accumulated Depreciation—Trucks		27,100
21	Accounts Payable		4,500
31	Jeanne McQuay, Capital		126,400
32	Jeanne McQuay, Drawing	3,000	
41	Service Revenue		155,000
51	Wages Expense	72,000	
52	Rent Expense	7,600	
53	Truck Expense	5,350	
59	Miscellaneous Expense	5,450	
		325,000	325,000

The data needed to determine year-end adjustments are as follows:

- a. Supplies on hand at January 31 are \$2,850.
- b. Insurance premiums expired during the year are \$3,150.
- c. Depreciation of equipment during the year is \$5,250.
- d. Depreciation of trucks during the year is \$4,000.
- e. Wages accrued but not paid at January 31 are \$900.

Instructions

1. For each account listed in the unadjusted trial balance, enter the balance in the appropriate Balance column of a four-column account and place a check mark (✓) in the Posting Reference column.
2. (Optional.) Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet. Add the accounts listed in part (3) as needed.
3. Journalize and post the adjusting entries, inserting balances in the accounts affected. Record the adjusting entries on Page 26 of the journal. The following additional accounts from Recessive Interiors' chart of accounts should be used: Wages Payable, 22; Depreciation Expense—Equipment, 54; Supplies Expense, 55; Depreciation Expense—Trucks, 56; Insurance Expense, 57.
4. Prepare an adjusted trial balance.
5. Prepare an income statement, a statement of owner's equity (no additional investments were made during the year), and a balance sheet.
6. Journalize and post the closing entries. Record the closing entries on Page 27 of the journal. (Income Summary is account #33 in the chart of accounts.) Indicate closed accounts by inserting a line in both Balance columns opposite the closing entry.
7. Prepare a post-closing trial balance.

✓ 8. Net income:
\$53,775

SPREADSHEET

PR 4-5B Complete accounting cycle

OBJ. 4, 5

For the past several years, Jeff Horton has operated a part-time consulting business from his home. As of April 1, 2014, Jeff decided to move to rented quarters and to operate the

(Continued)

3. Journalize and post the closing entries. The income summary account is #33 in the ledger of PS Music. Indicate closed accounts by inserting a line in both Balance columns opposite the closing entry.
4. Prepare a post-closing trial balance.

Comprehensive Problem 1

✓ 8. Net income,
\$33,425

GENERAL LEDGER

Kelly Pitney began her consulting business, Kelly Consulting, on April 1, 2014. The accounting cycle for Kelly Consulting for April, including financial statements, was illustrated on pages 163–173. During May, Kelly Consulting entered into the following transactions:

- May 3. Received cash from clients as an advance payment for services to be provided and recorded it as unearned fees, \$4,500.
5. Received cash from clients on account, \$2,450.
 9. Paid cash for a newspaper advertisement, \$225.
 13. Paid Office Station Co. for part of the debt incurred on April 5, \$640.
 15. Recorded services provided on account for the period May 1–15, \$9,180.
 16. Paid part-time receptionist for two weeks' salary including the amount owed on April 30, \$750.
 17. Recorded cash from cash clients for fees earned during the period May 1–16, \$8,360.

Record the following transactions on Page 6 of the journal.

20. Purchased supplies on account, \$735.
21. Recorded services provided on account for the period May 16–20, \$4,820.
25. Recorded cash from cash clients for fees earned for the period May 17–23, \$7,900.
27. Received cash from clients on account, \$9,520.
28. Paid part-time receptionist for two weeks' salary, \$750.
30. Paid telephone bill for May, \$260.
31. Paid electricity bill for May, \$810.
31. Recorded cash from cash clients for fees earned for the period May 26–31, \$3,300.
31. Recorded services provided on account for the remainder of May, \$2,650.
31. Kelly withdrew \$10,500 for personal use.

Instructions

1. The chart of accounts for Kelly Consulting is shown on page 164, and the post-closing trial balance as of April 30, 2014, is shown on page 171. For each account in the post-closing trial balance, enter the balance in the appropriate Balance column of a four-column account. Date the balances May 1, 2014, and place a check mark (✓) in the Posting Reference column. Journalize each of the May transactions in a two-column journal starting on Page 5 of the journal and using Kelly Consulting's chart of accounts. (Do not insert the account numbers in the journal at this time.)
2. Post the journal to a ledger of four-column accounts.
3. Prepare an unadjusted trial balance.
4. At the end of May, the following adjustment data were assembled. Analyze and use these data to complete parts (5) and (6).
 - a. Insurance expired during May is \$275.
 - b. Supplies on hand on May 31 are \$715.
 - c. Depreciation of office equipment for May is \$330.
 - d. Accrued receptionist salary on May 31 is \$325.
 - e. Rent expired during May is \$1,600.
 - f. Unearned fees on May 31 are \$3,210.

5. (Optional.) Enter the unadjusted trial balance on an end-of-period spreadsheet (work sheet) and complete the spreadsheet.
6. Journalize and post the adjusting entries. Record the adjusting entries on page 7 of the journal.
7. Prepare an adjusted trial balance.
8. Prepare an income statement, a statement of owner's equity, and a balance sheet.
9. Prepare and post the closing entries. Record the closing entries on Page 8 of the journal. (Income Summary is account #33 in the chart of accounts.) Indicate closed accounts by inserting a line in both the Balance columns opposite the closing entry.
10. Prepare a post-closing trial balance.


Cases & Projects



CP 4-1 Ethics and professional conduct in business

Picasso Graphics is a graphics arts design consulting firm. Pablo Taylor, its treasurer and vice president of finance, has prepared a classified balance sheet as of July 31, 2014, the end of its fiscal year. This balance sheet will be submitted with Picasso Graphics' loan application to Paris Trust & Savings Bank.

In the Current Assets section of the balance sheet, Pablo reported a \$56,000 receivable from Becky Holt, the president of Picasso Graphics, as a trade account receivable. Becky borrowed the money from Picasso Graphics in January 2012 for a down payment on a new home. She has orally assured Pablo that she will pay off the account receivable within the next year. Pablo reported the \$56,000 in the same manner on the preceding year's balance sheet.

 Evaluate whether it is acceptable for Pablo to prepare the July 31, 2014, balance sheet in the manner indicated above.

CP 4-2 Financial statements

The following is an excerpt from a telephone conversation between Ben Simpson, president of Main Street Co., and Tami Lundgren, owner of Reliable Employment Co.

Ben: Tami, you're going to have to do a better job of finding me a new computer programmer. That last guy was great at programming, but he didn't have any common sense.

Tami: What do you mean? The guy had a master's degree with straight A's.

Ben: Yes, well, last month he developed a new financial reporting system. He said we could do away with manually preparing an end-of-period spreadsheet (work sheet) and financial statements. The computer would automatically generate our financial statements with "a push of a button."

Tami: So what's the big deal? Sounds to me like it would save you time and effort.

Ben: Right! The balance sheet showed a minus for supplies!

Tami: Minus supplies? How can that be?

Ben: That's what I asked.



Tami: So, what did he say?

Ben: Well, after he checked the program, he said that it must be right. The minuses were greater than the pluses. . . .

Tami: Didn't he know that Supplies can't have a credit balance—it must have a debit balance?

Ben: He asked me what a debit and credit were.



Tami: I see your point.

1.  Comment on (a) the desirability of computerizing Main Street Co.'s financial reporting system, (b) the elimination of the end-of-period spreadsheet (work sheet) in a computerized accounting system, and (c) the computer programmer's lack of accounting knowledge.
2.  Explain to the programmer why Supplies could not have a credit balance.

CP 4-3 Financial statements

Assume that you recently accepted a position with Five Star National Bank & Trust as an assistant loan officer. As one of your first duties, you have been assigned the responsibility of evaluating a loan request for \$300,000 from West Gate Auto Co., a small proprietorship. In support of the loan application, Joan Whalen, owner, submitted a "Statement of Accounts" (trial balance) for the first year of operations ended October 31, 2014.

West Gate Auto Co. Statement of Accounts October 31, 2014		
Cash	5,000	
Billings Due from Others	40,000	
Supplies (chemicals, etc.)	7,500	
Building	222,300	
Equipment	50,000	
Amounts Owed to Others		31,000
Investment in Business		179,000
Service Revenue		215,000
Wages Expense	75,000	
Utilities Expense	10,000	
Rent Expense	8,000	
Insurance Expense	6,000	
Other Expenses	1,200	
	425,000	425,000

1.  Explain to Joan Whalen why a set of financial statements (income statement, statement of owner's equity, and balance sheet) would be useful to you in evaluating the loan request.
2. In discussing the "Statement of Accounts" with Joan Whalen, you discovered that the accounts had not been adjusted at October 31. Analyze the "Statement of Accounts" and indicate possible adjusting entries that might be necessary before an accurate set of financial statements could be prepared.
3.  Assuming that an accurate set of financial statements will be submitted by Joan Whalen in a few days, what other considerations or information would you require before making a decision on the loan request?

Internet Project**CP 4-4 Compare balance sheets****Group Project**

In groups of three or four, compare the balance sheets of two different companies, and present to the class a summary of the similarities and differences of the two companies. You may obtain the balance sheets you need from one of the following sources:

1. Your school or local library.
2. The investor relations department of each company.
3. The company's Web site on the Internet.
4. EDGAR (Electronic Data Gathering, Analysis, and Retrieval), the electronic archives of financial statements filed with the Securities and Exchange Commission.

SEC documents can be retrieved using the EdgarScan™ service at <http://sec.gov>. To obtain annual report information, under Filings & Forms click on "Search for Company Filings," click on "Company or fund name, ticker symbol, ..." type in the company name, and then click on "Find Companies." Click on the CIK related to the company name, search for Form 10-K, and click on "Retrieve Selected Findings." Finally, click on the "html" for the latest period and the related document.



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Accounting Systems

Intuit Inc.

Whether you realize it or not, you likely interact with accounting systems. For example, your bank statement is a type of accounting system. When you make a deposit, the bank records an addition to your cash; when you withdraw cash, the bank records a reduction in your cash. Such a simple accounting system works well for a person with just a few transactions per month. However, over time, you may find that your financial affairs will become more complex and involve many different types of transactions, including investments and loan payments. At this point, relying on your bank statement may not be sufficient for managing your financial affairs. Personal financial planning software, such as **Intuit's** Quicken, can be useful when your financial affairs become more complex.

What happens if you decide to begin a small business? Transactions expand to include

customers, vendors, and employees. As a result, the accounting system will need to adjust to this complexity. Thus, many small businesses will use small-business accounting software, such as Intuit's QuickBooks, as their first accounting system. As a business grows, more sophisticated accounting systems will be needed. Companies such as **SAP, Oracle, Microsoft, and Sage Software, Inc.**, offer accounting system solutions for businesses that become larger with more complex accounting needs.

Accounting systems used by large and small businesses employ the basic principles of the accounting cycle discussed in the previous chapters. However, these accounting systems include features that simplify the recording and summary process. In this chapter, we will discuss these simplifying procedures as they apply to both manual and computerized systems.



Learning Objectives

After studying this chapter, you should be able to:

Example Exercises

- | | | |
|--------------|--|--------|
| OBJ 1 | Define and describe an accounting system.
Basic Accounting Systems | |
| OBJ 2 | Journalize and post transactions in a manual accounting system that uses subsidiary ledgers and special journals.
Manual Accounting Systems | |
| | Subsidiary Ledgers | |
| | Special Journals | |
| | Revenue Journal | EE 5-1 |
| | Cash Receipts Journal | |
| | Accounts Receivable Control Account and Subsidiary Ledger | EE 5-2 |
| | Purchases Journal | EE 5-3 |
| | Cash Payments Journal | |
| | Accounts Payable Control Account and Subsidiary Ledger | EE 5-4 |
| OBJ 3 | Describe and illustrate the use of a computerized accounting system.
Computerized Accounting Systems | |
| OBJ 4 | Describe the basic features of e-commerce.
E-Commerce | |
| OBJ 5 | Use segment analysis in evaluating the operating performance of a company.
Financial Analysis and Interpretation: Segment Analysis | EE 5-5 |

At a Glance 5 Page 225

- OBJ 1** Define and describe an accounting system.

Basic Accounting Systems

In Chapters 1–4, an accounting system for NetSolutions was described and illustrated. An **accounting system** is the methods and procedures for collecting, classifying, summarizing, and reporting a business's financial and operating information. Most accounting systems, however, are more complex than NetSolutions'. For example, **Southwest Airlines**'s accounting system not only records basic transaction data, but also records data on such items as ticket reservations, credit card collections, frequent-flier mileage, and aircraft maintenance.

As a business grows and changes, its accounting system also changes in a three-step process. This three-step process is as follows:

- Step 1. *Analyze* user information needs.
- Step 2. *Design* the system to meet the user needs.
- Step 3. *Implement* the system.

For NetSolutions, our analysis determined that Chris Clark needed financial statements for the new business. We designed the system, using a basic manual system that included a chart of accounts, a two-column journal, and a general ledger. Finally, we implemented the system to record transactions and prepare financial statements.

Once a system has been implemented, input from users is used to analyze and improve the system. For example, in later chapters, NetSolutions expands its chart of accounts to record more complex transactions.

The accounting system design consists of:

1. internal controls and
2. information processing methods.



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As shown above, transactions that are recorded in the revenue and cash receipts journals will affect the accounts receivable subsidiary ledger. Likewise, transactions that are recorded in the purchases and cash payments journals will affect the accounts payable subsidiary ledger.

We will assume that NetSolutions had the following selected general ledger balances on March 1, 2014:

Account Number	Account	Balance
11	Cash	\$6,200
12	Accounts Receivable	3,400
14	Supplies	2,500
18	Office Equipment	2,500
21	Accounts Payable	1,230

Revenue Journal

Fees earned on account would be recorded in the **revenue journal**. *Cash fees earned* would be recorded in the cash receipts journal.

To illustrate the efficiency of using a revenue journal, an example for NetSolutions is used. Specifically, assume that NetSolutions recorded the following four revenue transactions for March in its general journal:

2014						
Mar.	2	Accounts Receivable—Accessories By Claire	12/✓	2,200		
		Fees Earned	41		2,200	
	6	Accounts Receivable—RapZone	12/✓	1,750		
		Fees Earned	41		1,750	
	18	Accounts Receivable—Web Cantina	12/✓	2,650		
		Fees Earned	41		2,650	
	27	Accounts Receivable—Accessories By Claire	12/✓	3,000		
		Fees Earned	41		3,000	

For the above entries, NetSolutions recorded eight accounts and eight amounts. In addition, NetSolutions made 12 postings to the ledgers—four to Accounts Receivable in the general ledger, four to the accounts receivable subsidiary ledger (indicated by each check mark), and four to Fees Earned in the general ledger.

The preceding revenue transactions could be recorded more efficiently in a revenue journal, as shown in Exhibit 2. In each revenue transaction, the amount of the debit to Accounts Receivable is the same as the amount of the credit to Fees Earned. Thus, only a single amount column is necessary. The date, invoice number, customer name, and amount are entered separately for each transaction.

Revenues are normally recorded in the revenue journal when the company sends an invoice to the customer. An **invoice** is the bill that is sent to the customer by the company. Each invoice is normally numbered in sequence for future reference.

To illustrate, assume that on March 2 NetSolutions issued Invoice No. 615 to Accessories By Claire for fees earned of \$2,200. This transaction is entered in the revenue journal, shown in Exhibit 2, by entering the following items:

1. Date column: *Mar. 2*
2. Invoice No. column: *615*

EXHIBIT 2

Revenue Journal

Revenue Journal					Page 35
Date	Invoice No.	Account Debited	Post. Ref.	Accts. Rec. Dr.	Fees Earned Cr.
2014					
Mar.	2	615			2,200
	6	616			1,750
	18	617			2,650
	27	618			3,000
	31				<u>9,600</u>

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- Account Debited column: *Accessories By Claire*
- Accts. Rec. Dr./Fees Earned Cr. column: *2,200*

The process of posting from a revenue journal, shown in Exhibit 3, is as follows:

- Each transaction is posted individually to a customer account in the accounts receivable subsidiary ledger. Postings to customer accounts should be made on a regular basis. In this way, the customer's account will show a current balance. Since the balances in the customer accounts are usually debit balances, the three-column account form is shown in Exhibit 3.

To illustrate, Exhibit 3 shows the posting of the \$2,200 debit to Accessories By Claire in the accounts receivable subsidiary ledger. After the posting, Accessories By Claire has a debit balance of \$2,200.

- To provide a trail of the entries posted to the subsidiary and general ledger, the source of these entries is indicated in the Posting Reference column of each account by inserting the letter R (for revenue journal) and the page number of the revenue journal.

To illustrate, Exhibit 3 shows that after \$2,200 is posted to Accessories By Claire's account, R35 is inserted into the Post. Ref. column of the account.

- To indicate that the transaction has been posted to the accounts receivable subsidiary ledger, a check mark (✓) is inserted in the Post. Ref. column of the revenue journal, as shown in Exhibit 3.

To illustrate, Exhibit 3 shows that a check mark (✓) has been inserted in the Post. Ref. column next to Accessories By Claire in the revenue journal to indicate that the \$2,200 has been posted.

- A single monthly total is posted to Accounts Receivable and Fees Earned in the general ledger. This total is equal to the sum of the month's debits to the individual accounts in the subsidiary ledger. It is posted in the general ledger as a debit to Accounts Receivable and a credit to Fees Earned, as shown in Exhibit 3. The accounts receivable account number (12) and the fees earned account number (41) are then inserted below the total in the revenue journal to indicate that the posting is completed.

To illustrate, Exhibit 3 shows the monthly total of \$9,600 was posted as a debit to Accounts Receivable (12) and as a credit to Fees Earned (41).

Exhibit 3 illustrates the efficiency gained by using the revenue journal rather than the general journal. Specifically, all of the transactions for fees earned during the month are posted to the general ledger only once—at the end of the month.

EXHIBIT 3

Revenue Journal and Postings

Revenue Journal							Page 35	
Date	Invoice No.	Account Debited	Post. Ref.	Accts. Rec. Dr.			Fees Earned Cr.	
2014 Mar. 2	615	Accessories By Claire	✓	2,200				
6	616	RapZone	✓	1,750				
18	617	Web Cantina	✓	2,650				
27	618	Accessories By Claire	✓	3,000				
31				9,600				
							(12) (41)	

General Ledger						
Account Accounts Receivable					Account No. 12	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014 Mar. 1	Balance	✓			3,400	
31		R35	9,600		13,000	

Account Fees Earned						
Account Fees Earned					Account No. 41	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014 Mar. 31		R35		9,600	9,600	

Accounts Receivable Subsidiary Ledger						
Name: Accessories By Claire						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 2		R35	2,200		2,200	
27		R35	3,000		5,200	

Name: RapZone						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 6		R35	1,750		1,750	

Name: Web Cantina						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 1	Balance	✓			3,400	
18		R35	2,650		6,050	

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Example Exercise 5-1 Revenue Journal

OBJ 2

The following revenue transactions occurred during December:

- Dec. 5. Issued Invoice No. 302 to Butler Company for services provided on account, \$5,000.
- 9. Issued Invoice No. 303 to JoJo Enterprises for services provided on account, \$2,100.
- 15. Issued Invoice No. 304 to Double D Inc. for services provided on account, \$3,250.

Record these transactions in a revenue journal as illustrated in Exhibit 2.

Follow My Example 5-1

REVENUE JOURNAL				
Date	Invoice No.	Account Debited	Post. Ref.	Accts. Rec. Dr. Fees Earned Cr.
Dec. 5	302	Butler Company		5,000
9	303	JoJo Enterprises		2,100
15	304	Double D Inc.		3,250

Practice Exercises: **PE 5-1A, PE 5-1B**

Cash Receipts Journal

All transactions that involve the receipt of cash are recorded in a **cash receipts journal**. The cash receipts journal for NetSolutions is shown in Exhibit 4.

This journal has a Cash Dr. column. The types of cash receipt transactions and their frequency determine the titles of the other columns. For example, NetSolutions often receives cash from customers on account. Thus, the cash receipts journal in Exhibit 4 has an Accounts Receivable Cr. column.

To illustrate, on March 28 Accessories By Claire made a payment of \$2,200 on its account. This transaction is recorded in the cash receipts journal, shown in Exhibit 4, by entering the following items:

1. Date column: *Mar. 28*
2. Account Credited column: *Accessories By Claire*

EXHIBIT 4 Cash Receipts Journal and Postings

Cash Receipts Journal						Page 14	
Date	Account Credited	Post. Ref.	Other Accounts Cr.	Accounts Receivable Cr.	Cash Dr.		
2014 Mar. 1	Rent Revenue	42	400		400		
19	Web Cantina	✓		3,400	3,400		
28	Accessories By Claire	✓		2,200	2,200		
30	RapZone	✓		1,750	1,750		
31			400 (✓)	7,350 (12)	7,750 (11)		

General Ledger						
Account Cash			Account No. 11			
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014 Mar. 1	Balance	✓			6,200	
31		CR14	7,750		13,950	

Accounts Receivable Subsidiary Ledger						
Name: Accessories By Claire						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 2		R35	2,200			2,200
27		R35	3,000			5,200
28		CR14		2,200		3,000

Name: RapZone						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 6		R35	1,750			1,750
30		CR14		1,750		—

Name: Web Cantina						
Date	Item	Post. Ref.	Debit	Credit	Balance	
2014 Mar. 1	Balance	✓				3,400
18		R35	2,650			6,050
19		CR14		3,400		2,650

Account Accounts Receivable						
Account Accounts Receivable			Account No. 12			
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014 Mar. 1	Balance	✓			3,400	
31		R35	9,600		13,000	
31		CR14		7,350	5,650	

Account Rent Revenue						
Account Rent Revenue			Account No. 42			
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014 Mar. 1		CR14		400		400

3. Accounts Receivable Cr. column: 2,200
4. Cash Dr. column: 2,200

The Other Accounts Cr. column in Exhibit 4 is used for recording credits to any account for which there is no special credit column. For example, NetSolutions received cash on March 1 for rent. Since no special column exists for Rent Revenue, Rent Revenue is entered in the Account Credited column. Thus, this transaction is recorded in the cash receipts journal, shown in Exhibit 4, by entering the following items:

1. Date column: *Mar. 1*
2. Account Credited column: *Rent Revenue*
3. Other Accounts Cr. column: *400*
4. Cash Dr. column: *400*

At the end of the month, all of the amount columns are totaled. The debits must equal the credits. If the debits do not equal the credits, an error has occurred. Before proceeding further, the error must be found and corrected.

The process of posting from the cash receipts journal, shown in Exhibit 4, is:

1. Each transaction involving the receipt of cash on account is posted individually to a customer account in the accounts receivable subsidiary ledger. Postings to customer accounts should be made on a regular basis. In this way, the customer's account will show a current balance.

To illustrate, Exhibit 4 shows on March 19 the receipt of \$3,400 on account from Web Cantina. The posting of the \$3,400 credit to Web Cantina in the accounts receivable subsidiary ledger is also shown in Exhibit 4. After the posting, Web Cantina has a debit balance of \$2,650. If a posting results in a customer's account with a credit balance, the credit balance is indicated by an asterisk or parentheses in the Balance column. If an account's balance is zero, a line may be drawn in the Balance column.

2. To provide a trail of the entries posted to the subsidiary ledger, the source of these entries is indicated in the Posting Reference column of each account by inserting the letter CR (for cash receipts journal) and the page number of the cash receipts journal.

To illustrate, Exhibit 4 shows that after \$3,400 is posted to Web Cantina's account in the accounts receivable subsidiary ledger, CR14 is inserted into the Post. Ref. column of the account.

3. To indicate that the transaction has been posted to the accounts receivable subsidiary ledger, a check mark (✓) is inserted in the Posting Reference column of the cash receipts journal.

To illustrate, Exhibit 4 shows that a check mark (✓) has been inserted in the Post. Ref. column next to Web Cantina to indicate that the \$3,400 has been posted.

4. A single monthly total of the Accounts Receivable Cr. column is posted to the accounts receivable general ledger account. This is the total cash received on account and is posted as a credit to Accounts Receivable. The accounts receivable account number (12) is then inserted below the Accounts Receivable Cr. column to indicate that the posting is complete.

To illustrate, Exhibit 4 shows the monthly total of \$7,350 was posted as a credit to Accounts Receivable (12).

5. A single monthly total of the Cash Dr. column is posted to the cash general ledger account. This is the total cash received during the month and is posted as a debit to Cash. The cash account number (11) is then inserted below the Cash Dr. column to indicate that the posting is complete.

To illustrate, Exhibit 4 shows the monthly total of \$7,750 was posted as a debit to Cash (11).

6. The accounts listed in the Other Accounts Cr. column are posted on a regular basis as a separate credit to each account. The account number is then inserted in the Post. Ref. column to indicate that the posting is complete. Because accounts in the Other Accounts Cr. column are posted individually, a check mark is placed below the column total at the end of the month to show that no further action is needed.

To illustrate, Exhibit 4 shows that \$400 was posted as a credit to Rent Revenue in the general ledger, and the rent revenue account number (42) was entered in the Post. Ref. column of the cash receipts journal. Also, at the end of the month a check mark (✓) is entered below the Other Accounts Cr. column to indicate that no further action is needed.

At the end of the month, all of the amount columns are totaled. The debits must equal the credits. If the debits do not equal the credits, an error has occurred. Before proceeding further, the error must be found and corrected.

The process of posting from the purchases journal shown in Exhibit 5 is as follows:

1. Each transaction involving a purchase on account is posted individually to a creditor's account in the accounts payable subsidiary ledger. Postings to creditor accounts should be made on a regular basis. In this way, the creditor's account will show a current balance.

To illustrate, Exhibit 5 shows on March 3 the purchase of supplies of \$600 on account from Howard Supplies. The posting of the \$600 credit to Howard Supplies accounts payable subsidiary ledger is also shown in Exhibit 5. After the posting, Howard Supplies has a credit balance of \$600.

2. To provide a trail of the entries posted to the subsidiary and general ledgers, the source of these entries is indicated in the Posting Reference column of each account by inserting the letter P (for purchases journal) and the page number of the purchases journal.

To illustrate, Exhibit 5 shows that after \$600 is posted to Howard Supplies account, P11 is inserted into the Post. Ref. column of the account.

3. To indicate that the transaction has been posted to the accounts payable subsidiary ledger, a check mark (✓) is inserted in the Posting Reference column of the purchases journal, as shown in Exhibit 5.

To illustrate, Exhibit 5 shows that a check mark (✓) has been inserted in the Post. Ref. column next to Howard Supplies to indicate that the \$600 has been posted.

4. A single monthly total of the Accounts Payable Cr. column is posted to the accounts payable general ledger account. This is the total amount purchased on account and is posted as a credit to Accounts Payable. The accounts payable account number (21) is then inserted below the Accounts Payable Cr. column to indicate that the posting is complete.

To illustrate, Exhibit 5 shows the monthly total of \$6,230 was posted as a credit to Accounts Payable (21).

5. A single monthly total of the Supplies Dr. column is posted to the supplies general ledger account. This is the total supplies purchased on account during the month and is posted as a debit to Supplies. The supplies account number (14) is then inserted below the Supplies Dr. column to indicate that the posting is complete.

To illustrate, Exhibit 5 shows the monthly total of \$3,430 was posted as a debit to Supplies (14).

6. The accounts listed in the Other Accounts Dr. column are posted on a regular basis as a separate debit to each account. The account number is then inserted in the Post. Ref. column to indicate that the posting is complete. Because accounts in the Other Accounts Dr. column are posted individually, a check mark is placed below the column total at the end of the month to show that no further action is needed.

To illustrate, Exhibit 5 shows that \$2,800 was posted as a debit to Office Equipment in the general ledger, and the office equipment account number (18) was entered in the Post. Ref. column of the purchases journal. Also, at the end of the month, a check mark (✓) is entered below the Amount column to indicate no further action is needed.

Example Exercise 5-3 Purchases Journal



The following purchase transactions occurred during October for Helping Hand Cleaners:

- Oct. 11. Purchased cleaning supplies for \$235, on account, from General Supplies.
- 19. Purchased cleaning supplies for \$110, on account, from Hubble Supplies.
- 24. Purchased office equipment for \$850, on account, from Office Warehouse.

Record these transactions in a purchases journal as illustrated at the top of Exhibit 5.

(Continued)

Follow My Example 5-3

PURCHASES JOURNAL

Date	Account Credited	Post. Ref.	Accounts Payable	Cleaning Supplies	Other Accounts	Post. Ref.	Amount
			Cr.	Dr.	Dr.		
Oct. 11	General Supplies		235	235			
19	Hubble Supplies		110	110			
24	Office Warehouse		850		Office Equipment		850

Practice Exercises: PE 5-3A, PE 5-3B

Cash Payments Journal

All transactions that involve the payment of cash are recorded in a **cash payments journal**. The cash payments journal for NetSolutions is shown in Exhibit 6.

The cash payments journal shown in Exhibit 6 has a Cash Cr. column. The kinds of transactions in which cash is paid and how often they occur determine the titles of the other columns. For example, NetSolutions often pays cash to creditors on account. Thus, the cash payments journal in Exhibit 6 has an Accounts Payable Dr. column. In addition, NetSolutions makes all payments by check. Thus, a check number is entered for each payment in the Ck. No. (Check Number) column to the right of the Date column. The check numbers are helpful in controlling cash payments and provide a useful cross-reference.

To illustrate, on March 15 NetSolutions issued Check No. 151 for \$1,230 to Grayco Supplies for payment on its account. This transaction is recorded in the cash payments journal shown in Exhibit 6 by entering the following items:

1. Date column: *Mar. 15*
2. Ck. No. column: *151*
3. Account Debited column: *Grayco Supplies*
4. Accounts Payable Dr. column: *1,230*
5. Cash Cr. column: *1,230*

The Other Accounts Dr. column in Exhibit 6 is used for recording debits to any account for which there is no special debit column. For example, NetSolutions issued Check No. 150 on March 2 for \$1,600 in payment of March rent. This transaction is recorded in the cash payments journal, shown in Exhibit 6, by entering these items:

1. Date column: *Mar. 2*
2. Ck. No. column: *150*
3. Account Debited column: *Rent Expense*
4. Other Accounts Dr. column: *1,600*
5. Cash Cr. column: *1,600*

At the end of the month, all of the amount columns are totaled. The debits must equal the credits. If the debits do not equal the credits, an error has occurred. Before proceeding further, the error must be found and corrected.

The process of posting from the cash payments journal, Exhibit 6, is as follows:

1. Each transaction involving the payment of cash on account is posted individually to a creditor account in the accounts payable subsidiary ledger. Postings to creditor accounts should be made on a regular basis. In this way, the creditor's account will show a current balance. *To illustrate, Exhibit 6 shows on March 22 the payment of \$420 on account to Donnelly Supplies. The posting of the \$420 debit to Donnelly Supplies in the accounts payable subsidiary ledger is also shown in Exhibit 6. After the posting, Donnelly Supplies has a credit balance of \$1,450.*
2. To provide a trail of the entries posted to the subsidiary and general ledgers, the source of these entries is indicated in the Posting Reference column of each account by inserting the letter CP (for cash payments journal) and the page number of the cash payments journal. *To illustrate, Exhibit 6 shows that after \$420 is posted to Donnelly Supplies account, CP7 is inserted into the Post. Ref. column of the account.*

EXHIBIT 6 Cash Payments Journal and Postings

Cash Payments Journal							Page 7
Date	Ck. No.	Account Debited	Post. Ref.	Other Accounts Dr.	Accounts Payable Dr.	Cash Cr.	
2014							
Mar. 2	150	Rent Expense	52	1,600		1,600	
15	151	Grayco Supplies	✓		1,230	1,230	
21	152	Jewett Business Systems	✓		2,800	2,800	
22	153	Donnelly Supplies	✓		420	420	
30	154	Utilities Expense	54	1,050		1,050	
31	155	Howard Supplies	✓		600	600	
31				2,650	5,050	7,700	
				(✓)	(21)	(11)	

General Ledger						
Account Cash Account No. 11						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 1	Balance	✓			6,200	
31		CR14	7,750		13,950	
31		CP7		7,700		6,250

Account Accounts Payable Account No. 21						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 1	Balance	✓				1,230
31		P11		6,230		7,460
31		CP7	5,050			2,410

Account Rent Expense Account No. 52						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 2		CP7	1,600		1,600	

Account Utilities Expense Account No. 54						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 30		CP7	1,050		1,050	

Accounts Payable Subsidiary Ledger						
Name: Donnelly Supplies						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 7		P11		420		420
19		P11		1,450		1,870
22		CP7	420			1,450

Name: Grayco Supplies						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 1	Balance	✓				1,230
15		CP7	1,230			—

Name: Howard Supplies						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 3		P11		600		600
27		P11		960		1,560
31		CP7	600			960

Name: Jewett Business Systems						
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
2014						
Mar. 12		P11		2,800		2,800
21		CP7	2,800			—

- To indicate that the transaction has been posted to the accounts payable subsidiary ledger, a check mark (✓) is inserted in the Posting Reference column of the cash payments journal. To illustrate, Exhibit 6 shows that a check mark (✓) has been inserted in the Post. Ref. column next to Donnelly Supplies to indicate that the \$420 has been posted.
- A single monthly total of the Accounts Payable Dr. column is posted to the accounts payable general ledger account. This is the total cash paid on account and is posted

as a debit to Accounts Payable. The accounts payable account number (21) is then inserted below the Accounts Payable Dr. column to indicate that the posting is complete. To illustrate, Exhibit 6 shows the monthly total of \$5,050 was posted as a debit to Accounts Payable (21).

5. A single monthly total of the Cash Cr. column is posted to the cash general ledger account. This is the total cash payments during the month and is posted as a credit to Cash. The cash account number (11) is then inserted below the Cash Cr. column to indicate that the posting is complete.

To illustrate, Exhibit 6 shows the monthly total of \$7,700 was posted as a credit to Cash (11).

6. The accounts listed in the Other Accounts Dr. column are posted on a regular basis as a separate debit to each account. The account number is then inserted in the Post. Ref. column to indicate that the posting is complete. Because accounts in the Other Accounts Dr. column are posted individually, a check mark is placed below the column total at the end of the month to show that no further action is needed.

To illustrate, Exhibit 6 shows that \$1,600 was posted as a debit to Rent Expense (52) and \$1,050 was posted as a debit to Utilities Expense (54) in the general ledger. The account numbers (52 and 54, respectively) were entered in the Post. Ref. column of the cash payments journal. Also, at the end of the month, a check mark (✓) is entered below the Other Accounts Dr. column to indicate that no further action is needed.

Accounts Payable Control Account and Subsidiary Ledger

After all posting has been completed for the month, the balances in the accounts payable subsidiary ledger should be totaled. This total can be summarized in a separate schedule of creditor balances. The total should then be compared with the balance of the accounts payable controlling account in the general ledger. If the controlling account and the subsidiary ledger do not agree, an error has occurred, and must be located and corrected.

The total of NetSolutions' accounts payable creditor balances is \$2,410. This total agrees with the balance of its accounts payable controlling account on March 31, 2014, as shown below.

Accounts Payable (Controlling)		NetSolutions Accounts Payable Creditor Balances March 31, 2014	
Balance, March 1, 2014	\$1,230	Donnelly Supplies	\$1,450
Total credits (from purchases journal)	6,230	Grayco Supplies	0
Total debits		Howard Supplies	960
(from cash payments journal)	(5,050)	Jewett Business Systems	0
Balance, March 31, 2014	<u>\$2,410</u>	Total	<u>\$2,410</u>

↑ Equal credit balances ↑

Example Exercise 5-4 Accounts Payable Subsidiary Ledger

OBJ
2

The debits and credits from two transactions are presented in the following creditor's (supplier's) account:

NAME		Lassiter Services Inc.			
ADDRESS		301 St. Bonaventure Ave.			
Date	Item	Post. Ref.	Debit	Credit	Balance
Aug. 1	Balance				320
12	Invoice No. 101	CP36	200		120
22	Invoice No. 106	P16		140	260

Describe each transaction and the source of each posting.

Follow My Example 5-4

- Aug. 12. Paid \$200 to Lassiter Services Inc. on account (Invoice No. 101). Amount posted from page 36 of the cash payments journal.
22. Purchased \$140 of services on account from Lassiter Services Inc. itemized on Invoice No. 106. Amount posted from page 16 of the purchases journal.

Practice Exercises: PE 5-4A, PE 5-4B

Business



Connection

ACCOUNTING SYSTEMS AND PROFIT MEASUREMENT

A Greek restaurant owner in Canada had his own system of accounting. He kept his accounts payable in a cigar box on the left-hand side of his cash register, his daily cash returns in the cash register, and his receipts for paid bills in another cigar box on the right. A truly "manual" system.

When his youngest son graduated as an accountant, he was appalled by his father's primitive methods. "I don't

know how you can run a business that way," he said. "How do you know what your profits are?"

"Well, son," the father replied, "when I got off the boat from Greece, I had nothing but the pants I was wearing. Today, your brother is a doctor. You are an accountant. Your sister is a speech therapist. Your mother and I have a nice car, a city house, and a country home. We have a good business, and everything is paid for. . . ."

"So, you add all that together, subtract the pants, and there's your profit!"

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Obj 3 Define and illustrate the use of a computerized accounting system.

Computerized Accounting Systems

Computerized accounting systems are widely used by even the smallest of companies. Computerized accounting systems have the following three main advantages over manual systems:

1. Computerized systems simplify the record-keeping process by recording transactions in electronic journals or forms and, at the same time, posting them electronically to general and subsidiary ledger accounts.
2. Computerized systems are generally more accurate than manual systems.
3. Computerized systems provide management with current account balance information to support decision making, since account balances are posted as the transactions occur.

The popular QuickBooks accounting software for small- to medium-sized businesses is used to illustrate a computerized accounting system for **NetSolutions**. To simplify, the illustration is limited to transactions involving revenue earned on account and the subsequent recording of cash collections. Exhibit 7 illustrates the use of QuickBooks for NetSolutions to record transactions as follows:



Large companies have their accounting systems integrated within the automated business systems of the firm. Such integrated software is termed ERP, or enterprise resource planning.

Step 1. Record fees by completing an electronic invoice form and sending to customer (print and mail, or e-mail).

Sales transactions are entered onto the computer screen using an electronic invoice form. The electronic form appears like a paper form with spaces, or fields, to input transaction data. The data spaces may have pull-down lists to ease data entry. After the form is completed, it is printed out and mailed, or e-mailed, to the customer.

To illustrate, on March 2, NetSolutions earned \$2,200 on account from Accessories By Claire. As shown in Exhibit 7, Invoice No. 615 was created using an electronic form. Upon submitting the invoice form, QuickBooks automatically posts a \$2,200 debit to the Accessories By Claire customer account and a credit to Fees Earned. An invoice is either e-mailed or printed for mailing to Accessories By Claire.

Step 2. Record collection of payment by completing a "receive payment" form.

Upon collection from the customer, a "receive payment" electronic form is opened and completed. As with the "invoice form," data are input into the various spaces directly or by using pull-down lists.

To illustrate, a \$2,200 payment was collected from Accessories By Claire on March 28. The \$2,200 was applied to Invoice No. 615, as shown by the check mark (✓) next to the March 2 date at the bottom of the form in Exhibit 7. As shown at the bottom of the form, the March 27 invoice of \$3,000 remains uncollected. When the screen is completed, a debit of \$2,200 is automatically posted to the cash account, and a credit for \$2,200 is posted to the Accessories By Claire account. This causes the balance of the Accessories By Claire account to be reduced from \$5,200 to \$3,000.

E-Commerce

Using the Internet to perform business transactions is termed **e-commerce**. The U.S. Census Bureau indicates that e-commerce represents over \$173 billion in retail sales, or over 4% of all retail sales.¹ When transactions are between a company and a consumer, it is termed B2C (business-to-consumer) e-commerce. Examples of companies engaged in B2C e-commerce include Amazon.com, [priceline.com Incorporated](http://priceline.com), and Apple Inc. The B2C business allows consumers to shop and receive goods at home, rather than going to the store. For example, Apple Inc. allows consumers to use its Web site to select and purchase Apple products for direct shipment to the home.

When transactions are conducted between two companies, it is termed B2B (business-to-business) e-commerce. Examples of companies engaged in B2B e-commerce include Cisco Systems, Inc., an Internet equipment manufacturer, and [Bristol-Myers Squibb Company \(BMS\)](http://Bristol-Myers Squibb Company (BMS)), a pharmaceutical company. BMS, for example, uses e-commerce to purchase supplies and equipment from its suppliers. E-commerce streamlines purchases and payments by automating transactions and eliminating paperwork. BMS claims over \$90 million in savings by placing its purchase/payment cycle on the Internet.

The Internet creates opportunities for improving the speed and efficiency of transactions. Many companies are realizing these benefits of using e-commerce as illustrated above. Three additional areas where the Internet is being used for business purposes are as follows:

1. **Supply chain management (SCM):** Internet applications to plan supply needs and coordinate them with suppliers.
2. **Customer relationship management (CRM):** Internet applications to plan and coordinate marketing and sales effort.
3. **Product life-cycle management (PLM):** Internet applications to plan and coordinate the product development and design process.

E-commerce also provides opportunities for faster business processes that operate at lower costs. New Internet applications are continually being introduced as the Internet develops into a preferred method of conducting business.

Financial Analysis and Interpretation: Segment Analysis

Accounting systems often use computers to collect, classify, summarize, and report financial and operating information in a variety of ways. One way is to report revenue earned by different segments of business. Businesses may be segmented by region, by product or service, or by type of customer. Segment revenues are determined from the invoice data that are entered into the accounting system.

For example, Intuit Inc. uses invoice data from the accounting system to determine the amount of revenue earned by different products and services. Segment analysis uses horizontal and vertical comparisons to analyze the contributions of various segments to the total operating performance of a company. To illustrate, selected product and service segment revenue information from the notes to Intuit's financial statements for two recent fiscal years is presented on the following page.



Describe the basic features of e-commerce.



A new trend is toward "cloud" software solutions whereby the accounting system and data are stored and distributed over the Internet by a third party. Under this model, the software is "rented," while analysis, design, and implementation are largely provided by the software vendor.



Use segment analysis in

evaluating the operating performance of a company.

¹ Estimated Quarterly U.S. Retail Sales: Total and E-commerce, U.S. Census Bureau, May 16, 2011.

Segment	Recent Year (in millions)	Prior Year (in millions)
Financial Management Solutions	\$ 611	\$ 579
Employee Management Solutions	418	365
Payments Solutions	313	291
Consumer Tax	1,146	996
Accounting Professionals	373	352
Financial Institutions	332	311
Other Businesses	262	215
Total revenues	\$3,455	\$3,109

This segment information can be used to perform horizontal analysis using the prior year as the base year as follows:

Segment	Recent Year (in millions)	Prior Year (in millions)	Increase (Decrease)	
			Amount	Percent
Financial Management Solutions	\$ 611	\$ 579	\$ 32	5.5%
Employee Management Solutions	418	365	53	14.5
Payments Solutions	313	291	22	7.6
Consumer Tax	1,146	996	150	15.1
Accounting Professionals	373	352	21	6.0
Financial Institutions	332	311	21	6.8
Other Businesses	262	215	47	21.9
Total revenues	\$3,455	\$3,109	\$346	11.1

Intuit Inc. increased total revenue by 11.1% between the two years. This increase came from strong revenue gains in the Employee Management Solutions, Consumer Tax, and Other Businesses segments.

In addition, vertical analysis could be performed on the segment disclosures as follows:

Segment	Recent Year		Prior Year	
	Amount (in millions)	Percent	Amount (in millions)	Percent
Financial Management Solutions	\$ 611	17.7%	\$ 579	18.6%
Employee Management Solutions	418	12.1	365	11.7
Payments Solutions	313	9.1	291	9.4
Consumer Tax	1,146	33.2	996	32.0
Accounting Professionals	373	10.8	352	11.3
Financial Institutions	332	9.6	311	10.0
Other Businesses	262	7.6	215	6.9
Total revenues	\$3,455	100.0%*	\$3,109	100.0%*

*Percentages do not add exactly to 100% due to rounding.

The preceding analysis shows that revenue in the Employee Management Solutions, Consumer Tax, and Other Businesses segments increased as a percent of total revenues between the two years. The remaining segments all decreased as a percent of total revenues between the two years.

Both analyses together show that the largest segment, Consumer Tax, has increased revenues by 15.1% and has increased the segment's share of total revenues from 32.0% to 33.2% across the two years. In addition, the remaining segments are all showing strong revenue growth.