Accrual Accounting Concepts



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study objectives

After studying this chapter, you should be able to:

- **1** Explain the revenue recognition principle and the matching principle.
- 2 Differentiate between the cash basis and the accrual basis of accounting.
- **3** Explain why adjusting entries are needed, and identify the major types of adjusting entries.
- 4 Prepare adjusting entries for deferrals.
- **5** Prepare adjusting entries for accruals.
- 6 Describe the nature and purpose of the adjusted trial balance.
- **7** Explain the purpose of closing entries.
- 8 Describe the required steps in the accounting cycle.
- **9** Understand the causes of differences between net income and cash provided by operating activities.



feature story



What Was You<mark>r Profit?</mark>

The accuracy of the financial reporting system depends on answers to a few fundamental questions. At what point has revenue been earned? At what point is the earnings process complete? When have expenses really been incurred?

During the 1990s the stock prices of dot-com companies boomed. Many dot-com companies earned most of their revenue from selling advertising space on their Web sites. To boost reported revenue, some dotcoms began swapping website ad space. Company A would put an ad for its website on company B's website, and company B would put an ad for its website on company A's website. No money ever changed hands, but each company recorded revenue (for the value of the space that it gave up on its site). This practice did little to boost net income and resulted in no additional cash

flow-but it did boost *reported revenue*. Regulators eventually put an end to the practice.

Another type of transgression results from companies recording revenue or expenses in the wrong year. In fact, shifting revenues and expenses is one of the most common abuses of financial accounting. Xerox recently admitted reporting billions of dollars of lease revenue in periods earlier than it should have been reported. And WorldCom stunned the financial markets with its admission that it had boosted net income by billions of dollars by delaying the recognition of expenses until later years.

Unfortunately, revelations such as these have become all too common in the corporate world. It is no wonder that recently the U.S. Trust Survey of affluent Americans reported that 85 percent of its respondents believed

that there should be tighter regulation of financial disclosures, and 66 percent said they did not trust the management of publicly traded companies.

Why did so many companies violate basic financial reporting rules and sound ethics? Many speculate that as stock prices climbed, executives were under increasing pressure to meet higher and higher earnings expectations. If actual results weren't as good as hoped for, some gave in to temptation and "adjusted" their numbers to meet market expectations.

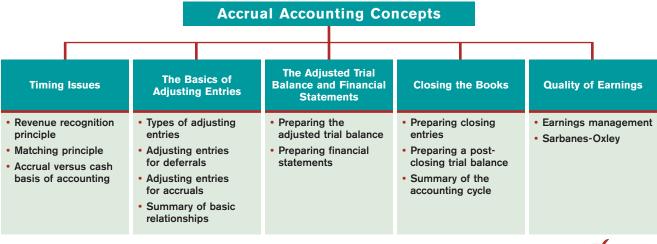


On the World Wide Web Xerox: www.xerox.com

Preview of Chapter 4

As indicated in the Feature Story, making adjustments is necessary to avoid misstatement of revenues and expenses such as those at Xerox and WorldCom. In this chapter we introduce you to the accrual accounting concepts that make such adjustments possible.

The organization and content of the chapter are as follows.





study objective 1

Explain the revenue recognition principle and the matching principle.

Helpful Hint An accounting time period that is one year long is called a **fiscal year**.

Service performed Customer At time requests cash service received

Revenue should be recognized in the accounting period in which it is earned (generally when service is performed).

Timing Issues

Most businesses need immediate feedback about how well they are doing. For example, management usually wants monthly reports on financial results, most large corporations are required to present quarterly and annual financial statements to stockholders, and the Internal Revenue Service requires all businesses to file annual tax returns. Accounting divides the economic life of a business into artificial time periods. As indicated in Chapter 2, this is the time period assumption. Accounting time periods are generally a month, a quarter, or a year.

Many business transactions affect more than one of these arbitrary time periods. For example, a new building purchased by Citigroup or a new airplane purchased by Delta Air Lines will be used for many years. It doesn't make sense to expense the full cost of the building or the airplane at the time of purchase because each will be used for many subsequent periods. Instead, we determine the impact of each transaction on specific accounting periods.

Determining the amount of revenues and expenses to report in a given accounting period can be difficult. Proper reporting requires an understanding of the nature of the company's business. Two principles are used as guidelines: the revenue recognition principle and the matching principle.

THE REVENUE RECOGNITION PRINCIPLE

The **revenue recognition principle** requires that companies recognize revenue in the accounting period **in which it is earned**. In a service company, revenue is considered to be earned at the time the service is performed. To illustrate, assume Conrad Dry Cleaners cleans clothing on June 30, but customers do not claim and pay for their clothes until the first week of July. Under the revenue recognition principle, Conrad earns revenue in June when it performs the service, not in July when it receives the cash. At June 30 Conrad would report a receivable on its balance sheet and revenue in its income statement for the service performed. The journal entries for June and July would be as follows.

June	Accounts Receivable	XXX	
	Service Revenue		XXX
July	Cash	XXX	
	Accounts Receivable		XXX



THE MATCHING PRINCIPLE

In recognizing expenses, a simple rule is followed: "Let the expenses follow the revenues." Thus, expense recognition is tied to revenue recognition. Applied to the preceding example, this means that the salary expense Conrad incurred in performing the cleaning service on June 30 should be reported in the same period in which it recognizes the service revenue. The critical issue in expense recognition is determining when the expense makes its contribution to revenue. This may or may not be the same period in which the expense is paid. If Conrad does not pay the salary incurred on June 30 until July, it would report salaries payable on its June 30 balance sheet.

The practice of expense recognition is referred to as the **matching principle** because it dictates that efforts (expenses) be matched with accomplishments (revenues). Illustration 4-1 shows these relationships.

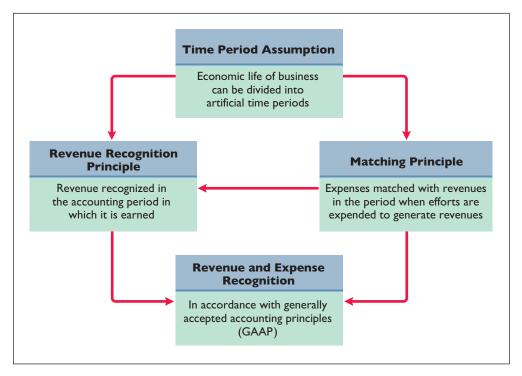


Illustration 4-1 GAAP relationships in revenue and expense recognition



DECISIO	IN TOOLKIT		
DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
At what point should the company record expenses?	Need to understand the nature of the company's business	Expenses should "follow" revenues—that is, match the effort (expense) with the result (revenue).	Recognizing expenses too early overstates current period expense; recognizing them too late understates current period expense.

ACCRUAL VERSUS CASH BASIS OF ACCOUNTING

study objective

Differentiate between the cash basis and the accrual basis of accounting.

often used by companies in other countries, the accrual basis of accounting is central to all of these standards.

International Note Although different accounting standards are

Accrual-basis accounting means that transactions that change a company's financial statements are recorded in the periods in which the events occur, even if cash was not exchanged. For example, using the accrual basis means that companies recognize revenues when earned (the revenue recognition principle), even if cash was not received. Likewise, under the accrual basis, companies recognize expenses when incurred (the matching principle), even if cash was not paid.

An alternative to the accrual basis is the cash basis. Under cash-basis accounting, companies record revenue only when cash is received. They record expense only when cash is paid. The cash basis of accounting is prohibited under generally accepted accounting principles. Why? Because it does not record revenue when earned, thus violating the revenue recognition principle. Similarly, it does not record expenses when incurred, which violates the matching principle.

Illustration 4-2 compares accrual-based numbers and cash-based numbers. Suppose that Fresh Colors paints a large building in 2009. In 2009 it incurs and pays total expenses (salaries and paint costs) of \$50,000. It bills the customer \$80,000, but does not receive payment until 2010. On an accrual basis, Fresh Colors reports \$80,000 of revenue during 2009 because that is when it is earned.

Illustration 4-2 Accrual versus cash basis accounting

	2009	2010
Activity	Bob Bait Barn Bob Bait Barn PART AND ANY	Bod's Sain Sain
Accrual basis	Purchased paint, painted building, paid employees Revenue \$80,000 Expense 50,000	Received payment for work done in 2009 Revenue \$ 0 Expense 0
	Net income \$30,000 Revenue \$ 0	Net income \$ 0 Revenue \$80,000
Cash basis	Expense <u>50,000</u> Net loss \$(50,000)	Expense 0 Net income \$80,000

The company matches expenses of \$50,000 to the \$80,000 of revenue. Thus, 2009 net income is \$30,000 (\$80,000 - \$50,000). The \$30,000 of net income reported for 2009 indicates the profitability of Fresh Colors' efforts during that period.

If, instead, Fresh Paint were to use cash-basis accounting, it would report \$50,000 of expenses in 2009 and \$80,000 of revenues during 2010. As shown in Illustration 4-2, it would report a loss of \$50,000 in 2009 and would report net income of \$80,000 in 2010. Clearly, the cash-basis measures are misleading because the financial performance of the company would be misstated for both 2009 and 2010.



Ethics Insight

Allegations of abuse of the revenue recognition principle have become all too common in recent years. For example, it was alleged that Krispy Kreme sometimes doubled the number of doughnuts shipped to wholesale customers at the end of a quarter to boost quarterly results. The customers shipped the unsold doughnuts back after the beginning of the next quarter for a refund. Conversely, Computer Associates International was accused of backdating sales—that is, saying that a sale that occurred at the beginning of one quarter occurred at the end of the previous quarter in order to achieve the previous quarter's sales targets.





What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues?

The Basics of Adjusting Entries

In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred, companies make adjusting entries. Adjusting entries ensure that the revenue recognition and matching principles are followed.

Adjusting entries are necessary because the **trial balance**—the first pulling together of the transaction data—may not contain up-to-date and complete data. This is true for several reasons:

- 1. Some events are not recorded daily because it is not efficient to do so. Examples are the use of supplies and the earning of wages by employees.
- 2. Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions. Examples are charges related to the use of buildings and equipment, rent, and insurance.
- 3. Some items may be unrecorded. An example is a utility service bill that will not be received until the next accounting period.

Adjusting entries are required every time a company prepares financial statements. The company analyzes each account in the trial balance to determine whether it is complete and up to date for financial statement purposes. Every adjusting entry will include one income statement account and one balance sheet account.

TYPES OF ADJUSTING ENTRIES

Adjusting entries are classified as either deferrals or accruals. As Illustration 4-3 [(next page) shows, each of these classes has two subcategories.

study objective

2

Explain why adjusting entries are needed, and identify the major types of adjusting entries.

International Note Recording correct financial information requires good internal control. Internal controls are a system of checks and balances designed to detect and prevent fraud and errors. The Sarbanes-Oxley Act requires U.S. companies to enhance their systems of internal control. However, many foreign companies do not have this requirement, and some U.S. companies believe that not having it gives foreign firms unfair advantage in the capital markets.

Illustration 4-3

Categories of adjusting entries

Deferrals:

- 1. Prepaid expenses: Expenses paid in cash and recorded as assets before they are used or consumed.
- 2. Unearned revenues: Cash received and recorded as liabilities before revenue is earned.

Accruals:

- 1. Accrued revenues: Revenues earned but not yet received in cash or recorded.
- 2. Accrued expenses: Expenses incurred but not yet paid in cash or recorded.

Subsequent sections give examples of each type of adjustment. Each example is based on the October 31 trial balance of Sierra Corporation, from Chapter 3, reproduced in Illustration 4-4. Note that Retained Earnings, with a zero balance, has been added to this trial balance. We will explain its use later.

Illustration 4-4 Trial balance

SIERRA CORF Trial Bala October 31	ance		
Cash Advertising Supplies Prepaid Insurance Office Equipment Notes Payable Accounts Payable Unearned Service Revenue Common Stock Retained Earnings Dividends Service Revenue Salaries Expense Rent Expense	\$15,200 2,500 600 5,000 5,000 500 4,000 900 \$28,700	\$ 5,000 2,500 1,200 10,000 0 10,000	

We assume that Sierra Corporation uses an accounting period of one month. Thus, monthly adjusting entries are made. The entries are dated October 31.

ADJUSTING ENTRIES FOR DEFERRALS

study objective 4.

Prepare adjusting entries for deferrals.

To defer means to postpone or delay. Deferrals are costs or revenues that are recognized at a date later than the point when cash was originally exchanged. Companies make adjusting entries for deferrals to record the portion of the deferred item that was incurred as an expense or earned as revenue during the current accounting period. The two types of deferrals are prepaid expenses and unearned revenues.

Prepaid Expenses

Companies record payments of expenses that will benefit more than one accounting period as assets called **prepaid expenses** or **prepayments**. When expenses are prepaid, an asset account is increased (debited) to show the service or benefit that the company will receive in the future. Examples of common

prepayments are insurance, supplies, advertising, and rent. In addition, companies make prepayments when they purchase buildings and equipment.

Prepaid expenses are costs that expire either with the passage of time (e.g., rent and insurance) or through use (e.g., supplies). The expiration of these costs does not require daily entries, which would be impractical and unnecessary. Accordingly, companies postpone the recognition of such cost expirations until they prepare financial statements. At each statement date, they make adjusting entries to record the expenses applicable to the current accounting period and to show the remaining amounts in the asset accounts.

Prior to adjustment, assets are overstated and expenses are understated. Therefore, as shown in Illustration 4-5, an adjusting entry for prepaid expenses results in an increase (a debit) to an expense account and a decrease (a credit) to an asset account.

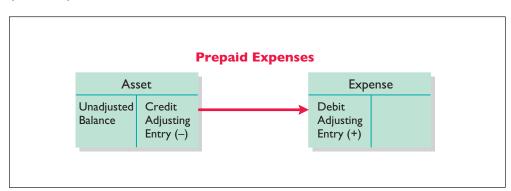


Illustration 4-5 Adjusting entries for prepaid expenses

Let's look in more detail at some specific types of prepaid expenses, beginning with supplies.

SUPPLIES. The purchase of supplies, such as paper and envelopes, results in an increase (a debit) to an asset account. During the accounting period, the company uses supplies. Rather than record supplies expense as the supplies are used, companies recognize supplies expense at the **end** of the accounting period. At the end of the accounting period the company counts the remaining supplies. The difference between the unadjusted balance in the Supplies (asset) account and the actual cost of supplies on hand represents the supplies used (an expense) for that period.

Recall from Chapter 3 that Sierra Corporation purchased advertising supplies costing \$2,500 on October 5. Sierra recorded the payment by increasing (debiting) the asset Advertising Supplies. This account shows a balance of \$2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that \$1,000 of supplies are still on hand. Thus, the cost of supplies used is \$1,500 (\$2,500 - \$1,000). This use of supplies decreases an asset, Advertising Supplies. It also decreases stockholders' equity by increasing an expense account, Advertising Supplies Expense. The use of supplies affects the accounting equation in the following way.



Thus, Sierra makes the following adjusting entry:

Oct. 31	Advertising Supplies Expense	1,500	
	Advertising Supplies		1,500
	(To record supplies used)		



After the adjusting entry is posted, the accounts, in T account form, appear as in Illustration 4-6.

Illustration 4-6 Supplies accounts after adjustment

A	dvertising	Supplies		Ad	vertis	ing Su	pplies Expense
Oct. 5	2,500	Oct. 31 Adj. 1,50	0	ct. 31	Adj.	1,500	
Oct. 31 B	al. 1,000		O	ct. 31	Bal.	1,500	

The asset account Advertising Supplies now shows a balance of \$1,000, which is equal to the cost of supplies on hand at the statement date. In addition, Advertising Supplies Expense shows a balance of \$1,500, which equals the cost of supplies used in October. If Sierra does not make the adjusting entry, October expenses will be understated and net income overstated by \$1,500. Moreover, both assets and stockholders' equity will be overstated by \$1,500 on the October 31 balance sheet.



Accounting Across the Organization

The method of accounting for advertising costs affects sales and marketing executives. In the past, companies sometimes recorded as assets the costs of media advertising for burgers, bleaches, athletic shoes, and such products and expensed those costs in subsequent periods as sales took place. The reasoning behind this treatment was that long ad campaigns provided benefits over multiple accounting periods. Today the accounting profession no longer allows this treatment because it was decided that the benefits were too difficult to measure.

Instead, companies now must expense advertising costs when the advertising takes place. The issue is important because the outlays for advertising can be substantial. Recent big spenders: Coca-Cola spent \$2.8 billion, PepsiCo., Inc. \$1.9 billion, Nike, Inc. \$1.9 billion, and Limited Brands \$519 million.



Why might the new accounting method cause companies sometimes to spend less on advertising?



	Insurance Policy						
Oct	Nov	Dec	Jan				
\$50	\$50	\$50	\$50				
Feb	March	April	May				
\$50	\$50	\$50	\$50				
June	July	Aug	Sept				
\$50	\$50	\$50	\$50				
	I YEAR \$600						

Oct.31 Insurance expired; record insurance expense

INSURANCE. Companies purchase insurance to protect themselves from losses due to fire, theft, and unforeseen events. Insurance must be paid in advance, often for more than one year. The cost of insurance (premiums) paid in advance is recorded as an increase (debit) in the asset account Prepaid Insurance. At the financial statement date companies increase (debit) Insurance Expense and decrease (credit) Prepaid Insurance for the cost of insurance that has expired during the period.

On October 4 Sierra Corporation paid \$600 for a one-year fire insurance policy. Coverage began on October 1. Sierra recorded the payment by increasing (debiting) Prepaid Insurance. This account shows a balance of \$600 in the October 31 trial balance. Insurance of \$50 ($$600 \div 12$) expires each month. The expiration of Prepaid Insurance decreases an asset, Prepaid Insurance. It also decreases stockholders' equity by increasing an expense account, Insurance Expense. The expiration of Prepaid Insurance affects the accounting equation in October (and in each of the next 11 months) in the following way.

Assets	=	Liabilities	+	Stockholders'	Equity
-\$50				-\$50	

Thus, the following adjusting entry is made.

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50
	(To record insurance expired)		

After Sierra posts the adjusting entry, the accounts appear as in Illustration 4-7.

	Prepaid Insu	ırance			Insurance	Expense
Oct. 4	600	Oct. 31	Adj. 50	Oct. 31	Adj. 50	
Oct. 31	Bal. 550		_	Oct. 31	Bal. 50	

Illustration 4-7 Insurance accounts after adjustment

The asset Prepaid Insurance shows a balance of \$550, which represents the unexpired cost for the remaining 11 months of coverage. At the same time the balance in Insurance Expense equals the insurance cost that expired in October. If Sierra does not make this adjustment, October expenses are understated by \$50 and net income is overstated by \$50. Moreover, as the accounting equation shows, both assets and stockholders' equity will be overstated by \$50 on the October 31 balance sheet.

DEPRECIATION. A company typically owns a variety of assets that have long lives, such as buildings, equipment, and motor vehicles. The period of service is referred to as the **useful life** of the asset. Because a building is expected to provide service for many years, it is recorded as an asset, rather than an expense, on the date it is acquired. As explained in Chapter 2, companies record such assets **at cost**, as required by the cost principle. To follow the matching principle, companies allocate a portion of this cost as an expense during each period of the asset's useful life. **Depreciation** is the process of allocating the cost of an asset to expense over its useful life.

Need for adjustment. The acquisition of long-lived assets is essentially a long-term prepayment for the use of an asset. An adjusting entry for depreciation is needed to recognize the cost that has been used (an expense) during the period and to report the unused cost (an asset) at the end of the period. One very important point to understand: **Depreciation is an allocation concept, not a valuation concept.** That is, depreciation **allocates an asset's cost to the periods in which it is used. Depreciation does not attempt to report the actual change in the value of the asset.**

For Sierra Corporation, assume that depreciation on the office equipment is \$480 a year, or \$40 per month. Rather than decrease (credit) the asset account directly, Sierra instead credits Accumulated Depreciation. Accumulated Depreciation is called a **contra asset account**. Such an account is offset against an asset account on the balance sheet. Thus, the Accumulated Depreciation—Office Equipment account offsets the asset Office Equipment. This account keeps track of the total amount of depreciation expense taken over the life of the asset. To keep the accounting equation in balance, Sierra decreases stockholders' equity by increasing an expense account, Depreciation Expense. Depreciation affects the accounting equation in the following way.





Sierra recognizes depreciation for October by this adjusting entry.

Oct. 31	Depreciation Expense	40	
	Accumulated Depreciation—Office		
	Equipment		40
	(To record monthly depreciation)		

After the company posts the adjusting entry, the accounts appear as in Illustration 4-8.

Illustration 4-8 Accounts after adjustment for depreciation

Office Eq	uipment				
Oct. 2 5,000					
Oct. 31 Bal. 5,000					
Accumulated I	_	n—			
Office Eq	uipment			Depreciation	on Expense
Office Eq	Oct. 31	Adj. 40	Oct. 31	Adj. 40	on Expense

Helpful Hint All contra accounts have increases, decreases, and normal balances **opposite to** the account to which they relate.

The balance in the Accumulated Depreciation account will increase \$40 each month, and the balance in Office Equipment remains \$5,000.

Statement presentation. As noted above, Accumulated Depreciation—Office Equipment is a contra asset account. It is offset against Office Equipment on the balance sheet. The normal balance of a contra asset account is a credit. A theoretical alternative to using a contra asset account would be to decrease (credit) the asset account by the amount of depreciation each period. But using the contra account is preferable for a simple reason: it discloses *both* the original cost of the equipment *and* the total cost that has expired to date. Thus, in the balance sheet, Sierra deducts Accumulated Depreciation—Office Equipment from the related asset account as shown in Illustration 4-9.

Illustration 4-9 Balance sheet presentation of accumulated depreciation

Office equipment	\$ 5,000	
Less: Accumulated depreciation—office equipment	40	
	\$4,960	

Alternative Terminology Book value is also referred to as *carrying value*.

Book value is the difference between the cost of any depreciable asset and its related accumulated depreciation. In Illustration 4-9, the book value of the equipment at the balance sheet date is \$4,960. The book value and the market value of the asset are generally two different values. As noted earlier, **the purpose of depreciation is not valuation, but a means of cost allocation.**

Depreciation expense identifies the portion of an asset's cost that expired during the period (in this case, in October). The accounting equation shows that without this adjusting entry, total assets, total stockholders' equity, and net income are overstated by \$40 and depreciation expense is understated by \$40.

Illustration 4-10 summaries the accounting for prepaid expenses.

ACCOUNTING FOR PREPAID EXPENSES					
Reason for Accounts Before Adjusting Examples Adjustment Adjustment Entry					
Insurance, supplies, advertising, rent, depreciation	Prepaid expenses recorded in asset accounts have been used.	Assets overstated. Expenses understated.	Dr. Expenses Cr. Assets		

Illustration 4-10 Accounting for prepaid expenses

Unearned Revenues

Companies record cash received before revenue is earned by increasing (crediting) a liability account called **unearned revenues**. Items like rent, magazine subscriptions, and customer deposits for future service may result in unearned revenues. Airlines such as **United**, **American**, and **Delta**, for instance, treat receipts from the sale of tickets as unearned revenue until the flight service is provided.

Unearned revenues are the opposite of prepaid expenses. Indeed, unearned revenue on the books of one company is likely to be a prepayment on the books of the company that has made the advance payment. For example, if identical accounting periods are assumed, a landlord will have unearned rent revenue when a tenant has prepaid rent.

When a company receives payment for services to be provided in a future accounting period, it increases (credits) an unearned revenue (a liability) account to recognize the liability that exists. The company subsequently earns revenues by providing service. During the accounting period it is not practical to make daily entries as the company earns the revenue. Instead, we delay recognition of earned revenue until the adjustment process. Then the company makes an adjusting entry to record the revenue earned during the period and to show the liability that remains at the end of the accounting period. Typically, prior to adjustment, liabilities are overstated and revenues are understated. Therefore, as shown in Illustration 4-11, the adjusting entry for unearned revenues results in a decrease (a debit) to a liability account and an increase (a credit) to a revenue account.



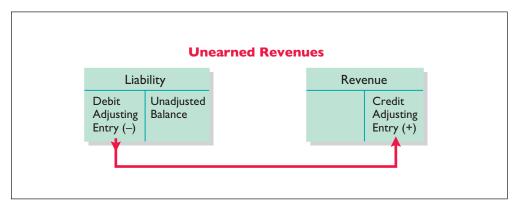


Illustration 4-11
Adjusting entries for unearned revenues

Sierra Corporation received \$1,200 on October 2 from R. Knox for advertising services expected to be completed by December 31. Sierra credited the payment to Unearned Service Revenue, and this liability account shows a balance of \$1,200 in the October 31 trial balance. From an evaluation of the work Sierra performed for Knox during October, the company determines that it has earned \$400 in October. The liability (Unearned Service Revenue) is therefore decreased, and stockholders' equity (Service Revenue) is increased. The accounting equation is affected in the following way.

Thus, Sierra makes the following adjusting entry.

After the company posts the adjusting entry, the accounts appear as in Illustration 4-12.

Illustration 4-12 Service revenue accounts after adjustment

Unearned Service Revenue		renue	Service Revenue
Oct. 31 Adj. 400	Oct. 2	1,200	Oct. 3 10,000 31 Adj. 400
	Oct. 31	Bal. 800	Oct. 31 Bal. 10,400

The liability Unearned Service Revenue now shows a balance of \$800. That amount represents the remaining advertising services expected to be performed in the future. At the same time, Service Revenue shows total revenue earned in October of \$10,400. Without this adjustment, revenues and net income are understated by \$400 in the income statement. Moreover, liabilities are overstated and stockholders' equity is understated by \$400 on the October 31 balance sheet.

Illustration 4-13 summarizes the accounting for unearned revenues.

Illustration 4-13
Accounting for unearned revenues

ACCOUNTING FOR UNEARNED REVENUES					
Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry		
Rent, magazine subscriptions, customer deposits for future service	Unearned revenues recorded in liability accounts have been earned.	Liabilities overstated. Revenues understated.	Dr. Liabilities Cr. Revenues		

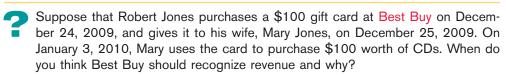


Accounting Across the Organization

Those of you who are marketing majors (and even most of you who are not) know that gift cards are among the hottest marketing tools in merchandising today. Customers purchase gift cards and give them to someone for later use. In a recent year gift-card sales topped \$95 billion.

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is exercised? How should expired gift cards be accounted for? In its 2007 balance sheet Best Buy reported unearned revenue related to gift cards of \$496 million.

Source: Robert Berner, "Gift Cards: No Gift to Investors," Business Week (March 14, 2005), p. 86.



before you go on...

The ledger of Hammond, Inc., on March 31, 2010, includes these selected accounts before adjusting entries are prepared.

ADJUSTING ENTRIES FOR DEFERRALS

	Debit	Credit
Prepaid Insurance	\$ 3,600	
Office Supplies	2,800	
Office Equipment	25,000	
Accumulated Depreciation—Office Equipment		\$5,000
Unearned Service Revenue		9,200

An analysis of the accounts shows the following.

- 1. Insurance expires at the rate of \$100 per month.
- 2. Supplies on hand total \$800.
- 3. The office equipment depreciates \$200 a month.
- 4. One-half of the unearned service revenue was earned in March.

Prepare the adjusting entries for the month of March.

Solution

Insurance Expense Prepaid Insurance (To record insurance expired)	100	100
 Office Supplies Expense Office Supplies (To record supplies used) 	2,000	2,000
 Depreciation Expense Accumulated Depreciation—Office Equipment (To record monthly depreciation) 	200	200
4. Unearned Service Revenue Service Revenue (To record revenue earned)	4,600	4,600

Action Plan

- · Make adjusting entries at the end of the period for revenues earned and expenses incurred in the period.
- Don't forget to make adjusting entries for prepayments. Failure to adjust for prepayments leads to overstatement of the asset or liability and understatement of the related expense or revenue.



ADJUSTING ENTRIES FOR ACCRUALS

The second category of adjusting entries is accruals. Prior to an accrual adjustment, the revenue account (and the related asset account) or the expense account (and the related liability account) are understated. Thus, the adjusting entry for accruals will increase both a balance sheet and an income statement account.

Accrued Revenues

Revenues earned but not yet recorded at the statement date are accrued revenues. Accrued revenues may accumulate (accrue) with the passing of time, as in the case of interest revenue. These are unrecorded because the earning of interest does not involve daily transactions. Companies do not record interest revenue on a daily basis because it is often impractical to do so. Accrued revenues also may result from services that have been performed but not yet billed nor collected, as in the case of commissions and fees. These may be unrecorded because only a portion of the total service has been provided and the clients won't be billed until the service has been completed.

An adjusting entry records the receivable that exists at the balance sheet date and the revenue earned during the period. Prior to adjustment both assets and



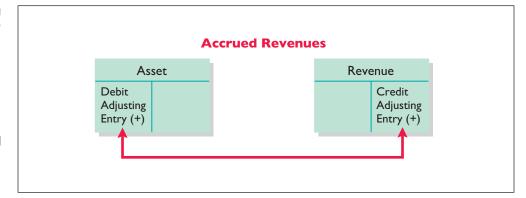


Prepare adjusting entries for accruals.



revenues are understated. As shown in Illustration 4-14, an adjusting entry for accrued revenues results in an increase (a debit) to an asset account and an increase (a credit) to a revenue account.

Illustration 4-14 Adjusting entries for accrued revenues



Helpful Hint For accruals, there may have been no prior entry, and the accounts requiring adjustment may both have zero balances prior to adjustment.

Ethics Note Computer Associates International was accused of backdating sales—that is, saying that a sale that occurred at the beginning of one quarter occurred at the end of the previous quarter, in order to achieve the previous quarter's sales targets.

In October Sierra Corporation earned \$200 for advertising services that were not billed to clients before October 31. Because these services are not billed, they are not recorded. The accrual of unrecorded service revenue increases an asset account, Accounts Receivable. It also increases stockholders' equity by increasing a revenue account, Service Revenue. The accrual of unrecorded service revenue affects the accounting equation in the following way.

$$\frac{\textbf{Assets}}{+\$200} = \frac{\textbf{Liabilities}}{+\$200} + \frac{\textbf{Stockholders' Equity}}{+\$200}$$

Thus, Sierra makes the following adjusting entry.

Oct. 31	Accounts Receivable	200	
	Service Revenue		200
	(To record revenue earned)		

After the company posts the adjusting entry, the accounts appear as in Illustration 4-15.

Illustration 4-15 Receivable and revenue

Receivable and revenue accounts after accrual adjustments

Accounts Receivable	Service Revenue
Oct. 31 Adj. 200	Oct. 3 10,000 31 400 31 Adj. 200
Oct. 31 Bal. 200	Oct. 31 Bal. 10,600

The asset Accounts Receivable shows that clients owe Sierra \$200 at the balance sheet date. The balance of \$10,600 in Service Revenue represents the total revenue Sierra earned during the month (\$10,000 + \$400 + \$200). Without the adjusting entry, assets and stockholders' equity on the balance sheet and revenues and net income on the income statement are understated.

On November 10, Sierra receives cash of \$200 for the services performed in October and makes the following entry.

Nov. 10	Cash	200	
	Accounts Receivable		200
	(To record cash collected on account)		

The company records the collection of the receivables by a debit (increase) to Cash and a credit (decrease) to Accounts Receivable.

Illustration 4-16 summarizes the accounting for accrued revenues.

ACCOUNTING FOR ACCRUED REVENUES					
Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry		
Interest, rent, services performed but not collected	Revenues have been earned but not yet received in cash or recorded.	Assets understated. Revenues understated.	Dr. Assets Cr. Revenues		

+ 200 -200 Cash Flows +200

Equation analyses summarize the effects of transactions on the three elements of the accounting equation, as well as the effect on cash flows.

Illustration 4-16 Accounting for accrued revenues

Accrued Expenses

Expenses incurred but not yet paid or recorded at the statement date are called accrued expenses. Interest, taxes, and salaries are common examples of accrued expenses.

Companies make adjustments for accrued expenses to record the obligations that exist at the balance sheet date and to recognize the expenses that apply to the current accounting period. Prior to adjustment, both liabilities and expenses are understated. Therefore, an adjusting entry for accrued expenses results in an increase (a debit) to an expense account and an increase (a credit) to a liability account.

Ethics Note A report released by Fannie Mae's board of directors stated that improper adjusting entries at the mortgage-finance company resulted in delayed recognition of expenses caused by interest-rate changes. The motivation for such accounting apparently was the desire to hit earnings estimates.

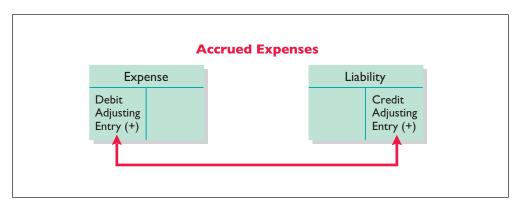


Illustration 4-17

Adjusting entries for accrued expenses

Let's look in more detail at some specific types of accrued expenses, beginning with accrued interest.

ACCRUED INTEREST. Sierra Corporation signed a three-month note payable in the amount of \$5,000 on October 1. The note requires Sierra to pay interest at an annual rate of 12%.

The amount of the interest recorded is determined by three factors: (1) the face value of the note, (2) the interest rate, which is always expressed as an annual rate, and (3) the length of time the note is outstanding. For Sierra, the total interest due on the \$5,000 note at its maturity date three months in the future is \$150 (\$5,000 \times 12% $\times \frac{3}{12}$), or \$50 for one month. Illustration 4-18 shows the formula for computing interest and its application to Sierra Corporation for the month of October.

Illustration 4-18 Formula for computing interest

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
\$5,000	×	12%	X	$\frac{1}{12}$	=	\$50

Helpful Hint In computing interest, we express the time period as a fraction of a year.

The accrual of interest at October 31 increases a liability account, Interest Payable. It also decreases stockholders' equity by increasing an expense account, Interest Expense. The accrual of interest at October 31 affects the accounting equation in the following way.

$$\underline{Assets} = \underline{Liabilities} + \underline{Stockholders' Equity} \\
+ \$50 - \$50$$

Thus, Sierra makes an accrued expense adjusting entry at October 31 as follows.

After the company posts this adjusting entry, the accounts appear as in Illustration 4-19.

Illustration 4-19 Interest accounts after adjustment

Interest Expense		Interest	Payable		
Oct. 31	Adj. 50			Oct. 31	Adj. 50
Oct. 31	Bal. 50			Oct. 31	Bal. 50

Interest Expense shows the interest charges for the month of October. Interest Payable shows the amount of interest the company owes at the statement date. Sierra will not pay the interest until the note comes due at the end of three months. Companies use the Interest Payable account, instead of crediting Notes Payable, to disclose the two different types of obligations—interest and principal—in the accounts and statements. Without this adjusting entry, liabilities and interest expense are understated, and net income and stockholders' equity are overstated.

ACCRUED SALARIES. Companies pay for some types of expenses, such as employee salaries and commissions, after the services have been performed. Sierra Corporation last paid salaries on October 26; the next payment of salaries will not occur until November 9. As the calendar in Illustration 4-20 shows, three working days remain in October (October 29–31).

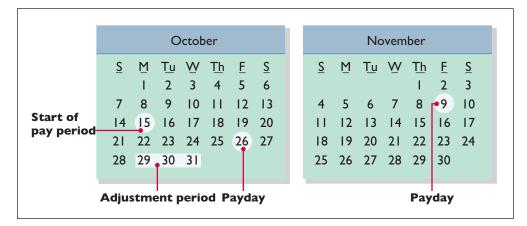


Illustration 4-20 Calendar showing Sierra Corporation's pay periods

At October 31 the salaries for these three days represent an accrued expense and a related liability to Sierra. The employees receive total salaries of \$2,000 for a five-day work week, or \$400 per day. Thus, accrued salaries at October 31 are $$1,200 ($400 \times 3)$. This accrual increases a liability, Salaries Payable. It also decreases stockholders' equity by increasing an expense account, Salaries Expense. The accrual of salaries affects the accounting equation in the following way.

$$\frac{\textbf{Assets}}{+\$1,200} = \frac{\textbf{Liabilities}}{+\$1,200} + \frac{\textbf{Stockholders' Equity}}{-\$1,200}$$

Thus, Sierra makes the following adjusting entry:

After the company posts this adjusting entry, the accounts are as shown in Illustration 4-21.

Salaries Expense		Salaries	Payable		
Oct. 26 31	4,000 Adj. 1,200			Oct. 31	Adj. 1,200
Oct. 31	Bal. 5,200			Oct. 31	Bal. 1,200

Illustration 4-21 Salary accounts after adjustment

After this adjustment, the balance in Salaries Expense of \$5,200 (13 days \times \$400) is the actual salary expense for October. The balance in Salaries Payable of \$1,200 is the amount of the liability for salaries Sierra owes as of October 31. Without the \$1,200 adjustment for salaries, Sierra's expenses are understated \$1,200 and its liabilities are understated \$1,200.

Sierra Corporation pays salaries every two weeks. Consequently, the next payday is November 9, when the company will again pay total salaries of \$4,000. The payment consists of \$1,200 of salaries payable at October 31 plus

\$2,800 of salaries expense for November (7 working days, as shown in the November calendar \times \$400). Therefore, Sierra makes the following entry on November 9.

Nov. 9	Salaries Payable	1,200	
	Salaries Expense	2,800	
	Cash		4,000
	(To record November 9 payroll)		

This entry eliminates the liability for Salaries Payable that Sierra recorded in the October 31 adjusting entry, and it records the proper amount of Salaries Expense for the period between November 1 and November 9.

Illustration 4-22 summarizes the accounting for accrued expenses.

Illustration 4-22

Accounting for accrued expenses

ACCOUNTING FOR ACCRUED EXPENSES							
Examples	Reason for Adjustment	Accounts Before Adjustment	Adjusting Entry				
Interest, rent, salaries	Expenses have been incurred but not yet paid in cash or recorded.	Expenses understated. Liabilities understated.					

before you go on...

ADJUSTING ENTRIES FOR ACCRUALS

Micro Computer Services Inc. began operations on August 1, 2010. At the end of August 2010, management attempted to prepare monthly financial statements. The following information relates to August.

- 1. At August 31 the company owed its employees \$800 in salaries that will be paid on September 1.
- 2. On August 1 the company borrowed \$30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
- 3. Revenue earned but unrecorded for August totaled \$1,100.

Prepare the adjusting entries needed at August 31, 2010.

Action Plan

- Make adjusting entries at the end of the period for revenues earned and expenses incurred in the period.
- Don't forget to make adjusting entries for accruals. Adjusting entries for accruals will increase both a balance sheet and an income statement account.



Solution

Salaries Expense Salaries Payable (To record accrued salaries)	800	800
2. Interest Expense Interest Payable (To record accrued interest: $$30,000 \times 10\% \times \frac{1}{12} = 250)	250	250
3. Accounts Receivable Service Revenue (To record revenue earned)	1,100	1,100

SUMMARY OF BASIC RELATIONSHIPS

Illustration 4-23 summarizes the four basic types of adjusting entries. Take some time to study and analyze the adjusting entries. Be sure to note that each adjusting entry affects one balance sheet account and one income statement account.

Type of Adjustment	Accounts Before Adjustment	Adjusting Entry
Prepaid expenses	Assets overstated Expenses understated	Dr. Expenses Cr. Assets
Unearned revenues	Liabilities overstated Revenues understated	Dr. Liabilities Cr. Revenues
Accrued revenues	Assets understated Revenues understated	Dr. Assets Cr. Revenues
Accrued expenses	Expenses understated Liabilities understated	Dr. Expenses Cr. Liabilities

Illustration 4-23 Summary of adjusting entries

Illustrations 4-24 and 4-25 (page 22) show the journalizing and posting of adjusting entries for Sierra Corporation on October 31. When reviewing the general ledger in Illustration 4-25, note that the adjustments are highlighted in color.

GENERAL JOURNAL					
Date	Account Titles and Explanation	Debit	Credit		
2010	Adjusting Entries				
Oct. 31	Advertising Supplies Expense Advertising Supplies (To record supplies used)	1,500	1,500		
31	Insurance Expense Prepaid Insurance (To record insurance expired)	50	50		
31	Depreciation Expense Accumulated Depreciation—Office Equipment (To record monthly depreciation)	40	40		
31	Unearned Service Revenue Service Revenue (To record revenue earned)	400	400		
31	Accounts Receivable Service Revenue (To record revenue earned)	200	200		
31	Interest Expense Interest Payable (To record interest on notes payable)	50	50		
31	Salaries Expense Salaries Payable (To record accrued salaries)	1,200	1,200		

Illustration 4-24 General journal showing adjusting entries

Illustration 4-25 General ledger after adjustments

GENERAL LEDGER						
Ca			Comm	on Stock	ζ	
Oct. 1 10,000	Oct. 2	5,000			Oct.	1 10,000
1 5,000 2 1.200	3 4	900 600			Oct. 3	1 Bal. 10,000
2 1,200 3 10,000	20	500		Retaine	d Earnin	gs
	26	4,000			Oct. 3	1 Bal. 0
Oct. 31 Bal. 15,200				Div	idends	
Accounts	Receivable	<u> </u>	Oct. 20	500		
Oct. 31 200			Oct. 31	Bal. 500		
Oct. 31 Bal. 200				Service	e Revenu	e
Advertisin	g Supplies	8			Oct.	3 10,000
Oct. 5 2,500	Oct. 31	1,500			3:	
Oct. 31 Bal. 1,000					3:	
Prepaid 1	Insurance			0.1.1		1 Bal. 10,600
Oct. 4 600	Oct. 31	50			s Expens	se
Oct. 31 Bal. 550			Oct. 26	4,000 1,200		
Office Ed	quipment			Bal. 5,200		
Oct. 2 5,000		_		dvertising S	upplies I	Expense
Oct. 31 Bal. 5,000			Oct. 31	1,500		
Accumulated 1		on—		Bal. 1,500		
Office Ed	quipment		Oct. 31		Expense	
	Oct. 31	40	Oct. 3	900		
	Oct. 31	Bal. 40	Oct. 31	Bal. 900		
Notes 1	Payable		Oct. 31		' ce Expen	ise
	Oct. 1	5,000	Oct. 31	50		
	Oct. 311	Bal. 5,000	Oct. 31	Bal. 50		
Accounts	s Payable				t Expens	se
	Oct. 5	2,500	Oct. 31	50		
	Oct. 311	Bal. 2,500	Oct. 31	Bal. 50		
Interest	Payable			Depreciat	ion Expe	ense
	Oct. 31	50	Oct. 31	40		
	Oct. 31	Bal. 50	Oct. 31	Bal. 40		
Unearned Ser	rvice Reve	nue	300.01	2011 10		
Oct. 31 400	Oct. 2	1,200				
	Oct. 31	Bal. 800				
Salaries	Payable					
	Oct. 31	1,200				
	Oct. 311	Bal. 1,200				

The Adjusted Trial Balance and Financial Statements

After a company has journalized and posted all adjusting entries, it prepares another trial balance from the ledger accounts. This trial balance is called an adjusted trial balance. It shows the balances of all accounts, including those adjusted, at the end of the accounting period. The purpose of an adjusted trial balance is to prove the equality of the total debit balances and the total credit balances in the ledger after all adjustments. Because the accounts contain all data needed for financial statements, the adjusted trial balance is the primary basis for the preparation of financial statements.

study objective Describe the nature and purpose of the adjusted

trial balance.

PREPARING THE ADJUSTED TRIAL BALANCE

Illustration 4-26 presents the adjusted trial balance for Sierra Corporation prepared from the ledger accounts in Illustration 4-25. The amounts affected by the adjusting entries are highlighted in color.

SIERRA CORPORATION Adjusted Trial Balance October 31, 2010	I	
Cash Accounts Receivable Advertising Supplies Prepaid Insurance Office Equipment	Dr. \$ 15,200 200 1,000 550 5,000	Cr.
Accumulated Depreciation—Office Equipment Notes Payable Accounts Payable Interest Payable Unearned Service Revenue Salaries Payable Common Stock Retained Earnings Dividends	500	\$ 40 5,000 2,500 50 800 1,200 10,000
Service Revenue Salaries Expense Advertising Supplies Expense Rent Expense Insurance Expense Interest Expense Depreciation Expense	5,200 1,500 900 50 50 40 \$30,190	\$30.190

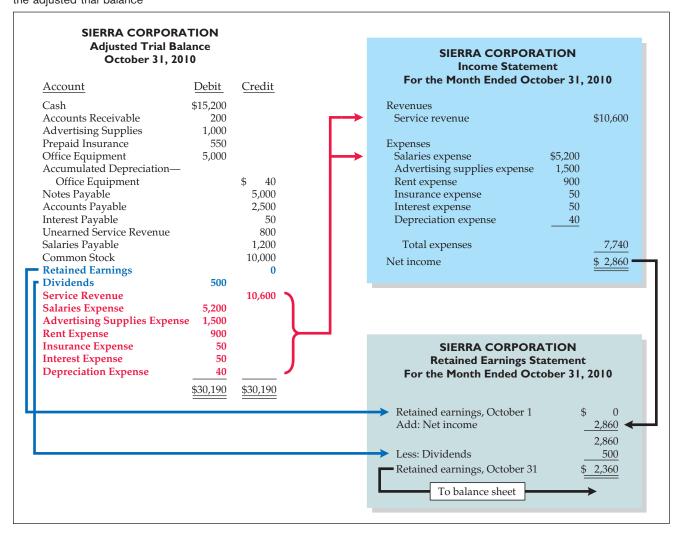
Illustration 4-26 Adjusted trial balance

PREPARING FINANCIAL STATEMENTS

Companies can prepare financial statements directly from an adjusted trial balance. Illustrations 4-27 (page 24) and 4-28 (page 25) present the interrelationships of data in the adjusted trial balance of Sierra Corporation. As Illustration 4-27 shows, companies prepare the income statement from the revenue and expense accounts. Similarly, they derive the retained earnings statement from the retained earnings account, dividends account, and the net income (or net loss) shown in the income statement. As Illustration 4-28 shows, companies then prepare the balance sheet from the asset, liability, and stockholders' equity accounts. They obtain the amount reported for retained earnings on the balance sheet from the ending balance in the retained earnings statement.

Illustration 4-27

Preparation of the income statement and retained earnings statement from the adjusted trial balance



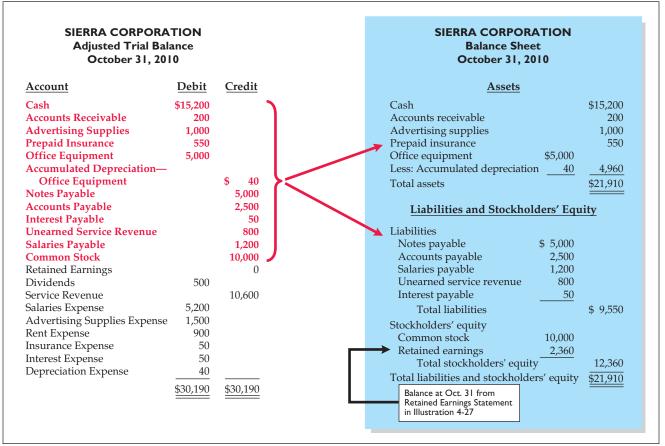


Illustration 4-28

Preparation of the balance sheet from the adjusted trial balance

before you go on...

Skolnick Co. was organized on April 1, 2010. The company prepares quarterly financial statements. The adjusted trial balance amounts at June 30 are shown below:

0010111			
	Debits		Credits
Cash	\$ 6,700	Accumulated Depreciation—Equipment	\$ 850
Accounts Receivable	600	Notes Payable	5,000
Prepaid Rent	900	Accounts Payable	1,510
Supplies	1,000	Salaries Payable	400
Equipment	15,000	Interest Payable	50
Dividends	600	Unearned Rent	500
Salaries Expense	9,400	Common Stock	14,000
Rent Expense	1,500	Commission Revenue	14,200
Depreciation Expense	850	Rent Revenue	800
Supplies Expense	200		
Utilities Expense	510		
Interest Expense	50		
Total debits	\$37,310	Total credits	\$37,310

TRIAL BALANCE

Action Plan

- In an adjusted trial balance, all asset, liability, revenue, and expense accounts are properly stated.
- To determine the ending balance in Retained Earnings, add net income and subtract dividends.
- (a) Determine the net income for the quarter April 1 to June 30.
- (b) Determine the total assets and total liabilities at June 30, 2010 for Skolnick Co.
- (c) Determine the amount that appears for Retained Earnings.

Solution

(a) The net income is determined by adding revenues and subtracting expenses. The net income is computed as follows:

Revenues		
Commission revenue	\$14,200	
Rent revenue	800	
Total revenues		\$15,000
Expenses		
Salaries expense	\$ 9,400	
Rent expense	1,500	
Depreciation expense	850	
Supplies expense	200	
Utilities expense	510	
Interest expense	50	
Total expenses		12,510

(b) Total assets and liabilities are computed as follows:

Net income

Asse	Liabilities			
Cash		\$ 6,700	Notes payable	\$5,000
Accounts receivable		600	Accounts payable	1,510
Supplies		1,000	Unearned rent	500
Prepaid rent		900	Salaries payable	400
Equipment	15,000		Interest payable	50
Less: Accumulated				
depreciation	850	14,150		
Total assets		\$23,350	Total liabilities	\$7,460
etained earnings, April 1	\$ ()		
ld: Net income	2,490)		
ess: Dividends	600)		
etained earnings, June 30	\$1,890) =		

\$ 2,490



Closing the Books

Alternative Terminology

Temporary accounts are sometimes called *nominal accounts*, and permanent accounts are sometimes called *real accounts*.

In previous chapters you learned that revenue and expense accounts and the dividends account are subdivisions of retained earnings, which is reported in the stockholders' equity section of the balance sheet. Because revenues, expenses, and dividends relate to only a given accounting period, they are considered **temporary accounts**. In contrast, all balance sheet accounts are considered **permanent accounts** because their balances are carried forward into future accounting periods. Illustration 4-29 (next page) identifies the accounts in each category.

PREPARING CLOSING ENTRIES

study objective 7
Explain the purpose of

closing entries.

At the end of the accounting period, companies transfer the temporary account balances to the permanent stockholders' equity account—Retained Earnings—through the preparation of closing entries. Closing entries transfer net income (or net loss) and dividends to Retained Earnings, so the balance in Retained Earnings agrees with the retained earnings statement. For example, notice that

Temporary

All revenue accounts All expense accounts Dividends

Permanent

All asset accounts
All liability accounts
Stockholders' equity accounts

Illustration 4-29

Temporary versus permanent accounts

in the adjusted trial balance in Illustration 4-24, Retained Earnings has a balance of zero. Prior to the closing entries, the balance in Retained Earnings will be its beginning-of-the-period balance. (For Sierra this is zero because it is Sierra's first month of operations.)

In addition to updating Retained Earnings to its correct ending balance, closing entries produce a **zero balance in each temporary account**. As a result, these accounts are ready to accumulate data about revenues, expenses, and dividends in the next accounting period separate from the data in the prior periods. **Permanent accounts are not closed.**

When companies prepare closing entries, they could close each income statement account directly to Retained Earnings. However, to do so would result in excessive detail in the retained earnings account. Accordingly, companies close the revenue and expense accounts to another temporary account, **Income Summary**, and they transfer only the resulting net income or net loss from this account to Retained Earnings. Illustration 4-30 depicts the closing process. While it still takes the average large company seven days to close, some companies such as Cisco employ technology that allows them to do a so-called "virtual close" almost instantaneously any time during the year. Besides dramatically reducing the cost of closing, the virtual close provides companies with accurate data for decision making whenever they desire it.

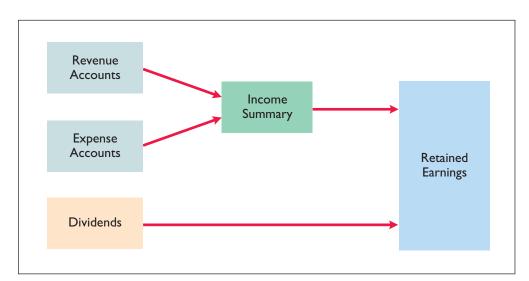


Illustration 4-30 The closing process

Illustration 4-31 shows the closing entries for Sierra Corporation. Illustration 4-32 (page 29) diagrams the posting process for Sierra Corporation's closing entries.

Illustration 4-31 Closing entries journalized

Helpful Hint Income Summary is a very descriptive title: Companies close total revenues to Income Summary and total expenses to Income Summary. The balance in the Income Summary is a net income or net loss.

GENERAL JOURNAL					
Date	Account Titles and Explanation	Debit	Credit		
2010	Closing Entries				
2010	(1)				
Oct. 31	Service Revenue	10,600			
	Income Summary		10,600		
	(To close revenue account)				
	(2)				
31	Income Summary	7,740			
	Salaries Expense		5,200		
	Advertising Supplies Expense		1,500		
	Rent Expense		900		
	Insurance Expense		50		
	Interest Expense		50		
	Depreciation Expense		40		
	(To close expense accounts)				
	(3)				
31	Income Summary	2,860			
	Retained Earnings		2,860		
	(To close net income to retained earnings)				
	(4)				
31	Retained Earnings	500			
	Dividends		500		
	(To close dividends to retained earnings)				

PREPARING A POST-CLOSING TRIAL BALANCE

After a company journalizes and posts all closing entries, it prepares another trial balance, called a **post-closing trial balance**, from the ledger. A post-closing trial balance is a list of all permanent accounts and their balances after closing entries are journalized and posted. The purpose of this trial balance is to prove the equality of the permanent account balances that the company carries forward into the next accounting period. Since all temporary accounts will have zero balances, the post-closing trial balance will contain only permanent—balance sheet—accounts.

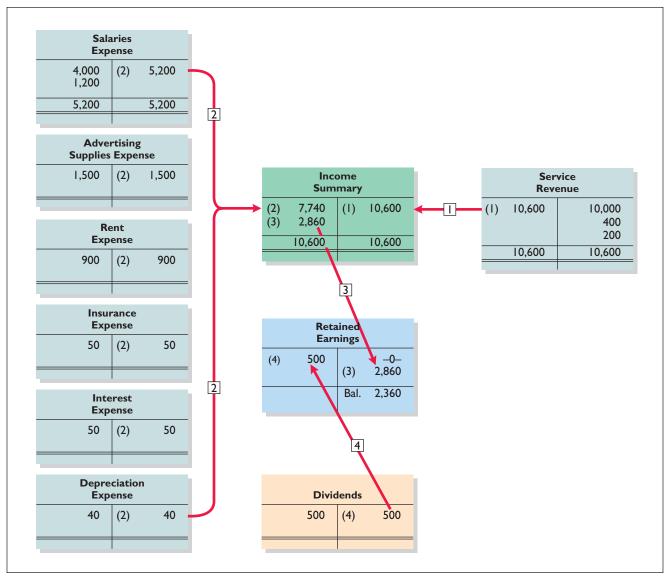


Illustration 4-32 Posting of closing entries

before you go on...

After making entries to close its revenue and expense accounts to Income Summary, Hancock Company has the following balances.

CLOSING ENTRIES

Dividends \$15,000 Retained Earnings \$42,000

Income Summary \$18,000 (credit balance)

Prepare the closing entries at December 31 that affect the stockholders' equity accounts.

Solution

Dec. 31	Income Summary Retained Earnings (To close net income to Retained Earnings)	18,000	18,000
31	Retained Earnings Dividends (To close Dividends to Retained Earnings)	15,000	15,000
	Earnings)		

Action Plan

- Close Income Summary to Retained Earnings.
- Close Dividends to Retained Earnings.



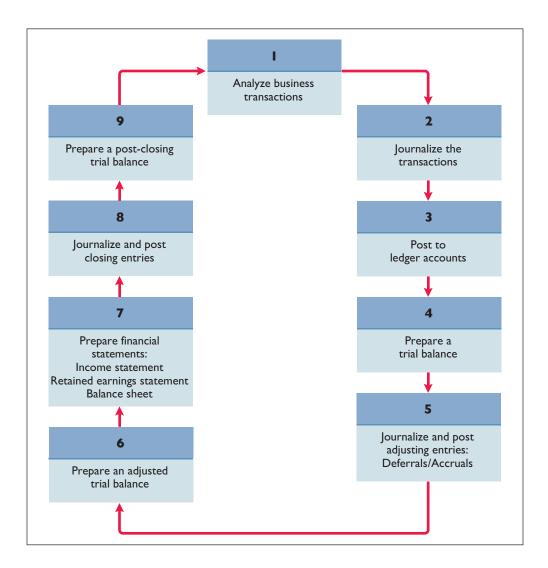
SUMMARY OF THE ACCOUNTING CYCLE

study objective 8

Describe the required steps in the accounting cycle.

Illustration 4-33 shows the required steps in the accounting cycle. You can see that the cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. Companies perform the steps in the cycle in sequence and repeat them in each accounting period.

Illustration 4-33
Required steps in the accounting cycle



Helpful Hint Some companies prefer to reverse certain adjusting entries at the beginning of a new accounting period. The company makes a reversing entry at the beginning of the next accounting period; this entry is the exact opposite of the adjusting entry made in the previous period.

Steps 1–3 may occur daily during the accounting period, as explained in Chapter 3. Companies perform Steps 4–7 on a periodic basis, such as monthly, quarterly, or annually. Steps 8 and 9, closing entries and a post-closing trial balance, usually take place only at the end of a company's **annual** accounting period.

Quality of Earnings

"Did you make your numbers today?" is a question asked often in both large and small businesses. Companies and employees are continually under pressure to "make the numbers"—that is, to have earnings that are in line with expectations. As a consequence it is not surprising that many companies practice earnings management. **Earnings management** is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. The quality of

earnings is greatly affected when a company manages earnings up or down to meet some targeted earnings number. A company that has a high **quality of earnings** provides full and transparent information that will not confuse or mislead users of the financial statements. A company with questionable quality of earnings may mislead investors and creditors, who believe they are relying on relevant and reliable information. As a consequence, investors and creditors lose confidence in financial reporting, and it becomes difficult for our capital markets to work efficiently.

Companies manage earnings in a variety of ways. One way is through the use of **one-time items** to prop up earnings numbers. For example, ConAgra Foods recorded a nonrecurring gain from the sale of Pilgrim's Pride stock for \$186 million to help meet an earnings projection for the quarter.

Another way is to **inflate revenue** numbers in the short-run to the detriment of the long-run. For example, Bristol-Myers Squibb provided sales incentives to its wholesalers to encourage them to buy products at the end of the quarter. As a result Bristol-Myers was able to meet its sales projections. The problem was that the wholesalers could not sell that amount of merchandise and ended up returning it to Bristol-Myers. The result was that Bristol-Myers had to restate its income numbers.

Companies also manage earnings through **improper adjusting entries**. Regulators investigated Xerox for accusations that it was booking too much revenue up-front on multi-year contract sales. Financial executives at Office Max resigned amid accusations that the company was recognizing rebates from its vendors too early and therefore overstating revenue. Finally, WorldCom's abuse of adjusting entries to meet its net income targets is unsurpassed: It used adjusting entries to increase net income by reclassifying liabilities as revenue and reclassifying expenses as assets. Investigations of the company's books after it went bankrupt revealed adjusting entries of more than a billion dollars that had no supporting documentation.

The good news is that, as a result of investor pressure as well as the **Sarbanes-Oxley Act**, many companies are trying to improve the quality of their financial reporting. For example, hotel operator Marriott is now providing detailed information on the write-offs it has on loan guarantees it gives hotels. General Electric has decided to provide more detail on its revenues and operating profits for individual businesses it owns. IBM is attempting to provide a better breakdown of its earnings. At the same time, regulators are taking a tough stand on the issue of quality of earnings. For example, one regulator noted that companies may be required to restate their financials every single time that they account for any transaction that had no legitimate purpose but was done solely for an accounting purpose, such as to smooth net income.

In this chapter you learned that adjusting entries are used to adjust numbers that would otherwise be stated on a cash basis. Sierra Corporation's income statement (Illustration 4-27) shows net income of \$2,860. The statement of cash flows reports a form of cash basis income referred to as "Net cash provided by operating activities." For example, Illustration 1-9 (page 16), which shows a statement of cash flows, reports net cash provided by operating activities of \$5,700 for Sierra. Net income and net cash provided by operating activities often differ. The difference for Sierra is \$2,840 (\$5,700 - \$2,860). The following summary shows the causes of this difference of \$2,840.

KEEPING AN EYE ON CASH

SO 9

Understand the causes of differences between net income and cash provided by operating activities.

		Computation of Net Cash Provided by Operating Activities	Computation of Net Income
(1)	Cash received in advance from customer	\$ 1,200	\$ 0
` /	Cash received from customers for services provided	10,000	10,000
(3)	Services provided for cash received previously in (1)	0	400
(4)	Services provided on account	0	200
(5)	Payment of rent	(900)	(900)
(6)	Purchase of insurance	(600)	0
(7)	Payment of employee salaries	(4,000)	(4,000)
(8)	Use of supplies	0	(1,500)
(9)	Use of insurance	0	(50)
(10)	Depreciation	0	(40)
(11)	Interest cost incurred, but not paid	0	(50)
(12)	Salaries incurred, but not paid	0	(1,200)
		\$ 5,700	\$ 2,860

For each item included in the computation of net cash provided by operating activities, you should confirm that cash was either received or paid. For each item in the income statement, the company should confirm that revenue was earned (even when cash was not received) or that an expense was incurred (even when cash was not paid).



Humana Corporation provides managed health care services to approximately 7 million people. Headquartered in Louisville, Kentucky, it has over 13,700 employees in 15 states and Puerto Rico. A simplified version of Humana's December 31, 2007, adjusted trial balance is shown at the top of the next page.

Instructions

From the trial balance, prepare an income statement, retained earnings statement, and classified balance sheet. Be sure to prepare them in that order, since each statement depends on information determined in the preceding statement.

 \Box

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HUMANA CORPORATION

Adjusted Trial Balance December 31, 2007 (in millions)

Account	Dr.	Cr.
Cash	\$ 2,040	
Short-Term Investments	3,635	
Receivables	606	
Other Current Assets	2,451	
Property and Equipment, Net	637	
Long-Term Investments	1,015	
Goodwill	1,664	
Other Long-Term Assets	830	
Benefits Payable		\$ 2,697
Accounts Payable		1,269
Other Current Liabilities		1,826
Long-Term Debt		3,059
Common Stock		1,272
Dividends	0	
Retained Earnings		1,922
Revenues		25,290
Medical Cost Expense	20,271	
Selling, General, and Administrative Expense	3,476	
Depreciation Expense	185	
Interest Expense	69	
Income Tax Expense	456	
	\$37,335	\$37,335

Solution

Art t/k

HUMANA CORPORATION

Income Statement For the Year Ended December 31, 2007 (in millions)

Revenues		\$25,290
Medical cost expense	\$20,271	
Selling, general, and administrative expense	3,476	
Depreciation expense	185	
Interest expense	69	
Income tax expense	456	24,457
Net income		\$ 833

Art t/k

HUMANA CORPORATION

Retained Earnings Statement For the Year Ended December 31, 2007 (in millions)

Beginning retained earnings Add: Net income	\$1,922 833
Less: Dividends	0
Ending retained earnings	\$2,755

Art t/k

HUMANA CORPORATION

Balance Sheet December 31, 2007 (in millions)

(in millions)		
Assets		
Current assets Cash Short-term investments Receivables Other current assets Total current assets Long-term investments Property and equipment, net Goodwill Other long-term assets	\$ 2,040 3,635 606 2,451	\$8,732 1,015 637 1,664 830
Total assets		\$12,878
Liabilities and Stockhol Liabilities Current liabilities Accounts payable	\$1,269	
Benefits payable Other current liabilities	2,697 1,826	
Total current liabilities Long-term debt Total liabilities		\$5,792 3,059 8,851
Stockholders' equity Common stock Retained earnings Total stockholders' equity	1,272 2,755	4,027
Total liabilities and stockholders' equity		<u>\$12,878</u>



Summary of Study Objectives



- 1 Explain the revenue recognition principle and the matching principle. The revenue recognition principle dictates that companies recognize revenue in the accounting period in which it is earned. The matching principle dictates that companies recognize expenses when expenses make their contribution to revenues.
- 2 Differentiate between the cash basis and the accrual basis of accounting. Accrual-based accounting means that companies record, in the periods in which the events occur, events that change a company's financial statements even if cash has not been exchanged. Under the cash basis, companies record events only in the periods in which the company receives or pays cash.
- **3** Explain why adjusting entries are needed, and identify the major types of adjusting entries. Companies make adjusting entries at the end of an accounting period. These entries ensure that companies record revenues in the period in which they are earned and that com-

- panies recognize expenses in the period in which they are incurred. The major types of adjusting entries are prepaid expenses, unearned revenues, accrued revenues, and accrued expenses.
- **4** Prepare adjusting entries for deferrals. Deferrals are either prepaid expenses or unearned revenues. Companies make adjusting entries for deferrals at the statement date to record the portion of the deferred item that represents the expense incurred or the revenue earned in the current accounting period.
- **5** Prepare adjusting entries for accruals. Accruals are either accrued revenues or accrued expenses. Adjusting entries for accruals record revenues earned and expenses incurred in the current accounting period that have not been recognized through daily entries.
- **6** Describe the nature and purpose of the adjusted trial balance. An adjusted trial balance is a trial balance

that shows the balances of all accounts, including those that have been adjusted, at the end of an accounting period. The purpose of an adjusted trial balance is to show the effects of all financial events that have occurred during the accounting period.

- **7** Explain the purpose of closing entries. One purpose of closing entries is to transfer net income or net loss for the period to Retained Earnings. A second purpose is to "zero-out" all temporary accounts (revenue accounts, expense accounts, and dividends) so that they start each new period with a zero balance. To accomplish this, companies "close" all temporary accounts at the end of an accounting period. They make separate entries to close revenues and expenses to Income Summary; Income Summary to Retained Earnings; and Dividends to Retained Earnings. Only temporary accounts are closed.
- 8 Describe the required steps in the accounting cycle. The required steps in the accounting cycle are: (a) analyze business transactions, (b) journalize the transactions, (c) post to ledger accounts, (d) prepare a trial balance, (e) journalize and post adjusting entries, (f) prepare an adjusted trial balance, (g) prepare financial statements, (h) journalize and post closing entries, and (i) prepare a post-closing trial balance.
- Understand the causes of differences between net income and net cash provided by operating activities. Net income is based on accrual accounting, which relies on the adjustment process. Net cash provided by operating activities is determined by adding cash received from operating the business and subtracting cash expended during operations.

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	SUMMARY TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
At what point should the company record revenue?	Need to understand the nature of the company's business	Record revenue when earned. A service business earns revenue when it performs a service.	Recognizing revenue too early overstates current period revenue; recognizing it too late understates current period revenue.
At what point should the company record expenses?	Need to understand the nature of the company's business	Expenses should "follow" revenues-that is, match the effort (expense) with the result (revenue).	Recognizing expenses too early overstates current period expense; recognizing them too late understates current period expense.

appendix

Adjusting Entries in an Automated World-Using a Worksheet

In the previous discussion we used T accounts and trial balances to arrive at the amounts used to prepare financial statements. Accountants frequently use a device known as a worksheet to determine these amounts. A **worksheet** is a multiple-column form that may be used in the adjustment process and in preparing financial statements. Accountants can prepare worksheets manually, but today most use computer spreadsheets.

As its name suggests, the worksheet is a working tool for the accountant. A worksheet is not a permanent accounting record; it is neither a journal nor a part of the general ledger. The worksheet is merely a supplemental device used to make it easier to prepare adjusting entries and the financial statements. Small companies with relatively few accounts and adjustments may not need a worksheet. In large companies with numerous accounts and many adjustments, a worksheet is almost indispensable.

study objective

10

Describe the purpose and the basic form of a worksheet.

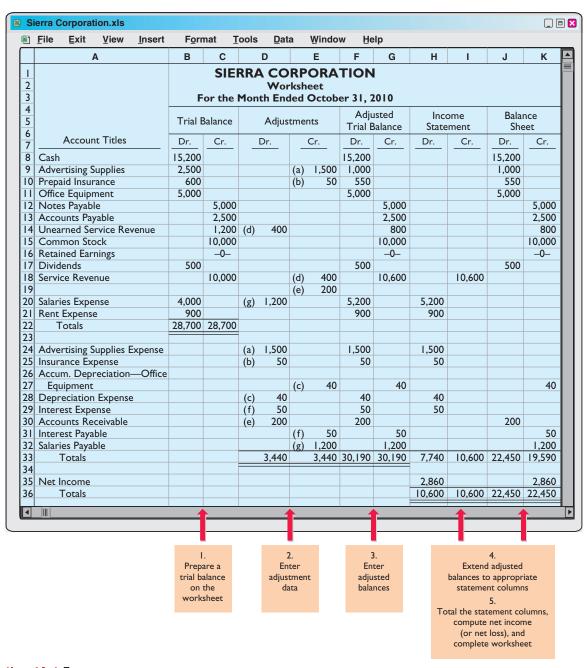


Illustration 4A-1 Form and procedure for a worksheet

Illustration 4A-1 shows the basic form of a worksheet. Note the headings: The worksheet starts with two columns for the Trial Balance. The next two columns record all Adjustments. Next is the Adjusted Trial Balance. The last two sets of columns correspond to the Income Statement and the Balance Sheet. All items listed in the Adjusted Trial Balance columns are included in either the Income Statement or the Balance Sheet columns.

Summary of Study Objective for Appendix



10 Describe the purpose and the basic form of a worksheet. The worksheet is a device to make it easier to prepare adjusting entries and the financial statements. Companies often prepare a worksheet on a

computer spreadsheet. The sets of columns of the worksheet are, from left to right, the unadjusted trial balance, adjustments, adjusted trial balance, income statement, and balance sheet.

Glossary

- **Accrual-basis accounting** (p. 6) Accounting basis in which companies record, in the periods in which the events occur, transactions that change a company's financial statements, even if cash was not exchanged. **Accrued expenses** (p. 17) Expenses incurred but not yet paid in cash or recorded. **Accrued revenues** (p. 15) Revenues earned but not yet
- received in cash or recorded.
- Adjusted trial balance (p. 23) A list of accounts and their balances after all adjustments have been made.
- **Adjusting entries** (*p.* 7) Entries made at the end of an accounting period to ensure that the revenue recognition and matching principles are followed.
- **Book value** (p. 12) The difference between the cost of a depreciable asset and its related accumulated depreciation.
- **Cash-basis accounting** (*p.* 6) Accounting basis in which a company records revenue only when it receives cash, and an expense only when it pays out cash.
- Closing entries (p. 25) Entries at the end of an accounting period to transfer the balances of temporary accounts to a permanent stockholders' equity account, Retained Earnings.
- Contra asset account (p. 11) An account that is offset against an asset account on the balance sheet.
- **Depreciation** (p. 11) The process of allocating the cost of an asset to expense over its useful life.
- **Earnings management** (p. 30) The planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income.
- **Fiscal year** (p. 4, in margin) An accounting period that is one year long.
- **Income Summary** (p. 27) A temporary account used in closing revenue and expense accounts.
- **Matching principle** (p. 5) The principle that dictates that companies match efforts (expenses) with accomplishments (revenues).

- **Permanent accounts** (p. 25) Balance sheet accounts whose balances are carried forward to the next account-
- **Post-closing trial balance** (p. 28) A list of permanent accounts and their balances after a company has journalized and posted closing entries.
- **Prepaid expenses (Prepayments)** (p. 8) Assets that result from the payment of expenses that benefit more than one accounting period.
- **Quality of earnings** (p. 30) Indicates the level of full and transparent information that a company provides to users of its financial statements.
- **Revenue recognition principle** (p. 4) The principle that companies recognize revenue in the accounting period in which it is earned.
- **Reversing entry** (p. 30, in margin) An entry made at the beginning of the next accounting period; the exact opposite of the adjusting entry made in the previous period.
- **Temporary accounts** (p. 25) Revenue, expense, and dividend accounts whose balances a company transfers to Retained Earnings at the end of an accounting period.
- **Time period assumption** (p. 4) An assumption that the economic life of a business can be divided into artificial time periods.
- **Unearned revenues** (p. 13) Cash received before a company earns revenues and recorded as a liability until earned.
- **Useful life** (p. 11) The length of service of a productive
- **Worksheet** (p. 34) A multiple-column form that companies may use in the adjustment process and in preparing financial statements.

Comprehensive Do it!



Terry Thomas and a group of investors incorporate the Green Thumb Lawn Care Corporation on April 1. At April 30 the trial balance shows the following balances for selected accounts.

Prepaid Insurance	\$ 3,600
Equipment	28,000
Notes Payable	20,000
Unearned Service Revenue	4,200
Service Revenue	1,800

Analysis reveals the following additional data pertaining to these accounts.

- 1. Prepaid insurance is the cost of a 2-year insurance policy, effective April 1.
- 2. Depreciation on the equipment is \$500 per month.
- 3. The note payable is dated April 1. It is a 6-month, 12% note.



- 4. Seven customers paid for the company's 6-month lawn service package of \$600 beginning in April. These customers received the first month of services in April.
- 5. Lawn services performed for other customers but not billed at April 30 totaled \$1,500.

Prepare the adjusting entries for the month of April. Show computations.

Instructions

Action Plan

- Note that adjustments are being made for one month.
- · Make computations carefully.
- · Select account titles carefully.
- Make sure debits are made first and credits are indented.
- Check that debits equal credits for each entry.

Solution to Comprehensive Do it!

GENERAL JOURNAL					
Date	Account Titles and Explanation	Debit	Credit		
	Adjusting Entries				
Apr. 30	Insurance Expense Prepaid Insurance	150	150		
•	(To record insurance expired: $\$3,600 \div 24 = \150 per month)				
30	Depreciation Expense Accumulated Depreciation—Equipment	500	500		
30	(To record monthly depreciation) Interest Expense Interest Payable	200	200		
	(To accrue interest on notes payable: $$20,000 \times 12\% \times \frac{1}{12} = 200)		200		
30	Unearned Service Revenue Service Revenue (To record revenue earned: \$600 ÷ 6 = \$100;	700	700		
30	\$100 per month × 7 = \$700) Accounts Receivable	1,500			
	Service Revenue (To accrue revenue earned but not billed or collected)		1,500		



Self-Study Questions

Answers are at the end of this chapter.

- (\$0 1) 1. What is the time period assumption?
 - (a) Companies should recognize revenue in the accounting period in which it is earned.
 - (b) Companies should match expenses with revenues.
 - (c) The economic life of a business can be divided into artificial time periods.
 - (d) The fiscal year should correspond with the calendar year.
- (\$0 1) **2.** Which principle dictates that efforts (expenses) be recorded with accomplishments (revenues)?
 - (a) Matching principle.
 - (b) Cost principle.
 - (c) Periodicity principle.
 - (d) Revenue recognition principle.



- **3.** Which one of these statements about the (\$0.2) accrual basis of accounting is *false?*
 - (a) Companies record events that change their financial statements in the period in which events occur, even if cash was not exchanged.
 - (b) Companies recognize revenue in the period in which it is earned.
 - (c) This basis is in accord with generally accepted accounting principles.
 - (d) Companies record revenue only when they receive cash, and record expense only when they pay out cash.
- **4.** Adjusting entries are made to ensure that:
 - (a) expenses are recognized in the period in which they are incurred.

(S03)

- (b) revenues are recorded in the period in which they are earned.
- (c) balance sheet and income statement accounts have correct balances at the end of an accounting period.
- (d) All of the above.
- (\$0 4, 5) **5.** Each of the following is a major type (or category) of adjusting entry *except*:
 - (a) prepaid expenses.
 - (b) accrued revenues.
 - (c) accrued expenses.
 - (d) earned expenses.
- (\$0 4) **6.** The trial balance shows Supplies \$1,350 and Supplies Expense \$0. If \$600 of supplies are on hand at the end of the period, the adjusting entry is:

(a) Supplies	600	
Supplies	Expense	600
(b) Supplies	750	
Supplies	Expense	750
(c) Supplies Expe	ense 750	
Supplies		750
(d) Supplies Expe	ense 600	
Supplies		600

- (\$0 4) 7. Adjustments for unearned revenues:
 - (a) decrease liabilities and increase revenues.
 - (b) increase liabilities and increase revenues.
 - (c) increase assets and increase revenues.
 - (d) decrease revenues and decrease assets.
- (\$0.4) **8.** Adjustments for prepaid expenses:
 - (a) decrease assets and increase revenues.
 - (b) decrease expenses and increase assets.
 - (c) decrease assets and increase expenses.
 - (d) decrease revenues and increase assets.
- (\$0 4) 9. Queenan Company computes depreciation on delivery equipment at \$1,000 for the month of June. The adjusting entry to record this depreciation is as follows:

(a)	Depreciation Expense	1,000	
	Accumulated Depreciation—		
	Queenan Company		1,000
(b)	Depreciation Expense	1,000	
	Delivery Equipment		1,000
(c)	Depreciation Expense	1,000	
	Accumulated Depreciation—		
	Delivery Equipment		1,000
(d)	Delivery Equipment Expense	1,000	
	Accumulated Depreciation—		
	Delivery Equipment		1,000

- (\$0 5) 10. Adjustments for accrued revenues:
 - (a) increase assets and increase liabilities.
 - (b) increase assets and increase revenues.

- (c) decrease assets and decrease revenues.
- (d) decrease liabilities and increase revenues.
- 11. Colleen Mooney earned a salary of \$400 for the last (\$0.5) week of September. She will be paid on October 1. The adjusting entry for Colleen's employer at September 30 is:
 - (a) No entry is required.

(b) Salaries Expense	400	
Salaries Payable		400
(c) Salaries Expense	400	
Cash		400
(d) Salaries Payable	400	
Cash		400

- **12.** Which statement is *incorrect* concerning the ad- (\$0.6) justed trial balance?
 - (a) An adjusted trial balance proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments are made.
 - (b) The adjusted trial balance provides the primary basis for the preparation of financial statements.
 - (c) The adjusted trial balance does not list temporary accounts.
 - (d) The company prepares the adjusted trial balance after it has journalized and posted the adjusting entries.
- 13. Which account will have a zero balance after a company has journalized and posted closing entries?
 - (a) Service Revenue.
 - (b) Advertising Supplies.
 - (c) Prepaid Insurance.
 - (d) Accumulated Depreciation.
- **14.** Which types of accounts will appear in the post- (\$0.7) closing trial balance?
 - (a) Permanent accounts.
 - (b) Temporary accounts.
 - (c) Accounts shown in the income statement columns of a work sheet.
 - (d) None of the above.
- **15.** All of the following are required steps in the accounting cycle *except*:
 - (a) journalizing and posting closing entries.
 - (b) preparing an adjusted trial balance.
 - (c) preparing a post-closing trial balance.
 - (d) preparing a work sheet.

Go to the book's companion website, **www.** wiley.com/college/kimmel, to access additional Self-Study Questions.



Note: All asterisked Questions relate to material in the appendix to the chapter.

Questions

- **1.** (a) How does the time period assumption affect an accountant's analysis of accounting transactions?
 - (b) Explain the term *fiscal year*.

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

- 3. Tony Carino, a lawyer, accepts a legal engagement in March, performs the work in April, and is paid in May. If Carino's law firm prepares monthly financial statements, when should it recognize revenue from this engagement? Why?
- 4. Carino pays no costs in March, \$2,500 in April, and \$2,000 in May (incurred in April). How much expense should the firm deduct from revenues in the month when it recognizes the revenue? Why?
- **5.** "The cost principle of accounting requires adjusting entries." Do you agree? Explain.
- **6.** Why may the financial information in a trial balance not be up-to-date and complete?
- 7. Distinguish between the two categories of adjusting entries, and identify the types of adjustments applicable to each category.
- **8.** What accounts does a company debit and credit in a prepaid expense adjusting entry?
- **9.** "Depreciation is a process of valuation that results in the reporting of the fair market value of the asset." Do you agree? Explain.
- **10.** Explain the differences between depreciation expense and accumulated depreciation.
- 11. Harding Company purchased equipment for \$15,000. By the current balance sheet date, the company had depreciated \$9,000. Indicate the balance sheet presentation of the data.
- **12.** What accounts are debited and credited in an unearned revenue adjusting entry?
- 13. Computer Technologies provides maintenance service for computers and office equipment for companies throughout the Northeast. The sales manager is elated because she closed a \$300,000 three-year maintenance contract on December 29, 2009, two days before the company's year-end. "Now we will hit this year's net income target for sure," she crowed. The customer is required to pay \$100,000 on December 29 (the day the deal was closed). Two more payments of \$100,000 each are also required on December 29, 2010 and 2011. Discuss the effect that this event will have on the company's financial statements.
- 14. SquareDeal, a large national retail chain, is nearing its fiscal year-end. It appears that the company is not going to hit its revenue and net income targets. The company's marketing manager, Mickey Cox, suggests running a promotion selling \$50 gift cards for \$40. He believes that this would be very popular and would enable the company to meet its targets for revenue and net income. What do you think of this idea?
- 15. A company fails to recognize revenue earned but not yet received. Which of the following accounts are involved in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense? For the accounts selected, indicate whether they would be debited or credited in the entry.
- **16.** A company fails to recognize an expense incurred but not paid. Indicate which of the following

- accounts is debited and which is credited in the adjusting entry: (a) asset, (b) liability, (c) revenue, or (d) expense.
- 17. A company makes an accrued revenue adjusting entry for \$800 and an accrued expense adjusting entry for \$500. How much was net income understated prior to these entries? Explain.
- **18.** On January 9 a company pays \$6,000 for salaries, of which \$1,100 was reported as Salaries Payable on December 31. Give the entry to record the payment.
- 19. For each of the following items before adjustment, indicate the type of adjusting entry—prepaid expense, unearned revenue, accrued revenue, and accrued expense—that is needed to correct the misstatement. If an item could result in more than one type of adjusting entry, indicate each of the types.
 - (a) Assets are understated.
 - (b) Liabilities are overstated.
 - (c) Liabilities are understated.
 - (d) Expenses are understated.
 - (e) Assets are overstated.
 - (f) Revenue is understated
- **20.** One-half of the adjusting entry is given below. Indicate the account title for the other half of the entry.
 - (a) Salaries Expense is debited.
 - (b) Depreciation Expense is debited.
 - (c) Interest Payable is credited.
 - (d) Supplies is credited.
 - (e) Accounts Receivable is debited.
 - (f) Unearned Service Revenue is debited.
- **21.** "An adjusting entry may affect more than one balance sheet or income statement account." Do you agree? Why or why not?
- **22.** Which balance sheet account provides evidence that Tootsie Roll records sales on an accrual basis rather than a cash basis? Explain.
- **23.** Why is it possible to prepare financial statements directly from an adjusted trial balance?
- **24.** © G
 - (a) What information do accrual basis financial statements provide that cash basis statements do not?
 - (b) What information do cash basis financial statements provide that accrual basis statements do not?
- **25.** What is the relationship, if any, between the amount shown in the adjusted trial balance column for an account and that account's ledger balance?
- **26.** Identify the account(s) debited and credited in each of the four closing entries, assuming the company has net income for the year.
- Some companies employ technologies that allow them to do a so-called "virtual close." This enables them to close their books nearly instantaneously any time during the year. What advantages does a "virtual close" provide?
- **28.** Describe the nature of the Income Summary account, and identify the types of summary data that may be posted to this account.

- **29.** What items are disclosed on a post-closing trial balance, and what is its purpose?
- **30.** Which of these accounts would not appear in the post-closing trial balance? Interest Payable, Equipment, Depreciation Expense, Dividends, Unearned Service Revenue, Accumulated Depreciation— Equipment, and Service Revenue.
- **31.** Indicate, in the sequence in which they are made, the three required steps in the accounting cycle that involve journalizing.
- **32.** Identify, in the sequence in which they are prepared, the three trial balances that are required in the accounting cycle.
- Explain the terms earnings management and quality of earnings.
- **34.** Give examples of how companies manage earnings.
- *35. What is the purpose of a worksheet?
- *36. What is the basic form of a worksheet?



Net

Brief Exercises

BE4-1 Transactions that affect earnings do not necessarily affect cash.

Instructions

Identify the effect, if any, that each of the following transactions would have upon cash and net income. The first transaction has been completed as an example.

Identify impact of transactions on cash and net income.

(S02, 9)

					Cash	Income
(a)	Purchased \$100 of supplies for cash.				-\$100	\$ 0
a \	D 1 1 1:	1	C & 40	C .1	1	1.

- (b) Recorded an adjusting entry to record use of \$40 of the above supplies.
- (c) Made sales of \$1,300, all on account.
- (d) Received \$800 from customers in payment of their accounts.
- (e) Purchased equipment for cash, \$2,500.
 - (f) Recorded depreciation of building for period used, \$600.

BE4-2 The ledger of Greenwood Company includes the following accounts. Explain why each account may require adjustment.

- (a) Prepaid Insurance.
- (b) Depreciation Expense.
- (c) Unearned Service Revenue.
- (d) Interest Payable.

BE4-3 Bura Company accumulates the following adjustment data at December 31. Indicate (1) the type of adjustment (prepaid expense, accrued revenue, and so on) and

- (2) the status of the accounts before adjustment (overstated or understated).
- (a) Supplies of \$400 are on hand. Supplies account shows \$1,900 balance.
- (b) Service Revenue earned but unbilled total \$700.
- (c) Interest of \$300 has accumulated on a note payable.
- (d) Rent collected in advance totaling \$1,100 has been earned.

BE4.4 Dawes Advertising Company's trial balance at December 31 shows Advertising Supplies \$8,800 and Advertising Supplies Expense \$0. On December 31 there are \$1,400 of supplies on hand. Prepare the adjusting entry at December 31 and, using T accounts, enter the balances in the accounts, post the adjusting entry, and indicate the adjusted balance in each account.

BE4-5 At the end of its first year, the trial balance of Hinz Company shows Equipment \$22,000 and zero balances in Accumulated Depreciation—Equipment and Depreciation Expense. Depreciation for the year is estimated to be \$2,200. Prepare the adjusting entry for depreciation at December 31, post the adjustments to T accounts, and indicate the balance sheet presentation of the equipment at December 31.

BE4-6 On July 1, 2010, Noble Co. pays \$10,800 to Russo Insurance Co. for a 2-year insurance contract. Both companies have fiscal years ending December 31. For Noble Co. journalize and post the entry on July 1 and the adjusting entry on December 31.

BE4-7 Using the data in BE4-6, journalize and post the entry on July 1 and the adjusting entry on December 31 for Russo Insurance Co. Russo uses the accounts Unearned Insurance Revenue and Insurance Revenue.

BE4-8 The bookkeeper for Biggs Company asks you to prepare the following accrual adjusting entries at December 31.

Indicate why adjusting entries are needed.

(S0 3)

Identify the major types of adjusting entries.

(SO 3)



Prepare adjusting entry for supplies.

(SO 4)

Prepare adjusting entry for depreciation.

(S0 4)

Prepare adjusting entry for prepaid expense.

(SO 4)

Prepare adjusting entry for unearned revenue.

(SO 4)

Prepare adjusting entries for accruals.

(SO 5)

- (a) Interest on notes payable of \$300 is accrued.
- (b) Service revenue earned but unbilled totals \$1,400.
- (c) Salaries of \$780 earned by employees have not been recorded.

Use these account titles: Service Revenue, Accounts Receivable, Interest Expense, Interest Payable, Salaries Expense, and Salaries Payable.

Analyze accounts in an adjusted trial balance.

(80.6)



BE4-9 The trial balance of Fink Company includes the following balance sheet accounts. Identify the accounts that might require adjustment. For each account that requires adjustment, indicate (1) the type of adjusting entry (prepaid expenses, unearned revenues, accrued revenues, and accrued expenses) and (2) the related account in the adjusting entry.

(a) Accounts Receivable.

(e) Notes Payable.

(b) Prepaid Insurance.

(f) Interest Payable.

(c) Equipment.

- (g) Unearned Service Revenue.
- (d) Accumulated Depreciation-Equipment.

Prepare an income statement from an adjusted trial balance.

(S0.6)

Prepare a retained earnings statement from an adjusted trial balance.

(SO 6)

Identify financial statement for selected accounts.

(80.6)

Identify post-closing trial balance accounts.

(S07)

Prepare and post closing entries

(S07)

List required steps in the accounting cycle sequence.

(808)

BE4-10 The adjusted trial balance of Rose Corporation at December 31, 2010, includes the following accounts: Retained Earnings \$17,200; Dividends \$6,000; Service Revenue \$32,000; Salaries Expense \$13,000; Insurance Expense \$1,800; Rent Expense \$3,500; Supplies Expense \$1,200; and Depreciation Expense \$1,000. Prepare an income statement for the year.

BE4-11 Partial adjusted trial balance data for Rose Corporation are presented in BE4-10. The balance in Retained Earnings is the balance as of January 1. Prepare a retained earnings statement for the year assuming net income is \$10,000.

BE4-12 The following selected accounts appear in the adjusted trial balance for Reno Company. Indicate the financial statement on which each account would be reported.

- (a) Accumulated Depreciation.
- (e) Service Revenue.

(b) Depreciation Expense.

(f) Supplies.

(c) Retained Earnings.

(g) Accounts Payable.

(d) Dividends.

BE4-13 Using the data in BE4-12, identify the accounts that would be included in a post-closing trial balance.

BE4-14 The income statement for the Edgebrook Golf Club Inc. for the month ended July 31 shows Green Fees Revenue \$16,000; Salaries Expense \$8,400; Maintenance Expense \$2,500; and Income Tax Expense \$1,000. The statement of retained earnings shows an opening balance for Retained Earnings of \$20,000 and Dividends \$1,000.

- (a) Prepare and post the closing journal entries.
- (b) What is the ending balance in Retained Earnings?

BE4-15 The required steps in the accounting cycle are listed in random order below. List the steps in proper sequence.

- (a) Prepare a post-closing trial balance.
- (b) Prepare an adjusted trial balance.
- (c) Analyze business transactions.
- (d) Prepare a trial balance.
- (e) Journalize the transactions.
- (f) Journalize and post closing entries.
- (g) Prepare financial statements.
- (h) Journalize and post adjusting entries.
- (i) Post to ledger accounts.

Review



Do it! 4-1 The ledger of Buerhle, Inc. on March 31, 2010, includes the following selected accounts before adjusting entries.

	<u>Debit</u>	Credit
Prepaid Insurance	2,400	
Office Supplies	2,500	
Office Equipment	30,000	
Unearned Revenue		10,000

Prepare adjusting entries for deferrals.

(S0 4)

An analysis of the accounts shows the following:

- 1. Insurance expires at the rate of \$300 per month.
- 2. Supplies on hand total \$900.
- 3. The office equipment depreciates \$500 per month.
- 4. 2/5 of the unearned revenue was earned in March.

Prepare the adjusting entries for the month of March.

Do it! 4-2 Jose Contreras is the new owner of Curveball Computer Services. At the end of July 2010, his first month of ownership, Jose is trying to prepare monthly financial statements. He has the following information for the month.

Prepare adjusting entries for accruals. (S05)

- 1. At July 31, Contreras owed employees \$1,100 in salaries that the company will pay in August.
- 2. On July 1, Contreras borrowed \$20,000 from a local bank on a 10-year note. The annual interest rate is 12%.
- 3. Service revenue unrecorded in July totaled \$1,600.

Prepare the adjusting entries needed at July 31, 2010.

Do it! 4-3 Explain in which financial statement each of the following adjusted trial balance accounts would be presented.

Prepare financial statements from adjusted trial balance. (S06)

Service Revenue Accounts Receivable Notes Payable

Accumulated Depreciation Common Stock Utilities Expense

Do it! 4-4 After closing revenues and expense, Adams Company shows the following account balances.

Prepare closing entries.

(S0.7)

\$22,000 Dividends Retained Earnings 70.000

Income Summary 29,000 (credit balance) Prepare the remaining closing entries at December 31.

Exercises

E4-1 The following independent situations require professional judgement for determining when to recognize revenue from the transactions.

(a) Southwest Airlines sells you an advance-purchase airline ticket in September for your flight home at Christmas.

(b) Ultimate Electronics sells you a home theatre on a "no money down, no interest, and no payments for one year" promotional deal.

- (c) The Toronto Blue Jays sell season tickets online to games in the Skydome. Fans can purchase the tickets at any time, although the season doesn't officially begin until April. The major league baseball season runs from April through October.
- (d) You borrow money in August from RBC Financial Group. The loan and the interest are repayable in full in November.
- (e) In August, you order a sweater from Sears using its online catalog. The sweater arrives in September, and you charge it to your Sears credit card. You receive and pay the Sears bill in October.

Instructions

Identify when revenue should be recognized in each of the above situations.

E4-2 These are the assumptions, principles, and constraints discussed in this and previous chapters.

1. Economic entity assumption.

- 2. Matching principle.
- 3. Monetary unit assumption.
- 4. Time period assumption.
- 5. Cost principle.
- 6. Materiality.

Identify point of revenue recognition.

(S0.1)



Identify accounting assumptions, principles, and constraints.

(S01)

- 7. Full disclosure principle.
- 8. Going concern assumption.
- 9. Revenue recognition principle.
- 10. Conservatism.

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a number more than once.

- _____ (a) Is the rationale for why plant assets are not reported at liquidation value. (Do not use the cost principle.)
- (b) Indicates that personal and business record-keeping should be separately maintained.
 - (c) Ensures that all relevant financial information is reported.
- ____ (d) Assumes that the dollar is the "measuring stick" used to report on financial performance.
- ____ (e) Requires that accounting standards be followed for all *significant* items.
- ____ (f) Separates financial information into time periods for reporting purposes.
- ____ (g) Requires recognition of expenses in the same period as related revenues.
- (h) Indicates that market value changes subsequent to purchase are not recorded in the accounts.

E4-3 Here are some accounting reporting situations.

- (a) Hansell Company recognizes revenue at the end of the production cycle but before sale. The price of the product, as well as the amount that can be sold, is not certain.
- (b) Falk Company is in its fifth year of operation and has yet to issue financial statements. (Do not use the full disclosure principle.)
- (c) Tavarez, Inc. is carrying inventory at its original cost of \$100,000. Inventory has a market value of \$110,000.
- (d) Forgetta Hospital Supply Corporation reports only current assets and current liabilities on its balance sheet. Property, plant, and equipment and bonds payable are reported as current assets and current liabilities, respectively. Liquidation of the company is unlikely.
- (e) Kile Company has inventory on hand that cost \$400,000. Kile reports inventory on its balance sheet at its current market value of \$425,000.
- (f) Kim Farris, president of Classic Music Company, bought a computer for her personal use. She paid for the computer by using company funds and debited the "Computers" account.

Instructions

For each situation, list the assumption, principle, or constraint that has been violated, if any. Some of these assumptions, principles, and constraints were presented in earlier chapters. List only one answer for each situation.

E4-4 Your examination of the records of a company that follows the cash basis of accounting tells you that the company's reported cash basis earnings in 2010 are \$33,640. If this firm had followed accrual basis accounting practices, it would have reported the following year-end balances.

	2010	2009
Accounts receivable	\$3,400	\$2,800
Supplies on hand	1,300	1,160
Unpaid wages owed	2,000	2,400
Other unpaid amounts	1.400	1.600

Instructions

Determine the company's net earnings on an accrual basis for 2010. Show all your calculations in an orderly fashion.

E4-5 In its first year of operations Cope Company earned \$28,000 in service revenue, \$6,000 of which was on account and still outstanding at year-end. The remaining \$22,000 was received in cash from customers.

The company incurred operating expenses of \$15,500. Of these expenses \$13,000 were paid in cash; \$2,500 was still owed on account at year-end. In addition, Cope prepaid \$2,600 for insurance coverage that would not be used until the second year of operations.

Identify the violated assumption, principle, or constraint.

(SO 1)



Convert earnings from cash to accrual basis. (\$0 2, 4, 5, 9)

Determine cash basis and accrual basis earnings. (\$0 2, 9)



Instructions

- (a) Calculate the first year's net earnings under the cash basis of accounting, and calculate the first year's net earnings under the accrual basis of accounting.
- (b) Which basis of accounting (cash or accrual) provides more useful information for decision makers?

E4-6 Boulder Company, a ski tuning and repair shop, opened in November 2009. The company carefully kept track of all its cash receipts and cash payments. The following information is available at the end of the ski season, April 30, 2010.

	Cash Receipts	Cash Payments
Issue of common shares	\$20,000	
Payment for repair equipment		\$ 9,200
Rent payments		1,225
Newspaper advertising payment		375
Utility bills payments		970
Part-time helper's wages payments		2,600
Income tax payment		10,000
Cash receipts from ski and		
snowboard repair services	32,150	
Subtotals	52,150	24,370
Cash balance		_27,780
Totals	<u>\$52,150</u>	<u>\$52,150</u>

You learn that the repair equipment has an estimated useful life of 5 years. The company rents space at a cost of \$175 per month on a one-year lease. The lease contract requires payment of the first and last months' rent in advance, which was done. The part-time helper is owed \$420 at April 30, 2010, for unpaid wages. At April 30, 2010, customers owe Boulder Company \$350 for services they have received but have not yet paid for.

Instructions

- (a) Prepare an accrual-basis income statement for the 6 months ended April 30, 2010.
- (b) Prepare the April 30, 2010, classified balance sheet.

E4-7 FunPlay, a maker of electronic games for kids, has just completed its first year of operations. The company's sales growth was explosive. To encourage large national stores to carry its products FunPlay offered 180-day financing—meaning its largest customers do not pay for nearly 6 months. Because FunPlay is a new company, its components suppliers insist on being paid cash on delivery. Also, it had to pay up front for 2 years of insurance. At the end of the year FunPlay owed employees for one full month of salaries, but due to a cash shortfall, it promised to pay them the first week of next year.

Instructions

- (a) Explain how cash and accrual accounting would differ for each of the events listed above and describe the proper accrual accounting.
- (b) Assume that at the end of the year FunPlay reported a favorable net income, yet the company's management is concerned because the company is very short of cash. Explain how FunPlay could have positive net income and yet run out of cash.

E4-8 Proctor Company accumulates the following adjustment data at December 31.

- (a) Service Revenue earned but unbilled totals \$600.
- (b) Store supplies of \$300 are on hand. Supplies account shows \$1,900 balance.
- (c) Utility expenses of \$275 are unpaid.
- (d) Service revenue of \$490 collected in advance has been earned.
- (e) Salaries of \$800 are unpaid.
- (f) Prepaid insurance totaling \$400 has expired.

Instructions

For each item indicate (1) the type of adjustment (prepaid expense, unearned revenue, accrued revenue, or accrued expense) and (2) the status of the accounts before adjustment (overstated or understated).

E4-9 The ledger of Thurston Rental Agency on March 31 of the current year includes these selected accounts before adjusting entries have been prepared.

Convert earnings from cash to accrual basis; prepare accrual-based financial statements.

(SO 2, 4, 5, 9)

Identify differences between cash and accrual accounting. (\$0.2, 3, 9)

Identify types of adjustments and accounts before adjustment.

(\$0 3, 4, 5)

Prepare adjusting entries from selected account data. (\$0.4.5)

	Debits	Credits
Prepaid Insurance	\$ 3,600	
Supplies	3,000	
Equipment	25,000	
Accumulated Depreciation—Equipment		\$ 8,400
Notes Payable		20,000
Unearned Rent Revenue		10,200
Rent Revenue		60,000
Interest Expense	0	
Wage Expense	14,000	

An analysis of the accounts shows the following.

- 1. The equipment depreciates \$280 per month.
- 2. Half of the unearned rent revenue was earned during the quarter.
- 3. Interest of \$440 is accrued on the notes payable.
- 4. Supplies on hand total \$850.
- 5. Insurance expires at the rate of \$400 per month.

Instructions

Prepare the adjusting entries at March 31, assuming that adjusting entries are made quarterly. Additional accounts are: Depreciation Expense, Insurance Expense, Interest Payable, and Supplies Expense.

Prepare adjusting entries.

E4-10 Mark Bennett, D.D.S., opened an incorporated dental practice on January 1, 2010.

S0 4.5 During the first month of operations the following transactions occurred:

- Performed services for patients who had dental plan insurance. At January 31, \$680 of such services was earned but not yet billed to the insurance companies.
- 2. Utility expenses incurred but not paid prior to January 31 totaled \$520.
- 3. Purchased dental equipment on January 1 for \$80,000, paying \$20,000 in cash and signing a \$60,000, 3-year note payable (Interest is paid each December 31). The equipment depreciates \$400 per month. Interest is \$500 per month.
- 4. Purchased a 1-year malpractice insurance policy on January 1 for \$24,000.
- 5. Purchased \$1,750 of dental supplies (recorded as increase to Supplies). On January 31 determined that \$550 of supplies were on hand.

Instructions

Prepare the adjusting entries on January 31. Account titles are: Accumulated Depreciation—Dental Equipment, Depreciation Expense, Service Revenue, Accounts Receivable, Insurance Expense, Interest Expense, Interest Payable, Prepaid Insurance, Supplies, Supplies Expense, Utilities Expense, and Utilities Payable.

E4-11 The unadjusted trial balance for Sierra Corp. is shown in Illustration 4-4 (page 8). In lieu of the adjusting entries shown in the text at October 31, assume the following adjustment data

- 1. Advertising supplies on hand at October 31 total \$500.
- 2. Expired insurance for the month is \$100.
- 3. Depreciation for the month is \$50.
- 4. As of October 31, \$800 of the previously recorded unearned revenue had been earned.
- Services provided but unbilled (and no receivable has been recorded) at October 31 are \$200.
- 6. Interest expense accrued at October 31 is \$70.
- 7. Accrued salaries at October 31 are \$1,400.

Instructions

Prepare the adjusting entries for the items above.

E4-12 The income statement of Marx Co. for the month of July shows net income of \$1,500 based on Service Revenue \$5,500; Wages Expense \$2,300; Supplies Expense \$900, and Utilities Expense \$800. In reviewing the statement, you discover the following:

- 1. Insurance expired during July of \$350 was omitted.
- 2. Supplies expense includes \$200 of supplies that are still on hand at July 31.
- 3. Depreciation on equipment of \$150 was omitted.
- 4. Accrued but unpaid wages at July 31 of \$300 were not included.
- 5. Revenue earned but unrecorded totaled \$700.

(S0 4, 5)

Prepare adjusting entries. (\$0 4, 5)

Prepare a correct income statement.







Instructions

Prepare a correct income statement for July 2010.

E4-13 This is a partial adjusted trial balance of Orlando Company.

ORLANDO COMPANY Adjusted Trial Balance January 31, 2010

	Debit	Credit
Supplies	\$ 700	
Prepaid Insurance	1,560	
Salaries Payable		\$1,200
Unearned Service Revenue		750
Supplies Expense	950	
Insurance Expense	520	
Salaries Expense	1,800	
Service Revenue		2,000

Analyze adjusted data. (S0 1, 4, 5, 6)



Instructions

Answer these questions, assuming the year begins January 1.

- (a) If the amount in Supplies Expense is the January 31 adjusting entry, and \$650 of supplies was purchased in January, what was the balance in Supplies on January 1?
- (b) If the amount in Insurance Expense is the January 31 adjusting entry, and the original insurance premium was for 1 year, what was the total premium and when was the policy purchased?
- (c) If \$2,500 of salaries was paid in January, what was the balance in Salaries Payable at December 31, 2009?
- (d) If \$1,800 was received in January for services performed in January, what was the balance in Unearned Service Revenue at December 31, 2009?

E4-14 A partial adjusted trial balance for Orlando Company is given in E4-13.

Instructions

Prepare the closing entries at January 31, 2010.

E4-15 Selected accounts of Callahan Company are shown here.

Supplies Expense				Salaries	Payable		
July 31	750					July 31	1,200
Salaries Expense				Accounts	Receivabl	e	
July 15 31	1,200 1,200			July 31	500		
Service Revenue			Unearned Service Revenue				
		July 14 31 31	4,100 900 500	July 31	900	July 1 20	Bal. 1,500 600
	Sup	plies					
July 1 10	Bal. 1,100 200	July 31	750				

Instructions

After analyzing the accounts, journalize (a) the July transactions and (b) the adjusting entries that were made on July 31. (*Hint:* July transactions were for cash.)

E4-16 The trial balances shown below are before and after adjustment for Ivy Company at the end of its fiscal year.

Prepare closing entries. (S0 7)

Journalize basic transactions and adjusting entries.

(\$0 4, 5, 6)

Prepare adjusting entries from analysis of trial balance.



IVY COMPANY Trial Balance August 31, 2010

	Before Adjustment		After	
			Adjus	tment
	Dr.	Cr.	Dr.	Cr.
Cash	\$10,900		\$10,900	
Accounts Receivable	8,800		9,400	
Office Supplies	2,500		500	
Prepaid Insurance	4,000		2,500	
Office Equipment	16,000		16,000	
Accumulated Depreciation—Office Equipment		\$ 3,600		\$ 4,800
Accounts Payable		5,800		5,800
Salaries Payable		0		1,100
Unearned Rent Revenue		1,800		900
Common Stock		10,000		10,000
Retained Earnings		5,600		5,600
Dividends	2,800		2,800	
Service Revenue		34,000		34,600
Rent Revenue		13,200		14,100
Salaries Expense	17,000		18,100	
Office Supplies Expense	0		2,000	
Rent Expense	12,000		12,000	
Insurance Expense	0		1,500	
Depreciation Expense	0		1,200	
	\$74,000	\$74,000	\$76,900	\$76,900

Instructions

Prepare the adjusting entries that were made.

Prepare financial statements from adjusted trial balance. **(SO 6)**

E4-17 The adjusted trial balance for Ivy Company is given in E4-16.

Instructions

Instructions

Prepare the income and retained earnings statements for the year and the classified balance sheet at August 31.

Prepare closing entries. (S07)

E4-18 The adjusted trial balance for Ivy Company is given in E4-16.

Prepare the closing entries for the temporary accounts at August 31.

Exercises: Set B



Visit the book's companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site, to access Exercise Set B.

Problems: Set A



Record transactions on accrual basis; convert revenue to cash receipts. (SO 2, 4, 9)

P4-1A The following selected data are taken from the comparative financial statements of Ottawa Curling Club. The Club prepares its financial statements using the accrual basis of accounting.

September 30	2010	2009
Accounts receivable for member dues	\$ 18,000	\$ 11,000
Unearned ticket revenue	20,000	26,000
Dues revenue	153,000	\$135,000

Dues are billed to members based upon their use of the Club's facilities. Unearned ticket revenues arise from the sale of tickets to events such as the Skins Game.

Problems: Set A 207

Instructions

(*Hint:* You will find it helpful to use T accounts to analyze the following data. You must analyze these data sequentially, as missing information must first be deduced before moving on. Post your journal entries as you progress, rather than waiting until the end.)

- (a) Prepare journal entries for each of the following events that took place during 2010.
 - 1. Dues receivable from members from 2009 were all collected during 2010.
 - 2. Unearned ticket revenue at the end of 2009 was all earned during 2010.
 - 3. Additional tickets were sold for \$44,000 cash during 2010; a portion of these were used by the purchasers during the year. The entire balance remaining relates to the upcoming Skins Game in 2010.
 - 4. Dues for the 2009-2010 fiscal year were billed to members.
 - Dues receivable for 2010 (i.e., those billed in item (4) above) were partially collected.
- (b) Determine the amount of cash received by the Club from the above transactions during the year ended September 30, 2010.

P4-2A Nick Waege started his own consulting firm, Waegelein Consulting, on June 1, 2010. The trial balance at June 30 is as follows.

WAEGELEIN CONSULTING Trial Balance June 30, 2010

	Debit	Credit
Cash	\$ 6,850	
Accounts Receivable	7,000	
Prepaid Insurance	2,640	
Supplies	2,000	
Office Equipment	15,000	
Accounts Payable		\$ 4,540
Unearned Service Revenue		5,200
Common Stock		21,750
Service Revenue		8,000
Salaries Expense	4,000	
Rent Expense	2,000	
	\$39,490	\$39,490

In addition to those accounts listed on the trial balance, the chart of accounts for Waegelein also contains the following accounts: Accumulated Depreciation—Office Equipment, Utilities Payable, Salaries Payable, Depreciation Expense, Insurance Expense, Utilities Expense, and Supplies Expense.

Other data:

- 1. Supplies on hand at June 30 total \$980.
- 2. A utility bill for \$180 has not been recorded and will not be paid until next month.
- 3. The insurance policy is for a year.
- 4. \$3,900 of unearned service revenue has been earned at the end of the month.
- 5. Salaries of \$1,250 are accrued at June 30.
- 6. The office equipment has a 5-year life with no salvage value and is being depreciated at \$250 per month for 60 months.
- 7. Invoices representing \$3,500 of services performed during the month have not been recorded as of June 30.

Instructions

- (a) Prepare the adjusting entries for the month of June.
- (b) Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances. Use T accounts.
- (c) Prepare an adjusted trial balance at June 30, 2010.

(b) Service rev.

(c) Tot. trial

\$44,670

(b) Cash received

\$190,000

Prepare adjusting entries, post to ledger accounts, and prepare adjusted trial balance.

(SO 4, 5, 6)





Prepare adjusting entries, adjusted trial balance, and financial statements.

(\$0 4, 5, 6, 7)



P4-3A The Olathe Hotel opened for business on May 1, 2010. Here is its trial balance before adjustment on May 31.

OLATHE HOTEL Trial Balance May 31, 2010

	Debit	Credit
Cash	\$ 2,500	
Prepaid Insurance	1,800	
Supplies	2,600	
Land	15,000	
Lodge	70,000	
Furniture	16,800	
Accounts Payable		\$ 4,700
Unearned Rent Revenue		3,300
Mortgage Payable		36,000
Common Stock		60,000
Rent Revenue		9,000
Salaries Expense	3,000	
Utilities Expense	800	
Advertising Expense	500	
	\$113,000	\$113,000

Other data:

- 1. Insurance expires at the rate of \$300 per month.
- 2. A count of supplies shows \$1,050 of unused supplies on May 31.
- 3. Annual depreciation is \$3,600 on the lodge and \$3,000 on furniture.
- 4. The mortgage interest rate is 7%. (The mortgage was taken out on May 1.)
- 5. Unearned rent of \$2,500 has been earned.
- 6. Salaries of \$750 are accrued and unpaid at May 31.

Instructions

- (a) Journalize the adjusting entries on May 31.
- (b) Prepare a ledger using T accounts. Enter the trial balance amounts and post the adjusting entries.
- (c) Prepare an adjusted trial balance on May 31.
- (d) Prepare an income statement and a retained earnings statement for the month of May and a classified balance sheet at May 31.
- (e) Identify which accounts should be closed on May 31.

P4-4A Four Oaks Golf Inc. was organized on July 1, 2010. Quarterly financial statements are prepared. The trial balance and adjusted trial balance on September 30 are shown here.

FOUR OAKS GOLF INC. Trial Balance September 30, 2010

	Unadjusted		Adjusted	
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 6,700		\$ 6,700	
Accounts Receivable	400		1,000	
Prepaid Rent	1,800		900	
Supplies	1,200		360	
Equipment	15,000		15,000	
Accumulated Depreciation—Equipment				\$ 350
Notes Payable		\$ 5,000		5,000
Accounts Payable		1,710		1,710
Salaries Payable				600
Interest Payable				50
Unearned Rent Revenue		1.000		800

(c) Rent revenue \$ 11,500
Tot. adj. trial
balance \$114,510
(d) Net income \$ 3,840

Prepare adjusting entries and financial statements; identify accounts to be closed.

(\$0 4, 5, 6, 7)



Problems: Set A 209

\$ 2,050

\$23,610

(b) Net income Tot. assets

(S04, 5)

Prepare adjusting entries.

	Unadjusted		Adjusted	
	Dr.	Cr.	Dr.	Cr.
Common Stock		14,000		14,000
Retained Earnings		0		0
Dividends	600		600	
Dues Revenue		13,800		14,400
Rent Revenue		400		600
Salaries Expense	8,800		9,400	
Rent Expense	900		1,800	
Depreciation Expense			350	
Supplies Expense			840	
Utilities Expense	510		510	
Interest Expense			50	
	\$35,910	\$35,910	\$37,510	\$37,510

Instructions

- (a) Journalize the adjusting entries that were made.
- (b) Prepare an income statement and a retained earnings statement for the 3 months ending September 30 and a classified balance sheet at September 30.
- (c) Identify which accounts should be closed on September 30.
- (d) If the note bears interest at 12%, how many months has it been outstanding?

P4-5A A review of the ledger of Napier Company at December 31, 2010, produces these data pertaining to the preparation of annual adjusting entries.

- 1. Prepaid Insurance \$15,200. The company has separate insurance policies on its buildings and its motor vehicles. Policy B4564 on the building was purchased on July 1, 2009, for \$9,600. The policy has a term of 3 years. Policy A2958 on the vehicles was purchased on January 1, 2010, for \$7,200. This policy has a term of 2 years.
- 2. Unearned Subscription Revenue \$29,400: The company began selling magazine subscriptions on October 1, 2010 on an annual basis. The selling price of a subscription is \$30. A review of subscription contracts reveals the following.

Subscription Start Date	Number of Subscriptions
October 1	280
November 1	300
December 1	400
	980

- 3. Notes Payable, \$40,000: This balance consists of a note for 6 months at an annual interest rate of 7%, dated October 1.
- 4. Salaries Payable \$0: There are eight salaried employees. Salaries are paid every Friday for the current week. Five employees receive a salary of \$600 each per week, and three employees earn \$700 each per week. December 31 is a Wednesday. Employees do not work weekends. All employees worked the last 3 days of December.

Instructions

Prepare the adjusting entries at December 31, 2010.

P4-6A Happy Camper Travel Court was organized on July 1, 2009, by Kristen Silas. Kristen is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Kristen prepared the following income statement for her fourth quarter, which ended June 30, 2010.

Prepare adjusting entries and a corrected income statement.

(S0 4, 5)

HAPPY CAMPER TRAVEL COURT Income Statement For the Quarter ended June 30, 2010

\$216,000

Revenues

Travel court rental revenues

Operating expenses

Advertising \$ 3,800 Wages \$ 80,500

 Utilities
 900

 Depreciation
 2,700

 Repairs
 4,000

 Total operating expenses
 91,900

 Net income
 \$124,100

Kristen suspected that something was wrong with the statement because net income had never exceeded \$30,000 in any one quarter. Knowing that you are an experienced accountant, she asks you to review the income statement and other data.

You first look at the trial balance. In addition to the account balances reported above in the income statement, the ledger contains the following additional selected balances at June 30, 2010.

Supplies	\$ 8,200
Prepaid Insurance	14,400
Note Payable	12,000

You then make inquiries and discover the following.

- 1. Travel court rental revenues include advanced rental payments received for summer occupancy, in the amount of \$55,000.
- 2. There were \$1,800 of supplies on hand at June 30.
- 3. Prepaid insurance resulted from the payment of a one-year policy on April 1, 2010.
- 4. The mail in July 2010 brought the following bills: advertising for the week of June 24, \$110; repairs made June 18, \$4,450; and utilities for the month of June, \$215.
- 5. There are three employees who receive wages that total \$300 per day. At June 30, two days' wages have been incurred but not paid.
- 6. The note payable is a 8% note dated May 1, 2010, and due on July 31, 2010.
- 7. Income tax of \$13,400 for the quarter is due in July but has not yet been recorded.

Instructions

- (a) Prepare any adjusting journal entries required at June 30, 2010.
- (b) Prepare a correct income statement for the quarter ended June 30, 2010.
- (c) Explain to Kristen the generally accepted accounting principles that she did not recognize in preparing her income statement and their effect on her results.

P4-7A On November 1, 2010, the following were the account balances of Montana Equipment Repair.

	Debits		Credits
Cash	\$ 2,790	Accumulated Depreciation	\$ 500
Accounts Receivable	2,910	Accounts Payable	2,300
Supplies	1,120	Unearned Service Revenue	400
Store Equipment	10,000	Salaries Payable	620
		Common Stock	10,000
		Retained Earnings	3,000
	\$16,820		\$16,820

During November the following summary transactions were completed.

- Nov. 8 Paid \$1,220 for salaries due employees, of which \$600 is for November and \$620 is for October salaries payable.
 - 10 Received \$1,500 cash from customers in payment of account.
 - 12 Received \$1,700 cash for services performed in November.
 - 15 Purchased store equipment on account \$4,000.
 - 17 Purchased supplies on account \$1,300.
 - 20 Paid creditors \$2,500 of accounts payable due.
 - 22 Paid November rent \$450.
 - 25 Paid salaries \$1,000.
 - 27 Performed services on account and billed customers for services provided
 - 29 Received \$550 from customers for services to be provided in the future.

(b) Net income

\$40,165

Journalize transactions and follow through accounting cycle to preparation of financial statements.

(S0 4, 5, 6)



Problems: Set B 211

Adjustment data:

- 1. Supplies on hand are valued at \$1,100.
- 2. Accrued salaries payable are \$480.
- 3. Depreciation for the month is \$250.
- 4. Unearned service revenue of \$300 is earned.

Instructions

- (a) Enter the November 1 balances in the ledger accounts. (Use T accounts.)
- (b) Journalize the November transactions.
- (c) Post to the ledger accounts. Use Service Revenue, Depreciation Expense, Supplies Expense, Salaries Expense, and Rent Expense.
- (d) Prepare a trial balance at November 30.
- (e) Journalize and post adjusting entries.
- (f) Prepare an adjusted trial balance.
- (g) Prepare an income statement and a retained earnings statement for November and a classified balance sheet at November 30.

P4-8A Linda Blye opened Cardinal Window Washing Inc. on July 1, 2010. During July the following transactions were completed.

- July 1 Issued 11,000 shares of common stock for \$11,000 cash.
 - 1 Purchased used truck for \$9,000, paying \$2,000 cash and the balance on account.
 - 3 Purchased cleaning supplies for \$900 on account.
 - 5 Paid \$1,800 cash on 1-year insurance policy effective July 1.
 - 12 Billed customers \$3,200 for cleaning services.
 - Paid \$1,000 cash on amount owed on truck and \$500 on amount owed on cleaning supplies.
 - 20 Paid \$2,000 cash for employee salaries.
 - 21 Collected \$1,400 cash from customers billed on July 12.
 - 25 Billed customers \$2,500 for cleaning services.
 - 31 Paid \$260 for gas and oil used in the truck during month.
 - 31 Declared and paid \$600 cash dividend.

The chart of accounts for Cardinal Window Washing contains the following accounts: Cash, Accounts Receivable, Cleaning Supplies, Prepaid Insurance, Equipment, Accumulated Depreciation—Equipment, Accounts Payable, Salaries Payable, Common Stock, Retained Earnings, Dividends, Income Summary, Service Revenue, Gas & Oil Expense, Cleaning Supplies Expense, Depreciation Expense, Insurance Expense, Salaries Expense.

Instructions

- (a) Journalize the July transactions.
- (b) Post to the ledger accounts. (Use T accounts.)
- (c) Prepare a trial balance at July 31.
- (d) Journalize the following adjustments.
 - (1) Services provided but unbilled and uncollected at July 31 were \$1,700.
 - (2) Depreciation on equipment for the month was \$250.
 - (3) One-twelfth of the insurance expired.
 - (4) An inventory count shows \$360 of cleaning supplies on hand at July 31.
 - (5) Accrued but unpaid employee salaries were \$400.
- (e) Post adjusting entries to the T accounts.
- (f) Prepare an adjusted trial balance.
- (g) Prepare the income statement and a retained earnings statement for July and a classified balance sheet at July 31.
- (h) Journalize and post closing entries and complete the closing process.
- (i) Prepare a post-closing trial balance at July 31.

Problems: Set B

P4-1B The following data are taken from the comparative balance sheets of Pinebluff Club, which prepares its financial statements using the accrual basis of accounting.

(g) Tot. assets \$21,000

\$ 4,240

(f) Cash

Record transactions on accrual basis; convert revenue to cash receipts. (\$0 2, 4, 9)

Complete all steps in accounting cycle.

(SO 4, 5, 6, 7, 8)



December 31	2010	2009
Accounts receivable for member fees	\$20,000	\$ 6,000
Unearned fees revenue	17,000	18,000

Fees are billed to members based upon their use of the club's facilities. Unearned fees arise from the sale of gift certificates, which members can apply to their future use of club facilities. The 2010 income statement for the club showed that fee revenue of \$162,000 was earned during the year.

Instructions

(*Hint*: You will find it helpful to use T accounts to analyze these data.)

- (a) Prepare journal entries for each of the following events that took place during 2010.
 - 1. Fees receivable from 2009 were all collected during 2010.
 - 2. Gift certificates outstanding at the end of 2009 were all redeemed during 2010.
 - 3. An additional \$40,000 worth of gift certificates were sold during 2010; a portion of these were used by the recipients during the year; the remainder were still outstanding at the end of 2010.
 - 4. Fees for 2010 were billed to members.
 - 5. Fees receivable for 2010 (i.e., those billed in item (4) above) were partially collected.
- (b) Determine the amount of cash received by the club with respect to fees during 2010.

P4-2B Tiffany Goren started her own consulting firm, Goren Consulting, on May 1, 2010. The trial balance at May 31 is as shown below.

\$147,000

Prepare adjusting entries, post to ledger accounts, and prepare an adjusted trial balance.

(SO 4, 5, 6)





GOREN CONSULTING Trial Balance May 31, 2010

	Debit	Credit
Cash	\$ 7,500	
Accounts Receivable	3,000	
Prepaid Insurance	3,600	
Supplies	2,500	
Office Furniture	12,000	
Accounts Payable		\$ 3,500
Unearned Service Revenue		4,000
Common Stock		19,100
Service Revenue		7,500
Salaries Expense	4,000	
Rent Expense	1,500	
	\$34,100	\$34,100

In addition to those accounts listed on the trial balance, the chart of accounts for Goren Consulting also contains the following accounts: Accumulated Depreciation—Office Furniture, Travel Payable, Salaries Payable, Depreciation Expense, Insurance Expense, Travel Expense, and Supplies Expense.

Other data:

- 1. \$500 of supplies have been used during the month.
- 2. Travel costs incurred but not paid are \$260.
- 3. The insurance policy is for 3 years.
- 4. \$1,500 of the balance in the Unearned Service Revenue account remains unearned at the end of the month.
- 5. May 31 is a Wednesday and employees are paid on Fridays. Goren Consulting has two employees that are paid \$600 each for a 5-day work week.
- 6. The office furniture has a 5-year life with no salvage value and is being depreciated at \$200 per month for 60 months.
- 7. Invoices representing \$2,400 of services performed during the month have not been recorded as of May 31.

Problems: Set B 213

Instructions

- (a) Prepare the adjusting entries for the month of May.
- (b) Post the adjusting entries to the ledger accounts. Enter the totals from the trial balance as beginning account balances. Use T accounts.
- (c) Prepare an adjusted trial balance at May 31, 2010.

P4-3B Flint Hills Resort opened for business on June 1 with eight air-conditioned units. Its trial balance before adjustment on August 31 is presented here.

FLINT HILLS RESORT Trial Balance August 31, 2010

	Debit	Credit
Cash	\$ 24,600	
Prepaid Insurance	5,400	
Supplies	4,300	
Land	40,000	
Cottages	132,000	
Furniture	36,000	
Accounts Payable		\$ 6,500
Unearned Rent Revenue		6,800
Mortgage Payable		120,000
Common Stock		100,000
Dividends	5,000	
Rent Revenue		80,000
Salaries Expense	53,000	
Utilities Expense	9,400	
Repair Expense	3,600	
	\$313,300	\$313,300

Other data:

- 1. Insurance expires at the rate of \$450 per month.
- 2. A count of supplies on August 31 shows \$700 of supplies on hand.
- 3. Annual depreciation is \$4,400 on cottages and \$4,000 on furniture.
- 4. Unearned rent of \$5,000 was earned prior to August 31.
- 5. Salaries of \$600 were unpaid at August 31.
- 6. Rentals of \$1,200 were due from tenants at August 31. (Use Accounts Receivable.)
- 7. The mortgage interest rate is 8% per year. (The mortgage was taken out August 1.)

Instructions

- (a) Journalize the adjusting entries on August 31 for the 3-month period June 1-August 31.
- (b) Prepare a ledger using T accounts. Enter the trial balance amounts and post the adjusting entries.
- (c) Prepare an adjusted trial balance on August 31.
- (d) Prepare an income statement and a retained earnings statement for the 3 months ended August 31 and a classified balance sheet as of August 31.
- (e) Identify which accounts should be closed on August 31.

P4-4B Longly Advertising Agency was founded by Jeff Longly in January 2005. Presented here are both the adjusted and unadjusted trial balances as of December 31, 2010.

LONGLY ADVERTISING AGENCY Trial Balance December 31, 2010

	Unadjusted		Adjus	ted
	Dr.	Cr.	Dr.	Cr.
Cash	\$ 11,000		\$ 11,000	
Accounts Receivable	16,000		19,500	
Art Supplies	8,400		6,500	
Prepaid Insurance	3,350		1,790	
Printing Equipment	60,000		60,000	

(c) Tot. trial balance \$37,680

Prepare adjusting entries, adjusted trial balance, and financial statements.

(\$0 4, 5, 6, 7)

GLS

(c) Tot. adj. trial balance \$318,000 (d) Net income \$11,750

Prepare adjusting entries and financial statements; identify accounts to be closed.

(\$0 4, 5, 6, 7)



Accumulated Depreciation		\$ 25,000		\$ 30,000
Notes Payable		8,000		8,000
Accounts Payable		2,000		2,000
Interest Payable		0		320
Unearned Advertising Revenue		4,000		3,100
Salaries Payable		0		1,300
Common Stock		20,000		20,000
Retained Earnings		5,500		5,500
Dividends	10,000		10,000	
Advertising Revenue		57,600		62,000
Salaries Expense	9,000		10,300	
Insurance Expense			1,560	
Interest Expense			320	
Depreciation Expense			5,000	
Art Supplies Expense			1,900	
Rent Expense	4,350		4,350	
	\$122,100	\$122,100	\$132,220	\$132,220

Instructions

(a) Journalize the annual adjusting entries that were made.

(b) Net income \$38,570 Tot. assets \$68,790

- (b) Prepare an income statement and a retained earnings statement for the year ended December 31, and a classified balance sheet at December 31.
- (c) Identify which accounts should be closed on December 31.
- (d) If the note has been outstanding 6 months, what is the annual interest rate on that note?
- (e) If the company paid \$10,500 in salaries in 2010, what was the balance in Salaries Payable on December 31, 2009?

Prepare adjusting entries. (\$0 4, 5)

P4-5B A review of the ledger of Quayle Company at December 31, 2010, produces the following data pertaining to the preparation of annual adjusting entries.

- 1. Salaries Payable \$0: There are eight salaried employees. Salaries are paid every Friday for the current week. Six employees receive a salary of \$800 each per week, and two employees earn \$600 each per week. December 31 is a Wednesday. Employees do not work weekends. All employees worked the last 3 days of December.
- 2. Unearned Rent Revenue \$300,000: The company began subleasing office space in its new building on November 1. Each tenant is required to make a \$5,000 security deposit that is not refundable until occupancy is terminated. At December 31 the company had the following rental contracts that are paid in full for the entire term of the lease.

Date	Term (in months)	Monthly Rent	Number of Leases
Nov. 1	6	\$4,000	5
Dec. 1	6	7,500	4

3. Prepaid Advertising \$13,200: This balance consists of payments on two advertising contracts. The contracts provide for monthly advertising in two trade magazines. The terms of the contracts are as follows.

			Number of	
Contract	Date	Amount	Magazine Issues	
A650	May 1	\$6,000	12	
B974	Sept. 1	7,200	18	

The first advertisement runs in the month in which the contract is signed.

4. Notes Payable \$80,000: This balance consists of a note for 1 year at an annual interest rate of 7%, dated October 1, 2010.

Instructions

Prepare the adjusting entries at December 31, 2010. Show all computations.

Problems: Set B 215

P4-6B The Wyandotte Travel Agency was organized on January 1, 2008, by Ron Dexter. Ron is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Ron prepared the following income statement for the quarter that ended March 31, 2010.

Prepare adjusting entries and a corrected income statement.

(S0 4, 5)

WYANDOTTE TRAVEL AGENCY Income Statement For the Quarter Ended March 31, 2010

Revenues		
Travel service revenue		\$50,000
Operating expenses		
Advertising	\$2,600	
Depreciation	400	
Income tax	1,500	
Salaries	9,000	
Utilities	400	13,900
Net income		\$36,100

Ron knew that something was wrong with the statement because net income had never exceeded \$5,000 in any one quarter. Knowing that you are an experienced accountant, he asks you to review the income statement and other data.

You first look at the trial balance. In addition to the account balances reported above in the income statement, the trial balance contains the following additional selected balances at March 31, 2010.

Supplies	\$ 2,900
Prepaid insurance	1,200
Note payable	10,000

You then make inquiries and discover the following:

- 1. Travel service revenue includes advance payments for cruises, \$20,000.
- 2. There were \$800 of supplies on hand at March 31.
- 3. Prepaid insurance resulted from the payment of a one-year policy on March 1, 2010.
- 4. The mail on April 1, 2010, brought the utility bill for the month of March's heat, light, and power, \$210.
- 5. There are two employees who receive salaries of \$75 each per day. At March 31, three days' salaries have been incurred but not paid.
- 6. The note payable is a 6-month, 8% note dated January 1, 2010.

Instructions

- (a) Prepare any adjusting journal entries required at March 31, 2010.
- (b) Prepare a correct income statement for the quarter ended March 31, 2010.
- (c) Explain to Ron the generally accepted accounting principles that he did not recognize in preparing his income statement and their effect on his results.

P4-7B On September 1, 2010, the following were the account balances of Pittsburg Equipment Repair.

	Debits		Credits
Cash	\$ 4,880	Accumulated Depreciation	\$ 1,600
Accounts Receivable	3,820	Accounts Payable	3,100
Supplies	800	Unearned Service Revenue	400
Store Equipment	15,000	Salaries Payable	700
	\$24,500	Common Stock	10,000
	Ψ24,300	Retained Earnings	8,700
			\$24,500

During September the following summary transactions were completed.

- Sept. 8 Paid \$1,100 for salaries due employees, of which \$400 is for September and \$700 is for August salaries payable.
 - 10 Received \$1,500 cash from customers in payment of account.
 - 12 Received \$3,400 cash for services performed in September.
 - 15 Purchased store equipment on account \$3,000.

(b) Net income \$13,040

Journalize transactions and follow through accounting cycle to preparation of financial statements.

(S0 4, 5, 6)



- Sept. 17 Purchased supplies on account \$2,000.
 - 20 Paid creditors \$4,500 of accounts payable due.
 - 22 Paid September rent \$400.
 - 25 Paid salaries \$1,200.
 - 27 Performed services on account and billed customers for services provided \$1,850.
 - 29 Received \$650 from customers for services to be provided in the future.

Adjustment data:

- 1. Supplies on hand \$1,800.
- 2. Accrued salaries payable \$400.
- 3. Depreciation \$200 per month.
- 4. Unearned service revenue of \$250 earned.

Instructions

- (a) Enter the September 1 balances in the ledger T accounts.
- (b) Journalize the September transactions.
- (c) Post to the ledger T accounts. Use Service Revenue, Depreciation Expense, Supplies Expense, Salaries Expense, and Rent Expense.
- (d) Prepare a trial balance at September 30.
- (e) Journalize and post adjusting entries.
- (f) Prepare an adjusted trial balance.
- (g) Prepare an income statement and a retained earnings statement for September and a classified balance sheet at September 30.

P4-8B Kathy Herman opened Kwick Cleaners on March 1, 2010. During March, the following transactions were completed.

Mar. 1 Issued 10,000 shares of common stock for \$15,000 cash.

- 1 Purchased used truck for \$8,000, paying \$3,000 cash and the balance on account.
- 3 Purchased cleaning supplies for \$1,200 on account.
- 5 Paid \$2,400 cash on 1-year insurance policy effective March 1.
- 14 Billed customers \$3,700 for cleaning services.
- 18 Paid \$1,500 cash on amount owed on truck and \$500 on amount owed on cleaning supplies.
- 20 Paid \$1,750 cash for employee salaries.
- 21 Collected \$1,600 cash from customers billed on March 14.
- 28 Billed customers \$4,200 for cleaning services.
- 31 Paid \$350 for gas and oil used in truck during month.
- 31 Declared and paid a \$900 cash dividend.

The chart of accounts for Kwick Cleaners contains the following accounts: Cash, Accounts Receivable, Cleaning Supplies, Prepaid Insurance, Equipment, Accumulated Depreciation—Equipment, Accounts Payable, Salaries Payable, Common Stock, Retained Earnings, Dividends, Income Summary, Service Revenue, Gas & Oil Expense, Cleaning Supplies Expense, Depreciation Expense, Insurance Expense, Salaries Expense.

Instructions

- (a) Journalize the March transactions.
- (b) Post to the ledger accounts. (Use T accounts.)
- (c) Prepare a trial balance at March 31.
- (d) Journalize the following adjustments.
 - 1. Earned but unbilled revenue at March 31 was \$600.
 - 2. Depreciation on equipment for the month was \$250.
 - 3. One-twelfth of the insurance expired.
 - 4. An inventory count shows \$280 of cleaning supplies on hand at March 31.
 - 5. Accrued but unpaid employee salaries were \$830.
- (e) Post adjusting entries to the T accounts.
- (f) Prepare an adjusted trial balance.
- (g) Prepare the income statement and a retained earnings statement for March and a classified balance sheet at March 31.
- (h) Journalize and post closing entries and complete the closing process.
- (i) Prepare a post-closing trial balance at March 31.

(g) Tot. adj. trial - balance \$30,800 (g) Tot. assets \$25,400

Complete all steps in accounting cycle.

(SO 4, 5, 6, 7, 8)

GLS

(f) Tot. adj. trial balance (g) Tot. assets

\$28,780 \$23,330

Problems: Set C



Visit the book's companion website at **www.wiley.com/college/kimmel** and choose the Student Companion site to access Problem Set C.

Continuing Cookie Chronicle

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 3.)

CCC4 Cookie Creations is gearing up the winter holiday season. Natalie has had a busy month of December. She needs to journalize and post the month's transactions and complete the accounting cycle, including preparation of financial statements.



Go to the book's companion website. www.wiley.com/college/kimmel, to see the completion of this problem.

broadening your perspective



Financial Reporting and Analysis

FINANCIAL REPORTING PROBLEM: Tootsie Roll Industries, Inc.

BYP4-1 The financial statements of Tootsie Roll are presented in Appendix A at the end of this book.



Instructions

- (a) Using the consolidated income statement and balance sheet, identify items that may result in adjusting entries for prepayments.
- (b) Using the consolidated income statement, identify two items that may result in adjusting entries for accruals.
- (c) What was the amount of depreciation expense for 2007 and 2006? (You will need to examine the notes to the financial statements or the statement of cash flows.) Where was accumulated depreciation reported?
- (d) What was the cash paid for income taxes during 2007, reported at the bottom of the consolidated statement of cash flows? What was income tax expense (provision for income taxes) for 2007? Where is income tax payable reported?

COMPARATIVE ANALYSIS PROBLEM: Tootsie Roll vs. Hershey Foods

BYP4-2 The financial statements of Hershey Foods are presented in Appendix B, following the financial statements for Tootsie Roll in Appendix A.



Instructions

- (a) Identify two accounts on Hershey Foods' balance sheet that provide evidence that Hershey uses accrual accounting. In each case, identify the income statement account that would be affected by the adjustment process.
- (b) Identify two accounts on Tootsie Roll's balance sheet that provide evidence that Tootsie Roll uses accrual accounting (different from the two you listed for Hershey). In each case, identify the income statement account that would be affected by the adjustment process.

RESEARCH CASE

BYP4-3 The August 16, 2007, issue of the *Wall Street Journal* includes an article by Michael Corkery and David Reilly titled "Beazer's Accounting Woes Extend Roller-Coaster Ride."

Instructions

Read the article and answer the following.

- (a) Explain what is meant by *cookie-jar accounting*? Why might a company engage in cookie-jar accounting?
- (b) The article says the company released "unaudited" financial statements to investors. What does "unaudited" mean? What are the implications to investors of receiving "unaudited" financial statements?
- (c) Because of its accounting problems, Beazer was late in providing its audited financial statements to the SEC. What are the possible ramifications of not submitting an annual report on a timely basis?

INTERPRETING FINANCIAL STATEMENTS

BYP4-4 Laser Recording Systems, founded in 1981, produces disks for use in the home market. The following is an excerpt from Laser Recording Systems' financial statements (all dollars in thousands).

LASER RECORDING SYSTEMS

Management Discussion

Accrued liabilities increased to \$1,642 at January 31, from \$138 at the end of the previous fiscal year. Compensation and related accruals increased \$195 due primarily to increases in accruals for severance, vacation, commissions, and relocation expenses. Accrued professional services increased by \$137 primarily as a result of legal expenses related to several outstanding contractual disputes. Other expenses increased \$35, of which \$18 was for interest payable.

Instructions

- (a) Can you tell from the discussion whether Laser Recording Systems has prepaid its legal expenses and is now making an adjustment to the asset account Prepaid Legal Expenses, or whether the company is handling the legal expense via an accrued expense adjustment?
- (b) Identify each of the adjustments Laser Recording Systems is discussing as one of the four types of possible adjustments discussed in the chapter. How is net income ultimately affected by each of the adjustments?
- (c) What journal entry did Laser Recording make to record the accrued interest?

FINANCIAL ANALYSIS ON THE WEB

BYP4-5 *Purpose:* To learn about the functions of the Securities and Exchange Commission (SEC).

Address: www.sec.gov/about/whatwedo.shtml, or go to www.wiley.com/college/kimmel

Instructions

Use the information in this site to answer the following questions.

- (a) What event spurred the creation of the SEC? Why was the SEC created?
- (b) What are the four divisions of the SEC? Briefly describe the purpose of each.
- (c) What are the responsibilities of the chief accountant?

Critical Thinking

DECISION MAKING ACROSS THE ORGANIZATION



BYP4-6 Grand Valley Park was organized on April 1, 2009, by Janet Elston. Janet is a good manager but a poor accountant. From the trial balance prepared by a part-time bookkeeper, Janet prepared the income statement shown at the top of page 6 for the quarter that ended March 31, 2010.

GRAND VALLEY PARK

Income Statement For the Quarter Ended March 31, 2010

Revenues		
Rental revenues		\$89,000
Operating expenses		
Advertising	\$ 4,200	
Wages	27,600	
Utilities	900	
Depreciation	800	
Repairs	2,800	
Total operating expenses		_36,300
Net income		\$52,700

Janet knew that something was wrong with the statement because net income had never exceeded \$20,000 in any one quarter. Knowing that you are an experienced accountant, she asks you to review the income statement and other data.

You first look at the trial balance. In addition to the account balances reported in the income statement, the ledger contains these selected balances at March 31, 2010.

Supplies	\$ 5,200
Prepaid Insurance	7,200
Notes Pavable	20.000

You then make inquiries and discover the following.

- 1. Rental revenues include advanced rentals for summer-month occupancy, \$21,000.
- 2. There were \$1,800 of supplies on hand at March 31.
- 3. Prepaid insurance resulted from the payment of a 1-year policy on January 1, 2010.
- 4. The mail on April 1, 2010, brought the following bills: advertising for week of March 24, \$110; repairs made March 10, \$380; and utilities \$240.
- 5. There are four employees who receive wages totaling \$290 per day. At March 31, 3 days' wages have been incurred but not paid.
- 6. The note payable is a 3-month, 8% note dated January 1, 2010.

Instructions

With the class divided into groups, answer the following.

- (a) Prepare a correct income statement for the quarter ended March 31, 2010.
- (b) Explain to Janet the generally accepted accounting principles that she did not follow in preparing her income statement and their effect on her results.

COMMUNICATION ACTIVITY

BYP4-7 On numerous occasions proposals have surfaced to put the federal government on the accrual basis of accounting. This is no small issue because if this basis were used, it would mean that billions in unrecorded liabilities would have to be booked and the federal deficit would increase substantially.

Instructions

- (a) What is the difference between accrual basis accounting and cash basis accounting?
- (b) Comment on why politicians prefer a cash basis accounting system over an accrual basis system.
- (c) Write a letter to your senators explaining why you think the federal government should adopt the accrual basis of accounting.



ETHICS CASE



BYP4-8 Diamond Company is a pesticide manufacturer. Its sales declined greatly this year due to the passage of legislation outlawing the sale of several of Diamond's chemical pesticides. During the coming year, Diamond will have environmentally safe and competitive replacement chemicals to replace these discontinued products. Sales in the next year are expected to greatly exceed those of any prior year. Therefore, the decline in this year's sales and profits appears to be a one-year aberration.

Even so, the company president believes that a large dip in the current year's profits could cause a significant drop in the market price of Diamond's stock and make it a takeover target. To avoid this possibility, he urges Holton, controller, in making this period's year-end adjusting entries to accrue every possible revenue and to defer as many expenses as possible. The president says to Terry, "We need the revenues this year, and next year we can easily absorb expenses deferred from this year. We can't let our stock price be hammered down!" Terry didn't get around to recording the adjusting entries until January 17, but she dated the entries December 31 as if they were recorded then. Terry also made every effort to comply with the president's request.

Instructions

- (a) Who are the stakeholders in this situation?
- (b) What are the ethical considerations of the president's request and Terry's dating the adjusting entries December 31?
- (c) Can Terry accrue revenues and defer expenses and still be ethical?

"ALL ABOUT YOU" ACTIVITY

BYP4-9 Companies prepare balance sheets in order to know their financial position at a specific point in time. This enables them to make a comparison to their position at previous points in time and gives them a basis for planning for the future. In order to evaluate *your* financial position, you can prepare a personal balance sheet. Assume that you have compiled the following information regarding your finances. (*Hint:* Some of the items might not be used in your personal balance sheet.)

Amount owed on student loan balance (long-term)	\$5,000
Balance in checking account	1,200
Certificate of deposit (6-month)	3,000
Annual earnings from part-time job	11,300
Automobile	7,000
Balance on automobile loan (current portion)	1,500
Balance on automobile loan (long-term portion)	4,000
Home computer	800
Amount owed to you by younger brother	300
Balance in money market account	1,800
Annual tuition	6,400
Video and stereo equipment	1,250
Balance owed on credit card (current portion)	150
Balance owed on credit card (long-term portion)	1,650

Instructions

Prepare a personal balance sheet using the format you have learned for a classified balance sheet for a company. For the equity account, use M. Y. Own, Capital.

Answers to Insight and Accounting Across the Organization Questions

- p. 7
- Q. What motivates sales executives and finance and accounting executives to participate in activities that result in inaccurate reporting of revenues?
- A. Sales executives typically receive bonuses based on their ability to meet quarterly sales targets. In addition, they often face the possibility of losing their jobs if they miss those targets. Executives in accounting and finance are very aware of the earnings targets

of Wall Street analysts and investors. If they fail to meet these targets, the company's stock price will fall. As a result of these pressures, executives sometimes knowingly engage in unethical efforts to misstate revenues. As a result of the Sarbanes-Oxley Act of 2002, the penalties for such behavior are now much more severe.

- p. 10
 - Q. Why might the new accounting method cause companies sometimes to spend less on advertising?
 - A. Under the old approach companies could delay to future periods the expensing of advertising costs. Under that approach, money spent this period did not necessarily immediately reduce income. Under the new approach, a dollar spent on advertising immediately reduces this year's income. If the company is concerned that it might not hit this year's earnings target, it might decide to reduce its advertising spending.
- p. 14
 - Q. Suppose that Robert Jones purchases a \$100 gift card at Best Buy on December 24, 2009, and gives it to his wife Mary Jones on December 25, 2009. On January 3, 2010, Mary uses the card to purchase \$100 worth of CDs. When do you think Best Buy should recognize revenue and why?
 - A. According to the revenue recognition principle, companies should recognize revenue when earned. In this case revenue is not earned until Best Buy provides the goods. Thus, when Best Buy receives cash in exchange for the gift card on December 24, 2009, it should recognize a liability, Unearned Revenue, for \$100. On January 3, 2010, when Mary Jones exchanges the card for merchandise, Best Buy should recognize revenue and eliminate \$100 from the balance in the Unearned Revenue account.

Answers to Self-Study Questions

 $oldsymbol{V}$ Remember to go back to the navigator box on the chapter-opening page and check off your completed work.